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# 15th Annual Seminar on Estate Planning

Office of Continuing Legal Education at the University of Kentucky College of Law

Mark T. MacDonald  
*Wyatt, Tarrant & Combs*

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# **UK CLE**

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**15th ANNUAL  
SEMINAR  
ON  
ESTATE PLANNING**

**JULY 15-16, 1988**

**Presented by the  
OFFICE OF CONTINUING LEGAL EDUCATION  
UNIVERSITY OF KENTUCKY COLLEGE OF LAW**

**In Cooperation with the  
KENTUCKY BAR ASSOCIATION**

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UNIVERSITY OF KENTUCKY  
COLLEGE OF LAW  
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An enormous debt of gratitude is owed to those who contribute their time, expertise and practical insight for the advance planning, the instructional presentations, and the written materials that make our seminars possible.

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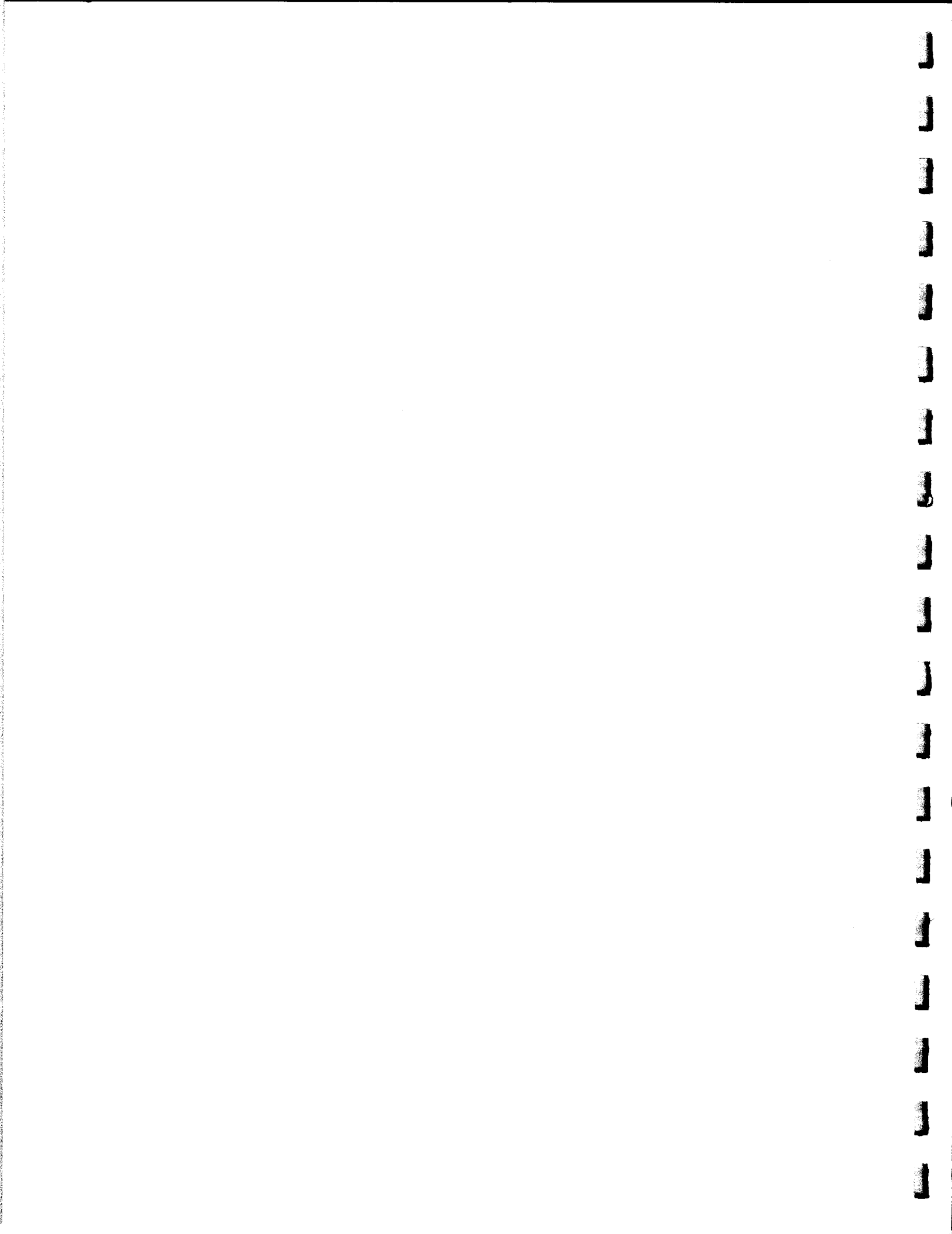


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PROGRAM

Program Planning Chair & Moderator:

Glen S. Bagby  
Brock, Brock & Bagby  
Lexington, KY

- 8:00 a.m. Late Registration, Main Courtroom, College of Law
- 8:55 a.m. Welcoming Remarks, Todd B. Eberle, Associate Dean & Director of Continuing Legal Education, University of Kentucky College of Law

Friday, July 15, 1988

- 9:00-9:50 a.m. IMPACT OF THE 1988 KENTUCKY GENERAL ASSEMBLY ON ESTATE PLANS AND ADMINISTRATION  
Mark T. MacDonald  
Wyatt, Tarrant & Combs  
Lexington, KY.
- 9:50-10:40 a.m. ESTATE PLANNING MALPRACTICE: Exposures to Liability for the Estate Planning Attorney  
Gerald P. Johnston, Professor  
George Washington University  
Washington, D.C.
- 10:40-10:55 a.m. BREAK
- 10:55-11:45 a.m. DESTRUCTION OF THE FAMILY FARM AND THE FAMILY FIRM: 2036 (c) Considerations  
Edward A. Rothschild  
Washer, Kaplan, Rothschild, Aberson & Miller  
Louisville, KY.
- 11:45 12:35 p.m. TAX PLANNING TECHNIQUES FOR POTENTIAL AUDITS AND LITIGATION  
Turney P. Berry  
Greenebaum Doll & McDonald  
Louisville, KY.
- 12:35-2:00 p.m. LUNCH
- 2:00-2:50 p.m. ESTATE PLANNING CONSIDERATION RELATED TO ENTITY SELECTION  
Norvie L. Lay  
University of Louisville, School of Law  
Louisville, KY.
- 2:50-3:40 p.m. PROBLEMS IN DEALING WITH THE IMPAIRED BENEFICIARY  
Barry Bond  
Bank One, Lexington NA  
Lexington, KY.

3:40-3:55 p.m. BREAK

3:55-4:45 p.m. THE EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING  
F. Gerald Greenwell  
Brown, Todd and Heyburn  
Louisville, KY.

4:45 p.m. RECESS

Saturday July, 16, 1988

9:00-9:50 a.m. FIDUCIARY INVESTING: Legal Aspects  
Marjorie Bassler  
Citizens Fidelity Bank & Trust Company  
Louisville, KY.

FIDUCIARY INVESTING: The Investment Process  
Mary Helen Myles  
Citizens Fidelity  
Louisville, KY

9:50-10:40 a.m. ASSET TRANSFERS AFTER "DICKMAN"  
Bruce K. Dudley  
First Kentucky Trust Company  
Louisville, KY.

10:40-10:55 a.m. BREAK

10:55-11:45 a.m. RETIREMENT PLAN DISTRIBUTION OPTIONS  
- Qualified & Non-Qualified Plans  
- New Excise Tax

Valerie T. Mayer  
Ewen, Mackenzie & Peden, P.S.C.  
Louisville, Ky

11:45 a.m. ADJOURN

IMPACT OF THE 1988 KENTUCKY GENERAL ASSEMBLY  
ON ESTATE PLANS AND ADMINISTRATION

Mark T. MacDonald, Attorney, CPA  
Wyatt, Tarrant and Combs  
Lexington, Kentucky

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SECTION A





IMPACT OF THE 1988 KENTUCKY GENERAL  
ASSEMBLY ON ESTATE PLANS AND ADMINISTRATION

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## I. LEGISLATION IMPACTING ESTATE ADMINISTRATION

A. Claims Against a Decedent's Estate. 1988 Kentucky Acts, Chapter 90 (SB 8), Sections 6-27, and 32 contain a complete revision of KRS Chapter 396 which deals with creditor's claims against a decedent's estate. The Act repeals all former sections of the Chapter and replaces them with new sections based in part on Article III, Part 8 of the Uniform Probate Code. Paragraph 1 below contains a brief overview of some of the changes made by the Act. Paragraphs 2 through 22 contain a detailed discussion of the new sections of KRS Chapter 396. Paragraph 23 contains a discussion of the effective date of the Act and its implications for estates then in existence. Unless otherwise noted, citations to section numbers of Chapter 396 refer to the new KRS sections.

1. Overview of Changes Made by the Act. The Act generally retains the requirement that creditors must file their claims with a personal representative, but changes both the time for the filing of the claim and the content of the claim. The Act prescribes the manner in which a claim is to be allowed or disallowed and establishes a presumption of allowance where the personal representative takes no action on a presented claim. The Act offers additional protection to creditors whose claims are disallowed and affords greater flexibility to the personal representative and creditors in dealing with problems associated with contingent, unmatured and unliquidated claims. In addition, the Act alters the priority of claims and sets forth

new rules regarding both the payment of interest on claims and the payment of claims where administration occurs in more than one state. The Act also incorporates into a single chapter of the KRS all periods of limitation arising on a claim as a result of the decedent's death and establishes a uniform period of limitation for the commencement of an action on a claim against a personal representative, heir or beneficiary once the estate has been settled.

2. Requirement of Presentation of Claim.

a. All claims against a decedent's estate which arose before the death of the decedent, if not barred earlier by other statute of limitations, are barred against the estate, the personal representative and heirs and devisees of the decedent unless presented within 6 months after the appointment of the personal representative, or where no personal representative has been appointed, within 2 years after the decedent's death. This rule applies irrespective of whether a claim is matured or unmatured, absolute or contingent, liquidated or unliquidated, founded on contract, tort or other legal basis. KRS 396.011(1).

Comment - Former KRS 396.025 required that a claim be "proven as required by law" within 1 year after the date of the appointment of the personal representative, or where no personal representative was appointed, within 3 years after the decedent's death. However, KRS 395.190 authorized the

personal representative to distribute the estate 6 months after his appointment. Since it was possible for the personal representative to distribute the estate before the time elapsed for claims to be filed, the Attorney General had advised clerks responsible for publication of notice to creditors to state in the notice that creditors should file their claims within 6 months from the date of appointment of the personal representative. AOG 76-215. Notices referencing only the 6 months were potentially misleading to a creditor. By reducing the time for presentation of a claim to 6 months, the new law eliminates any confusion which may result from varying time periods for filing and distribution.

b. The Act provides three exceptions to the requirement of presentation.

(1) Presentation is not required for any claim of the United States, the state of Kentucky, or any subdivision thereof. KRS 396.011(1).

(2) The requirement of presentation does not affect or prevent, to the extent of the security only, any proceeding to enforce any mortgage, pledge, lien or other security interest securing an obligation of the decedent or upon property of the estate. KRS 396.011(2).

(3) The requirement of presentation does not affect or prevent, to the limits of insurance protection only, any proceeding to establish liability of the decedent or the personal representative for which he is protected by liability

insurance. KRS 396.011(2).

Comment - Since the exceptions noted in Subparagraphs (2) and (3) above are limited to the extent of security or insurance only, secured claims or claims which the decedent or his estate may be partially insured against should always be presented within 6 months of the appointment of the personal representative.

3. Method of Presenting Claims. A claim may either be (a) delivered or mailed to the personal representative, or (b) filed with the clerk of the court. If filed with the clerk of the court, the claimant must certify as provided in the civil rules that a copy of the claim has been given or mailed to the personal representative and his attorney. A claim is deemed to be presented on either the receipt of the claim by the personal representative or the filing of the claim with the clerk of the court, whichever occurs first. KRS 396.015(1).

Comments - (1) As a general rule a claim should always be filed with the court to put the court on notice of the existence of the claim. This can prevent an attempted settlement of the estate without resolution of the claim.

- (2) Filing with the court will also be important in situations where the time remaining for the presentation of the claim is about to expire and the claimant cannot rely on the timely receipt of the claim by the personal representative.

- (3) If a claimant chooses to

present his claim directly to the personal representative, certified mail with return receipt requested should be used to evidence the date of receipt.

4. Written Statement of Claim; Content.

a. A claim must be presented in the form of a written statement and contain at least the following information:

- (1) the basis of the claim,
- (2) the name and address of the claimant,
- (3) the amount claimed,
- (4) if the claim is not yet due, the date when it will become due,
- (5) if the claim is contingent or unliquidated, the nature of the uncertainty, and
- (6) if the claim is secured, a description of the security. KRS 396.015(1).

Comment - The Act eliminates the former requirements under KRS 396.010 that the claim be in affidavit form and that the claim, if not based on an obligation signed by the decedent or a judgment, be supported by an affidavit of a person other than the claimant. However, see Paragraph 5 below for the right of the personal representative to require an affidavit of the claimant after the claim has been presented.

b. Failure to describe correctly the security, the nature of any uncertainty or the due date of a claim not yet due will not invalidate the presentation of the claim. KRS

396.015(2).

c. A written statement of claim filed with the court is required to be in the form prescribed by rule. KRS 396.015(1).

d. If an action is pending against a decedent at the time of his death, and the action is of a type which survives the decedent's death, the substitution of the personal representative for the decedent, or a motion therefor, will constitute the presentation of the litigated claim. The claim is deemed to have been presented from the time of substitution or motion therefor. KRS 396.015(2).

Comment - This rule eliminates the uncertainty under prior law as to whether a claimant had to file his claim with the personal representative in addition to obtaining the substitution of the personal representative in the pending action.

5. Personal Representative May Require Affidavit of Claimant. Following the presentment of any claim the personal representative may, by request in writing mailed to the claimant, require an affidavit or other satisfactory evidence that the claim is justly due, that no payments have been made thereon and that there are no offsets against the claim to the knowledge of the claimant. If any payments have been made or any offsets exist, their nature and amount must be stated in the affidavit or shown from the evidence. KRS 396.026.

Comment - Since a claim is no longer required to



be in affidavit form and the contents of the written statement of claim have been simplified, this provision will allow the personal representative to obtain additional information from the claimant if needed to evaluate the validity of a presented claim.

6. Presentment Required Before Commencement of Action on Claim. A claimant must present his claim before bringing an action against the personal representative on the claim. This restriction is in addition to that provided in KRS 395.270 which prohibits the commencement of an action against the personal representative within the first 2 months after his appointment. KRS 396.035.

7. Statute of Limitations - Miscellaneous Rules.

a. No claim will be barred by a statute of limitations which expires during the first 6 months after the decedent's death, if such claim is presented at any time within that 6 month period. This rule does not apply to any limitation period imposed by KRS Chapter 396. KRS 396.045(1).

Example - A claim is based on a breach of contract. The applicable statute of limitations on the claim would expire January 1, 1989. The person who breached the contract dies December 1, 1988. The claimant may present his claim at any time prior to July 1, 1989.

Comment - Note the 6 months under the rule runs from the date of the decedent's death and not from the date of the personal representative's appointment.

b. For purposes of any statute of limitations, the proper presentment of the claim is considered the equivalent of the commencement of an action on the claim. KRS 396.045(2).

c. The personal representative may waive any defense of limitations available to the estate provided that the estate is solvent and the consent of the beneficiaries whose interest would be affected is obtained. If the defense is not waived, no claim which was barred by any statute of limitations at the time of the decedent's death may be allowed or paid by the personal representative. KRS 396.065.

Query - How is a will provision directing the personal representative to pay "my just debts" or to pay "my just debts whether or not the same may be legally enforceable against my estate" to be interpreted in light of this statutory rule?

8. Allowance or Disallowance of Presented Claims.

a. As to claims properly and timely presented, the personal representative may mail a notice to any claimant stating that the claim is allowed or disallowed. KRS 396.055(1).

Comment - While the mailing of notice of allowance or disallowance appears permissive, see Subparagraph d below as to the consequence of not giving notice.

b. After giving notice of allowance or disallowance of a claim, the personal representative may change his decision; but if he does so, he must notify the claimant of

the change. An exception to this rule is that the personal representative may not change his disallowance of the claim if the time for the claimant to commence an action on the rejected claim has run and the claim has been barred. KRS 396.055(1).

c. A claim or part thereof which has been disallowed will become barred unless the claimant commences an action on the claim within 60 days after the mailing of the notice of disallowance. However, for the 60 day period to be triggered, the notice of disallowance must warn the claimant of the impending bar. In the case of a disallowance of an unmatured, contingent or unliquidated claim, either the personal representative may consent to an extension of the 60 day period or the court on petition may order an extension of the period. KRS 396.055(1),(3).

Comments - (1) Former KRS 396.027 contained a similar limitation period on a disallowed claim. However, it failed to clearly specify when the limitation period began to run and did not require the notice to warn the claimant of the impending bar.

- (2) If notice of disallowance is given, but the notice does not contain the necessary warning, the claimant may file an action on the disallowed claim at any time prior to the expiration of 2 years from the discharge of the personal representative. See Paragraph 22 below for a discussion of the 2 year period of limitation.

d. The failure of the personal representative to

mail notice to a claimant of action on his claim for 60 days after the time for original presentation of the claim has expired (i.e., 6 months and 60 days from the date of appointment of the personal representative) results in the allowance of the claim. However, the personal representative may file a petition with the court and upon good cause shown obtain an order permitting the disallowance of the claim. Notice of the petition must be given to the claimant. KRS 396.055(1).

e. A judgment against the personal representative to enforce a claim against a decedent's estate is considered an allowance of the claim. KRS 396.055(2).

9. Payment of Claims.

a. The personal representative is authorized after the expiration of 6 months from his appointment to proceed to pay claims which have been properly presented and allowed against the estate. In so doing, he must pay the claims in the order of their priority, making appropriate provisions for claims already presented which have not yet been allowed, and for unbarred claims which may be presented, including costs of administration. KRS 396.075(1).

b. The personal representative may pay at any time any just claim which has not been barred, with or without formal presentation; but he is personally liable to any other claimant whose claim is allowed and who is injured by such payment if:

- (1) the payment is made prior to 6 months

from the date of his appointment and he fails to require the payee to give adequate security for refund, or

(2) the payment was made due to the negligent or willfull fault of the personal representative, in such manner as to deprive the injured claimant of his priority. KRS 396.075(2).

c. A claimant whose claim has been allowed but not paid may petition the court for an order directing the personal representative to pay the claim to the extent that funds of the estate are available for payment. KRS 396.075(1).

Comments - (1) Since the personal representative is not authorized to proceed to pay claims until 6 months after his appointment, it appears that a claimant would not be entitled to file a petition under this section until after the expiration of the 6 month period. Since a petition may be filed only on an allowed claim, a claimant who has not received written notice of allowance or disallowance of the claim must wait until after the claim is deemed to be allowed (i.e., 6 months and 60 days after the date of the appointment of the personal representative) before filing a petition.

- (2) The right to petition the court for an order directing payment of an allowed claim provides a claimant with a practical solution to the problem of a personal representative unduely delaying payment of the claim.

#### 10. Interest on Allowed Claims.

a. An allowed claim not based on a contract

making provision for interest bears no interest from the date of the decedent's death until 60 days after the time for original presentation of the claim has expired (i.e., 6 months and 60 days after the appointment of the personal representative, or where no personal representative has been appointed, 2 years and 60 days after the death of the decedent). Interest thereafter accrues on the claim at the legal rate provided that the claimant has demanded the payment of interest in the written statement of his claim. KRS 396.085(1).

b. An allowed claim based on a contract making provision for interest bears interest from the date of the decedent's death in accordance with the contract provision. KRS 396.085(2).

c. The above rules apply in the absence of a judgment against the personal representative that provides to the contrary.

Comments - (1) As a matter of course, all written statements of claim should demand the payment of interest.

- (2) The personal representative should carefully scrutinize all demands for interest since the statute is very exacting in its terms and the personal representative could potentially be liable for an overpayment of the claim.

11. Priority of Claims.

a. If the assets of the estate are insufficient

to pay all claims in full (i.e., the estate is insolvent), claims are to be paid in the following order of priority:

- (1) costs and expenses of administration,
- (2) funeral expenses,
- (3) debts and taxes with preferences under federal laws and other laws of Kentucky,
- (4) all other claims. KRS 396.095(1).

b. Claims of the same class are to be paid on a prorata basis. Matured claims are not entitled to preference over unmatured claims of the same class. KRS 396.095(2).

Comments - (1) The above rules apply only to unsecured claims. Secured claims, to the extent of the security, are to be satisfied first.

- (2) Costs of administration and funeral expenses are no longer given equal priority. Costs of hospital services provided within 1 year of the decedent's death are no longer entitled to any priority.

12. Secured Claims. Secured claims are to be paid on the basis of one of the following:

a. if the creditor surrenders his security, the amount of the claim allowed,

b. if the creditor exhausts his security before receiving payment, unless precluded by other law, the amount of the claim allowed less the fair value of the security, or

c. if the creditor does not have the right to exhaust the security or has not done so, the amount of the claim

allowed less the value of the security.

For purposes of Subparagraph c above, the value of the security may be determined by conversion of the security into money or by agreement, arbitration, compromise or litigation. KRS 396.105.

Comment - Unless the security is worthless, it is unlikely that a creditor will ever choose to surrender his security even if his claim has been allowed by the personal representative. In doing so, the creditor would forfeit, to the extent of the value of the security, his priority for payment over unsecured creditors.

13. Unmatured, Contingent and Unliquidated Claims.

a. If an unmaturing, contingent or unliquidated claim matures or becomes certain before distribution of the estate, and the claim has been allowed, it is to be paid as any other matured and absolute claim which has been allowed. KRS 396.115(1).

b. If the claim does not mature or become certain before distribution of the estate, the personal representative or the court on petition of the personal representative or claimant may provide for payment in any of the following ways:

(1) if the claimant consents, he may be paid the present or agreed value of the claim taking any uncertainty into account, or

(2) an arrangement for future payment on a happening of the contingency or liquidation of the claim may be



made by creating a trust, giving a mortgage, obtaining a bond or security from a distributee or otherwise. KRS 396.115(2).

Comments - (1) The Act eliminates the right under prior law of the personal representative to force the payoff of an unmatured claim without the consent of the claimant. The Act also provides additional flexibility to the parties and the court in dealing with the problems presented by unmatured, unliquidated and contingent claims.

- (2) In dealing with an unmatured, unliquidated or contingent claim, the personal representative may choose to keep the estate open until a claim has matured or becomes absolute. However, the ability of the personal representative to do this is now limited by the right of the creditor to petition the court for a protective arrangement.

- (3) The personal representative should consider seeking court approval of any agreed "arrangement" with a creditor.

14. Deduction of Counterclaims. In allowing a claim, the personal representative may deduct any counterclaims which the estate has against the claimant. In determining a claim against the estate, a court may also deduct counterclaims and award judgment in favor of the estate where the counterclaims are found to exceed the amount of the allowed claim. For this purpose, the personal representative or the court may take into account all counterclaims of the estate, whether or not they arose from a transaction other than that upon which the claim is

based, and whether or not the counterclaim may give rise to relief different in kind from that sought in the claim. KRS 396.125.

15. Execution on Estate Assets Prohibited. Property of the estate is exempt from execution or levy. However, this rule does not apply to prevent the enforcement of any mortgage, pledge or lien. KRS 396.135.

16. Compromise of Claims. The personal representative may compromise any claim if it appears in the best interest of the estate. KRS 396.145.

Comment - The personal representative should consider obtaining court approval of any compromise agreement reached with a claimant.

17. Encumbrances.

a. If the assets of the estate are encumbered by mortgage, pledge, lien or security interest, the personal representative may pay the encumbrance or any part thereof, renew or extend any obligation secured by the encumbrance or convey or transfer the assets to the creditor in full or partial satisfaction of the lien. However, the personal representative may do so only if it appears to be in the best interest of the estate. The holder of the encumbrance need not have presented a claim. KRS 396.155.

b. Payment of an encumbrance does not increase the share of the distributee entitled to the encumbered assets unless the distributee is entitled to exoneration. KRS 396.155.

Comment - The Act essentially leaves the issue of exoneration for determination under common law and the statutory laws of contribution. For a discussion of the subject of exoneration, see Merritt, 2 Kentucky Practice Sec. 1417 (2d ed 1984).

18. Recovery of Overpayment. If a personal representative overpays a creditor or distributee due to a mistake as to the solvency of the estate or otherwise, he may recover from the creditor or distributee the amount of the overpayment with interest. KRS 396.165.

19. Administration in More Than One State.

a. All assets of an estate being administered in Kentucky are subject to all claims, allowances and charges existing or established against the personal representative wherever appointed. KRS 396.175(1).

b. If the estate either in Kentucky or as a whole is insufficient to cover all exemptions and allowances determined by the law of the decedent's domicile and all claims, then after satisfaction of such exemptions and allowances, each claimant whose claim has been allowed either in Kentucky or elsewhere is entitled to receive payment of an equal proportion of his claim. If a preference or security in regard to a claim is allowed in another jurisdiction but not in Kentucky, the creditor so benefited is to receive payment out of the Kentucky estate only on the balance of his claim after deducting the amount of the preference or security. KRS 396.175(2).

c. If all exemptions and allowances determined under the law of the decedent's domicile and all claims exceed the value of the Kentucky estate and Kentucky was not the state of the decedent's domicile, then claims allowed in Kentucky are to be paid their proportionate share (determined under the rules above) to the extent possible out of the Kentucky estate. Any assets remaining are to be remitted to the domicillary personal representative. KRS 396.175(3).

20. Liability of Personal Representative.

a. Unless otherwise provided in the contract, a personal representative is not individually liable on a contract entered into in his fiduciary capacity unless he fails to reveal his fiduciary capacity and identify the estate in the contract. KRS 396.185(1).

b. A personal representative is not individually liable for obligations arising from the ownership or control of the estate or for torts committed in the course of administration unless he is personally at fault. KRS 396.185(2).

c. Claims based on contracts entered into by a personal representative in his fiduciary capacity, on obligations arising from the ownership and control of the estate or on torts committed in the course of administration may be asserted against the estate by proceeding against the personal representative in his fiduciary capacity. KRS 396.185(3).

d. Issues of liability between the estate and

the personal representative may be determined in a proceeding for accounting, surcharge, indemnification or other appropriate proceeding. KRS 396.185(4).

21. Right of Claimant to Proceed Against Distributees on Undischarged Claim.

a. After assets of an estate have been distributed, an unsatisfied creditor whose claim has not been barred may institute a proceeding against one or more of the distributees of the estate. KRS 396.195.

b. A distributee is not liable for amounts received as exempt property (e.g., property distributed in satisfaction of the spousal exemption under KRS 391.030) or for amounts in excess of the value of his distribution as of the time of distribution. KRS 396.195.

c. A distributee who satisfies a claim is entitled to contribution from each of the other distributees to whom he had given notice of the claimant's demand. The notice must have been given in sufficient time to allow the distributee to join in the proceeding in which the claim had been asserted. The right of contribution is based on what each distributee would have been entitled to receive had the claim been satisfied in the course of the administration of the estate. KRS 396.195.

22. Statute of Limitations Applicable to Claims After Settlement of Estate.

a. No cause of action on any claim not otherwise barred by (a) the failure to timely present the claim, (b) the

operation of the 60 day limitation period on a disallowed claim, or (c) the operation of any other applicable statute of limitations, may be brought against the personal representative or any distributee after the expiration of 2 years from the date of the order of discharge of the personal representative. KRS 396.205.

Example - The applicable statute of limitations has not run on a claim after the decedent's death. The claimant properly and timely presents his claim to the personal representative or files the claim with the clerk of the court. The claim is allowed (either by the personal representative giving notice of allowance, or by the personal representative failing to take action on the claim within 6 months and 60 days of his appointment), but is not paid; or the claim is disallowed by the personal representative, but the notice of disallowance does not warn the claimant of the 60 day limitation period on a disallowed claim. The claimant may commence an action on the claim at any time prior to 2 years from the discharge of the personal representative.

b. The above limitation does not apply to an action by any claimant against the personal representative for fraud, misrepresentation or inadequate disclosure related to the settlement of the decedent's estate. KRS 395.205.

Comments - (1) The statute increases the period of limitation for bringing an action against the personal representative after the date of his discharge from 1 to 2

years.

- (2) Because the limitation period against the personal representative and the distributee is now incorporated into KRS Chapter 396, the former limitation provisions of KRS 413.200 and 413.210 have been repealed.

- (3) In providing that the 2 year limitation period is in addition to all other limitation periods imposed by KRS Chapter 396, the new statute is consistent with the holding of the Kentucky Court of Appeals in Morris v. Derry, 685 S.W.2d 199 (Ky. Ct. App. 1984).

23. Effective Date; Impact on Existing Estates. The new statutes dealing with creditor's claims against a decedent's estate become effective on July 15, 1988, and will thereafter apply to all estates irrespective of when the decedent died. Since the new statutes will apply to estates already in existence, a number of questions are raised as to how the new law will affect claims pending against such estates:

a. Under prior law a claimant had 1 year from the appointment of the personal representative to "prove" his claim. Under new law the claimant has 6 months to present his claim. If the 6 months has already expired by July 15, 1988, is the claimant precluded from asserting his claim? While the answer is not entirely clear, it appears that the Kentucky courts would take the position that the claimant would be given a reasonable time after the effective date to present his claim. See, Heath v. Hazelip, 167 S.W. 905 (Ky. 1914); Crawford

v. V. & C. Coal Co., 432 S.W.2d 403 (Ky. 1968). See also, 51 Am. Jur. 2d Limitation of Actions Sec. 38-39 (1970).

Comments - (1) In determining what is a reasonable time, a court should take into consideration the fact that published notice to creditors already contained a statement that creditors should file their claims with the personal representative within 6 months of appointment. In addition, the court should consider the fact that the public has been on notice of the pending change in the law since March 24, 1988, the date that Senate Bill 8 was signed by the Governor.

- (2) In most cases, the issue addressed by Paragraph a above will be moot since the creditor did not receive actual notice of the appointment of the personal representative. See discussion in Paragraph B below.

b. Under prior law, a claimant could bring an action on an otherwise unbarred claim within 1 year from the date of discharge of the personal representative. Under new law, the claimant has 2 years in which to bring such action. If on July 15, 1988, 1 but not 2 years has passed since the discharge of the personal representative, may a claimant take advantage of the extended period of limitations? The answer appears to be no. See, Herm v. Stafford, 663 F.2d 669 (6th Cir. 1981); Kiser v. Bartley Mining Co., 397 S.W.2d 56 (Ky. 1965).

c. The personal representative rejects a claim prior to July 15, 1988, but does not warn the claimant of the 60 day limitation period on the rejected claim. The new law



requires notification of the impending bar in order for the 60 day limitation period to be effective. No action is filed on the rejected claim within 60 days of the rejection. Is the claim barred? Presumably the claim would be barred if the 60 day period expired prior to the effective date. The answer is less clear when the 60 day period has not expired by the effective date.

d. The estate is insolvent and the personal representative has paid certain claims before July 15, 1988 in reliance on the order of priority assigned to such claims under prior law. The estate remains open on July 15, 1988 and the new law assigns a different order of priority to the claims. What affect does the new law have on the claims already paid and on the claims remaining to be paid? The law in effect at the time the claim is paid should govern the priority of payment.

B. Notice to Creditors.

1. Under the Kentucky statutes, the only required notice to creditors informing them of the appointment of a personal representative and of their obligation to present claims against the estate within the time period allowed under KRS Chapter 396 is by publication. KRS 424.340, as amended by 1988 Kentucky Acts, Chapter 90 (SB 8), Section 28, provides that the clerk of the probate court shall at least once each month cause to be published in a newspaper meeting the circulation requirements of KRS 424.120, a notice setting forth all fiduciary appointments made since the last publication. The

notice must contain (a) the names and addresses of the decedent, the personal representative and the attorney for the personal representative, (b) the date of the personal representative's appointment and (c) the date by which claims must be presented. The personal representative has no statutory duty to give notice to creditors of their obligation to file a claim.

2. In April, 1988, the U.S. Supreme Court in Tulsa Professional Collection Services v. Pope, 56 U.S.L.W. 4302 (U.S. Apr. 19, 1988), held in the context of a non-claim statute (i.e., a statute which imposes a time limit on the presentment of a claim after the death of the debtor) that notice by publication alone does not satisfy due process.

a. The Supreme Court found that the state's involvement in the probate process, and in particular in the appointment by its courts of the personal representative (which starts the running of the period of limitation for the presentment of a claim), was a significant enough state action to invoke the protections of the Due Process Clause of the 14th Amendment. "An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." In the context of a non-claim statute, the Court interpreted this to mean that if the identity of a creditor is known or "reasonably ascertainable" by the personal representative, the creditor must

be given notice of the appointment of the personal representative by mail or by such other means as is reasonably calculated to provide actual notice. The failure to give such notice renders inoperable the non-claim statute as to that creditor.

b. The Supreme Court opinion offers only a limited insight as to what steps the personal representative must take to identify creditors. The Court stated its intent was not to require "impractical and extended searches in the name of due process". "All that the [personal representative] must do is make 'reasonable diligent efforts' to uncover the identities of creditors. For creditors who are not 'reasonably ascertainable' publication notice can suffice. Nor is anyone who may conceivably have a claim properly considered a creditor entitled to actual notice. . . . [I]t is reasonable to dispense with actual notice to those with mere 'conjectural claims.'"

Comments - (1) The facts in Tulsa Professional Collection Services involved a claim of a collection service subsidiary of a hospital for medical care expenses which had been incurred by the decedent at the hospital. The decedent had entered the hospital 5 months prior to his death and died while still at the hospital. The decedent's wife was the executrix and as pointed out by the Court "of course was aware that her husband had endured a long stay at the hospital". Yet the Court stated that it could not be determined from the record whether the appellant was known to or reasonably ascertainable by the

executrix, and remanded the case for a determination as to whether "reasonably diligent efforts would have identified the appellant and uncovered its claims". What if anything can be learned from the Court's remand as to when a creditor is reasonably ascertainable?

- (2) A number of questions are raised by the Court's decision. For example: What constitutes "reasonably diligent efforts"? If the personal representative fails to give notice to a creditor who was known or could have been reasonably ascertained, does he become personally liable to the estate or beneficiaries if a claim is asserted after the period for the original presentation of the claim has expired? What is required of the personal representative where a creditor becomes known shortly before the expiration of the time for the original presentment of the claim?

- (3) Notice by publication will remain essential to cut off claims of creditors not identifiable by a reasonably diligent search.

C. Descent and Distribution.

1. Determination of Heirship. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 2 adds a new section to KRS Chapter 391 to authorize a proceeding in district court to determine heirship.

a. Whenever real or personal property passes by intestate succession or under a will to a beneficiary not named in the will (e.g. to a class of beneficiaries), the personal

representative or any person claiming an interest in the property may move the district court for a determination of all persons entitled to such property. KRS 391.035(1).

b. If estate administration is pending, the motion is to be filed in the district court where the administration is pending. If there is no administration in process or administration has been dispensed with, the motion may be filed in the district court of the county in which the decedent last resided, or if the decedent was not a Kentucky resident, in the district court of the county in which the property or greater part thereof is located. KRS 391.035(2)(a).

c. The motion must contain all facts known to the movant relating to the matter including the names, ages and addresses of all persons who are or may be entitled to share in the property and the relationship of such persons to the decedent or to the class of beneficiaries entitled to share. The motion must also contain a description of the property and an estimate of its value. KRS 391.035(2)(b).

Comment - Presumably, the requirement that the motion set forth the names, ages and addresses of all persons who are or may be entitled to share in the property imposes an obligation on the movant to make a reasonably diligent search to identify all such persons.

d. The statute directs that the motion shall be served in the manner authorized under the civil rules and shall set forth the place and time not less than 20 days from the date

of service when the motion shall be heard. KRS 391.035(2)(c).

Comment - While the statute does not expressly provide for who must be served, presumably it would be all persons potentially having an interest in the property as well as the personal representative.

e. At the hearing on the motion, any person claiming an interest in the property is entitled to introduce proof in support of his claim and the court is expressly authorized to entertain the admission of any other relevant evidence. The hearing may not be conducted by a commissioner. KRS 391.035(3), (9).

f. Any "party" may at any time prior to judgment, or any aggrieved "party" may no later than 30 days from the date of the judgment of the district court, institute an adversary proceeding in circuit court pursuant to KRS 24A.120(2). KRS 391.035(6), (7).

Comment - Presumably, the term "party" as used by the statute means any person who claims an interest in the property. It is unclear whether or not such party must have appeared and asserted his claim in the district court proceeding.

g. The statute provides that any unknown defendants constructively served shall be entitled to the protection afforded by CR 4.11. KRS 391.035(8).

Comment - Civil Rule 4.11 provides that the Court shall retain control over and preserve for 1 year after

the entry of judgment any property which the constructively summoned party has been deprived thereby. Alternatively, the successful party or parties may execute a bond. If no proceeding to obtain relief from judgment is instituted by the constructively served party within 1 year of the judgment, then the property is to be disposed of in accordance with the judgment.

2. Intestate Succession - Illegitimate Child

a. In 1978, the Kentucky Supreme Court in Pendleton v. Pendleton, 560 S.W.2d 538 (Ky. 1978) declared KRS 391.090, providing that a bastard child could inherit from his father only if he had been recognized by the father or had been legitimized through the marriage of his parents to each other, to be invalid. The Court's decision was reaffirmed in 1982 in Fykes v. Clark, 635 S.W.2d 316 (Ky. 1982). The statute was repealed in 1986.

b. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 3 creates a new section of KRS Chapter 391 to replace former KRS 391.090. The new section provides that for purposes of intestate succession or wrongful death actions, if a relationship of a parent to a child must be established to determine succession by, through or from a person, a child born out of wedlock:

- (1) is a child of the natural mother; and
- (2) is a child of the natural father, if:
  - (a) the natural parents participated in

a marriage ceremony before or after the birth of the child, even though the attempted marriage was void,

(b) in determining the right of the child or its kindred to inherit from or through the father, there has been either adjudication of paternity before the death of the father, or an adjudication of paternity after the death of the father based on clear and convincing proof, or

(c) in determining the rights of the father or his kindred to inherit from or through the child, there has been an adjudication of paternity before the death of the child, or there has been an adjudication of paternity after the death of the child based on clear and convincing proof and the evidence in such adjudication shall have demonstrated that the father openly treated the child as his and did not follow a consistent policy refusing to support the child on the ground of non-paternity. KRS 391.105.

3. Spousal Exemption. 1988 Kentucky Acts, Chapter 27 (SB 77) amends KRS 391.030 to reinstate a provision making available the \$7500 spousal exemption in cases where a decedent dies testate and the surviving spouse renounces the will. Prior to 1974, the exemption under KRS 391.030 was available in the event of renunciation. However, in 1974 the language in the statute authorizing the exemption in such cases was removed. It was reinstated in 1976 and removed again in 1982. After the removal in 1982, there was some confusion as to whether the removal had been intentional by the Legislature and whether the



exemption in the event of a renunciation could be implied from the general language of the statute anyway. Such confusion was eliminated by Brown v. Sammons, 743 S.W.2d 23 (Ky. 1988) in which the Kentucky Supreme Court held the exemption was unavailable in the event of a renunciation absent express statutory authorization. The Act also amends KRS 391.030 to make clear that the \$7500 spousal exemption applies in cases where the court, pursuant to KRS 395.455, dispenses with estate administration and directs the transfer of the probate assets to the spouse in satisfaction of the exemption (such a transfer can be directed by the court without requiring the surviving spouse to renounce the will).

D. Settlement Of Estates - Informal Settlement. KRS 395.605(2) authorizes the filing of an informal settlement by a personal representative if the settlement is accompanied by verified waivers executed by all beneficiaries of the estate and none of the beneficiaries is under a disability. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 31 amends KRS 395.605(2) to provide that no waiver need be obtained from a non-residuary legatee who has received and receipted for his legacy. In lieu of the waiver, a cancelled check or signed receipt evidencing satisfaction must be attached to the settlement.

E. Wills - Revocation By Subsequent Marriage. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 4 amends KRS 394.090 to provide that a will shall not be revoked by a subsequent marriage if the will expressly provides for the person who later

becomes the spouse of the testator and such person is married to the testator on the date of the testator's death.

F. Personal Representatives - Actions Against. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 5 amends KRS 395.270 to reduce from 5 to 2 months the period after the appointment of the personal representative before which an action may be commenced against the personal representative. The shortening of the period was made in conjunction with the reduction of time for the presentation of claims against an estate.

G. Fiducial Sale of Real Estate. 1988 Kentucky Acts, Chapter 90 (SB 8), Section 1 amends KRS 389A.010 to clarify that when a guardian or conservator of a person under legal disability commences an action in district court for the sale of real property belonging to his or her ward, a guardian ad litem is required to be appointed to defend the interest of the minor, and that service on the minor is to be made in accordance with CR 4.04(3).

H. Division Of Land Between Co-Owners; Allotment of Dower. 1988 Kentucky Acts, Chapter 227 (HB 650) amends KRS 381.135 to require that in an action for the division of land between co-owners or for the allotment of dower or curtesy, any survey of the land to be made in accordance with the determination of division or allotment and any resulting legal descriptions are to be performed and prepared by a registered land surveyor. The Act also amends KRS 381.135 to require that any such survey be certified by the clerk of the court along

with the approved commissioner's report to the county clerk for recording.

## II. LEGISLATION IMPACTING ESTATE PLANS

A. Revised Model Business Corporation Act. The 1988 General Assembly enacted sweeping revisions to Kentucky's statutes governing corporations. 1988 Kentucky Acts, Chapter 23 (HB 323) repeals the Kentucky Business Corporation Act (Chapter 271A) and replaces it with a new Chapter 271B patterned after the American Bar Association's Revised Model Business Corporation Act (1984). The Act is generally effective for all Kentucky corporations on January 1, 1989. However, a corporation may elect to be subject to the provisions of the Act after July 15, 1988. Identifying the nature and scope of even the most significant changes made by the Act is far beyond the scope of this outline. However, several changes which impact estate plans are discussed below:

1. Restriction on Transfer of Shares. The Act expressly validates certain types of share transfer restrictions contained in a corporation's articles of incorporation, by-laws or in agreements between or among shareholders and the corporation. A transfer restriction may generally be imposed for any reasonable purpose. The types of restrictions permissible under the statute vary from absolute prohibitions on transfers, such as restrictions necessary to avoid securities law violations or termination of a Subchapter S election, to

contractual restraints, such as those found in buy-sell, right of first refusal and option agreements. Specifically, a restriction on the transfer or registration of transfer of shares may without limitation:

a. obligate a shareholder first to offer a corporation or other persons (separately, consecutively or simultaneously) an opportunity to acquire the restricted shares,

b. obligate the corporation or other persons (separately, consecutively or simultaneously) to acquire the restricted shares,

c. require the corporation, the holders of any class of its shares, or other person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable, or

d. prohibit the transfer of the restricted shares to designated persons or classes of persons, if prohibition is not manifestly unreasonable.

Authorized transfer restrictions are valid and enforceable against the holder of the restricted shares and any transferee of such shares if the holder or transferee has actual knowledge of the restriction or the restriction is noted conspicuously on the share certificate. KRS 271B.6-270.

Comment - Contractual agreements imposing stock transfer restrictions are widely used in estate plans involving stock in a closely held corporation. The Act generally codifies the common law rules regarding the enforceability of such

agreements.

2. Preemptive Rights. The Act provides that shareholders of a corporation do not have preemptive rights to acquire the corporation's unissued shares unless the articles of incorporation so provide. KRS 271B.6-300. This is a complete reversal of the position taken by former KRS 271A.130 which provided for preemptive rights in the absence of a provision to the contrary in the articles of incorporation. The committee comments note that corporations having preemptive rights on the effective date of the Act will not lose them until the corporation amends its articles of incorporation and specifically eliminates such rights.

Comment - Preemptive rights may be important in some estate plans to assure that a shareholder maintains the threshold percentages of stock ownership necessary for qualification for certain estate tax benefits or elections. Where this is important in the context of a corporation formed after the effective date of the Act, care should be taken to insure preemptive rights are reserved in the articles of incorporation.

3. Stock Redemptions. The Act eliminates the former restriction under KRS 271A.030 that a corporation may acquire its shares only to the extent of unrestricted and unreserved earned surplus. The Act imposes two tests, both of which must be satisfied before any distribution (defined to include stock redemptions) may be made by a corporation. First, a

distribution may not be made if after making the distribution the corporation would not be able to pay its debts as they became due in the ordinary course of business ("equity insolvency test"). Second, a distribution may not be made if after the making of the distribution the corporation's total assets would be less than the sum of its total liabilities plus distribution preferences of senior equity securities ("balance sheet test"). For purposes of determining qualification under the balance sheet test, assets are permitted to be valued at fair value. In the case of a redemption, the balance sheet test is to be applied on the earlier of (a) the date money or other property is transferred or debt is incurred by the corporation to acquire the redeemed shares, or (b) the date the shareholder ceases to be a shareholder with respect to the acquired shares. KRS 271B.6-400.

Comment - Estate plans often involve stock redemptions (e.g., buy-sell agreements requiring the corporation to purchase the shares of a deceased shareholder, Section 302 stock redemptions, etc.). Such plans must consider whether a corporation will be able to satisfy the statutory requirements to acquire or redeem its own shares. The new tests imposed by the Act generally relax the qualification requirements making it easier to redeem stock. This will be helpful particularly in planning for the redemption of a major stockholder of a closely held corporation.

4. Capital Structure. The Act abandons the

traditional distinctions between "common stock" and "preferred stock" and completely eliminates the concepts of par value, stated capital and capital surplus. The Act allows a corporation to authorize through its articles of incorporation "classes of shares" whose rights and preferences may vary significantly. The flexible approach to structuring the capital of a corporation taken by the Act permits a variety of new types of shares such as callable common stock (i.e., shares of voting stock without preferential rights which are redeemable at the option of the corporation), "puttable" shares (i.e., shares which are manditorily redeemable at the option of the shareholder) and "upstream convertible" shares (i.e., shares which are convertible into a class of shares having superior rights and preferences or into debt securities). KRS 271B.6-010.

Comment - The additional flexibility afforded to corporations in the planning of its capital structure offers the creative estate planner new tools in planning for such things as shifts in control and estate freezes through recapitalization.

B. Revised Uniform Limited Partnership Act. The 1988 General Assembly also enacted sweeping revisions to Kentucky's law governing limited partnerships. 1988 Kentucky Acts, Chapter 284 (HB 582) repeals the Kentucky Uniform Limited Partnership Act and replaces it with new statutes patterned after the Revised Uniform Limited Partnership Act (1985). As with the Revised Model Business Corporations Act, identifying the nature

and scope of even the most significant changes made by the Act is far beyond the scope of this outline. However, some of the changes which impact estate plans are discussed below:

1. Dissolution on Death of General Partner. The Act provides that an "event of withdrawal" of a general partner will result in the dissolution of the partnership unless (a) at the time of withdrawal there is at least one other general partner and the partnership agreement permits the business of the partnership to be carried on by the remaining general partner and that partner does so, or (b) within 90 days after the withdrawal all partners agree in writing to continue the business of the limited partnership and to appoint one or more additional general partner(s) if necessary or desired. KRS 362.487(4). The term "event of withdrawal" is defined to include the death of a general partner.

Comment - Estate plans involving limited partnerships must take into consideration the possible adverse consequences resulting from the dissolution of the partnership on the death of a general partner. The Act specifically authorizes two means by which a partnership may be continued without dissolution.

2. Rights of Estate of Deceased Partner. The Act retains from prior law the right of a personal representative to exercise all of the deceased partner's rights for purposes of settling the estate or administering the decedent's property, including any power the partner had to give an assignee the



right to become a limited partner (note the term "substituted limited partner" is no longer used). KRS 362.485.

Query - Absent any provision in the partnership agreement to the contrary, the new Act provides to a "withdrawing" partner the right to receive, within a reasonable time after withdrawal, the fair value of his interest in the partnership. KRS 362.467. Since the death of a general partner is considered an "event of withdrawal" (see discussion in Paragraph 1 above), is the estate of a deceased general partner entitled to exercise this right to receive fair value absent the dissolution of the partnership?

C. Kentucky Tax Amnesty Act. 1988 Kentucky Acts, Chapter 322 (HB 856) directs the Revenue Cabinet to conduct a tax amnesty program during the fiscal year ending June 30, 1989. The program, which is to run for a period of 60 to 120 days, extends to a broad range of taxes administered by the Revenue Cabinet including inheritance and estate tax, fiduciary income tax and omitted intangible property tax.

1. The tax amnesty program is to apply to tax liabilities for taxable periods ending or transactions occurring prior to December 1, 1987. KRS 131.400(4).

2. Generally to qualify, a taxpayer must:

a. file an application for amnesty within the time prescribed by the Revenue Cabinet,

b. file completed or amended returns for all years or tax reporting periods as stated on the application for

which returns have not been previously filed or for which the tax liability was unreported, and

c. pay in full the taxes and interest due for the periods and taxes applied for at the time the application or amnesty returns are filed. KRS 131.420(1).

3. A taxpayer may participate in the program irrespective of the fact that an audit is pending or the amount due has been assessed or that a demand for payment has been made or that the amount due is subject to a pending administration or judicial proceeding, but may not participate if subject to a criminal investigation. KRS 131.410(2), 131.420(2)

4. For taxes which are owed as a result of the non-reporting or unreporting of tax liabilities, or the non-payment of any account receivable owed, the state will waive criminal prosecution and civil penalties for the taxable years or periods for which amnesty is requested, plus 1/2 of any interest due on the unpaid tax. KRS 131.410(1).

5. After the expiration of the amnesty period, the Act imposes stiff penalties for non-compliance.

a. A 20% "collection fee" is imposed on "all taxes which are or become final, due and owing to the cabinet for any reporting period, regardless of when due." KRS 131.440(1).

b. A 20% "collection fee" is imposed on "taxes which are assessed and collected ... for taxable years ending or transactions occurring prior to December 1, 1987." KRS

131.440(1).

c. A 50% "collection fee" is imposed on any tax deficiency for any previous tax period for which amnesty was available but for which the taxpayer failed to file a return during the amnesty period. KRS 131.440(1).

d. A 5% penalty is imposed on any tax deficiency if any part of the deficiency is due to intentional disregard of the statutes or regulations but without the intent to defraud. KRS 131.445(2)(a).

e. A 50% penalty is imposed on any tax deficiency if any part of the deficiency is due to fraud or intent to evade tax. KRS 131.445(2)(b).

f. A taxpayer who willfully fails to make a return, or willfully makes a false return, or willfully fails to pay taxes owing or collected, with intent to evade payment of the tax, is guilty of a class D felony. KRS 131.445(3).

6. The penalties described in Paragraph 5 above are in addition to all other penalties and charges prescribed by law. The Secretary of Revenue is given the authority to waive any penalty or collection fee when it is demonstrated that any deficiency was not due to negligence, intentional disregard of rules and regulations or fraud. KRS 131.440(2).

### III. PROBATE LEGISLATION INTRODUCED IN THE 1988 SESSION WHICH DID NOT PASS

A. Living will (HB 595).

B. Uniform Durable Power of Attorney Act (deleted from SB 8 in interim session).

C. Provision authorizing and establishing procedure for proposed final settlement (deleted from SB 8).

D. Provision to increase inheritance tax deduction for funeral expenses to \$7500 (HB 33).

E. Provision to extend custodianship under Uniform Transfers to Minors Act to age 22 (HB 499).

F. Provision to prohibit capital stock of bank or trust company from being accepted as security for fiduciary bond where cumulative amount of such entity's bonds exceed the net worth of such entity (HB 529).

G. Provision to effect that submission by fiduciary of proposed transaction for review by a court shall constitute compliance by fiduciary with applicable standards of fiduciary care in regard to that transaction (HB 783).

H. Omnibus income tax revision including amendment to raise minimum income filing requirement of fiduciaries to \$3,000 (HB 790, HB 949).

I. Alternative provision to enacted statute under SB 8 to establish rules for intestate succession in cases involving illegitimate children (HB 825).

J. Provision requiring Revenue Cabinet to complete asset appraisals within 90 days of receipt of inheritance tax return (SB 84).

AVOIDING MALPRACTICE CLAIMS THAT ARISE OUT OF COMMON  
ESTATE PLANNING SITUATIONS

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SECTION B



AVOIDING MALPRACTICE CLAIMS THAT ARISE OUT OF COMMON  
ESTATE PLANNING SITUATIONS

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# Avoiding Malpractice Claims That Arise Out of Common Estate Planning Situations

By GERALD P. JOHNSTON

The author believes that the prudent estate planner should learn to practice defensive law; he offers a number of suggestions to reduce the risk of malpractice claims.

## I. Introduction—The Omnipresent Threat of Malpractice

The threat of legal malpractice has become very real in the last 10 or 15 years. While all private practitioners have an ever increasing exposure to malpractice claims, estate planning is one of the areas where risks are the greatest.<sup>1</sup> As a consequence, the prudent estate planner should learn to practice defensive law and take precautionary steps to minimize the number and extent of future malpractice claims. Moreover, the same malpractice risks which present a threat to the attorney apply with equal force to other estate planning professionals, such as accountants, trust officers, life insurance underwriters, and financial planners.<sup>2</sup>

<sup>1</sup> Kirsch, "A Changing Insurance Game Threatens Lawyers," 5 *California Lawyer* 30, 33 (July 1985); Stern & Felix-Retzke, *A Practical Guide to Preventing Legal Malpractice* § 3.08 (McGraw-Hill 1983); Avery & Mallen, "Managing an Estate Planning Practice to Avoid Malpractice," *Estate Planning—1983* § 4.4 (U. C. L. A.-Cal. C. E. B.); Mallen & Levit, *Legal Malpractice* § 620 (West, 2d ed. 1981); Avery, "Is It Safe To Be an Estate Planner?," 16 *Law Office Economics & Management* 240 (1975); Eckhardt, "The Estate Planning Lawyer's Problems: Malpractice and Ethics," 8 *Miami Institute on Estate Planning* ¶ 74.600 (1974).

<sup>2</sup> See Zissman, "Potential Liability of Corporate Fiduciaries for Estate Planning Errors," 124 *Trusts & Estates* 28 (June 1985); Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 701-09 (1982).

There are a number of reasons that make estate planners uniquely vulnerable to claims of malpractice. While many fields of law are complex, estate planning cuts across many different areas. For example, an estate planner needs to be proficient in property law, intestacy, wills and trusts, probate administration, future interests, state and federal income taxes, and state and federal gift, estate, inheritance and generation-skipping transfer taxes, to name just a few of the more obvious ones. Thus, the difficulty of practicing estate planning is greatly increased by the need to be competent in a wide variety of fields of law. And, of course, the greater the complexity, the more opportunities for mistakes and the greater the malpractice risk.

Often, practitioners and others engaged in providing estate planning services are their own worst enemies in terms of fostering malpractice. There is a strong tendency among a substantial number of estate planners to make their services available on a cut-rate basis.<sup>3</sup> Lawyers, for example, will often bill their estate planning clients in an amount that does not even begin to cover their overhead. Others engaged in estate planning, such as trust departments of banks and life insurance salesmen, will provide substantial services without charge. There are often good explanations for these practices. An attorney may charge modest fees for work in this area in order to be competitive; or the practitioner may be trying to build up his or her clientele and prefer not to run the risk of frightening potential clients off by higher fees; and, of course, many lawyers

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take the "loss leader" approach to billing for estate planning with the expectation that the fees that they will subsequently earn probating various clients' estates will more than compensate them for their earlier efforts in preparing wills and trusts.<sup>4</sup> Similarly, many banks will render estate planning services without charge in the knowledge that a sufficient number of the people that they advise will name the bank as executor or trustee, and that the fees that will be earned as fiduciaries more than justify their "largess" at the outset.

The danger with such "loss leader" practices, at least in the case of lawyers, is that the possi-

bility of receiving a substantial fee for probate work in the future does not seem to provide sufficient incentive to devote the amount of time and effort that is required to do a thorough job of estate planning and drafting. Thus, the tendency to undercharge for such services often results in efforts to minimize the amount of time spent planning an estate, or in excessive delegation by attorneys to paralegals and others in the office whose hourly rates are more likely to be covered by the amounts billed for estate planning work. Thus, anticipated low billings will often result in a reduction of attorney time and effort, thereby increasing the chances for mistakes.

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There are other significant factors which tend to make an estate planning practice particularly vulnerable to malpractice claims. For example, wills are generally subject to close scrutiny in a way that other important documents, such as contracts, are not. A will, for instance, must be admitted to probate in order to commence estate administration, and in that process a determination must be made as to the validity of execution and attestation. Once admitted to probate, the will, which becomes a public document, is not only reviewed by the executor, but may also be scrutinized by others who have an interest, such as beneficiaries named in the document; those who expected to be included but were not; individuals who would have been heirs if the decedent had died intestate (or who may become heirs if the will is, for any reason, invalidated); and creditors of the estate. In addition to a will's inherent validity, any of these interested parties may raise basic questions dealing with interpretation

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<sup>3</sup> Kram, "Estate Planning: The Public's Perceptions & Attitudes," 8 *Real Property Probate & Trust Journal* 489, 493 (1973); *Time-Life Family Legal Guide* 39 (1971); Sussman, Cates & Smith, "Will Making: An Examination of Client and Lawyer Attitudes," 23 *Florida Law Review* 25, 44 (1970).

<sup>4</sup> See, e.g., Sussman, Cates & Smith, *supra* note 3, at 43-50.

and construction of the will's provisions. Finally, preparation and filing of state inheritance and federal estate tax returns may result in a review of the underlying testamentary documents by the executor, the attorney for the estate, and the revenue authorities to determine the tax consequences of a will's or a trust's provisions. Thus, for example, the wording of the marital deduction clause, as well as other terms of the will, may affect an estate's entitlement to the marital deduction. As a consequence of the review of the will by so many different persons for so many different purposes, it is possible, even likely, that any mistake or error committed in drafting, execution and attestation will come to light during administration of the estate.

Other considerations also tend to make estate planning a rather high-risk field in terms of malpractice exposure. Certain difficulties may be encountered in an attempt to prove a malpractice claim against an attorney practicing in some other area of the law. Take the classic malpractice case in litigation, where the plaintiff's attorney inadvertently failed to file a complaint within the limitations period. Proof of negligence under such circumstances is relatively easy, but the elements of causation and damages may present substantial obstacles. The malpractice claimant is required to try "a case within a case" in order to prove that if the action had been filed in a timely manner, the underlying claim would have been successfully prosecuted and a jury verdict rendered in the plaintiff's favor.<sup>8</sup> Thus, the attorney's failure to file the complaint was a proximate cause of the claimant's damages that would not have been incurred if the prior action had been properly pursued. By contrast, in many instances of estate planning malpractice, causation and damages are readily provable. Take, for example, the analogous situation in estate planning to the missed statute of limitations, where the will that has been prepared is not properly attested.<sup>9</sup> Here, a disappointed beneficiary, who loses a legacy because of a mistake in attestation, can easily demonstrate that if the will had been witnessed in the required manner, he or she would have received the anticipated bequest or devise. Proximate cause is obvious, and damages are established by the value of the legacy that would have been received.<sup>7</sup> Similarly, if something goes afoul in drafting provisions to secure the marital deduction, and that significant tax benefit is lost, proof of causation and damages presents little problem.<sup>8</sup> Thus, in estate planning a number of the typical mistakes and errors that

have occurred are relatively easy to prove, and the filing of malpractice claims is thereby encouraged.

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In most areas of legal malpractice, the privity doctrine applies with considerable force, so that only the original client who was in "privity" with the lawyer in question is entitled to bring suit for malpractice.<sup>9</sup> In contrast, in the area of estate planning the courts have rather consistently held that a disappointed beneficiary can bring suit after the testator's death, even though such person or entity had no prior relationship with the defendant attorney. The consequences of removal of the privity barrier are discussed in more detail below,<sup>10</sup> and the only point to be noted here is the fact that the risk of malpractice is enhanced by expanding the class of potential plaintiffs beyond the party who received the purportedly faulty legal services.

One final factor which increases the estate planning malpractice risk should be noted. Due to the fact that wills generally lie dormant until

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<sup>8</sup> See Coggin, "Attorney Negligence . . . A Suit Within a Suit," 60 *West Virginia Law Review* 225 (1958); Wade, "The Attorney's Liability for Negligence," 12 *Vanderbilt Law Review* 755 (1959); "The Standard of Proof of Causation in Legal Malpractice Cases," 63 *Cornell Law Review* 666 (1978); *Lysick v. Walcom*, 65 Cal. Rptr. 406 (1968); *Coon v. Ginsburg*, 509 P. 2d 1293 (Colo. 1973); *Piper v. Green*, 216 Ill. App. 590 (1920); *Utterback-Gleason Co. v. Standard Accident Ins. Co.*, 184 N. Y. Supp. 862 (1920); *Jackson v. Urban*, 516 S. W. 2d 948 (Tex. 1974).

<sup>9</sup> See, e.g., *Binkanja v. Irving*, 320 P. 2d 16 (Cal. 1958); *Mickel v. Murphy*, 305 P. 2d 993 (Cal. 1957); *Buckley v. Gray*, 42 P. 900 (Cal. 1895); *Licata v. Spector*, 225 A. 2d 28 (Conn. 1966); *Woodfork v. Sanders*, 248 So. 2d 419 (La. 1971); *Goldberg v. Bosworth*, 215 N. Y. S. 2d 849 (1961); *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983); *Schirmer v. Nethercutt*, 288 Pac. 265 (Wash. 1930); and *Auric v. Continental Cas. Co.*, 331 N. W. 2d 325 (Wis. 1983).

<sup>10</sup> *Id.*

<sup>7</sup> *Bucquet v. Livingston*, 129 Cal. Rptr. 514 (1976); *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984). See also *Horne v. Peckham*, 158 Cal. Rptr. 714 (1979) (malpractice in establishing Clifford trust).

<sup>8</sup> *National Savings Bank v. Ward*, 100 U. S. 195 (1879); *Jacobsen v. Overseas Tankship Corp.*, 11 F. R. D. 97 (E. D. N. Y. 1950); *Mickel v. Murphy*, 305 P. 2d 993 (Cal. 1957); *Buckley v. Gray*, 42 Pac. 900 (Cal. 1895); *Rose v. Davis*, 157 S. W. 2d 284 (Ky. 1941); *Kasen v. Morrell*, 183 N. Y. S. 2d 928 (1959); *Hakala v. Van Schaick*, 12 N. Y. S. 2d 928 (1939). See generally Mallen & Levit, *Legal Malpractice* §§ 71-82 (West, 2d ed. 1981).

<sup>9</sup> See pages 783-85, *infra*.

a testator's death, any mistake or error committed by the draftsman may not be uncovered until years later. Again, this is somewhat unique to estate planning.<sup>11</sup> Thus, an estate planner may be responsible for his or her work product for a much longer period of time than what is generally the case in other fields of law. This unusual aspect of estate planning malpractice will also be developed more fully below in connection with a discussion of the tolling of the statute of limitations until the mistake or error has come to light.<sup>12</sup> Because the risk factor is thus extended in time, it becomes essential for the prudent estate planner to maintain accurate files and records for years longer than might otherwise be necessary.

## II. Demise of the Privity Barrier

Under a long-standing, well-established doctrine, the only person who had standing to bring a legal malpractice suit was the client who had initially contracted for the legal services.<sup>13</sup> This rule was applied by the U. S. Supreme Court in an analogous malpractice action in 1879,<sup>14</sup> and it was thereafter adopted in the estate planning setting to preclude disappointed beneficiaries from bringing suit against the draftsman of a will after the testator's death.<sup>15</sup> For over half a century this rule remained well entrenched, and as a consequence many lawyers benefitted from strict application of this privity barrier.

Some 25 years ago, the California Supreme Court put the first small chink in the lawyer's protective armor. In 1958, the California court held in *Biakanja v. Irving*<sup>16</sup> that a would-be beneficiary under an invalid will could state a cause of action against the notary public who prepared the will. Any doubt about application of this new rule to attorney-drawn documents, where unauthorized practice would not be a factor, was put to rest three years later when the California Supreme Court rendered its now famous decision in *Lucas v. Hamm*.<sup>17</sup> In *Lucas*, the drafting attorney prepared a testamentary trust which violated the rule against perpetuities. The court reaffirmed its holding in *Biakanja* rejecting the privity doctrine, and substituted a balancing-of-factors test to determine who, other than the original client, had standing to bring a legal malpractice suit against the attorney whose mistake had caused the problem. In determining whether a third party was entitled to initiate suit, a court under this test would look to such factors as the extent to which the attorney's services were intended to benefit the third party in question; the foreseeability of harm to the plaintiff; the proximity of

the attorney's error and the resulting injury; the policy of preventing similar detrimental conduct in the future; and the extent to which the allowance of such causes of action would be an undue burden on the legal profession.<sup>18</sup>

The *Biakanja* and *Lucas* decisions have been widely followed in other jurisdictions.<sup>19</sup> When the balancing-of-factors test is applied in the estate planning setting, disappointed beneficiaries are uniformly allowed to bring suit against the draftsman in spite of a lack of privity between the parties.<sup>20</sup> Some courts have shown a concern that the balancing-of-factors test may open the floodgates to too many nonclient malpractice litigants, and have adopted a narrower, third-party beneficiary exception to the privity requirement.<sup>21</sup> While this more conservative approach may have the effect of precluding malpractice claims in other circumstances, beneficiaries, or at least would-be beneficiaries, have consistently been held to meet the more restrictive requirements, and their claims against attorneys who have prepared defective wills have withstood attack.<sup>22</sup>

<sup>11</sup> See, e.g., *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983) (will drafted in 1957; testator died in 1972; malpractice suit filed in 1976); *Bucquet v. Livingston*, 129 Cal. Rptr. 514 (1976) (trusts for husband and wife prepared in 1961; husband died in 1964 and wife died in 1969; malpractice suit filed in 1970). One area that is analogous involves the search and certification of title to real estate. There, a substantial amount of time may pass between the date the error was committed (e.g., failure to detect a lien during title search) and when that error was discovered (e.g., years later when the lien holder forecloses on the property). See *Mumford v. Staton, Whaley & Price*, 255 A. 2d 359 (Md. 1969), where the plaintiff had been required to surrender realty she had purchased 12 years earlier in reliance on a defective title search. See generally *Mallen & Levit, Legal Malpractice* §§ 600-610 (West, 2d ed. 1981).

<sup>12</sup> See pages 785-86, *infra*.

<sup>13</sup> See cases and authorities cited in note 9, *supra*.

<sup>14</sup> *National Savings Bank v. Ward*, 100 U. S. 195 (1879) (suit brought against attorney for negligent certification of title to realty by third party who relied on certificate but who had not employed the attorney).

<sup>15</sup> *Buckley v. Gray*, 42 Pac. 900 (Cal. 1895); *Mickel v. Murphy*, 305 P. 2d 993 (Cal. 1957); *Maneri v. Amodeo*, 238 N. Y. S. 2d 302 (1963).

<sup>16</sup> 320 P. 2d 16 (Cal. 1958).

<sup>17</sup> 364 P. 2d 685 (Cal. 1961).

<sup>18</sup> *Id.* at 687-88.

<sup>19</sup> See, e.g., *Fickett v. Superior Court*, 558 P. 2d 988 (Ariz. 1976); *Heyer v. Flain*, 449 P. 2d 161 (Cal. 1969); *Licata v. Spector*, 225 A. 2d 28 (Conn. 1966); *Needham v. Hamilton*, 459 A. 2d 1060 (Dist. of Col. 1983); *McAbee v. Edwards*, 340 So. 2d 1167 (Fla. 1976); *Ogle v. Fuiten*, 466 N. E. 2d 224 (Ill. 1984); *Stewart v. Sbarro*, 362 A. 2d 581 (N. J. 1976); and *Auric v. Continental Cas. Co.*, 331 N. W. 2d 325 (Wis. 1983).

<sup>20</sup> See cases cited in note 19, *supra*.

<sup>21</sup> *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983); *Stowe v. Smith*, 441 A. 2d 81 (Conn. 1981).

<sup>22</sup> See cases cited in note 21, *supra*. But see *Lorraine v. Grover, Cincut, Weinstein*, 467 So. 2d 315 (Fla. (Continued on following page.)

A number of years ago New York made it clear that the privity barrier would not be lowered to permit suit against a will's draftsman by persons other than the testator.<sup>23</sup> But several recent decisions in New York have provided a strong indication that that jurisdiction, too, may soon be joining the states that allow disappointed beneficiaries to maintain suit in spite of a lack of privity with the attorney-draftsman.<sup>24</sup> Nebraska, on the other hand, appears to be solidly in the "privity" camp, and may be the only jurisdiction that will continue to preclude suit in the will drafting-disappointed legatee setting. In two recent decisions involving malpractice claims filed by such would-be beneficiaries, the Nebraska Supreme Court unequivocally barred suit for lack of privity without a moment's hesitation.<sup>25</sup> It is significant to note that there was no mention in either case of the fact that the identical issue had been resolved in favor of permitting suit in numerous other jurisdictions, and it may be that the Nebraska Court did not pay adequate attention to the strong movement away from privity in virtually every other state that has considered this precise will drafting issue in the last 25 years.

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Thus, with the exception of Nebraska, and possibly New York, disappointed beneficiaries are now able to bring malpractice claims against draftsmen of defective wills or trusts. This precise issue has been decided in many jurisdictions, and there is little reason to believe that any different result will be reached in the other states when the question is presented.<sup>26</sup>

Resolution of this issue seemingly has had much less to do with a particular court's reaction to the privity requirement as such than it has had with the practical consequences of the application of this barrier in these particular circumstances. As several courts have indicated,<sup>27</sup> since a mistake or error in a testamentary document generally will not, because of its nature, be discovered until after the testator's death, unless an erstwhile beneficiary who has been injured as a result of the draftsman's mistake or error is allowed to bring suit, no one will be entitled to relief. In theory, at least, an executor or administrator of the decedent's estate might be able to file a malpractice claim against the erring attorney,<sup>28</sup> since the fiduciary is considered as standing in

the shoes of the decedent. The problem, however, is that any damages that might be recoverable would be so modest that they would not, in most cases, be worth pursuing. A personal representative might be entitled to recover the cost of will preparation if, as a result of faulty drafting or supervision of execution and attestation, the will was determined to be invalid.<sup>29</sup> But such measure of damages hardly provides sufficient incentive to pursue a malpractice claim, no matter how legitimate.

On the other hand, it seems clear that the personal representative would not be entitled to damages based on the value of a lost legacy. Suppose, for example, that a testator executed a will under which a nephew was to be left an entire estate worth \$100,000, to the exclusion of grandchildren who were issue of the testator's predeceased children. If the will was not properly witnessed, then at the client's death the estate would pass by intestacy to the grandchildren. Even if the nephew were precluded from bringing suit because of a lack of privity, the ad-

(Footnote 22 continued.)

App. 1985), where a Florida court refused to extend the rule previously adopted in that jurisdiction that excepted a disappointed will beneficiary from the privity requirement to a highly analogous estate planning situation involving an inter vivos transfer.

<sup>23</sup> In *Maneri v. Amodio*, 238 N. Y. S. 2d 302 (1963), the New York Supreme Court, Appellate Division, specifically rejected the *Biakanja* and *Lucas* decisions. The court in *Victor v. Goldman*, 344 N. Y. S. 2d 672 (1973), recognized the new trend in which attorneys could be held liable to third parties in certain circumstances, and referred to the "well-considered" decisions of the California Supreme Court in *Biakanja* and *Lucas*, but felt compelled to follow the decision in *Victor v. Goldman* in the draftsman-will beneficiary setting.

<sup>24</sup> See *Estate of Douglas*, 428 N. Y. S. 2d 558 (1980); and *Baer v. Broder*, 447 N. Y. S. 2d 538 (1982).

<sup>25</sup> *St. Mary's Church of Schuyler v. Tomck*, 325 N. W. 2d 164 (Neb. 1982); *Lütyhorn v. Dier*, 335 N. W. 2d 554 (Neb. 1983).

<sup>26</sup> It should be noted, however, that a Maryland court recently sidestepped the privity issue in a case involving a will that was allegedly drafted in a negligent manner. *Kirgan v. Parks*, 478 A. 2d 713 (Md. App. 1984). After reviewing the law in other jurisdictions in considerable depth, the Maryland court decided the case on another issue, and left for another day the decision "whether, in an appropriate case, the beneficiary of a will can maintain a legal malpractice action in this state against the testator's attorney for negligence in preparing the will or in supervising its execution. . . ." 478 A. 2d at 718.

<sup>27</sup> E. g., *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983); *Heyer v. Flaig*, 449 P. 2d 161 (Cal. 1969).

<sup>28</sup> In *Heyer v. Flaig*, supra note 27, the court indicated that a testator is not injured as a consequence of the negligent preparation of a will "except to the extent of fees paid" for such work, and that "only the beneficiaries suffer the real loss." 449 P. 2d at 165.

<sup>29</sup> *Guy v. Liederbach*, supra note 27; *Heyer v. Flaig*, supra note 27.

ministrator would not be entitled to recover the \$100,000 legacy as the measure of the damages suffered by the decedent. Any other result would be nonsensical, as such a \$100,000 recovery would, in the hands of the personal representative, have to be distributed as an asset of the intestate estate to the heirs-at-law. Any suit by the administrator would rebound only for the benefit of the heirs, and not for the real party who was injured by the attorney's negligence. Thus the heirs would receive yet a second windfall—one as a consequence of the will's invalidity; the other due to the administrator's recovery of the lost legacy.

### III. Tolling the Statute of Limitations

Once courts began to hold that disappointed beneficiaries could bring malpractice claims against a will or trust draftsman without regard to a lack of privity between the parties, a second substantial barrier faced such claimants. Just as in the case with "privity," malpractice plaintiffs had to overcome a well-entrenched statute of limitations rule that had also served for years to protect attorneys from the consequences of their own negligence. It had long been held that the statute began to run in an action for professional malpractice at the time that the mistake or error was committed.<sup>30</sup> In the case of estate planning, this often meant that the applicable statute would have run well before the testator's death, and hence prior to the time that such a mistake or error would come to light.<sup>31</sup> Again, courts were faced with a dilemma of providing a cause of action based on malpractice, yet effectively negating such a right by imposition of a statute of limitations which began to run at the time the will or trust was defectively drafted.

By 1969, courts began to toll the statute of limitations until, at least, the time of the testator's death.<sup>32</sup> Thus, a disappointed beneficiary would be given an opportunity to learn of the loss of a legacy, and, presumably, the reason or reasons for such loss. The principal theory adopted to achieve this result was patterned on the "discovery" rule utilized in medical malpractice, and tolled the limitations period until the claimant discovered or should have discovered the attorney's error.<sup>33</sup> Numerous other jurisdictions have followed this lead and applied the discovery rule to the statute of limitations in cases arising out of the drafting of wills or trusts.<sup>34</sup> Other courts

have arrived at a similar result by a slightly different route, whereby the statute is tolled during the period that the client was continuing to utilize the attorney's services.<sup>35</sup>

In the last few years, some courts have shown a reluctance to apply the discovery rule in a broad manner which would entitle a third-party claimant to recover a legacy many years after the attorney-draftsman's negligence had caused a defective instrument to be executed.<sup>36</sup> In one extreme example of judicial hesitancy to permit the discovery rule to run its full course, the Iowa Supreme Court in *Millwright v. Romer*<sup>37</sup> determined that laymen are held to know the law, even the rule against perpetuities, and as a consequence a disappointed beneficiary was not entitled to wait until conclusion of appellate review of the validity of the bequest in question before bringing suit against the draftsman of the

<sup>30</sup> See, e.g., *Wilcox v. Plummer*, 29 U. S. (4 Pet.) 172 (1830); *Alter v. Michael*, 413 P. 2d 153 (Cal. 1966); *Bustamante v. Haet*, 35 Cal. Rptr. 176 (1963); *Master Mortgage Corp. v. Byers*, 202 S. E. 2d 566 (Ga. 1973); *Maloney v. Graham*, 171 Ill. App. 409 (1912); *Sullivan v. Stout*, 199 A. 1 (N. J. 1938); *Goldberg v. Bosworth*, 215 N. Y. S. 2d 849 (1961).

<sup>31</sup> See discussion of this point in *Heyer v. Flaig*, 449 P. 2d 161, 166 (Cal. 1969); see generally "The Commencement of the Statute of Limitations in Legal Malpractice Actions—The Need for Re-Evaluation," 15 *U. C. L. A. Law Review* 230 (1967).

<sup>32</sup> *Heyer v. Flaig*, note 31, supra; cf. *Mumford v. Staton, Whaley & Price*, 255 A. 2d 359 (Md. 1969) (statute of limitations tolled in malpractice case involving negligent certification of title until error discovered).

<sup>33</sup> See, e.g., *Mumford v. Staton, Whaley & Price*, note 32, supra; *Woodruff v. Tomlin*, 511 F. 2d 1019 (CA-6 1975); *Neal v. Magana, Olney, Levy, Cathcart & Gelfand*, 491 P. 2d 421 (Cal. 1971); *Downing v. Vaine*, 228 So. 2d 622 (Fl. App. 1969); *Kohler v. Woolen, Brown & Hawkins*, 304 N. E. 2d 677 (Ill. App. 1973); *Hendrickson v. Sears*, 310 N. E. 2d 131 (Mass. 1974); *McKee v. Riordan*, 366 A. 2d 472 (N. H. 1976); *Family Sav. & Loan, Inc. v. Ciccarello*, 207 S. E. 2d 157 (W. Va. 1974); cf. *Morgan v. Grace Hospital, Inc.*, 144 S. E. 2d 156 (W. Va. 1965) for an example of the classic application of the discovery rule in a medical malpractice case.

<sup>34</sup> E.g., *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984); *Millwright v. Romer*, 322 N. W. 2d 30 (Iowa 1982); *Succession of Killingsworth*, 270 So. 2d 196 (La. App. 1972); *Jaramillo v. Hood*, 601 P. 2d 66 (N. M. 1979); and *Auric v. Continental Cas. Co.*, 331 N. W. 2d 325 (Wis. 1983).

<sup>35</sup> This is known as the "continuous treatment" rule, and it also has its genesis in medical malpractice decisions. Under this approach, the statute does not begin to run until the attorney-client relationship has terminated, regardless of when the negligent act occurred. *Kramer v. Belfi*, 482 N. Y. S. 2d 898 (1984); *Greene v. Greene*, 436 N. E. 2d 496 (N. Y. 1982); *Siegel v. Kranis*, 288 N. Y. S. 2d 831 (1968); *Keaton Co. v. Kolby*, 271 N. E. 2d 772 (Ohio 1971).

<sup>36</sup> See, e.g., *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984); *Millwright v. Romer*, 322 N. W. 2d 30 (Iowa 1982); and *Jaramillo v. Hood*, 601 P. 2d 66 (N. M. 1979).

<sup>37</sup> 322 N. W. 2d 30 (Iowa 1982).

instrument which violated the rule.<sup>39</sup> In spite of such indications that the discovery rule may be applied more strictly by courts in the future, any such trend in the estate planning setting will simply affect the amount of additional time after the testator's death that the limitations period would continue to be tolled and will have no impact on the tolling of the statute prior to the date of the testator's death.

Other courts have begun to show some hesitancy in allowing disgruntled beneficiaries to bring malpractice actions against attorney-draftsmen when the wills in question do not indicate that a mistake or error has been committed. The Connecticut Supreme Court's decision in *Stowe v. Smith*<sup>40</sup> highlights this concern. There, the beneficiary claimed that the terms of a testamentary trust were not accurately reflected in his deceased mother's will. According to the son, the trust remainder was to be distributed to *him* on his fiftieth birthday, but a review of the will after his mother's death indicated that the corpus would be distributed directly to the son's *issue* when he reached 50. While upholding a cause of action against the attorney-draftsman, the court was careful to point out that "because no invalidity appears on the face of the will, the present case may very well present greater obstacles to recovery than cases in which intended beneficiaries brought actions against attorneys who prepared ineffective wills."<sup>40</sup>

Courts in at least two other jurisdictions have been more emphatic in limiting legal malpractice actions in these circumstances. Intermediate appellate courts in both Florida and Maryland have recently held that disappointed beneficiaries have no cause of action against the attorney-draftsmen when the alleged mistakes were not apparent on the face of the wills.<sup>41</sup> The rationale of these courts is based on the purported need to preserve the sanctity of the statute of wills and the long-standing doctrine that extrinsic evidence should not be admitted where the terms of a will are clear and unambiguous. On the other hand, in upholding the right of a disappointed beneficiary to bring suit against the draftsman of a will, the Illinois Supreme Court expressly rejected this same contention and held that a legal malpractice action was not a collateral attack on the underlying will as such. The Illinois court thus allowed the admission of extrinsic evidence to show that the attorney had negligently drafted the testamentary document, whether or not the error was obvious on the face of the will.<sup>42</sup>

While some jurisdictions may still recognize a few procedural barriers to estate planning malpractice claims, as the recent decisions in Florida and Maryland illustrate, technical defenses based on lack of privity and statutes of limitation have been largely removed. Clearly, prudent estate planning practitioners should not rely on technical rules to shield them, but should adopt good office practices and procedures, as well as maintain substantive competence in the field, in order to minimize the number and seriousness of potential malpractice claims.

#### **IV. Practicing Defensive Law— Guidelines to Reduce the Risk of Estate Planning Malpractice**

As outlined above, malpractice presents a serious threat to the estate planner. But much as the physician has resorted to the practice of defensive medicine, so, too, should legal practitioners take steps to protect their practices and reputations. While the phrase "defensive medicine" conjures up the spectre of unnecessary tests and procedures that are in no way beneficial to good medical treatment, this is not the case with "defensive law." Many of the steps which are recommended below are things that competent estate planners should be doing anyway as a matter of good practice for the benefit of their clients. The fact that such procedures are also effective to minimize the risk of future malpractice claims is simply icing on the cake.

**A. The Importance of Written Communications.**—At times, there may be some confusion as to whether an attorney has entered into an attorney-client relationship with a person who may have casually mentioned an interest in having a will or trust prepared.<sup>43</sup> To clarify the

<sup>39</sup> It is, of course, difficult to reconcile the holding in *Millwright v. Romer*, 322 N. W. 2d at 33, that "every citizen is assumed to know the law" and, therefore, "should have known that the will violated the rule against perpetuities," with the conclusion in *Lucas v. Hamm*, 364 P. 2d 685, 690 (Cal. 1961), that the rule against perpetuities is a technicality-ridden legal nightmare, fraught with confusion, and a trap for the unwary draftsman, so that the violation thereof did not indicate negligence on the part of an attorney who drafted a will which ran afoul of the rule.

<sup>40</sup> 441 A. 2d 81 (Conn. 1981).

<sup>41</sup> *Id.* at 84.

<sup>42</sup> See *DeMaris v. Asti*, 426 So. 2d 1153 (Fla. App. 1983); *Lorraine v. Grover, Ciment, Weinstein*, 467 So. 2d 315 (Fla. App. 1985); and *Kirgan v. Parks*, 478 A. 2d 713 (Md. App. 1984).

<sup>43</sup> *Ogle v. Fuiten*, 466 N. E. 2d 224 (Ill. 1984).

<sup>44</sup> See generally *McGlone v. Lacey*, 288 F. Supp. 662 (D. S. D. 1968); *Herston v. Whitesell*, 348 So. 2d 1054



matter, the attorney should write to the person in question and either confirm that the assignment will be undertaken, or indicate that no such services are to be performed unless the prospective client makes a more specific request. Such an "engagement" (or "nonengagement") letter is, of course, recommended procedure in all areas of practice.<sup>44</sup>

Assuming that estate planning services are to be rendered, the letter should outline the scope of the employment, give an estimate of the amount of time required for each task, and provide some indication of the fee that the attorney will charge for the work. The latter point is particularly important because much client dissatisfaction can be traced to unhappiness with the fee ultimately charged, and that is often the result of poor communication about fees at the outset of the relationship.<sup>45</sup>

At the conclusion of the estate planning assignment, the attorney should also write to the client, advise him or her that the work has been completed, and indicate whether or not the attorney anticipates having a continuing relationship with the client. In the absence of any indication to the contrary, there is a good chance that an attorney will be held to have an ongoing obligation *after* will or trust execution to advise the client of any changes, such as modifications of the tax laws, that might affect the previous estate plan.<sup>46</sup> Even without a commitment to provide such information, a court could well hold that an attorney was liable for any loss attributable to the failure to advise a present or former client of a change in the law, on the ground that the attorney owed such a duty to the testator.<sup>47</sup> If the drafting attorney does not plan to contact the testator about any such changes in the law, the attorney could obtain valuable protection against the possibility of a malpractice claim in the future by writing a letter to the client at the conclusion of the assignment indicating that the attorney does *not* plan to bring subsequent changes in the law to the testator's attention, unless the client specifically requests such additional, continuing services.

In fact, any time an estate planner gives specific advice to a client that is not apparent from the terms of a will or trust that has been prepared, that advice should be confirmed in writing. The facts in *Ward v. Arnold*<sup>48</sup> serve to illustrate the value of a written record whenever advice is given. There, the plaintiff-spouse retained the services of a lawyer to prepare a will for her husband, who was hospitalized. Under

the will, all of the testator's property was to be left to the surviving spouse. However, the husband's will, executed in the hospital, was not witnessed. According to the surviving spouse's allegations, when the attorney was subsequently asked about the need for another will because the first was not witnessed, the attorney advised that a new will was unnecessary since all of the husband's property would pass to the wife anyway under the local intestacy laws. The husband subsequently died without a will, and a portion of his estate passed by intestacy to his brother, to the surviving spouse's dismay. The court held that such allegations stated a cause of action for legal malpractice.

It seems unlikely, of course, that a lawyer who had just prepared a will for a client would turn around and give advice that no such will was really necessary since the intestacy laws would achieve the same result. Nevertheless, if the attorney had documented the actual advice that was given in a letter, such correspondence might have served as a rather effective rebuttal of the surviving spouse's allegations. Without such a letter, it would be simply the attorney's word against the client's (or a beneficiary under the client's will), and lawyers may not fare very well in the eyes of a jury asked to resolve such a factual dispute.<sup>49</sup>

*McAbee v. Edwards*<sup>50</sup> similarly illustrates the value of a written record of advice given to

(Ala. 1977); *Quaglino v. Quaglino*, 152 Cal. Rptr. 47 (1979); *Brandlin v. Belcher*, 134 Cal. Rptr. 1 (1977); *Alexander v. Russo*, 571 P. 2d 350 (Kan. 1977); and *Ronnigen v. Heriogs*, 199 N. W. 2d 420 (Minn. 1972).

<sup>44</sup>Smith, *Preventing Legal Malpractice* 2-5 (West 1981); Stern & Felix-Retzke, *A Practical Guide to Preventing Legal Malpractice* §§ 5.08-5.09 (McGraw-Hill 1983).

<sup>45</sup>Smith, *supra* note 44, at 5-10; Stern & Felix-Retzke, *supra* note 44, at § 5.06.

<sup>46</sup>ABA Formal Opinion 210 (1941) addresses the issue of unethical solicitation when an attorney contacts an estate planning client or former client about the need for review and revision of wills that were previously drafted because of changes in the law, economic changes, or changes within the testator's family. The ABA Committee on Professional Ethics and Grievances not only approved the propriety of such conduct, but indicated that an attorney might have a "duty" to contact testators in such circumstances.

<sup>47</sup>See Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 655-57 (1982).

<sup>48</sup>328 P. 2d 164 (Wash. 1958).

<sup>49</sup>See, e.g., Bridgman, "Legal Malpractice—A Consideration of the Elements of a Strong Plaintiff's Case," 30 *South Carolina Law Review* 213, 216 (1979); Goulden, *The Million Dollar Lawyers* 270 (1978); McCabe, "The Lawyer as Target: Today's Client Is Tomorrow's Plaintiff," 48 *Pennsylvania Bar Association Quarterly* 525, 531 (1977).

<sup>50</sup>340 So. 2d 1167 (Fla. App. 1976).



a client. There, a cause of action was stated on the basis of allegations that the attorney-draftsman advised his client that it was not necessary to redraw a will after the client's marriage to insure that the testatrix's daughter would remain as the sole beneficiary. The testatrix got married, did not revise her will, and died shortly thereafter. Under Florida law the new spouse, having not been specifically excluded under the prior will, was held to be entitled to a portion of his spouse's estate. Assuming that the attorney in question was familiar with the applicable law, then he should have put his advice in writing when he was asked whether a revision of the will was necessary or desirable.

Thus, it is highly advisable to maintain a record, via written communications with the testator, of important events in the relationship, such as the commencement and scope of the services; the completion of the assignment; and any legal advice given to the client which is not obvious from the face of the will or trust. Such a record could refresh a client's recollection (or indicate to a disappointed beneficiary what actually transpired), and could therefore serve as an effective means of persuading a client or interested third party of the futility of a malpractice claim. But even if suit were filed, the written record would serve as invaluable evidence to rebut any contention of erroneous advice allegedly given to the testator.

**B. The Need for Complete Information.—** It is axiomatic that a competent estate planner should obtain and review complete information with regard to a client's family history, the nature and extent of property interests, and other pertinent data such as pre- or post-nuptial agreements, divorce decrees, trusts in which the client has an interest, etc. Yet all too often an attorney will prepare a will or trust for a client without taking the time to collect and review this essential information. A recent case, *Lilyhorn v. Dier*,<sup>51</sup> serves to highlight the sort of problems that may result when an attorney proceeds without complete and accurate data from the client.

In *Lilyhorn*, the plaintiff, a would-be beneficiary, filed suit against the attorney who drafted a will for his deceased mother under which the testatrix purported to leave 240 acres to the plaintiff when, in fact, she owned only a life estate in the property. As a consequence, the plaintiff-son was effectively left out of the will, whereas he contended that he would have shared equally with his two sisters in the property interests that the mother could transmit at death if the attorney

had properly advised the testatrix that her interest in the 240 acres terminated at her death.

The need for the acquisition of complete information from a testator is also illustrated in *Lorraine v. Grover, Ciment, Weinstein*.<sup>52</sup> In that case, the drafting attorney failed to detect that the testator's residence was subject to Florida's homestead law, under the terms of which the property would pass at death to the testator's minor child. Consequently, the will was totally ineffective to devise a life estate in the residence to the testator's spouse. If the attorney had recognized that his client's estate contained property that was subject to the homestead statute, then it apparently would have been possible to achieve the testator's objective of giving his spouse a surviving life interest in the house by an inter vivos transfer.<sup>53</sup>

If an estate planner does not take the time necessary to collect, evaluate and verify data relating to his client's property holdings, it is entirely possible that the client will misdescribe his or her assets, or the extent of the interest therein, and the attorney drafting a testamentary document under such circumstances may well rely on inaccurate information. An unsophisticated client might well mistake a life estate for ownership in fee, think that he or she owns certain property outright when in fact it is owned as a joint tenant with right of survivorship, or fail to describe real property as a residence which would be subject to homestead laws. In any of these cases, the attorney might draw a will that specifically devised or bequeathed such property, when in fact the interest terminated at death, passed by survivorship, or was otherwise not subject to the terms of the testator's will. An instrument containing such an ineffective transfer is certain to upset an intended legatee or devisee, as it did in *Lilyhorn*<sup>54</sup> and *Lorraine*,<sup>55</sup> and disappointments caused by poor planning or draftsmanship can easily result in a malpractice claim.

<sup>51</sup> 335 N. W. 2d 554 (Neb. 1983).

<sup>52</sup> 467 So. 2d 315 (Fla. App. 1985).

<sup>53</sup> Note, however, that the Florida appellate court in *Lorraine* upheld summary judgment against the plaintiff-beneficiary on the grounds that the allegations of negligence relating to the failure of the testator's attorney to suggest an inter vivos transfer to avoid Florida's homestead law did not come within the limited exception to the privity requirement, and that the alleged error failed to appear on the face of the will.

<sup>54</sup> 335 N. W. 2d 554 (Neb. 1983). It should be noted that the Nebraska Supreme Court in *Lilyhorn* upheld application of the privity doctrine in the draftsman-disappointed beneficiary context, and thus affirmed the grant of summary judgment in the attorney's favor.

<sup>55</sup> 467 So. 2d 315 (Fla. App. 1985).

If the drafting attorney obtains and reviews the applicable title or certificate of ownership, the life estate, joint ownership, or homestead interest is likely to be uncovered, and a potentially costly error will be avoided.

Other illustrations could readily be given of similar attorney errors that can be directly traced to the failure to obtain and review information about the client, his or her assets, etc.<sup>66</sup> Thus, not only does good, competent estate planning suggest the need for collection and review of such information, but the practice of defensive law further confirms the desirability of following such procedures. Furthermore, it is highly advisable for estate planners to retain such back-up documentation in their files until well after a client dies. This can, admittedly, mean that such data will have to be retained by the attorney for, many, many years if there is a long period of time from will or trust execution until death, but because courts will toll the statute of limitations under such circumstances,<sup>67</sup> often for a substantial period of time,<sup>68</sup> such documentation could serve to exculpate the attorney from charges of malpractice brought after the testator's death. Even though it may be annoying and costly to retain files containing such data for long periods of time, it takes only one instance of safekeeping that serves to quell a malpractice claim to more than justify the expense of keeping hundreds of such client files.

**C. Adequate Time to Plan an Estate.**—It is quite common for a client to appear on an attorney's doorstep and announce that he or she is going on an extended trip in a week or two and wants to execute a new will before departing. Or perhaps the client wants to execute a will before having to enter a hospital for an operation. It is obvious under such circumstances that a thorough job of estate planning will not be possible. Yet lawyers rarely refuse a client's request for assistance, at least if the testator has a fairly substantial estate or is otherwise a valued client. Most estate planners will go ahead and do the best that is possible under the circumstances, and will rely on an admonition to the client that the document which has been drafted is to be considered "temporary" and that, as soon as the client returns or is released, he or she should make an appointment for full-blown estate planning services. But an interim will is hardly a satisfactory document, and preparation of such an instrument may leave an attorney open to a later claim of malpractice.

Because there is not adequate time to do a thorough job of estate planning, there is a significantly greater likelihood that the document that will be produced before the trip or operation will contain a mistake or error. In spite of an admonition, the client may return from the trip or be released from the hospital with the belief, if the client thinks about it at all, that the "temporary" document can continue to serve as his or her will, at least for the time being. If the testator were to die in the interim, a would-be beneficiary whose legacy is lost or diminished by some drafting error is not likely to be sympathetic to the draftsman because of the exigencies of the situation.

Moreover, an attorney may not be able to protect himself or herself fully by a letter to the client, explaining why the will that has been prepared is only a "temporary" measure, and suggesting that the client call for an appointment as soon as he or she returns from the trip or hospital stay. While such a letter is highly advisable, and may be of assistance in defending against a malpractice claim, a court could determine that a lawyer in such circumstances has a *duty* to take the initiative and follow up to make certain that the interim document is replaced by a more permanent one. Thus, in addition to preparing such a letter, it would be a good idea to pursue the matter with the client when he or she returns from the trip or is released from the hospital. At a minimum, the attorney should establish a written record to evidence efforts to get the testator back to the office to replace the interim will.

There are, of course, exceptions to the above warnings. If a client is elderly or in poor health, time may not permit the preparation of a thorough and deliberate testamentary document.<sup>69</sup> Ob-

<sup>66</sup> For instance, an inartfully drawn will could include a specific bequest of closely held stock when the stock in question was subject to the terms of a buy-sell agreement at the testator's death; or a will could attempt to distribute property interests whose disposition was governed by the terms of a legally binding will contract.

<sup>67</sup> See the discussion of the tolling of the statute of limitations at pages 785-86, *supra*.

<sup>68</sup> See *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983) (will drafted in 1957; testator died in 1972; malpractice action initiated in 1976); *Bucquet v. Livingston*, 129 Cal. Rptr. 514 (1976) (husband and wife trusts prepared in 1961; husband died in 1964 and wife in 1969; suit for malpractice brought in 1970). Cf. *Mumford v. Staton, Whaley & Price*, 255 A. 2d 359 (Md. 1969) (malpractice in title search of real estate).

<sup>69</sup> In *Linck v. Barokas & Martin*, 667 P. 2d 171 (Alaska 1983), for example, an attorney and an accountant were in the process of developing an estate plan for their client when he died. And in *Lorraine v. Grover, Ciment, Weinstein*, 467 So. 2d 315 (Fla. App.

(Continued on following page.)

viously, in such a situation the attorney should do his or her best under the circumstances. Even so, the estate planner would be well advised to make a written, contemporaneous record of the reasons why it was not possible to render the usual, complete estate planning services. If a letter setting forth such facts appears unseemly, then the lawyer should document the pertinent facts in a memorandum to the files.

**D. The Danger of Out-of-State Assets or Clients.**—The prudent estate planner should be alert to another red flag—the client who wants a will but lives out of state, or is about to move out of state. In such a situation, the practitioner might well be advised to refer the matter to a lawyer who practices in the other jurisdiction. It is, of course, important to exercise considerable care in recommending a particular lawyer to the client, as a malpractice claim could be posited on the negligent selection of an out-of-state attorney.<sup>60</sup>

An example will serve to highlight the potential dangers. Assume you are practicing in a Midwestern city and one of your longtime clients is being transferred to a city in the Southwest. Because of the travel involved, your client wants a new will prepared before departure. Federal tax law will obviously be the same in either jurisdiction, but that is not true of state law regarding wills, probate and inheritance taxes. An out-of-state lawyer may not know about the peculiarities of local law such as, for instance, expedited probate administration where a testator's will specifically brings that administrative procedure into play.<sup>61</sup> If a will is prepared before the move which contains no such provision, and the client dies while domiciled in the new state and the same will remains operative, then a malpractice claim for the additional expenses of full-scale probate could be filed against the attorney for preparing a will under these circumstances.

The difficulty is that it is virtually impossible for a lawyer in one jurisdiction to be knowledgeable of important local laws and procedures in a far-distant state. Moreover, the problem is not wholly resolved by an admonition to the client to have a new will prepared once he or she settles into the new home, as a reasonably prudent lawyer might be held to foresee the possibility that the client would not appreciate the need for hiring another attorney, and would thus continue with the original will. On the other hand, a letter spelling out the desirability of having a new will prepared would certainly help protect the attor-

ney from a later malpractice claim, but it would be even better to make arrangements for a referral to a lawyer in the new jurisdiction.<sup>62</sup>

Basically, the same issues are raised when a client domiciled in one state goes to a practitioner in that state to have a will drawn, and the client's assets include real property interests in another jurisdiction, like a condominium in Florida or oil and gas rights in Oklahoma. Under the generally applicable conflicts rule, the law of the situs applies to immovables,<sup>63</sup> and the lawyer in the state of domicile will probably not be knowledgeable about the local laws and procedures in the situs jurisdiction. Again, the prudent practitioner should seek the assistance of an attorney practicing in the situs state, at least where the out-of-state assets are sufficiently valuable that retention of a second attorney's services is warranted. If, however, the real estate interests located in another jurisdiction are not particularly valuable, or the client is not agreeable to employing another lawyer, the attorney in the domiciliary state should be sure to document these facts in a letter to the client, so that there will be a written record for future reference.

**E. Avoiding Delays.**—Once a practitioner undertakes an estate planning assignment, it is important that he or she proceed with reasonable dispatch. Often lawyers who prepare wills or trusts for clients do not specialize in estate planning, and the temptation may be great to put aside an assignment because of the press of

(Footnote 59 continued.)

1985), the testator was in a hospital when he contacted a lawyer to have a will prepared, and the lawyer's secretary took notes of the client's testamentary desires. The testator died of cancer two weeks after will execution.

<sup>60</sup> *Tormo v. Yormark*, 398 F. Supp. 1159 (D. N. J. 1975) (negligent referral to a out-of-state lawyer who subsequently embezzled the client's funds); *Wildermann v. Wachtell*, 267 N. Y. S. 840 (1933) (attorney held to standard of reasonable care in the selection of associate counsel from another state).

<sup>61</sup> See, e. g., Tex. Probate Code § 145.

<sup>62</sup> The same problem can, of course, arise if an attorney admitted to practice in State A prepares a will for a client domiciled in State A and, well after execution of the will, the client moves permanently to State B and dies. In these circumstances, there is no opportunity for referral to an out-of-state lawyer. A prudent estate planner should, however, do more than make certain that a will that is prepared, executed and attested meets the formalities of the statute of wills in the testator's domicile. The draftsman should follow broad procedures to increase the chances of validity of the will in various other states. See discussion in 1 Casner, *Estate Planning* 132-40 (4th ed., Little, Brown 1980).

<sup>63</sup> See Scoles & Rheinstein, "Conflict Avoidance in Succession Planning," 21 *Law & Contemporary Problems* 499, 502-04 (1956).

other business. Every effort should be made to avoid this temptation. At the outset, the attorney should write the client and establish a schedule for work on the matter, including a time for final preparation and execution. If the client fails to meet a deadline, such as the completion of a questionnaire on family history and property ownership, the attorney should send a reminder, which not only will serve as a courtesy but will document the fact that the attorney was not responsible for the delay. However, malpractice exposure could arise if, during a period of unreasonable delay due to attorney procrastination, the client were to die unexpectedly, and the unconsummated estate plan included beneficiaries who are not mentioned in an earlier will or are not heirs-at-law.<sup>64</sup>

The danger here is greater in situations where the client is not elderly or in obvious ill health. In these latter circumstances, the drafting attorney would be likely to realize the need to act expeditiously. Where the client appears to be in good health, the risk of procrastination is the greatest—and a disappointed beneficiary may not understand or appreciate unreasonable delays on the attorney's part.

**F. Effective Use of Forms.**—A competent estate planner should be proficient in the utilization of forms to meet the needs of his or her client. The use of forms has, of course, been made easier and more efficient with the advent of automated office equipment.<sup>65</sup> All of these technical advances benefit both the estate planner and the client if the draftsman does not fall into the trap of making his or her client's needs fit the existing forms, rather than tailoring the standardized clauses to meet the individualized needs of the client. Moreover, an attorney should never insert a clause in a will unless the draftsman fully understands each and every provision, as such a lack of comprehension increases the possibility of a mistake being inadvertently committed.<sup>66</sup>

Because of the need to use provisions that are fully understood, there are advantages to an attorney preparing his or her own set of forms. Here, however, the draftsman should be particularly on guard against the belief that such clauses, which are individually developed by the attorney, will meet the needs of individual clients. Forms, no matter how well drafted, should serve only as guides for the requirements of a particular testator. Of course, certain standardized clauses can and should be inserted in all or virtually all wills and trusts that are prepared. These include a common disaster or survivorship clause, a tax

clause, a rule-against-perpetuities savings clause, and a broad set of executor and trustee powers.

Although survivorship provisions may seem to be rather straightforward and routine, that is not necessarily the case. For example, in *Ogle v. Fuiten*,<sup>67</sup> reciprocal wills were drafted that inadvertently failed to cover the contingency of both spouses dying within a 30-day period, but not as a result of a common disaster. The attorney in that case had prepared wills for a husband and wife which stated that the entire estate should pass to the other spouse if that spouse survived by 30 days. In the very next article, the wills provided that in the event of a common disaster in which both spouses were killed, the estate should be divided equally between two named nephews. After the wills were executed, the husband died of a stroke and his wife died 15 days later from cancer. Since *neither* will provision was applicable, the estate passed intestate to persons other than the two nephews. The nephews filed suit against the drafting attorney for the negligent failure to cover the possible contingency that did in fact occur, when it was obvious that each testator wanted his or her estate to pass to the nephews, and not intestate, if the other spouse did not survive. Accordingly, drafters should be careful not to include conflicting survivorship and common disaster clauses in the same will or, as occurred in *Ogle*, not to leave a gap between two otherwise effective survivorship provisions.

Marital deduction provisions are also exceedingly important, and every attorney who drafts wills or trusts should be thoroughly familiar with the underlying law and terminology to assure that their utilization will result in the maximum

<sup>64</sup> *Victor v. Goldman*, 344 N. Y. S. 2d 672 (1973) (malpractice suit based on attorney's negligent failure to prepare will prior to testator's death). See generally Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 658-59 (1982); and Miller, "Functions and Ethical Problems of the Lawyer in Drafting a Will," 1950 *University of Illinois Law Forum* 415, 438. See also *Linck v. Barokas & Martin*, 667 P. 2d 171 (Alaska 1983), where an attorney and an accountant were working on an estate plan when their client died leaving an earlier will as his last will and testament. However, the details of the death were not disclosed in the opinion, and the malpractice action was not posited on any delay in completing the estate plan.

<sup>65</sup> E. g., Wilkens, *Drafting Wills and Trust Agreements: A Systems Approach* (Warren, Gorham & Lamont 1980).

<sup>66</sup> See, e. g., DeBruyn, "Will Drafting," in *Fundamental Concepts of Estate Planning 1979*, at 71, 73-74 (PLI 1979); Leach, "Planning and Drafting a Will," 27 *Boston University Law Review* 157 (1947); Miller, "Functions and Ethical Problems of the Lawyer in Drafting a Will," 1950 *University of Illinois Law Forum* 415, 438.

<sup>67</sup> 466 N. E. 2d 224 (Ill. 1984).

tax benefits. In fact, the marital deduction may present the single greatest risk in terms of estate planning malpractice.<sup>68</sup> The purpose of utilizing such provisions is obvious—to obtain federal estate tax benefits, usually in the amount of the maximum deduction provided by law. If a marital deduction clause is inserted which, for some reason, does not achieve its objective, then the presence of the mistake or error will be clear for all to see.<sup>69</sup> Furthermore, the marital deduction can be so beneficial from a tax standpoint that virtually all practitioners, and not just those who specialize in estate planning, utilize will provisions to take advantage of this liberal deduction. Thus, it is not surprising that inartfully drawn marital deduction clauses have been the source of a number of legal malpractice claims.<sup>70</sup> And because of the tax savings that can be achieved through proper utilization of the marital deduction, any mistakes or errors that are committed can result in rather substantial liability.

**G. Verification of Beneficiaries' Names.**—An estate planner should make every effort to verify the precise names of all beneficiaries prior to execution of a will or trust. Of course, in the case of individual legatees, the draftsman may have no alternative but to rely on the testator or settlor for verification. Even in this case, however, care should be taken to review the names prior to execution. This would serve to minimize the chances of an ambiguous bequest in the governing instrument, and the cost, after the testator's death, of expensive court proceedings to resolve any vagueness or uncertainty.

Verification is also important with regard to charitable organizations. The problems that can arise from an attorney's failure to check the exact name of a charity are illustrated in the legal malpractice claim brought in *Ventura County Humane Society v. Holloway*,<sup>71</sup> where one-quarter of a \$40 million estate was left to the "SOCIETY FOR THE PREVENTION OF CRUELTY TO ANIMALS (Local or National)." After the testator's death, over 100 charitable organizations filed a claim to the legacy, and it took thirteen days of trial in order to determine a division amongst the various claimants.<sup>72</sup> It seems inexcusable that the draftsman planning this large of an estate would utilize such an inaccurate and patently ambiguous name, since a well-known U. S. Government publication, the *IRS Cumulative List of Organizations*, contains an exhaustive list of all charitable organizations that have received favor-

able rulings for income tax purposes under Section 170(c).<sup>73</sup>

Thus, to avoid expensive will or trust construction proceedings and the malpractice exposure that could result if such proceedings are required, a draftsman should make every reasonable effort to verify the names of all beneficiaries. As indicated above, in the case of charitable bequests, this process is straightforward and should require little time or effort.

**H. The Draftsman Should Not Be a Beneficiary.**—An attorney cannot adequately represent a client's interests when that attorney also has a personal interest in the subject matter of the representation which may be adverse to the client's.<sup>74</sup> Thus, both the Code of Professional Responsibility and the newly adopted Model Rules of Professional Conduct include restrictions against the practice of drafting an instrument such as a will or trust in which the draftsman is named as a

<sup>68</sup> *Bucquet v. Livingston*, 129 Cal. Rptr. 514 (1976); *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984); see also *Mallen & Levit, Legal Malpractice*, Pkt. Supp. 126 (West 2d ed. 1981 & Supp. 1985).

<sup>69</sup> For example, in *Bucquet v. Livingston*, supra note 68, the inter vivos trust that the attorney prepared for the settlor-husband reserved the power to modify, alter, revoke or terminate the trust. The trust instrument further provided that after the settlor's death, his wife had the right to exercise these powers for her life. Upon the husband's death, the right given to the wife became tantamount to a general power of appointment which would inadvertently cause the corpus of the nonmarital share to be taxable to the wife's estate.

<sup>70</sup> See cases cited in note 68, supra.

<sup>71</sup> 115 Cal. Rptr. 464 (1974).

<sup>72</sup> After the will construction proceedings, a malpractice suit was brought against the attorney who had drafted the ambiguously worded charitable bequest. The court found in favor of the draftsman, on the ground that there was no damage flowing from the attorney's use of the ambiguous terminology, because the testamentary intent was carried out as a result of the will construction litigation. *Ventura County Humane Society v. Holloway*, 115 Cal. Rptr. 464 (1974).

<sup>73</sup> Because bequests to the charitable organizations listed in this government publication would also entitle an estate to a charitable deduction under Section 2055 of the Code, the book is used extensively by estate planners to verify charitable names and to make certain that the bequest to a specific charity will qualify for the deduction. See Frimmer, "Charitable Dispositions at Death," in *Advanced Will Drafting 1978*, at 155, 160-61 (PLI 1978).

<sup>74</sup> DR 5-101(A) of the Code of Professional Responsibility provides:

Except with the consent of his client after full disclosure, a lawyer shall not accept employment if exercise of his professional judgment on behalf of his client will be or reasonably may be affected by his own financial, business, property, or personal interests.

Comparable provisions are contained in Rule 1.7 of the newly adopted Model Rules of Professional Conduct.

beneficiary.<sup>78</sup> Yet, somewhat surprisingly, there are numerous court decisions involving precisely this conduct.<sup>79</sup> Some of the cases are will contests that challenge such attorney action as constituting undue influence;<sup>77</sup> other reported decisions involve disciplinary proceedings against attorneys who have drawn wills in which they are named as beneficiaries.<sup>78</sup> Needless to say, a number of courts have been critical of such conduct.<sup>79</sup> In the future, we may well see legal malpractice actions based on similar attorney conduct, brought by a beneficiary whose share would have been larger if the will had not included a devise or bequest for the draftsman.

Estate planners who would not think of drawing a will or trust in which they were to receive a substantial gift or share might include a token bequest at the insistence of a grateful client.<sup>80</sup> Although it may be a little awkward to refuse to prepare an instrument containing such a gift, it is important to remember that what might seem to be a token or modest bequest to both the testator and the draftsman may not be looked upon in the same light by another beneficiary whose portion is reduced by reason of such gift. Accordingly, a draftsman would be well advised not to prepare an instrument for a client that includes such a gift, no matter how small or insignificant it may appear at the time.

**I. Failure to Achieve the Lowest Possible Tax Consequences.**—It is perfectly proper to prepare an estate plan that provides for the distribution of property in a manner that does not result in the lowest possible state and federal transfer taxes. A client is entitled to make an informed decision about the person or entity that he or she wants to receive the estate, and that choice may well be based on factors other than maximum tax reduction. As long as the client has been fully advised of the various alternatives, the attorney should draft the necessary documents to carry out the testator's desires. Thus, for example, a wealthy client may decide to leave all of his or her estate to the surviving spouse to the exclusion of children, rather than combine the marital deduction with the unified credit, with a gift calculated on the amount of the maximum credit passing to the children. Such a disposition would, however, result in a higher tax upon the surviving spouse's death, and would thus reduce the amount which will ultimately pass to the children's generation after the death of both parents.

Any time an estate plan is established, such as the one above, that is not geared to achieving

the lowest possible transfer taxes, there is a risk that a malpractice claim will be filed down the road by a beneficiary whose share would have been larger had taxes been minimized.<sup>81</sup> This is not to say that an attorney should not follow the client's directions, which are, of course, para-

<sup>78</sup> Code of Professional Responsibility EC 5-5:

... If a client voluntarily offers to make a gift to his lawyer, the lawyer may accept the gift, but before doing so, he should urge that his client secure disinterested advice from an independent competent person who is cognizant of all the circumstances. Other than in exceptional circumstances, a lawyer should insist that an instrument in which his client desires to name him beneficially be prepared by another lawyer selected by the client.

Rule 1.8(c) of the Model Rules of Professional Conduct contains more specific restrictions:

A lawyer shall not prepare an instrument giving the lawyer or a person related to the lawyer as parent, child, sibling, or spouse any substantial gift, from a client, including a testamentary gift, except where the client is related to the donee.

<sup>79</sup> See extensive discussion of and citation to cases in which the drafting attorney is named as a beneficiary in Johnston, "An Ethical Analysis of Common Estate Planning Practices," 45 *Ohio State Law Journal* 57, 60-86 (1984); see also Thomason, "How Estate Planners Can Cope with the Increasing Risk of Malpractice Claims," 12 *Estate Planning* 130, 135-36 (May 1985).

<sup>80</sup> See, e.g., *In re Thompson's Estate*, 398 P. 2d 926 (Ariz. 1965); *Allen v. Estate of Dutton*, 394 So. 2d 132 (Fla. App. 1980); *In re Estate of Lawson*, 423 N. Y. S. 2d 106 (1980); *In re Estate of Nelson*, 274 N. W. 2d 584 (S. D. 1978); *In re Estate of Komarr*, 175 N. W. 2d 473 (Wis. 1970). See also *In re Estate of Pedrick*, 482 A. 2d 215 (Pa. 1984), where the Pennsylvania Supreme Court upheld the Register of Wills' action in denying admission of a will to probate because of the attorney's unethical behavior in preparing a will for an elderly, ill client in which all of the testator's modest estate was left to the attorney and the attorney's brother.

<sup>81</sup> E.g., *In re Krotenberg*, 527 P. 2d 510 (Ariz. 1974); *In re Saladino*, 375 N. E. 2d 102 (Ill. 1978); *Committee on Professional Ethics v. Sylvester*, 318 N. W. 2d 212 (Iowa 1982); *Committee on Professional Ethics v. Behnke*, 276 N. W. 2d 838 (Iowa 1979); *In re Disciplinary Action Against Prueter*, 359 N. W. 2d 613 (Minn. 1984); *Disciplinary Board v. Amundson*, 297 N. W. 2d 433 (N. D. 1980); *Columbus Bar Ass'n v. Ramey*, 290 N. E. 2d 831 (Ohio 1972); *In re Conduct of Tonkon*, 642 P. 2d 660 (Ore. 1982) (overruling earlier decision in *In re Jones*, 462 P. 2d 680 (Ore. 1969)); *In re Kneeland*, 377 P. 2d 861 (Ore. 1963); *Office of Disciplinary Counsel v. Walker*, 366 A. 2d 563 (Pa. 1976); *In re Gonyo*, 245 N. W. 2d 893 (Wis. 1976); *State v. Gulbankian*, 196 N. W. 2d 730 (Wis. 1972); *State v. Collentine*, 159 N. W. 2d 50 (Wis. 1968).

<sup>82</sup> See, e.g., *Committee on Professional Ethics v. Sylvester*, 318 N. W. 2d 212 (Iowa 1982); *Estate of Karabatian v. Hnot*, 170 N. W. 2d 166 (Mich. 1969); *Office of Disciplinary Counsel v. Walker*, 366 A. 2d 563 (Pa. 1976); *In re Estate of Pedrick*, 482 A. 2d 215 (Pa. 1984); and *In re Gonyo*, 245 N. W. 2d 893 (Wis. 1976).

<sup>83</sup> See Johnston, "An Ethical Analysis of Common Estate Planning Practices," 45 *Ohio State Law Journal* 57, 73-75 (1984).

<sup>84</sup> *Buquet v. Livingston*, 129 Cal. Rptr. 514 (1976) (loss of marital deduction); *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984) (marital deduction); *Horne v. Peckham*, 158 Cal. Rptr. 714 (1979) (Clifford trust).

mount. At the same time, having in mind the fact that a malpractice action can be maintained by a disappointed beneficiary after the client's death, an attorney who drafts and implements such a plan should be very careful to develop a written record establishing the fact that the client had been fully advised that the plan adopted would not achieve tax minimization and that the client still decided on an alternative course of action.<sup>82</sup> The logical time to create such a record is by letter to the client prior to will or trust execution, detailing the various choices and indicating the adverse tax consequences that will result if the client continues to pursue some other distributive plan.

**J. De Novo Internal Review.**—It is good office procedure to have a lawyer other than the draftsman provide a second review of the will or trust prior to execution. Of course, this involves an additional expense in terms of attorney time, but it should be worth the effort in the long run. It takes only one or two instances where such a second review uncovers a potential problem prior to execution, thus preventing the possibility of a later malpractice claim, to justify the additional cost. By way of illustration, suppose that in the process of going from a draft to the final copy, an important will clause was inadvertently omitted from the will.<sup>83</sup> While the drafting attorney should always read over the will or trust prior to execution, use of another lawyer experienced in estate planning to review the document serves as a valuable double check. This is a good example of the practice of defensive law.

If anything, the risks of accidental omission of a provision appear to be even greater in these days of word processors than before the advent of such automation. Careful proofreading is fast becoming a lost art, and yet it is possible for a mistake to occur while using such equipment. No matter how advanced office machines become, information has to be fed into the processor, and thus the chance for human error still exists. Accordingly, while automated equipment may reduce the time required for thorough sentence-by-sentence proofing, it clearly does not remove the need for careful examination prior to execution. If time does not permit such additional attorney review prior to execution, or if no one is available at that moment, then it is advisable to have the internal review performed as soon after execution as possible. Any mistake or error caught by that procedure can generally be corrected by the execution of another instrument. While the

client may not welcome the inconvenience of another execution ceremony, he or she is certain to appreciate the draftsman's precautionary measures.<sup>84</sup>

**K. Carrying Out the Testator's Testamentary Intentions.**—It goes without saying that an estate planner should carry out a client's testamentary intentions. Yet the fact remains that an ever increasing number of malpractice suits are based on the alleged failure of an attorney to achieve this overriding objective.<sup>85</sup> Even though such claims may be difficult to prove when the matter proceeds to trial,<sup>86</sup> if a beneficiary strongly believes that the testator intended to include a bequest to him or her, and would have but for the attorney's error, that frustrated, would-be beneficiary may be able to state a cause of action which will withstand pre-trial attack.<sup>87</sup> Thus, at

<sup>82</sup> Two recent cases illustrate the fact that failure to achieve tax minimization can also be a substantial motivating factor in the initiation of a legal malpractice claim, even in a post-mortem estate planning setting. See *Linck v. Barokas & Martin*, 667 P. 2d 171 (Alaska 1983) (attorney and accountant failed to advise widow to disclaim her interest under the will and thus avoid gift taxes attributable to the transfer of the inherited property to her children); *Kramer v. Belk*, 482 N. Y. S. 2d 898 (App. Div. 1984) (action for malpractice against attorney for failure to renounce trust created in deceased wife's will in order to help alleviate adverse tax consequences in husband's estate).

<sup>83</sup> See, e. g., *Connecticut Junior Republic v. Sharon Hospital*, 448 A. 2d 190 (Conn. 1982) (inadvertent substitution of wrong charities while drafting will); *Needham v. Hamilton*, 459 A. 2d 1060 (Dist. of Col. 1983) (failure of final version of will to include residuary clause); *In re Calabi's Estate*, 196 N. Y. S. 2d 443 (1959); and *In re Dorson's Estate*, 196 N. Y. S. 2d 344 (1959).

<sup>84</sup> In *Auric v. Continental Casualty Company*, 331 N. W. 2d 325 (Wis. 1983), an attorney prepared a will and a revocable trust for his client. The client came to the attorney's office to execute the documents and, while the attorney and his secretary both signed the trust as witnesses, due to either "confusion" or a "mistake of the moment," only the attorney signed as a witness to the will. 331 N. W. 2d at 327. This mistake, which the attorney conceded was the result of negligence, was not discovered until after the testator's death, and the will was denied admission to probate. A post-execution internal review, at least for purposes of verifying due execution and attestation, would have detected the error at a time when it could have been easily remedied.

<sup>85</sup> E. g., *Hicmstra v. Huston*, 91 Cal. Rptr. 269 (1970); *Stowe v. Smith*, 441 A. 2d 81 (Conn. 1981); *Ogle v. Fuiten*, 466 N. E. 2d 224 (Ill. 1984); *Lilyhorn v. Dier*, 335 N. W. 2d 554 (Neb. 1983); *St. Mary's Church of Schuyler v. Tomek*, 325 N. W. 2d 164 (Neb. 1982).

<sup>86</sup> *Stowe v. Smith*, supra note 85, at 84 ("Because no invalidity appears on the face of the will, the present case may very well present greater obstacles to recovery than cases in which intended beneficiaries brought actions against attorneys who prepared ineffective wills"); *Hicmstra v. Huston*, supra note 85, at 272.

<sup>87</sup> *Hicmstra v. Huston*, 91 Cal. Rptr. 269 (1970); *Stowe v. Smith*, 441 A. 2d 81 (Conn. 1981); *Ogle v. Fuiten*, 466 N. E. 2d 224 (Ill. 1984). But see *DeMaris v. Asti*, 426 So. 2d 1153 (Fla. App. 1983); *Lorraine v. Grover, Cement, Weinstein*, 467 So. 2d 315 (Fla. App. 1985), and *Kirgan*



a minimum, an attorney will have to go to the time, expense and embarrassment of defending against a malpractice claim. The cautious alternative is to take a few extra steps to provide additional certainty that the final draft of the will or trust reflects the client's intent, and then document that fact in a letter.

In addition to an internal review by a second lawyer described above, the draftsman should be certain that the testator carefully reads over the entire will immediately before execution.<sup>88</sup> If a provision has been inadvertently left out, or if a devise or bequest is not in the right amount, the testator, hopefully, will spot the omission. It is important to resist the temptation of foregoing a final review immediately before execution on the ground that photocopying and word processing make such an action unnecessary. Mistakes in transposition can and do occur.

Any time that a testator wishes to dispose of his or her estate in a manner that is substantially different than intestate distribution, that should serve as a red flag to the estate planner. Implementation of the testator's plan may result in a disappointed legatee who is a natural object of the testator's bounty. And, as has been noted, the existence of such a would-be beneficiary is often the cornerstone upon which a malpractice claim is mounted. The attorney should, of course, develop and implement a plan that will carry out the testator's wishes, but under such circumstances the attorney should be sure to document the fact that the plan, as evidenced in the will or trust, is an accurate reflection of the testator's desires. Such a written record could prove invaluable if questions are raised after the testator's death about his or her true intentions.

**L. Formal Procedures for Execution and Attestation.**—Many of the estate planning malpractice cases that have been reported to date involve the failure to have a will witnessed,<sup>89</sup> or the utilization of a beneficiary as one of the witnesses, causing that person to forfeit the legacy.<sup>90</sup> In either instance, negligence is rather obvious, and that fact is undoubtedly the main reason why so many suits are brought in these circumstances. Furthermore, a number of these cases involve laymen, rather than lawyers, who have drafted the wills and attempted to supervise their execution.<sup>91</sup> Yet this does not explain all of the decisions, as some of the cases involve lawyers who failed to see that the instruments they drafted were properly attested.<sup>92</sup>

There are several lessons inherent in these cases. First, a lawyer who is experienced in the field should handle the planning, draft the implementing documents, and personally supervise their execution. If this is not possible, then another attorney in the office should preside over execution and attestation. Although an attorney experienced in estate planning would be thoroughly familiar with the procedures for signing and witnessing of wills, others in the office may not have this degree of familiarity. Thus, it is suggested that a written set of procedures for the execution of wills and trusts be adopted for required use throughout an office, so that even the least

*v. Parks*, 478 A. 2d 713 (Md. App. 1984), all of which held that there is no cause of action for malpractice unless there is an indication on the face of the will that the testator's intent has been frustrated.

<sup>88</sup>A number of reported cases indicate the types of omissions or errors that might have been caught if a second lawyer had reviewed the documents prior to execution. *Levin v. Berley*, 728 F. 2d 551 (CA-1 1984) (problem with marital deduction); *Horne v. Peckham*, 158 Cal. Rptr. 714 (1979) (defective establishment of Clifford trust); *Buquet v. Livingston*, 129 Cal. Rptr. 514 (1976) (poor draftsmanship causing loss of marital deduction); *Lucas v. Hamm*, 364 P. 2d 685 (Cal. 1961) (terms of testamentary trust violated rule against perpetuities); *Connecticut Junior Republic v. Sharon Hospital*, 448 A. 2d 190 (Conn. 1982) (inadvertent insertion of wrong charitable beneficiaries); *Stowe v. Smith*, 441 A. 2d 81 (Conn. 1981) (alleged error in manner of distribution when income beneficiary reaches 50 years of age); *Needham v. Hamilton*, 459 A. 2d 1060 (Dist. of Col. 1983) (omission of residuary clause in final draft of will); *Ogle v. Fuiten*, 466 N. E. 2d 224 (Ill. 1984) (failure of wills to cover contingency which occurred); *Milwright v. Romer*, 322 N. W. 2d 30 (Iowa 1982) (provisions of will violated rule against perpetuities).

<sup>89</sup>See *Biakanja v. Irving*, 320 P. 2d 16 (Cal. 1958); *Mickel v. Murphy*, 305 P. 2d 993 (Cal. 1957); *Licata v. Spector*, 225 A. 2d 28 (Conn. 1966); *Auric v. Continental Cas. Co.*, 331 N. W. 2d 325 (Wis. 1983). Cf. *Price v. Holmes*, 422 P. 2d 976 (Kan. 1967); *Succession of Killingsworth*, 270 So. 2d 196 (La. App. 1972); and *Weintz v. Kramer*, 10 So. 416 (La. 1892).

<sup>90</sup>*Buckley v. Gray*, 42 Pac. 900 (Cal. 1895); *Woodfork v. Sanders*, 248 So. 2d 419 (La. 1971); *Goldberg v. Bosworth*, 215 N. Y. S. 2d 849 (1961); *Guy v. Liederbach*, 459 A. 2d 744 (Pa. 1983); *Schirmer v. Nethercutt*, 288 P. 265 (Wash. 1930).

<sup>91</sup>E.g., *Biakanja v. Irving*, 320 P. 2d 16 (Cal. 1958) (notary public); and *Price v. Holmes*, 422 P. 2d 976 (Kan. 1967) (will prepared by bank not attested by witness in testator's presence).

<sup>92</sup>The recent case of *Auric v. Continental Cas. Co.*, 331 N. W. 2d 325 (Wis. 1983) provides an excellent example of the types of problems that still arise. There, the attorney had the testator come to his office to execute a revocable living trust and a will. The attorney explained the provisions of the trust to the testator, who signed it, and then both the attorney and his secretary signed as witnesses. The attorney then went over the will and had the testator sign it, too. The attorney then signed as a witness, but because of "confusion" or a "mistake of the moment," the secretary failed to sign as a witness to the will, which was found to be invalid upon the testator's death a few years later. 331 N. W. 2d at 327.



experienced associate will be able to perform the ceremonies effectively and efficiently.

Also with regard to the execution and attestation of wills, it is strongly recommended that the testator come to the draftsman's office, or, if that is not possible, then the lawyer should be sure to supervise the execution ceremonies in the testator's home, in his or her hospital room, or wherever else the will may be signed. Conversely, a will should *never* be sent to a client for execution without professional supervision, no matter how detailed and explicit the instructions may be which accompany the unexecuted document. The fact is that clients, no matter how well versed in other matters, are simply not going to appreciate the importance of the formalities that are required, and may, therefore, intentionally or inadvertently, fail to follow all the steps. It is entirely possible that a would-be beneficiary who has lost a legacy because of faulty execution or attestation under such circumstances, where the drafting attorney failed to supervise the ceremonies, could state a cause of action in malpractice on the ground that the attorney in question breached a duty to supervise personally the signing and witnessing of the will in order to avoid any mistakes or errors.<sup>93</sup>

Thus, it is highly advisable to prepare a mandatory set of execution procedures for use throughout an office, and to be certain that the draftsman or some other attorney in the office supervises the ceremonies, rather than leave it to the testator to follow the required formalities.

**M. Maintenance of Complete Office Files.—**As indicated earlier, because of the tolling of the statute of limitations, an action for legal malpractice can be successfully maintained *years after* the will or trust was executed and the mistake or error occurred.<sup>94</sup> For this reason, it is imperative that an attorney maintain complete and accurate files of estate planning matters over an extended period of time. If a malpractice claim later arises, one key document could be worth its weight in gold in terms of exculpating the drafting attorney.

It is suggested that the following files, at a minimum, be maintained:

(1) A client file which would include the completed asset and family history questionnaire; all correspondence to and from the client; any memoranda about the estate plan; all drafts of wills or trusts; and a conformed copy of any documents that were executed.

(2) A separate master wills and trusts file, containing in one single location conformed copies of all such documents executed by firm clients. One set should be maintained alphabetically by clients' last names, another set kept in chronological order by date of execution. This will serve as a valuable backup to the complete files for each client.

(3) A file containing abbreviated descriptions of each client's will or trust that provides pertinent data on such things as whether the document contained a QTIP trust, a charitable unitrust, etc. Such data would be available (on index cards, stored in a computer, etc.) for the attorney to review as necessary, when, for instance, there has been a change in the tax laws.

**N. Good Client Relations.—**Articles dealing with the prevention of legal malpractice in general properly emphasize the importance of maintaining good client relations.<sup>95</sup> Many malpractice claims can be traced, at least in part, to the fact that the attorney did not communicate effectively with the client. While good client relations are also important in estate planning, they may not be as effective in avoiding malpractice claims. As has been noted, estate planning malpractice is somewhat unique, in that it is usually a would-be beneficiary, rather than the original client, who brings the claim.<sup>96</sup> Thus, in addition to developing a good rapport with the immediate client, an estate planner should, whenever possible, cultivate and maintain similar good relations with the client's family.

One way of maintaining a good relationship with the client and his family is to undertake a periodic review of the estate plan, say every three years, to see whether it needs updating. It is also appropriate to notify the client that a certain period of time has passed since will or trust execution, and suggest that the client may want to review the plan to see whether it still meets his or her needs.<sup>97</sup> In the event of any changes in the

<sup>93</sup> See Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 651-52 (1982).

<sup>94</sup> See pages 785-86, *supra*.

<sup>95</sup> Stern & Felix-Retzke, *A Practical Guide to Preventing Legal Malpractice* §§ 2.07, 5.01-5.15 (McGraw-Hill 1983); Smith, *Preventing Legal Malpractice* 18-21 (West 1931).

<sup>96</sup> See the discussion of the "Demise of the Privity Barrier" at pages 783-85, *supra*.

<sup>97</sup> See, e. g., Informal Opinion 159, 57 *Michigan State Bar Journal* 316 (Special Issue, Feb. 1978), reported in *Maru, 1980 Supplement to the Digest of Bar Association Ethics Opinions* No. 11572 (ABF 1982) (hereinafter cited as *Maru*, 1980 Supp.); Opinion in 188, 44 *New York State*

law that might affect a previously drawn will or trust; a client will appreciate receiving notice of that possibility from the drafting attorney. In fact, an attorney may even have a *duty* to contact the client or former client in such circumstances.<sup>98</sup> The draftsman could be found liable if he or she fails to so notify the client and it is later shown that the failure to modify the will or trust to accommodate the new law resulted in a loss to the estate (or to a beneficiary of the estate).<sup>99</sup>

**O. The Elderly or Disabled Client.**—The practice of defensive law can be put to very effective use when an attorney performs estate planning services for an elderly or disabled client. The mere presence of such a client, particularly if he or she has a substantial estate, should serve as a red flag, because of the increased possibility that a will or trust will be subject to attack after the client's death, on the grounds of lack of capacity, undue influence, etc. A prudent lawyer in such circumstances should anticipate such a challenge and begin to build an evidentiary record for later use. It goes without saying, of course, that the attorney should first be satisfied that the client has the necessary testamentary capacity and is not operating under any undue influence before proceeding with the drafting and execution of a will or trust.<sup>100</sup> In the event that there are any substantial questions in the planner's mind, he or she should not continue with the assignment.

The problems presented when representing an aged or disabled client are exacerbated if that client wants to leave his or her estate in a manner significantly different than that provided by intestate distribution. This could occur if, for instance, the testator wanted to exclude a child from the estate or was planning to include all of the children but did not want to treat them equally. Here, again, a red flag has been waved, and the attorney should take appropriate extra measures to guard against an attack on the instrument after the client's death.

Once the attorney anticipates the possibility of a will contest, and is satisfied that there is no valid basis for such a challenge, then there are certain steps that the planner may want to take. For example, it might be a good idea to make a videotape of the execution ceremonies, assuming, of course, that the testator is agreeable, as such visual evidence could provide valuable proof of the testator's condition at the time of will or trust execution. Or, with permission, the lawyer might want to talk to the client's physician, and, where appropriate, have

the doctor serve as one of the witnesses, or provide a statement about the testator's condition as close as possible to the date that the document was executed.

Inclusion of an attestation clause, while not required in any state, is always a good practice. In this connection, it might be a good idea to include a phrase as part of the attestation clause to the effect that the testator was, at the time of execution, of "sound mind and memory and not operating under any undue influence." Such a provision can provide valuable rebuttal evidence if a witness, after the testator's death, begins to have reservations about the testator's competency at the time the will was executed.<sup>101</sup>

**P. Avoidance of Intra-family Conflicts of Interest.**—Estate planning for more than one member of a family is fraught with potential and actual conflicts of interests, and it behooves the attorney in these circumstances to be sensitive to this problem and avoid dual representation when there is any indication of a lack of a meeting of the minds among the various individuals.<sup>102</sup> In situations where an attorney is

*Bar Journal* 56 (1972), reported in *Maru*, 1975 *Supp.* No. 8948; Opinion CPR-52, 22 *North Carolina Bar* No. 35 at 24 (1975), reported in *Maru*, 1980 *Supp.*, No. 12303; 10 *Tulsa Lawyer* 6 (Sept. 1970), reported in *Maru*, 1975 *Supp.* No. 9753.

<sup>98</sup> See ABA Comm. on Professional Ethics and Grievances, Formal Op. 210 (1941); N. Y. St. B. A. Committee on Professional Ethics, Op. 189 (1971), 44 *New York State Bar Journal* 56 (1972); N. C. St. B. Ethics Comm., Op. 813 (1972), 19 *North Carolina Bar* No. 4, at 9 (1972); Okla. St. B. Executive Council, Op. 209 (1961), 32 *Oklahoma Bar Journal* 1570 (1961).

<sup>99</sup> See Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 654-58 (1982).

<sup>100</sup> See, e.g., Opinion 354, N. Y. Co. L. A. 747 (1940), reported in *Maru*, *The Digest of Bar Association Ethics Opinions* No. 1971 (ABF 1970) (hereinafter cited as *Maru*); Opinion 517, N. Y. City 285 (Dec. 6, 1939), reported in *Maru*, No. 2673.

<sup>101</sup> See, e.g., *In re Velie's Estate*, 183 N. E. 2d 515 (Ill. 1962); *Munster v. Marcrum*, 393 N. E. 2d 256 (Ind. App. 1979).

<sup>102</sup> See *Haynes v. First Nat'l State Bk. of N. J.*, 432 A. 2d 890 (N. J. 1981); *Committee on Professional Ethics v. Christian*, 191 F. Supp. 87 (D. C. V. I. 1961). See also Wolfman & Holden, *Ethical Problems in Federal Tax Practice* 98-99 (1931); Thomason, "How Estate Planners Can Cope with the Increasing Risk of Malpractice Claims," 12 *Estate Planning* 130, 133-35 (May 1985); Brosterhous, "Conflicts of Interest in Estate Planning and Administration," 123 *Trusts & Estates* 18 (June 1984); Moore, "Conflicting Interest in Estate Planning and Administration after ERTA; Recognition and Resolution," 17 *Miami Institute on Estate Planning* ¶6.1-34 (1983); Flaherty, "Conflicts of Interest Arising in the Two-Spouse Estate Planning Context," *Estate, Gift & Trust Journal*, May-June 1982, at 17; and Midonick, "Attorney-Client Conflicts and Confidences in Trusts and Estates," 35 *Rec. A. B. City N. Y.* 215 (1980).

planning the estates of more than one family member, such as husband and wife or parent and child, and potential conflicts of interest cannot be resolved, one of the family members should retain the services of another lawyer to provide independent counsel.

If the initial attorney decides to represent both members of a family, as will often be the case, then it is important that each person be counseled individually. For instance, a lawyer should not prepare a will for a client's wife when all information regarding her desires is obtained from her husband. Care should be taken to meet with each person separately to insure that the testamentary intentions to be memorialized in a will are in fact those of the particular individual.

Areas of conflict of interest are numerous. For example, a husband may want to leave his estate in the form of a QTIP trust, but his wife cannot reconcile herself to such a disposition. In such circumstances the attorney would be well advised to represent only one of the parties. Furthermore, the forum for claims of conflicts of interest has largely shifted from disciplinary proceedings to litigation between private parties,<sup>103</sup> and it is entirely possible that a family member who had been a client could claim that the attorney had committed malpractice by attempting to represent diverse interests within the family, one of whom is now dead and has disposed of his or her estate in a manner which the surviving member does not find acceptable.<sup>104</sup> The transmission of a letter from the attorney to the appropriate family members explaining the potential problem areas and the attorney's understanding that the clients consent to joint representation could go a long way toward precluding a subsequent malpractice claim based on an alleged conflict of interest.

**Q. Conflicts Among Members of the "Estate Planning Team."**—While an attorney can and often does cooperate effectively with a testator's accountant, life insurance agent, or banker to develop an estate plan, the attorney should always be alert to the possibility of a conflict of interest in working with these other professionals. It is essential to remember that the testator is entitled to the independent advice and loyalty of his or her lawyer.<sup>105</sup> Thus, a practitioner should be careful that a continuing relationship with a bank or life insurance agent does not affect the attorney's judgment to the detriment of the client. For instance, if the

purchase of additional life insurance is part of an estate plan, there should be a clear, compelling need for such insurance. Its purchase should not in any respect serve as "compensation" to the agent for bringing new business to the attorney. Similarly, a lawyer should not urge a testator to utilize the fiduciary services of a bank merely because a particular financial institution has sent some of its customers to the lawyer in the past.<sup>106</sup> Moreover, a draftsman should not suggest inclusion of a bank, rather than an individual, as executor as a way of securing future business, due to the bank's long-standing practice of employing the drafting attorney to assist in probate.<sup>107</sup> Such "quid pro quo" dealings may have a place in the business world, but an attorney owes all of his or her allegiance to the client and should not be feathering his or her own nest at the client's expense.

A lawyer should always deal directly with the client, and not through an accountant, bank or life insurance agent. If an attorney takes directions from one of the other estate planning professionals as to what the testator needs or desires, then the attorney may find himself or herself serving principally as a scribe with little active involvement other than the drafting of documents.<sup>108</sup> An attorney owes it to the client to carry out the client's testamentary intentions, and this can best be accomplished by maintain-

<sup>103</sup> See generally "Disqualification of Counsel—Conflict of Interest Issues," 30 *Defense Law Journal* 149 (1981); "Developments in the Law: Conflicts of Interest in the Legal Professional," 94 *Harvard Law Review* 1244 (1981).

<sup>104</sup> See discussion under "Conflict of Interest" in Thomson, "How Estate Planners Can Cope with the Increasing Risk of Malpractice Claims," 12 *Estate Planning* 130, 133-35 (May 1985).

<sup>105</sup> Code of Professional Responsibility, DR 5-101(A) & DR 5-107(A) & (B); Model Code of Professional Conduct, Rules 1.7 & 5.4(c).

<sup>106</sup> See ethical provisions cited in note 105, supra; see generally Zissman, "Potential Liability of Corporate Fiduciaries for Estate Planning Errors," 124 *Trusts & Estates* 28 (June 1985).

<sup>107</sup> See discussion in Johnston, "An Ethical Analysis of Common Estate Planning Practices," 45 *Ohio State Law Journal* 57, 115-24 (1984).

<sup>108</sup> The dangers inherent in the lawyer's acceptance of such a limited role are illustrated in *Connecticut Junior Republic v. Sharon Hospital*, 448 A. 2d 190 (Conn. 1982). There, a trust officer took instructions for a codicil from the testator, and, in turn, the bank official passed those instructions on to the attorney-draftsman. The attorney prepared the codicil, but mistakenly reinstated seven charities as beneficiaries that had previously been deleted from the testamentary plan. The attorney turned the draft will over to the trust officer, who took it, alone, to the testator for execution. The testator executed the will without any detection of the mistake, which was uncovered for the first time when the testator died several years later.

ing direct and separate contact with the client.<sup>109</sup> The more distance that there is between the attorney and the client, and the more information from the client that is passed through one of the other planners, the greater the chance that the documents that are drafted will not reflect the testator's true intentions or serve to meet his or her needs.

**R. Proper Use of Paralegals.**—Legal assistants have long been used effectively in estate planning, and this practice is likely to continue. Much of the work—such as collecting and evaluating data regarding family history and property ownership, and assisting in the preparation of drafts of documents—can and should be performed by paralegals, *provided that* their work is directly and continuously supervised by the attorney responsible for the assignment.

In part because of the low fees generated by estate planning business,<sup>110</sup> there is a greater and greater tendency to overuse paralegals, and permit them, without adequate supervision, to do virtually all the work from initial client interview, through preparation of documents into final form, to supervision of the execution ceremonies. While an attorney may want to have a legal assistant present at the first meeting, and at execution and attestation, the attorney should be in charge of and responsible for these occasions.

No matter how intelligent or experienced, a paralegal does not have a law degree, and should not be permitted to function as a lawyer or to perform the more substantive tasks that lawyers typically undertake. Not only will such use of a legal assistant raise questions of unauthorized practice of law, but the lack of legal training may also result in the commission of errors that would have been avoided if a lawyer had performed the work or had provided the needed supervision. Moreover, overutilization of paralegals can leave a bad impression on clients, who like to think that their business is important enough to warrant a lawyer's time and attention.

Thus, legal assistants, if properly utilized and supervised, can perform invaluable services at the lowest possible cost. But cost consciousness can be a little dangerous. The desire to keep the time allocated to a matter in line with the amount that the client is going to be charged can put an undue premium on the use of a legal assistant in lieu of an attorney. This practice may result in bad client relations, and increase an estate planner's malpractice exposure.

**S. Higher Fees for Estate Planning Work.**—Many of the corners that attorneys cut in the provision of estate planning services are attributable, directly or indirectly, to the low fees that are charged for such work.<sup>111</sup> Conversely, if charges were based on hourly rates, much as other legal work is billed, then the higher fees would not only increase profitability, but would, in the long run, justify the expenditure of greater time and effort in performing the legal services. This, in turn, would serve to reduce the number of mistakes and errors, and thus lower the overall malpractice risk.

Perhaps a testator should have the alternative of paying for a low-priced will and running a greater risk of attorney error, just as a consumer can choose between a Chevette and a Cadillac. But there is no indication that this theory has even been recognized by the courts. Although there are now enumerable estate planning malpractice cases on the books, not one discusses the attorney's fee as a factor in determining the extent of the draftsman's liability, or even hints that such a consideration has any bearing on the malpractice issue. Thus, the lawyer who charges \$50 for preparing a will has exactly the same malpractice exposure as a practitioner who would bill \$1,000 for planning the same client's estate.

Moreover, if fees are discussed at the outset, and the lawyer carefully explains what is involved in providing estate planning services and why the work is not done on a cut-rate basis, there is no reason to believe that the client will balk at this approach. The preparation of a will or similar document is very important from a client's viewpoint, and that person is not likely to make cost comparisons if lower charges are seen as reflecting a reduction in the quality of services. Thus, with a little salesmanship, attorneys should be able to charge more for estate planning, and the increased profitability of such work should provide incentive for the expenditure of greater time and effort during the assignment.

<sup>109</sup> If an attorney receives instructions about will preparation from someone other than the testator, he or she may be an unwitting participant in conduct constituting undue influence. See, e.g., *In re Estate of Carpenter*, 253 So. 2d 697 (Fla. 1971); *Bowe & Parker, Page on Wills* §§ 29.84, 29.95 (1961).

<sup>110</sup> See the discussion under "S. Higher Fees for Estate Planning Work," *infra*.

<sup>111</sup> See Kram, "Estate Planning: The Public's Perceptions and Attitudes" 8 *Real Property Probate & Trust Journal* 489, 493 (1973); Miller, "Functions and Ethical Problems of the Lawyer in Drafting a Will," 1950 *University of Illinois Law Forum* 415, 441.

**T. Competency in Estate Planning.**—A lawyer should become competent as an estate planner if he or she plans to work in the area. In addition to the acquisition of such competence, an attorney should strive to maintain a high level of expertise in what has now become a rather fast-changing field, what with all the revisions in the federal gift and estate tax law in the last eight or nine years. To keep abreast of such changes, an estate planning attorney should subscribe to leading periodicals in the field, regularly attend CLE seminars, and become active in local estate planning councils. Ignorance of changes in the law and the failure to utilize new planning techniques implementing such changes may well result in malpractice liability.<sup>113</sup>

An attorney should not undertake an estate planning project unless that attorney, or some other lawyer in the firm, is competent to handle all aspects of the assignment, including the tax considerations.<sup>113</sup> If no one in the office has the necessary expertise, the matter should be referred to an outside attorney who is competent in the field.<sup>114</sup> In certain instances, it may be appropriate to associate a lawyer with the necessary expertise, rather than refer the entire matter.<sup>115</sup>

The case of *Horne v. Peckham*<sup>116</sup> serves to illustrate the dangers in accepting an assignment that may take an attorney into areas of the law in which he or she has little competency. In *Horne*, the clients, a husband and wife, approached a lawyer in general practice who had been representing them in other legal matters, and asked him to set up a Clifford trust for the benefit of their son. While professing his ignorance of tax law, the general practitioner agreed to take on the assignment and prepared a trust, which his clients executed. Several years later, the IRS challenged the effectiveness of the trust to shift taxable income from the grantors to the beneficiary-son, and a large deficiency was assessed against the parents.<sup>117</sup> They paid the deficiency and then bought a malpractice suit against the lawyer who had set up the trust. The court upheld the plaintiffs' malpractice claim, and in the process approved a jury instruction that had been borrowed from medical malpractice, which provided that a general practitioner owes a duty to refer a matter to a lawyer who specializes in the area if a reasonable practitioner similarly situated would have referred the matter.<sup>118</sup> On this basis, the

court ruled that a lawyer who is not competent in an area can be liable for malpractice for failing to refer a matter to another attorney with the necessary expertise.

Moreover, an attorney who is not a specialist in estate planning should avoid holding himself or herself out as being an expert in this field. Only a handful of states recognize certification or designation of specialties, so an explicit holding out of expertise is not likely in the great majority of jurisdictions. However, an attorney can make such an implicit representation by advertising that his or her law practice includes estate planning or the preparation of wills or trusts, or that the attorney limits his or her practice to certain specified areas, including estate planning.<sup>119</sup> While this may technically not be a statement of "specialization" in these areas, from a layman's point of view an advertisement that an attorney offers these services may implicitly involve some holding out of expertise, or at least experience in the fields indicated. There is a danger here, because a lawyer who holds himself or herself out as being experienced in estate planning is likely to be held to a higher standard of care in connection with the performance of such services. Thus, a general practitioner who indicates an ability to perform work in this field may be held for malpractice purposes to the standard of those who specialize in estate planning, rather than to the level of a generalist who from time to time undertakes estate planning assignments.<sup>120</sup>

<sup>113</sup> See Johnston, "Legal Malpractice in Estate Planning," 67 *Iowa Law Review* 629, 655-53 (1982).

<sup>114</sup> DR 6-101(A)(1) of the Code of Professional Responsibility provides that a lawyer shall not handle a legal matter that he is not competent to handle unless he associates another lawyer who is competent in the particular field. See also Rule 1.1, Model Rules of Professional Conduct.

<sup>115</sup> See *Horne v. Peckham*, 158 Cal. Rptr. 714 (1979).

<sup>116</sup> See DR 6-101(A)(1), discussed in note 113, supra; see also EC 6-3, Code of Professional Responsibility.

<sup>117</sup> 158 Cal. Rptr. 714 (1979).

<sup>118</sup> The settlors owned a valuable patent and originally planned to transfer it to the Clifford trust. At the last minute they changed their minds and, instead, assigned a nonexclusive patent license to the trust. The IRS assessed a deficiency on the grounds that a nonexclusive license was ineffective to transfer the income tax liability from the settlors to the trust beneficiaries.

<sup>119</sup> 158 Cal. Rptr. at 720.

<sup>120</sup> DR 2-101(B)(2) of the Code of Professional Responsibility permits attorneys to advertise "[o]ne or more fields of law in which the lawyer or law firm practices, a statement that practice is limited to one or more fields of law. . . ." See also the U. S. Supreme Court's decision in *In the Matter of R. M. J.*, 455 U. S. 191 (1982).

<sup>121</sup> See 2 *Restatement (2nd) of Torts* § 299A comment d (1965). The Supreme Court of Arkansas has noted

## V. Conclusion

Most of the suggestions that are made in this article about reducing the risk of malpractice claims in an estate planning practice are both time consuming and expensive. Many of the suggested practices involve additional time in gathering information and in the careful preparation of documents. All of this is time which, presumably, could be spent in a more monetarily productive way by working on other, higher paying client matters. There are at least two good answers to these admittedly legitimate concerns. First, and perhaps foremost, an attorney who practices in the wills and trusts area should strive to become competent in this field. Competency is its own reward, but it takes time and

effort. Second, if the adoption of the sort of practices and procedures recommended in this article saves a practitioner just one single malpractice claim over the next 10 or 15 years of practice, then the effort will have been worthwhile. In this area, at least, an ounce of prevention is clearly worth a pound of cure. ●

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that the right of attorneys to publish information about areas of practice involves a corresponding implication of expertise in those fields. *In re Amendments to the Code of Professional Responsibility and Canons of Judicial Ethics*, 590 S. W. 2d 2, 3 (1979). See also Rubinelli, "Risk of Liability for Malpractice Increased as Beneficiaries Bring Suit Against Planners," *Estate Planning*, March 1981, at 66, 69-70; "Specialization: The Resulting Standard of Care and Duty to Consult," 30 *Baylor Law Review* 729, 734-35 (1978).

ADDENDUM -- RECENT CASES

(1) Albright v. Burns, 206 N.J. Super. 625, 503 A.2d 386 (1986). This case highlights the serious malpractice implications that can arise out of an attorney's conflict of interest in attempting to represent clients with differing interests. Also, the New Jersey intermediate appellate court in this case reaffirmed the rule in that state that an attorney under certain circumstances may owe a duty to persons who are not his clients, under the balance-of-factors test adopted in Lucas v. Hamm, 364 P.2d 685 (Cal. 1961).

In Albright, the attorney-defendant was in the middle of a transaction between an elderly man that executed a power of attorney in favor of his nephew, who was also a defendant in the case. The court found that the attorney was providing services to both the principal and the attorney-in-fact, and thus did not adequately protect the elderly uncle's interests in connection with the nephew's sale of a substantial portion of the principal's estate in order to fund the nephew's own business ventures.

(2) Berry v. Dodson, Nunley & Taylor, P.C., 717 S.W.2d 716 (Tex. App. 1986). This decision is significant because, in a case of first impression in Texas, the intermediate appellate court upheld the privity barrier and precluded a malpractice suit brought by disappointed beneficiaries against an attorney employed to write a new will for a man terminally ill with cancer. The decision thus rejects the trend reflected by cases such as Lucas v. Hamm, 364 P.2d 685 (Cal. 1961), to lower the privity barrier in order to permit intended beneficiaries of a negligently drafted will to bring suit against the attorney who drafted the defective document.

The decision also highlights an area of considerable malpractice risk for estate planners. Here the allegations of malpractice were posited on the attorney's failure to prepare a will and have it executed prior to his client's death, where the attorney was retained while the client was hospitalized with terminal cancer. The client died some 60 days later, and while the attorney had prepared a draft of the new will, it was not executed prior to death. Suit was brought by the decedent's stepchildren, who would have been beneficiaries under the new will, but who had not been included in an earlier will.

When engaged to draft a will or trust for an elderly person, or one who is seriously ill, an attorney would be well advised to prepare the necessary documents and have them executed promptly in order to avoid a claim that he or she was negligent in not seeing such a matter through to conclusion more expeditiously.

(3) Brammer v. Taylor, 338 S.E.2d 207 (W. Va. 1985). Brammer demonstrates that the malpractice dangers of estate planners are by no means limited to attorneys. In this case, a bank and its president were successfully charged with malpractice for their involvement in the preparation, execution, and attestation of an invalid codicil. As a consequence of what was deemed the unauthorized practice of law, the bank and its president were held to the same standard of care of practicing attorneys for failing to have a codicil properly witnessed.

(4) Connecticut Jr. Republic v. Doherty, 20 Mass. App. 107, 478 N.E.2d 735 (1985). Eight charities brought a malpractice claim against the attorney who drafted a codicil which inadvertently reinstated different charities that had been beneficiaries under an earlier, superceded testamentary instrument. As a result of this mistake, the eight charities lost \$1.3 million in bequests, and after an unsuccessful attempt to have the will reformed [see 448 A.2d 190 (Conn. 1982)], the charities brought suit against the drafting attorney.

This case illustrates that there are dangers lurking even in the most ministerial functions, such as the transposition of the names of beneficiaries from one document to another. Yet, this sort of blatant mistake will often go unnoticed unless the drafting attorney's office has a routine proofreading procedure in the case of all wills, trusts and similar instruments prior to execution.

Here, the Massachusetts intermediate appellate court seemed to search for some theory that would allow the attorney in question to escape liability for his obviously negligent conduct, and found the necessary escape hatch in the issue of proximate cause. Since the codicil which incorporated the erroneous charities had been read word-for-word to the testator prior to execution, and the testator had subsequently indicated that his latest codicil had reverted back to charities previously included, the court concluded that the testator had ratified the inadvertent substitution of the earlier charities for the eight charities that were supposed to be included in the codicil in question.

(5) Dickey v. Jansen, 731 S.W.2d 581 (Tex. App. 1987). In this intermediate appellate decision, the court affirms its 1986 ruling [in Berry v. Dodson, et al., supra] that beneficiaries under a will are not in privity of contract with the drafting attorney, and thus have no cause of action for mistakes made in the preparation and execution of such documents. This is yet another recent decision which has declined to follow the Lucas v. Hamm trend that provides an exception to the privity barrier in the disappointed will beneficiary setting.



Of equal significance, however, is the attorney error which provoked the malpractice suit. Here, a well-known Houston firm prepared a will for one of its clients whose assets included mineral interests in Louisiana. The firm apparently was not knowledgeable regarding Louisiana law and did not seek outside assistance from a Louisiana firm, as it was discovered upon the testator's death that the testamentary trust was invalid as to the Louisiana mineral interests. Where a client has substantial assets located in another state that might be governed by that jurisdiction's law, a prudent estate planner should minimize the inherent malpractice risk by recommending that an attorney in the second jurisdiction be retained to review the estate plan to assure its effectiveness under the other state's law.

(6) Hale v. Groce, 304 Or. 281, 744 P.2d 1289 (1987). In this case, the Oregon Supreme Court adds that state to the growing list of jurisdictions that have overcome the privity barrier in order to allow a disappointed beneficiary to maintain a malpractice cause of action against an attorney whose negligence caused the loss of the legacy in question. The Oregon court arrived at its conclusion on the basis of a third party beneficiary contract theory followed by several states, rather than the balance-of-factors negligence theory popularized by the California Supreme Court in Lucas v. Hamm, 364 P.2d 685 (1961).

(7) Hamilton v. Needham, 519 A.2d 172 (D.C. 1986). In a prior appeal in this same case, Needham v. Hamilton, 459 A.2d 1060 (D.C. 1983), the District of Columbia court had added its jurisdiction to the growing number of states that permit a nonclient-beneficiary to bring suit against an attorney whose negligence resulted in the loss of a bequest or devise under a will. The particular error in this case was the inadvertent omission of a residuary clause, with the result that the rest and residue passed to an unintended intestate heir.

In the current appeal, two issues of interest are involved. First, the appellants challenged the plaintiff's failure to present expert testimony that the attorney's conduct fell below the required standard of care. The court overrode this contention by finding that the case came within the "common knowledge" exception to expert testimony, where the jury is capable of assessing the attorney's conduct without expert assistance. The second issue concerned the contention that the trial court erred in receiving evidence outside the will to establish the testator's true intent. The District of Columbia court rejected the holdings in DeMaris v. Asti, 426 So.2d 1153 (Fla. App. 1983) and Kirgan v. Parks, 484 A.2d 274 (Md. App. 1984), to the effect that an attorney is only liable to intended will or trust beneficiaries in instances where the testator's intent is reflected in the will itself. Thus, the plaintiff was entitled

to introduce earlier drafts of the testator's last will and testament which clearly demonstrated the testator's intention to include the plaintiff as the sole residuary beneficiary.

(8) Jenkins v. Wheeler, 69 N.C. App. 140, 316 S.E.2d 354 (1984). This case involves estate administration rather than estate planning as such, but the decision has considerable relevance in the latter context. In upholding a sole beneficiary's malpractice claim against the estate's lawyer for failing to include a wrongful death claim as an asset of the estate, the intermediate appellate court reaffirmed the balancing-of-factors test to allow a non-client third party to bring suit against an attorney whose negligent conduct injured the third party. The decision is also of interest for its further holding that an attorney's representation of conflicting interests can form an independent basis for an action in malpractice.

(9) Marker v. Greenberg, 313 N.W.2d 4 (Minn. 1981). Marker is significant because of the refusal of the Supreme Court of Minnesota to extend the balance-of-factors privity exception from the disappointed will beneficiary setting to a closely analogous situation. In Marker, a surviving joint tenant sought to bring suit against the attorney who had performed estate planning services for plaintiff's father, including preparation of a deed which succeeded in transferring certain real estate, owned by the father, to a joint tenancy between father and son, with right of survivorship. According to the son's allegations, \$20,858.18 in federal and state death taxes would have been saved if the attorney had transferred the property to father and son as tenants in common, rather than joint tenants.

The Minnesota Supreme Court applied the general rule against attorney liability to third parties, holding that the case at hand did not fall within the exception to the privity barrier often found in will drafting cases. Since the two estate planning situations appear to be quite analogous, it would appear that the court wanted to impose some rather substantial limitations on the balancing-of-factors test of Lucas v. Hamm in an attempt to keep a lid on the explosion of legal malpractice claims.

(10) Matter of McCoy, 419 N.W.2d 301 (Wis. 1987). This is an interesting case involving the duties and obligations of a corporate trustee of a revocable inter vivos trust to prevent ambiguities from arising regarding the settlor's testamentary intent. According to the Wisconsin Court of Appeals, a disappointed trust beneficiary has a cause of action against the

corporate trustee for its negligence in failing to advise the settlor of the steps she needed to take to amend her trust and make the plaintiff the recipient of the corpus upon the settlor's death. This appears to be a logical extension of the Lucas v. Hamm exception to the privity barrier, but in comparable situations other jurisdictions have limited, rather than extended, the Lucas v. Hamm rationale. See Marker v. Greenberg, supra.

(11) Matter of Strobel, 149 Ariz. 213, 717 P.2d 892 (1986). The Arizona Supreme Court's decision in Strobel illustrates that courts may be willing, under some circumstances, to look for ways in which an attorney's drafting error will not result in a loss to an intended beneficiary, thereby avoiding potential malpractice liability. Procedurally, the case involved a petition for construction of a will that purported to exercise a general power of appointment over an inter vivos trust created for marital deduction purposes by the testatrix's husband. The intended beneficiary asked the court to find that the power of appointment had been exercised by language in the will that did not comply exactly with the trust's requirements, so that the remainder of the trust would pass to the beneficiary, rather than to a taker in default. Alternatively, the beneficiary alleged that the attorney who drafted the will should be liable for negligence for failing to include the proper language that would exercise the power of appointment.

The probate court found that the will did not effectively exercise the power of appointment. The attorney was allowed to appeal this decision because the ruling on construction of the will was central to the beneficiary's alternative malpractice claim. The Supreme Court of Arizona held that it was clearly the testatrix's intent to exercise the general power of appointment over the marital deduction trust, and therefore it would give effect to the attempt to invoke that power even though the attempt was technically defective. Thus, the court chose to rectify a blatant drafting error by the attorney by construing the will in accordance with the testatrix's intent, rather than insisting on a strict construction that would have opened the door to a malpractice suit.

(12) McLane v. Russell, 159 Ill. App.3d 429, 111 Ill. Dec. 250, 512 N.E.2d 366 (1987). This case illustrates that malpractice exposure can exist after execution of a will. Here the drafting attorney failed to place title to the testatrix's property in an appropriate form so that it would be governed by the terms of the testator's newly executed will. The attorney had prepared a will under which the testatrix devised her interest in a 240 acre farm, worth \$325,000, to a father and son

who were tenant farmers of the property. However, the land was held jointly by the testatrix and her incompetent sister, with right of survivorship. At no time after execution of the will did the attorney take any action to sever the joint tenancy to covert it into a tenancy in common, which could then be devised under testatrix's will. The testatrix subsequently died and the farm passed by survivorship to the incompetent sister. Upon the latter death, the property, in its entirety, passed to the incompetent sister's cousins. The Illinois Appellate Court upheld the suit brought by the intended beneficiaries under testatrix's will, because the attorney's failure to sever the joint tenancy was a proximate cause of the beneficiaries' injury.

McLane serves to demonstrate the dangers lurking in the failure of an attorney to acquire full and complete information regarding all of a client's property and the exact manner in which it is held, and then to take such farther action as may be necessary so that the will will operate effectively to transfer the testator's property as intended.

The decision in this case is also of interest because of the court's application of the discovery rule, so that the five-year statute of limitations on the beneficiaries' malpractice claim did not begin to run until the testatrix's death, when they had their first opportunity to discover the facts underlying their claim.

(13) Persche v. Jones, 387 N.W.2d 32 (S.D. 1986). This is one of two recent cases (the other is Brammer v. Taylor, supra) which have held bankers liable for errors committed while assisting testators to draft and execute testamentary documents. In Persche, the testator requested that his bank draft a series of wills, the last of which was improperly executed. The court rejected the privity defense and found that the bank owed a duty to the disappointed beneficiaries of the defective will. The fact that the testator may have been contributorily negligent in rejecting advice that his will should be drawn up by a lawyer rather than a banker was irrelevant in the court's view to the question of the bank's breach of duty to the beneficiaries.

Unauthorized practice considerations aside, these decisions indicate (1) that banks (and other estate planning professionals) have no greater recourse to the privity defense than do attorneys, and (2) that the possible contributory negligence of the testator who ignores advice or fails to review the instrument will not abrogate liability of the estate planner to the beneficiaries.

(14) Schreiner v. Scoville, 410 N.W.2d 679 (Iowa 1987). The Iowa Supreme Court's decision in this case contains several significant points of law. First, Iowa joins the long list of

states which have permitted non-clients to bring a legal malpractice cause of action in situations involving disappointed beneficiaries whose interest under a will or trust has been lost or diminished by reason of the negligent conduct of the drafting attorney. While joining the trend begun in 1961 by the California Supreme Court in Lucas v. Hamm, 364 P.2d 685, the Iowa court went to extreme lengths in an attempt to limit its holding to the narrow set of circumstances presented in disappointed will beneficiary cases. Moreover, the court gratuitously added further limitations, even though its discussion had little to do with the facts in the case before it. The court in Schreiner expressly stated that such a cause of action could only arise where a testator's intent as expressed in a testamentary instrument has been frustrated by reason of a lawyer's negligent conduct to the detriment of an intended beneficiary. Thus, by imposing this further limitation on non-client legal malpractice claims, the Iowa Supreme Court has added its considerable weight to the earlier intermediate appellate decisions on this point in Florida and Maryland. See DeMaris v. Asti, 426 So.2d 1153 (Fla. App. 1983) and Kirgan v. Parks, 478 A.2d 713 (Md. App. 1984).

In addition to its holding, the facts in Schreiner illustrate yet another area of malpractice exposure for the estate planner. Here, an attorney prepared a will and then a codicil under which the testatrix devised her interest in certain real estate to a friend. Within a month after the codicil was executed, the same attorney brought an action for partition by sale of the identical real property interest, and the property was sold. A year and one-half later, the testatrix died without changing her will or codicil. As a consequence, the devise in question was adeemed, and the disappointed beneficiary filed suit against the attorney, based principally on the ground that the lawyer was negligent in failing to advise the testatrix of the consequence of the partition sale on the terms of her pre-existing will and codicil.

In reversing the lower court's decision, the Iowa court held that such allegations set forth a valid cause of action for malpractice. However, the court attempted to limit the impact of its decision by stating: "In most cases separate transactions between lawyer and client will not be linked, nor should they be. No lawyer reasonably can be expected to keep track of the provisions in the wills of his or her clients, nor the effect on those instruments caused by changes in the clients' affairs." (at p. 683.) Despite such disclaimer, the fact remains that the attorney in Schreiner, who apparently did not keep track of the provisions in a previously drawn will and codicil, was held to be responsible for the adverse consequences caused by his inadvertent conduct.

Thus, in order to minimize one's potential malpractice liability, a prudent estate planning should review other work that he or she has performed for a client, including previously

drafted testamentary instruments, and advise the client of any possible adverse impact of the current undertaking on work previously performed.

(15) Spivey v. Pulley, 526 N.Y.S.2d 145 (App. Div. 1988). In spite of particularly appealing facts, the intermediate appellate court in New York has once again held that a disappointed will beneficiary has no cause of action against the attorney who drafted a defective instrument, since the beneficiary is not the client and therefore is not in privity of contract with the attorney. In this case, the attorney used the sole residuary beneficiary named in the will he had just drafted as one of the essential attesting witnesses, thus voiding her bequest under New York law. Spivey thus reaffirms the New York intermediate appellate court's 1986 holding on this very point -- see Viscardi v. Lerner, *infra*.

In view of the recent decisions in Spivey and Viscardi, the statement with regard to the law in New York concerning the privity barrier that appears at the top of page 784 of my TAXES article needs to be modified. The law in New York is now clear that disappointed beneficiaries are barred by a lack of privity from bringing suit against an attorney who has prepared an ineffective will or trust. Thus, at the present time, New York, Nebraska [see Lilyhorn v. Dier, 335 N.W.2d 554 (Neb. 1983)] and Texas [see Berry v. Dodson et al. (1986) & Dickey v. Jansen (1987), *supra*] still subscribe to the privity barrier and therefore bar such causes of action. It should also be noted, however, that the New York and Texas decisions on this point have been rendered by intermediate appellate courts, not the highest court in the respective jurisdictions, although Lilyhorn was decided by the Nebraska Supreme Court.

(16) Stangland v. Brock, 109 Wash.2d 675, 747 P.2d 464 (1987). This is yet another significant case decided in the area of estate planning malpractice in the 2-1/2 years since publication of the TAXES article. On its facts, Stangland is very similar to Schreiner v. Scoville, *supra*, with regard to the duty of an attorney to consider the possible effect of present services for a client on the terms of testamentary instruments previously drawn for the same client.

In the case at hand, one of the defendant attorneys prepared a will for a long-term client which left all of testator's "real property" to two designated individuals. At the time of will execution, the only real property of any significance was testator's farm. About three years later, the same client utilized the services of another attorney in the same firm to prepare a real estate contract for the sale of the testator's farm. The second lawyer did not bring the subject matter of the sale to the attention of the lawyer in the firm that had prepared

the will, nor did anyone advise the testator of the impact that the sale of the farm would have on the devise of real property under the prior will. A year later the testator died, and by reason of the sale of the farm, the devisees were effectively deprived of their anticipated inheritance.

The disappointed beneficiaries brought suit against the two attorneys and their firm, alleging that the first attorney was negligent in not originally drafting the will in broader terms to protect the devisees' interest and in not advising the testator of the consequences of the subsequent sale of the farm, inasmuch as an internal firm memo should have brought the later representation of the testator in connection with the farm sale to the first attorney's attention. The second attorney was alleged to have acted negligently for not having reviewed the testator's will prior to working on the sale of the farm. If the attorney had done so, he would have been in a position to bring to the testator's attention the impact on the earlier will of the sale of the farm. The trial court granted the defendants' motion to dismiss for failure to state a claim and the Supreme Court of Washington affirmed.

At the outset of its decision, the court upheld the disappointed beneficiaries' standing to bring suit against the attorneys, in spite of a lack of privity, on both the Lucas v. Hamm balance-of-factors theory and the third party beneficiary contract theory. However, the court then proceeded to find that the allegations, even if true, did not show a failure on the attorneys' part to conform to the applicable standard of care. According to the court, an attorney "has no continuing obligation to monitor the testator's management of his property to ensure that the scheme originally established in the will is maintained. The time and expense that would be required for the attorney to follow all of the testator's activities with respect to his property would prevent the attorney from being able to provide reliable and economical services to the client, and would constitute an overwhelming burden on the attorney's practice as a whole." (at 469.) Moreover, to impute to another attorney, even one in the same firm, knowledge of the contents of wills executed at an earlier time "would impose potentially staggering responsibilities on attorneys. An attorney would have to research every matter that attorney's firm had previously handled for the client, no matter how large the firm or how extensive the firm's prior work for the client. This would place an unreasonable burden on the attorney and would markedly increase the cost of providing legal services." (at 469-70.)

(17) Teasdale v. Allen, 520 A.2d 295 (D.C. App. 1987). This is an abbreviated decision by the District of Columbia Court of Appeals that disappointed beneficiaries can bring a malpractice action against the attorney who drafted a will, even

though their precise status as beneficiaries cannot be discerned from the four corners of the will itself. Thus, the court decided against the broad sweep of a per se rule that appears in cases like Kirgan v. Parks, 60 Md. App. 1, 478 A.2d 713 (1984), that in order to be entitled to bring a legal malpractice suit it must be apparent from the face of the will that the testator's intent had been frustrated.

The facts in Teasdale serve to illustrate the need for an estate planner to anticipate possible contingencies in preparing testamentary documents. The testator's will left all of his residuary estate to his fourth wife, if she survived him. If she predeceased or they died in a common disaster, the residue was to pass to the testator's grandchildren (who were the plaintiffs in the subsequent malpractice action). Testator died, followed by his wife's death 62 days later. As a consequence, testator's residuary estate passed via his widow to her children from a previous marriage. The grandchildren-plaintiffs contended that the attorney who drafted the will should have provided for the possibility of the death of the fourth wife shortly after the testator, as well as providing for the disposition of his property if she predeceased him or they died in a common disaster.

In circumstances involving subsequent marriages, particularly where one or both spouses have children from an earlier marriage, additional planning is needed to avoid the sort of unfortunate and presumably unintended result that occurred in Teasdale v. Allen.

(18) Viscardi v. Lerner, 125 A.D.2d 662, 510 N.Y.S.2d 183 (1986). As previously noted in Spivey v. Pulley, supra, this is a decision of the intermediate appellate court in New York which specifically applies the general rule barring suits by non-clients against attorneys to the disappointed beneficiary who suffers a financial loss by reason of an attorney error in the preparation or execution of a will. First, the New York Court reviews authority to the contrary in numerous jurisdictions following the balance-of-factors theory of Lucas v. Hamm, and then rejects those holdings in favor of the firmly established privity requirement.

See further discussion of the New York rule in Spivey v. Pulley, supra.

(19) Walker v. Lawson, 514 N.E.2d 629 (Ind. App. 1987). In a case of first impression in Indiana, the intermediate appellate court in Walker holds that a disappointed beneficiary can maintain a malpractice action against an attorney who may have acted negligently in the drafting of a will. The court discusses both the balance-of-factors theory and the third party bene-



ficiary contract theory as limited exceptions to the privity barrier, and appears to approve of both approaches without specifically indicating a preference for one over the other.

The facts in this case serve to highlight an area of potential malpractice liability. Here, the attorney prepared a will for a testatrix who had cancer and wanted to leave all of her estate to two sons of a prior marriage. Such a will was prepared and executed, but when the testatrix died shortly thereafter, her spouse elected to take against the will, thereby substantially depleting the testatrix's estate. Testatrix's two sons brought suit against the attorney, alleging that he had negligently failed to advise the testatrix about her husband's statutory rights, and that if the attorney had forewarned his client, the testatrix would have chosen other means of disposition which would have effectively transferred all her property to her children. Although expressing no opinion on the difficult proximate cause issue, the Indiana court did hold that the complaint stated a cause of action.

If an attorney prepares a will at his or her client's request which leaves all or substantially all of the estate to persons other than the client's spouse, the attorney should, of course, advise the client of the elective share laws protecting spouses from such disinheritance. But the attorney should go a step further to help preclude a claim such as the one made in Walker v. Lawson. The attorney should leave a written record of the fact that the testator was so advised and still wanted to leave the spouse out of the will (or include the spouse, but for an amount less than the statutory share). One logical way to leave such a record would be to include a statement on the face of the will to the effect that the testator intended such omission and the reasons therefore.



IS CONGRESS OUT TO DESTROY THE FAMILY BUSINESS?  
SECTION 2036 (c) AND THE REPEAL OF THE "GENERAL UTILITIES" DOCTRINE

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SECTION C

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IS CONGRESS OUT TO DESTROY THE FAMILY BUSINESS?  
SECTION 2036 (c) AND THE REPEAL OF THE "GENERAL UTILITIES" DOCTRINE

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IS CONGRESS OUT TO DESTROY THE FAMILY BUSINESS?  
§2036 C AND THE REPEAL OF  
THE GENERAL UTILITIES DOCTRINE

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Congress through the combination of elimination of lower capital gain rates, repeal of the General Utilities Doctrine and adoption of 2036(c) has made the family business and family farm very difficult to preserve for future generations:

- I. The Revenue Act of 1987 inserted a new section 2036(c), "inclusion related to valuation freezes", into the Internal Revenue Code of 1986 in an effort to stop so-called "estate freezes".
  - A. For section 2036(c) to apply, each of the following four tests must be met:

Test #1. The person (the decedent to be, whom we think of as the parent in the typical situation, hereinafter referred to as "person") holds a substantial interest in an enterprise.

    - (a) The use of the word "holds" in the first test [sect. 2036(c)(1)(A)] suggests that the requisite holding must exist before the transfer and retention [sect. 2036(c)(1)(B)] described below occur;
    - (b) "Substantial interest" means 10% or more of the voting power and/or income stream in such enterprise owned directly or indirectly by the Person. A new constructive ownership rule has been enacted.
    - (c) The term "enterprise" is not defined in section 2036(c). However, the conference report says an enterprise includes a business or other property which may produce income or gain.

Test #2. After December 17, 1987, the person must "in effect" transfer property to a family member having a disproportionately large share of potential appreciation in such person's interest in the enterprise.

- (a) The conference report states that a "transfer" encompasses, but is not limited to, all transactions whereby property is passed to or conferred upon another, regardless of means or device employed in its accomplishment (includes gifts or sales).
- (b) A "disproportionately large share" of potential appreciation is any share of appreciation in the enterprise greater than the share of appreciation borne by the property retained by the person.

Test #3. The person at the same time must retain a disproportionately large share in the income of and/or rights in the enterprise.

- (a) The Conference Committee report says "rights" in the enterprise includes voting rights, conversion rights, liquidation rights, warrants, options and other rights of value.
- (b) Questions:
  - (i) Can a person's compensation for services to the enterprise in the future be counted as a share in the income of the enterprise for this purpose?
  - (ii) Is rent on a building the person has leased to the enterprise or interest on debt owed to person by the enterprise be considered income of the enterprise?

Test #4. At the time of the person's death he must still own a disproportionately large share of the income of or rights in the enterprise.

- (i) The three year rule of IRC §2035 - will apply

B. The result of meeting the four tests is that the transferred property will be included in the person's gross estate.



- (1) The transferred property is considered to be a retention of the enjoyment of the transferred property [sect. 2036(a)].
  - (2) Inclusion in the gross estate means valuing the property at the date of death of the person (or the alternate valuation date) whether higher or lower than the value at the time of the section 2036(c) transfer.
  - (3) Because the property included in the gross estate under section 2036(c) belongs to someone other than the decedent, it cannot be left to the decedent's spouse to qualify for the marital deduction.
- C. Adjustments to be made in what is included in the persons' gross estate.
- (1) The conference committee report indicates that a proportionate adjustment will reduce what's includable in the person's gross estate to just that part of the transferred property that is disproportionately large in relation to the preferred income or other rights or interest still retained at death.
  - (2) The amount included in the estate of the person will be reduced by the value of the consideration received by the decedent.
- D. Questions have been raised as to the effect of 2036(c) on many common situations.
- (1) How close together in time must successive transfers be in order to be treated as one transfer for purposes of applying 2036(c)?
  - (2) What will be includable if all the stock of an enterprise is owned by the child and the parent then buys preferred stock from the enterprise (or from the child)?
  - (3) What is includable if loans are made by the parent to an enterprise when all equity in the enterprise is owned by the child?
  - (4) What if the loan is instead made to the child who in turn loans the funds to the enterprise.
  - (5) What if after the loan to the child individually the child pledges his common stock as security?

- (6) If the person sells all his stock but obtains a salary continuation agreement?
- (7) What is the effect of Section 2036(c), if any, on the following?
  - (a) Private annuity?
  - (b) Inter-vivos charitable lead trust?
  - (c) Sales of remainder interest or joint purchase?
  - (d) Buy Sell agreement?
  - (e) Intra-family installments sale?
  - (f) Grantor Retained Income Trusts?

Other Areas:

- (i) How would tax be paid? Collected? What if the residuary estate is insufficient to pay tax?
- (ii) Constitutional challenges?

II. Pre-1989 liquidations of qualified corporations in accordance with the Tax Reform Act of 1986.

A. Transitional Rule qualification [sect. 633(d)]

- (1) Complete liquidation prior to 1/1/1989 by a qualified corporation.
  - (a) On 8/1/86 and at all times thereafter through liquidation over 50% of stock value held by 10 or fewer "qualified persons" determined after attribution.
    - (i) Qualified person - individual estate or trust described in 1361(c)(2)(ii) or (iii). However, Technical Correction Bill of 1988, 106(g)(B), would eliminate attribution from such trusts to their beneficiaries and would treat any such estate or trust as one person with a holding period including that of the estate, trust or decedent.
  - (b) Fair market value of corporation on date of Plan of liquidation adopted (or if greater on 8/1/86 (the applicable value) is no more than \$10,000. However, if applicable value exceeds \$5,000,000 the transitional relief is phased out. (Blue Book 353) staff of Joint Committee on Taxation general explanation of the Tax Reform Act of 1986 (May 8/87)

B. Non-recognition items

- (1) Long term capital gain

C. Major Exceptions to non-recognition at corporate level.

- (1) Tax benefit rule.

- (a) Previously expensed items. US v. Bliss Dairy Inc. 460 US 370 1983)

- (b) Bad debt reserve - sale not greater than net value

- (2) Assignment of income.

- (a) Cash basis accounts receivable. Williamson v. US 929 F2 524 CT CL 1961)

- (b) Condemnation award. Wood Harmon Corp. v. US 311 F2 918 (2nd cir. 1963)

- (3) Corporate debt to shareholder

- (a) Transfer of appreciated property in satisfaction of debt constitutes sale at a gain increasing earnings and profits.

- (4) Depreciation recapture on personal property and commercial real estate, section 1245

- (5) Excess of accelerated over straightline on residential real property, section 1250

- (6) Investment credit recapture, Section 47

- (7) Disposition of installment obligations. Section 453 B

- (8) Farm recapture property. Section 1261

- (9) Corporate tax preference, Section 291

- (10) In general check prior years tax returns for any special deduction, credit, exclusion or exemption the benefit of which might be recaptured.

D. Major Types of Liquidation:

1. Section 333

- (a) 80% of corporate shareholders made election
  - (b) Distribution within one calendar month
    - (i) Retain only cash to meet unascertained or contingent liabilities.
    - (ii) Non-assignable property, such as tax refund claims
    - (iii) shareholder cannot be located
  - (c) Form 964 filed within 30 days after plan of liquidation adopted.
  - (d) Recognition of gain
    - (i) earnings and profits
    - (ii) Money and securities
    - (iii) Pre-share basis
- E. Basis of shareholder stock (increased by gain recognized and decreased by money received) determines basis in assets received, which is further increased by liabilities on the assets (liabilities encumbering specific property increase its basis; other liabilities allocated among all properties by FMV)
- F. Accounts Receivable - may result in ordinary income to shareholder even though already taxed to the corporation.
- G. File forms 1096 and 1099 DIV
- H. Must file certain information with tax return and maintain permanent records. Reg. 1.333-6(a)
- I. Collapsibility precludes use of §333

2. Old Section 337 Liquidation

- (a) Time of sale or exchange (within 12 month period)
- (b) Inventory must be disposed in bulk sale for shareholders to take advantage of installments sale rule. 337(b)(1)(z) 453(b)(1)
- (c) Limitations apply to sales to related persons 453(G)(h)
- (d) File form 966 - 1096 and 1099 DIV

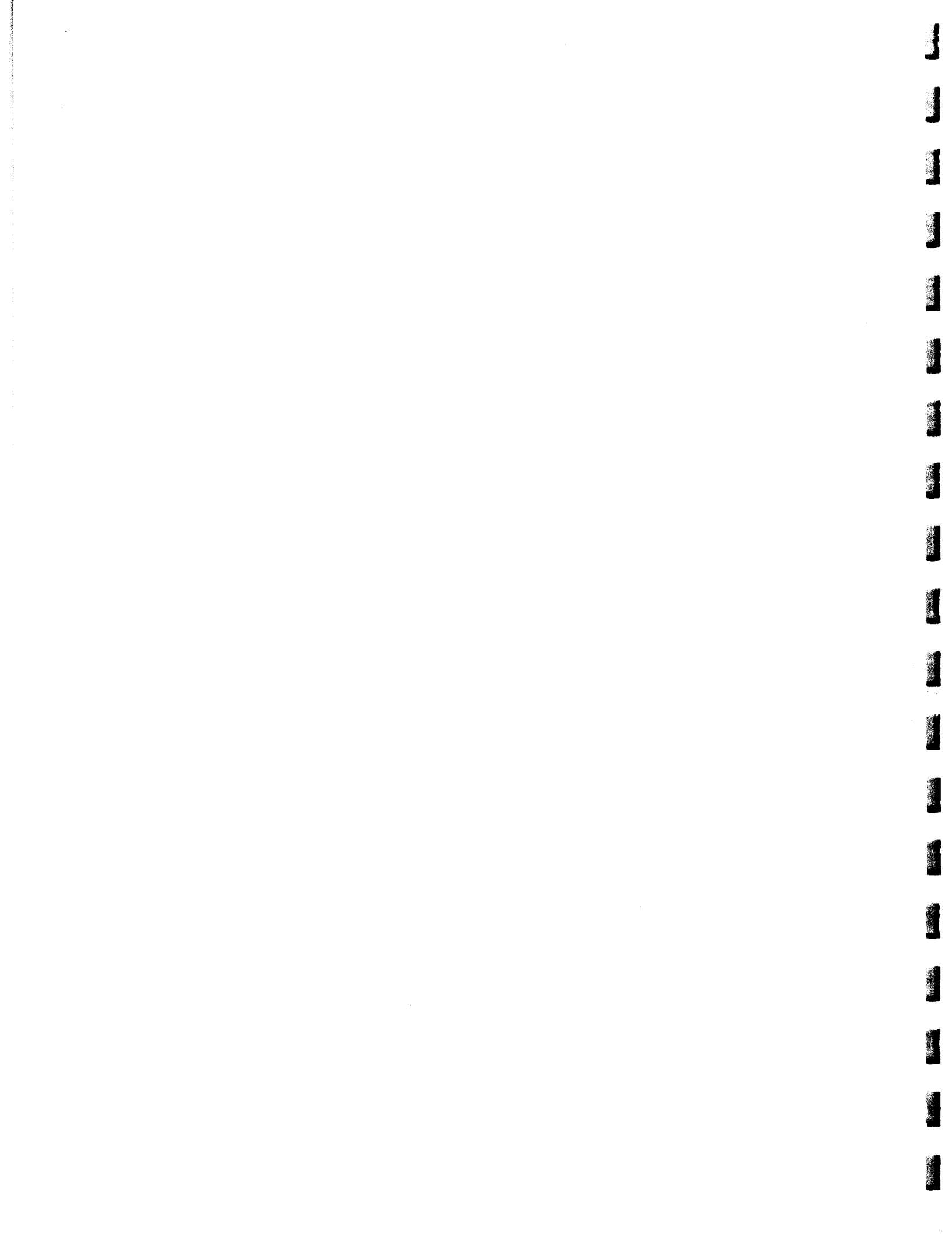
- (e) Use of limited partnership or liquidating trust. Rev. Proc. 82058 1782 2CB 847.

### III. CONCLUSION

Hopefully when the pending amendments to 2036(c) in the "Technical Correction Bill" is passed, which should be in 1988, it will be less difficult for taxpayers to identify which past 12/17/87 transfer to family members will cause inclusion and which will not. However, unfortunately, to date this bill does not answer 90% of the numerous questions raised under Sect. 3026(c).

Whether Sect. 2036(c) needed to be enacted in the first place is questionable. Clearly Sect. 2036 (c) makes the continuation of the family business and farm beyond the present owners' lifetime even more difficult and unlikely than in the past.

Closely held corporations are hurt by the removal of the lower long term capital gain rates on corporations, as well as higher maximum income tax rates on corporations than on individuals for the first time since 1913. In addition the resulting double income tax on sale or distributions of capital gain assets by domestic (Chapter C) corporations upon the corporation's sale or liquidation makes this form of corporation an unpopular and potentially costly form of doing and/or continuing to do business.

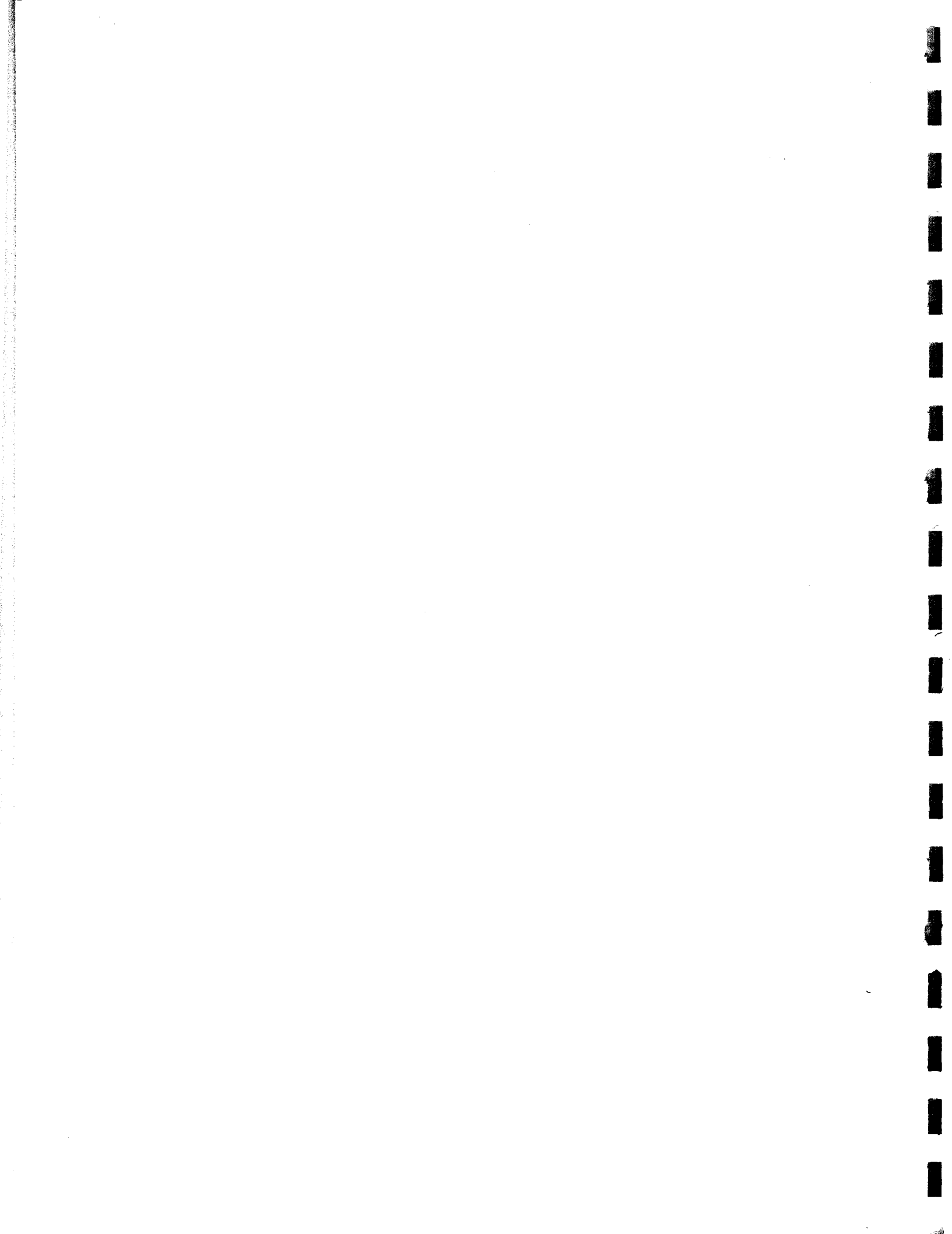


TAX PLANNING TECHNIQUES FOR POTENTIAL AUDITS AND LITIGATION

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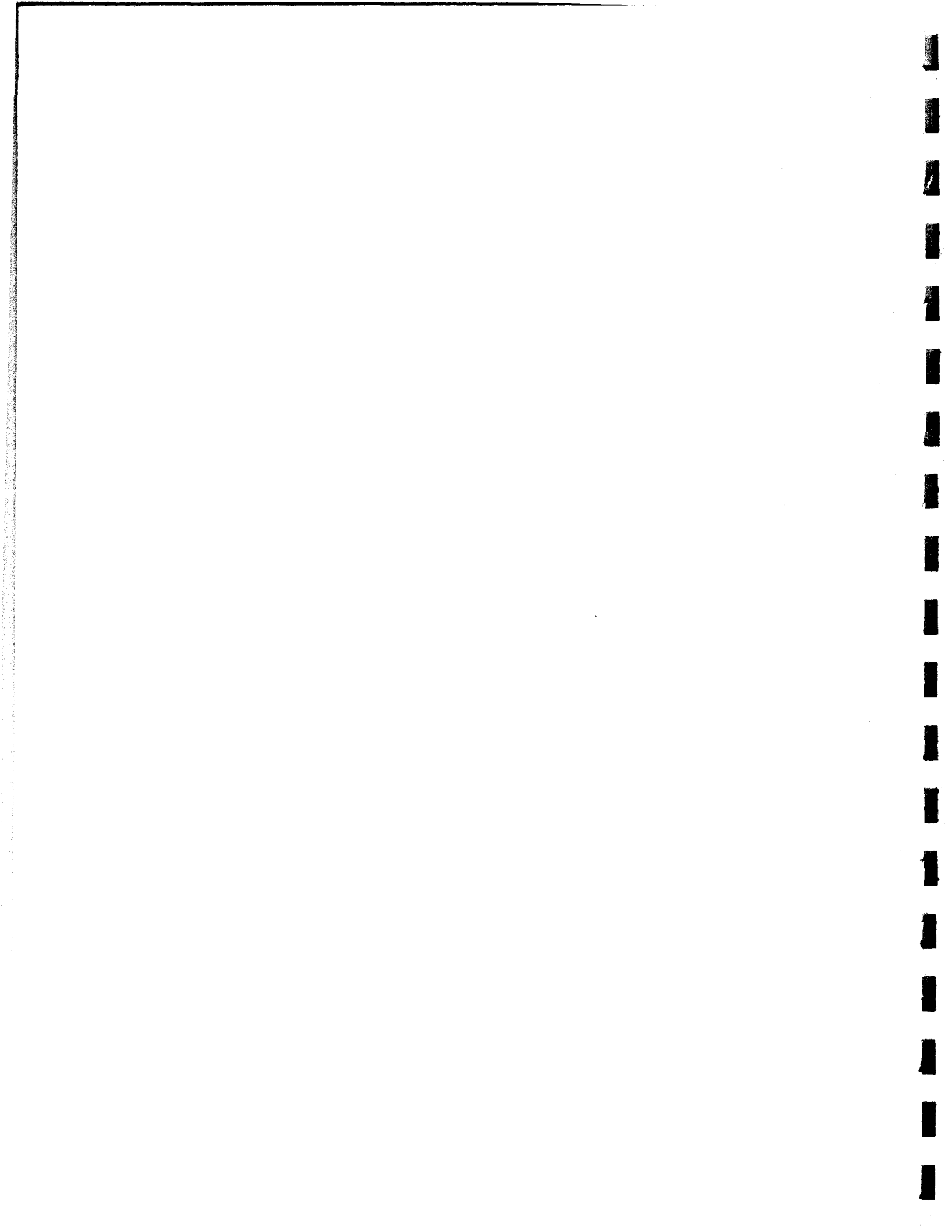




TAX PLANNING TECHNIQUES FOR POTENTIAL AUDITS AND LITIGATION

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**TAX PLANNING TECHNIQUES FOR  
POTENTIAL AUDITS AND LITIGATION**

A. Overview of the Examination and Judicial Review Process

1. Classification of the Return.

Most Returns are merely checked for mathematical accuracy. Generally, for a Return to be selected for examination, there must be not only issues to be resolved but also a significant sum of money involved (to recoup the Services' time expenditure).

2. The Examination (Audit).

Note that a contact for information may not be audit, if the information is required to "perfect the return." For instance, to supply a missing Form 712 or other document which should have been filed with the Return, or to correct mathematical errors or discrepancies.

a. Types.

- (1) Correspondence audit: exchange of information through the mail or by telephone.
- (2) Office audit: in person meeting between Examiner and Taxpayer (or representative), in Service office.
- (3) Field audit: an office audit conducted at the Taxpayer's or representative's office.

b. Proposed Changes to the Return.

The Examiner will present proposed changes. In formulating changes, the Examiner cannot consider the "hazards of litigation" and should not bargain on valuation issues. Nor can an Examiner "horse-trade" issues: accepting the estate's position on one issue in exchange for the estate's accepting an adjustment in another area.

c. Estate Agreement with Proposed Changes.

If the Estate agrees with the proposed changes, the Examiner will ask that the Estate sign a Form 890 waiving the requirement of a ninety-day letter (statutory notice of deficiency).

Signing a Form 890 bars subsequent access to the Tax Court unless there is a later statutory notice of deficiency. There may be a partial waiver: the Form 890 will enumerate those issues on which the Estate and the Examiner agree. If no form 890 is signed, assessment of the deficiency will be deferred for at least 120 days (30 days to file a protest after the preliminary notice of deficiency (30 day letter) plus 90 days to file a Tax Court petition after the statutory notice of deficiency (90 day letter)) during which time interest on the unpaid deficiency continues to accrue.

d. Estate Disagreement with Proposed Changes.

(1) Preliminary Notice of Deficiency (Thirty Day Letter).

A preliminary notice of a proposed deficiency will be issued if the Examiner determines a deficiency. Accompanying the 30 day letter will be a waiver, in case the Estate decides to accept the Examiner's findings. The Estate has 30 days to respond, by filing a written protest. Without a Protest timely filed, the Service will issue the statutory notice of deficiency. In certain instances, extensions of the 30 day period may be available.

(2) Protest.

The Protest is filed, in duplicate, with the District Director responsible for the audit, who in turn will forward the Protest to the Appeals Office. Incomplete Protests will be returned for additional information. The Protest should contain the following:

- (a) A statement that the taxpayer wants to appeal the findings of the examiner to the Appeals Office;
- (b) The taxpayer's name and address;
- (c) The date and symbols appearing on the thirty-day letter;

- (d) The tax periods or years involved, and in the case of the estate tax, the date of death;
- (e) An itemized schedule of the adjustments with which the taxpayer disagrees;
- (f) A statement of facts supporting the taxpayer's position in any contested factual issue;
- (g) A statement outlining the law or other authority on which the taxpayer relies; and
- (h) A declaration under penalty of perjury that the statement of facts is true to the best knowledge of the taxpayer. The following language is acceptable for this purpose: "Under penalties of perjury, I declare that I have examined the statement of the facts presented in this written protest and in any accompanying schedules and statements and to the best of my knowledge and belief they are true, correct and complete."

The Estate may request that the Appeals Office request Technical Advice from the National Office, which bind the Service, but not the Estate. Generally, the Appeals Office is more taxpayer oriented than the National Office; thus, the best strategy often is to avoid Technical Office.

(3) Appeals Office.

The conferences are informal and all evidence may be presented and considered. The Appeals Officer may consider the cost and risk of litigation, and may compromise issues, and may raise new issues. The Estate may also raise new issues. If agreement is reached between the Appeal Office and the Estate, the parties may sign the Form 890, or a Form 890-AD. Unlike the Form 890, the 890-AD requires both the Service and the Estate to agree not to reopen the case. Form 890-AD may be limited just to those issues agreed on. The legal effect of the Form

890-AD is not as clear as that of a closing agreement. A closing agreement binds the Estate and Service, absent a change in the law (and then only in certain instances), however the 890-AD may not.

(4) Statutory Notice of Deficiency (Ninety-Day Letter).

May be issued either because no Protest was filed within 90 days, or because the Appeals Office upheld the Examiner's proposed deficiency. The Estate has 90 calendar days in which to petition the Tax Court for review of the Appeal's Office determination. After the 90 day letter is issued, the Estate may pay the proposed deficiency without losing the right to Tax Court review (payment earlier will deprive the Estate of the right to go to Tax Court).

(5) Tax Court Petition.

- (a) File in Washington, D.C. with the Tax Court. Timely mailing is timely filing; however, because the Tax Court has no jurisdiction absent a timely filed petition, filing early and/or in person is generally most desirable. Note: transport by private delivery service, rather than U.S. Mail, will not constitute timely filing unless the Petition is actually received by the Tax Court within the 90 day period.
- (b) The Estate may request an appropriate hearing location (e.g., Louisville, Cincinnati).
- (c) For four months after the petition is filed and the case is transferred to the Appeals Office in the jurisdiction where the Tax Court is to hear the case, the Appeals Office may settle the case, and either the Service or the Estate may open negotiations. Subsequently, District Counsel will have jurisdiction to settle the case.

(6) Tax Court Decision.

The Tax Court may dismiss the petition (which has the effect of affirming the Service's deficiency determination) or grant a default judgment for the Service or for the Estate--subject to the general rules and standards of the Federal Rules of Civil Procedure ("genuine issue of material fact," Rule 56). The Tax Court may increase the Estate's deficiency above that proposed by the Service. In certain circumstances the Tax Court may award litigation costs against either the Service or the Estate.

(7) Appeal from Tax Court Decision.

Appeal may be taken by the Service and/or the Estate, and must be filed within 90 days after the Tax Court's decision is entered. The 90 day time limit probably must be met in order for the Court of Appeals to have jurisdiction. The other party has 120 days after the first party appeals to offer its own appeal. The proper Court of Appeals is the one in which the petitioner, if a person, has legal residence, or, if a corporation, has its principal place of business or principal office. Generally, the Federal Rules of Appellate Procedure must be followed. Appeal from the Court of Appeals is by writ of certiorari to the United States Supreme Court.

3. Estate Pays the Tax, Wants a Refund

a. Administrative Procedure.

- (1) Before litigation can be brought for a refund, a claim for refund must be filed with the Service. The claim must be filed within three years after the return was filed or two years from the time the tax was paid, whichever is later.
- (2) Form 843 is used to file estate and gift tax refund claims, and must be filed with the service center where the tax was paid.

- (3) The claim must provide specific grounds for the refund and sufficient facts must be stated as well. All grounds should be pressed and any interest due should be demanded.
- (4) Where filing the claim increases the administrative expenses allowable as a deduction on the estate tax return, the claim should include a refund of the estate taxes no longer due.
- (5) A protective claim or a claim for an amount which is as yet uncertain may be filed.

b. Internal Revenue Review.

Estate and gift tax refund claims are reviewed by the pertinent district office. The claim for refund will not be considered (and a "no consideration" letter issued) if the claim:

- (1) was not filed timely;
- (2) contests the constitutionality of the statute as its sole claim;
- (3) is for a refund which was waived in an offer and compromise acceptance, or in a settlement;
- (4) is for either issues, or a tax period, subject to a closing agreement (absent an exception);
- (5) is for a refund on a return closed due to a final order of a Court (absent an exception).

Generally, the review of the claim for refund is similar to the audit process discussed earlier. If the claim is not allowed for the full amount, the Service will request that the Estate sign a waiver of the statutory notice of disallowance. The waiver does not waive the 6 month waiting period before the taxpayer Estate can file suit, but does begin the statute of limitations running.



c. Litigation.

Suit for refund may be filed either in Federal District Court or the U.S. Claims Court. Choice of precedent may be important in deciding which forum to use. The Claims Court is bound by the decisions of the United States Court of Claims (its predecessor court), the Federal Circuit Court of Appeals, and the U.S. Supreme Court. A Federal District Court is bound by the decisions of the Court of Appeals for its circuit, and the U.S. Supreme Court. No jury trial is available in the Claims Court and it does not follow the Federal Rules of Civil Procedure (although its rules are similar). The District Court does follow the Federal Rules of Civil Procedure and a jury trial is available upon request of either party. Both courts follow the Federal Rules of Evidence.

d. Appeals.

Appeal from the District Court or the Claims Court is to the appropriate Circuit Court of Appeals, and from there, by writ of certiorari, to the U.S. Supreme Court.

B. Using the Internal Revenue Service Examination Technique Handbook for Estate Tax Examiners

1. General Emphasis.

- a. Handbook urges agents to be businesslike, but aggressive in the pursuit of additional tax revenue.
- b. Agents are not to be concerned with the relationship among the executor (donor) and his or her attorney, accountant, or appraiser. The agent is urged to contact the "taxpayer" directly in many instances--a prospect to which the executor should be alerted.
- c. Agents are reminded of the limit on their authority to compromise valuation issues, or "horse-trade" issues. Also, agents are instructed not to consider potential litigation hazards or the risk of reversal by the Appeals Office. In short, confidence and aggressiveness are the agent's "marching" orders.
- d. Agents are not supposed to settle every case, and their work may be scrutinized if they

resolve an excessive number of cases on an agreed basis. Generally, agents who settle too many cases are adopting values too low, or are accepting other positions overly favorable to the Estate. These sorts of institutional pressures must be considered when developing a proper audit strategy.

2. Concern About Statutes of Limitations.

The Service is very concerned that the applicable statutes of limitation are met. The Handbook notes that the statute of limitations may be extended in gift tax cases (or income tax cases) but not for estate tax.

a. Usual Time Period.

The deficiency must be assessed, or a statutory notice of deficiency mailed, within three years from the time the estate tax return was filed or was due, whichever is later. There are three exceptions to this rule:

- (1) When a "false or fraudulent return" has been filed with intent to evade the tax, the tax may be assessed at any time [IRC 6501(c)]
- (2) If the taxpayer has omitted from the gross estate items includible in the gross estate which exceed in value 25 percent of the gross estate stated in the return, the period is 6 years. In making this computation, any item omitted from the gross estate shall not be taken into account, if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of his delegate of the nature and amount of such item [IRC 6501(e)(2)]. Court decisions concerning application of a similar income tax provision indicate that this provision will have only a very limited effect in extending the statute of limitations.
- (3) An extra one-year period is allowed for assessment against a transferee [IRC 6901].

b. Service's goal is to process returns on an 18 month cycle (2 years for "exceptional cases").

c. Release of Executor from Personal Liability.

Under §2204, an executor may ask to be relieved of personal liability, and is entitled to be so relieved within 9 months after making written application for discharge, if the amount of tax the Service notifies is owing is paid during that period. Agents are instructed to consider priority handling for returns accompanied by such request, unless there is sufficient real property to secure payment of any potential deficiency. Corporate executors are not given priority due to the routine nature of their §2204 requests.

3. Selection of Returns for Audit.

a. Which Returns Are Likely To Be Audited.

Returns should be retained for audit only if it has "at least one issue identified likely to result in a material change in tax liability." An agent is not to examine a return merely hoping to find a change in tax liability, or to verify that all items are correctly reported. Such audits are "unnecessary and unproductive." Of course, if a return is selected for audit, closer scrutiny may be given to items too minor to generate an audit standing alone; however, at all times an examination is to focus on the essential areas which need investigation.

b. Order in Which Returns Are Audited.

"Ordinarily it is the practice of the Service to examine returns in the order in which they are filed, and this practice should not be deviated from except for compelling reasons." However, the Service recognizes a number of categories of so-called "priority returns" which are to be examined regardless of the first-in, first-out rule.

c. Priority Returns.

- (1) Cases in which the Government's or taxpayer's interest is in jeopardy due to the imminent expiration of the statute of limitation. Such cases require immediate attention.

- (2) Cases returned by Review for reconsideration. These cases should also be given immediate attention and be returned to Review within 30 days of receipt.
- (3) Cases on which the 18-month cycle is about to run, and cases not completed within the 18-month cycle. Since the announced policy of the Service is to complete all estate tax examinations within 18 months after the returns were filed, unless circumstances beyond the control of the Service prevent such completions, "overage" cases must be periodically checked to ensure that the Service does not become a party to continuing the delay in effecting their disposition.
- (4) Collateral examination requested by another district. These requests call for prompt completion of the requested investigation; complete such collateral examinations as early as possible in order not to delay the primary examinations.
- (5) Claims for refund. These should be associated with the related returns and receive a preliminary examination to ascertain whether they are entitled to further consideration, as provided in IRM 4512. If entitled to further consideration, claims will be assigned and the examination usually initiated within 30 workdays after receipt in the Examination Division.
- (6) Elections to pay estate tax in installments under IRC 6166. The Examination Division is responsible for determining whether an election made by an estate qualifies under IRC 6166 and for advising the installment billing function as to whether or not the election qualifies. See IRM 4398. Accordingly, determinations regarding acceptability of such elections should be made as soon as practicable after their receipt in the Examination function and the installment billing function notified prior to the first anniversary billing date.
- (7) Requests for discharge of lien. Good administration and sound public relations

require that requests for the discharge of a lien be processed promptly. IRM 4394 contains instructions for processing requests for discharge of property subject to the estate tax lien.

- (8) Informant's letters and claims for reward. It is the practice of the Service to consider informant's claims for reward at the earliest possible date.
- (9) Cases where adverse publicity might result or public relations might be impaired unless an early examination is made.

A number of priority items have been eliminated from the 1980 Handbook:

- (1) Requests for prompt determination of tax and discharge of executor from personal liability under Section 2204.
- (2) Referrals by Collection involving refusal to sign a delinquent return.
- (3) Cases involving property having a situs in a death duty or gift tax treaty country, or involving a beneficiary or donee residing in Japan.
- (4) Requests to postpone payment of tax under Section 6161(a)(2) because of reasonable cause.
- (5) Offers in compromise.
- (6) Returns including special-use valuation elections under Section 2032A.

4. Form 5225, Estate Tax Preplanning and Examination Workpaper Coversheet.

The examining agent is required to use Form 5225 to plan and record the audit. The agent is to list the items to be investigated, the depth of the examination, the records to be inspected, questions to be answered and audit techniques to be employed. The progress of the audit and the agent's findings at each stage are to be noted. References to worksheets developed during the audit are also called for. Managers and reviewers evaluate the quality of the examination by reference to the Form 5225 and the Handbook reminds the agent that

the activity on a case (as noted on the 5225) should correspond to the agents time entries, travel vouchers and sign-out sheet. Practitioners who find themselves in litigation over an estate tax return may want to pursue a copy of the Form 5225 through a Freedom of Information Act request.

5. Use of Background Information - the Estate Tax Return as a Whole.

a. Generally.

The agent is instructed to develop an integrated "picture" of the decedent, both before and at the time of death. This explains why details are often requested that do not appear to bear directly on the return's central purpose of reporting assets and liabilities. The decedent's age, cause of death, occupation, financial interest, assets and the deductions claimed on the return are all important.

b. To Locate Unreported Assets.

- (1) The Handbook notes that clues to assets may be found in the decedent's will and/or trusts. Specific items to examine are specific bequests of property, and powers of appointment. The Estate should be prepared to explain why such property should not be included in the gross estate, if it has not been listed on the return.
- (2) Schedule K deductions generally relate to specific assets; thus the Service will look for that correspondence. This is especially the case for mortgages, promissory notes or liens.
- (3) Special emphasis is placed on comparing insurance premium deductions for personal property with the value of the property set forth on the return.
- (4) The decedent's business or profession will dictate certain kinds of assets the Service expects to see on the return.
  - (a) The Handbook says anyone engaged in a profession should have accounts receivable and office equipment.

- (b) Sales persons may have extra commissions due, and life insurance agents generally have renewal commissions.
- (c) Farmers should have certain types of equipment, and may have unsold crops depending on the time of year of death. Farmers may also own stock in cooperatives, interests in pooled crops, or revolving fund certificates. Other occupations may have retirement pensions or other benefits includable in the gross estate.
- (d) The absence of any of these items where the decedent's occupation suggests their presence, may invite inquiry from the Service, inquiry which may broaden to include other issues.

6. Information Required By the Return.

The Handbook also takes the view that all information required by the return and by the instructions must be submitted by the taxpayer in order to comply with Sections 6011 and 6018. Reg. 20.6011-1(a) provides that the return must include the information required by the applicable Regulations or forms. When this Regulation was issued, the instructions for Form 706 were printed on the reverse side of the schedules of the return. While the instructions were removed from the form in a number of updates of Form 706, the latest version again includes the instructions on the back of each schedule. The Handbook concludes that the Regulation would be interpreted to require that all information requested in the instructions be filed with the return in order for the return to be complete. Given that the instructions are now on the form itself, this may well be the proper view.

7. High Profile Issues.

The Handbook enumerates a number of items which "are more likely to be incorrect and bear a closer scrutiny than the average item."

- a. Claims against the estate by heirs are to be reviewed as to their bona fides.

- b. Promissory notes issued to spouses or children are to be checked to see if any consideration was given for the issuance of the notes.
- c. If large claims are paid to the decedent's heirs, the examiner is to prepare an Information Report to ensure that the payment is included in the claimant's income for tax purposes.
- d. Marital and charitable deductions are to be checked to determine whether the beneficiary qualified and whether any contingency prevents the spouse or charity from receiving the amount claimed.
- e. Items listed on the inventory of the decedent's safe-deposit box and not included in the gross estate are to be given special investigation, with the presumption that the possession of property indicates ownership.
- f. Agents are to check whether the decedent retained the income, possession or enjoyment of property transferred without adequate consideration, regardless of whether there is a provision in the relevant instrument indicating that all of the rights were transferred by the decedent.
- g. Any mention of the word "discount" to explain the valuation of an asset is a signal for scrutiny of the value reported. Returns with discounted values are to be given special attention as to all other matters as well, since the use of discounted values demonstrates "an intent to reduce the value of the gross estate."
- h. If a fractional interest in an asset is reported, the other owners are to be identified, and the manner in which the fractional interest was acquired is to be determined. The purpose of this inquiry is to see if there are any unreported gifts involved in the creation of the fractional interest.
- i. If there is any indication that the decedent inherited property, special consideration should be given to tracing the assets received.
- j. In community property states, the agent is to determine whether the surviving spouse claims any separate property, and then determine if



this claim is valid. Similarly, the character of property included in returns as community property is to be verified.

- k. If supplemental documents are missing, this may indicate that the taxpayer did not obtain supporting data for valuations, or did not give proper consideration to preparation of an accurate return.
- l. The Handbook indicates that some taxpayers may obtain more than one appraisal of an asset, and only use the one reflecting the lowest value. Agents are therefore to request all appraisals of property made shortly before death or during the period of administration. The agent is to make sure that there is an appraisal from each firm for which an appraisal fee is deducted.

8. Valuation of Real Property.

a. Generally.

The Handbook contains extensive guidance for the agent with respect to real property valuation. Unless special-use valuation has been elected, the agent is instructed to obtain the "highest and best use" value which is defined as that reasonable and probable use that will support the highest present worth of the (improved) property based on the highest net return that it can produce over a reasonably foreseeable period of time. The Service recognizes that a bona fide, arms-length sale within a reasonable period of time after the valuation date probably represents the fair market value of the real estate.

b. Information to Obtain.

The Handbook instructs the examining agent to obtain 12 items of information for all types of real estate:

- (1) The taxpayer's basis for valuation, including comparable sales relied upon.
- (2) The tax assessor's parcel number.
- (3) The property's address or a map showing its exact location absent a street address.

- (4) A copy of the most recent county tax bill.
- (5) The dimensions or area of the land.
- (6) The size, age, condition and type of construction of all improvements.
- (7) Written permission from the estate to examine the tax assessor's files.
- (8) Copies of all appraisals made within five years of the valuation date.
- (9) Copies of all listings of the property, and names of realtors handling the realty, within the past three years.
- (10) Details of all offers made.
- (11) Copy of the closing statement if the property was purchased within five years of the valuation date.
- (12) Any special conditions, restrictions, or circumstances that would relate to valuation.

The following information about certain types of property should also be considered. For a single-family residence, the number and types of rooms, and special amenities such as pools and guest homes. For residential income property, the size and type of units, the actual economic rent for each unit, and the actual expenses. For commercial and industrial property, copies of leases, the names of tenants and terms of occupancy and expenses. On improved land, copies of any leases or options, the actual use of the property, and the description of any growing crops.

c. Valuation Techniques.

The focus of the section on Valuation of Realty has moved away from a general theoretical discussion of possible approaches, in favor of a discussion of techniques that are used improperly by taxpayers. The admonitions in the new Handbook include the following:

- (1) Do not use gross rental multipliers in determining the value of rental real

estate; net income multipliers are more exact and are actually used more frequently by investors.

- (2) In using the income capitalization approach, taxpayers cannot build capitalization rates based upon the yield on Treasury bonds at the time plus an additional yield for the risk factor, where the resulting rate is higher than the typical market rate. Potential appreciation and tax shelter aspects of real estate are said to add value to the investment over and above the net income generated. (Given the new limitations on passive losses adopted by TRA '86, the tax shelter benefit is questionable).
- (3) The comparable sales approach creates great difficulties because the comparables are rarely, if ever, sufficiently similar to the subject property to indicate fair market value without adjustments for significant differences. If comparables are used, all comparables must be viewed by the person making the adjustments and the valuation.
- (4) The residual method of valuation is to be rarely used, and is most appropriate when the value of the land and improvements is readily ascertainable and the net income is determinable. The approach is not of great value for ascertaining the total value includable in the gross estate, but is good for allocating value between land and improvements.
- (5) The replacement cost method is viable only when the improvements are fairly new and the fair market value of the land is independently ascertainable.
- (6) If the property is subject to a long-term lease, the value is largely determined by the present value of the lease payments, with residual value of the property itself being of little significance. However, if there are short or medium-term leases, the property is to be valued without the leases and adjusted for the positive or negative effects of the lease. This adjustment

is made by determining the difference between the present value of the lease payments and the present value of what the economic rent would have been absent the lease. If the lease is to a related person and the terms are not market rental, the value of the real estate subject to the lease should be "adjusted accordingly."

- (7) Leasehold interests held by the decedent as a tenant may be includable as an asset. The value is the difference between the present value of the payments according to the lease and the present value of the economic rent for that period of time. The Handbook does not indicate whether leases may constitute liabilities under the same rationale, if the actual rent exceeds economic rent on a present value comparison.

9. Special-Use Valuation.

a. Generally.

The special-use valuation election under Section 2032A is one area where the 1987 version of the Handbook gives substantial additional guidance to the examiner. It acknowledges that real estate other than farmland may be the subject of a special-use value election.

b. Requirements.

- (1) In order for property to meet the pre-death qualified use requirement, the decedent or a member of his family must have been receiving farm income, as opposed to passive rental income. According to the Handbook, this means that the decedent or a family member could not have cash rented to a nonfamily member and still qualify.
- (2) In applying the pre-death requirement that the realty must have been owned by decedent or a member of his family for at least five of the last eight years, the Handbook acknowledges that the decedent can acquire the property in a like-kind exchange or as a result of the reinvestment of involuntary conversion proceeds, with tacking of ownership allowed for

the swap or reinvestment amount. Any investment in excess of the swap or reinvestment portion must be held for a least five years.

- (3) Property held in a corporation or a partnership can qualify, if the corporation or partnership has fewer than 15 shareholders or partners and the decedent's ownership interest is at least 20% of the value of the voting stock or 20% of the capital interest of the partnership. This dual requirement varies from Section 6166(b), which requires that only one of the tests be met. Since Section 2032A(g) indicates that the 6166(b) approach is to be used, the Handbook appears unduly harsh. The transfer of land into a corporation or partnership will not require any five-year period if the transfer was nontaxable under Sections 351 or 721.
- (4) In determining whether the 25% and 50% tests for qualification are met, the agent is to take into account the rule of Section 2035(e)(3) and construct a hypothetical adjusted estate. Under that rule, transfers made within three years prior to death are generally added back to the estate for purposes of determining qualification under Section 2032A. The Handbook does not elaborate on how this hypothetical adjusted estate is to be constructed. Rev. Rul. 87-122, IRB 1987-46, 14, indicates that farmland given away within three years prior to death is added back to the estate for the purpose of meeting the 50% test, but not the 25% test.
- (5) While an undivided portion of an entire interest in realty can pass to a nonfamily member, any other interest passing to a nonfamily member generally will disqualify the property for special-use valuation. If property passes to a daughter and a stranger as tenants in common, the Handbook indicates that the daughter's portion can be specially valued. If the property passes to the daughter for life with remainder to the stranger, then no portion of that interest can be valued under Section 2032A.

c. Material Participation.

(1) Generally.

Detailed audit guidelines are also issued on material participation.

- (a) The first point of reference is whether self-employment taxes were paid on the alleged material participant's income tax returns. Even if self-employment tax is paid, the agent is instructed to scrutinize returns further.
- (b) If the return reflects cash rentals rather than crop sales, or if it does not show any sharing of expenses, the landlord's economic interest in the property may not be sufficient.
- (c) Further, if there is not depreciation or investment credit taken for farm equipment and machinery, this may indicate a lack of material participation. (Given the repeal of the investment credit, the latter should no longer be a criterion.)
- (d) If farm management fees are deducted on the return, the farm manager should be interviewed to explain the circumstances and to verify whether the decedent remained involved.
- (e) The Handbook does not direct the agent to check whether farm losses appeared as active or passive losses under TRA '86, but this may still be a factor.

(2) Other Information.

The agent is instructed to consider other schedules of the estate tax return itself regarding the material participation issue.

- (a) Inquiry is to be made for assets and debts usually involved in a

farming operation, such as growing crops, farm animals and production loans.

- (b) The death certificate is to be scrutinized to indicate whether the decedent's health was sufficient to permit the decedent to participate, and whether the decedent had the mental faculties to understand and decide farm management issues.
- (c) If the decedent died in a nursing home or in another area of the country during the growing season, this may indicate a lack of material participation by the decedent.
- (d) If the decedent owned a car, the agent is to consider the mileage accumulated, to see if it is sufficient to indicate regular trips to the farm for inspection and discussion.
- (e) Canceled checks are to be analyzed to determine if they indicate that the decedent might have had a summer home where significant time might have been spent away from the farm during the growing season. Review of personal checks is also suggested from the standpoint of indicating where and when they were cashed, to suggest the dates when the decedent may have been residing away from the farm.
- (f) Phone bills for the decedent's vacation home may also indicate when the decedent was in residence and how often conversations with the tenant occurred.

(3) Retired/Disabled Decedent.

The ability of a retired or disabled decedent to use the time period prior to retirement or disability to meet the five-of-eight-year test is acknowledged. The Handbook indicates that the retirement disability must be continuous in order for the exception to apply; if there is

any break, the five-of-eight-year period ends as of the last date of retirement or disability.

(4) Tenants.

The Handbook recommends that all of the tenants should be interviewed and detailed questions asked concerning every step in the operation of the farm, not only as to who did the task, but who decided that the task needed to be done and how and when it was to be done. A 72-question list is included in the Handbook for the agent to use in questioning the tenant. These provide an excellent outline for anyone attempting to prepare a material participation lease. The tenant should be asked such questions as, who decided:

What to plant?  
Where to plant?  
What crop rotation to follow?  
Whether to fertilize?  
The type of fertilizer?  
When to fertilize?  
How to fertilize?  
The supplier for fertilizer?  
Where to buy the fertilizer?  
When the fertilizer was to be delivered?  
Payment arrangements for the fertilizer?  
Whether to apply herbicides?  
The type of herbicides?  
When to apply the herbicides?  
How to apply the herbicides?  
The supplier for herbicides?  
Where to buy the herbicides?  
When the herbicides were to be delivered?  
Payment arrangements for the herbicides?  
Whether to apply pesticides?  
The type of pesticides?  
When to apply pesticides?  
How to apply the pesticides?  
The supplier for pesticides?  
Where to buy the pesticides?  
When the pesticides were to be delivered?  
Payment arrangements for the pesticides?



When to plough, disk or harrow?  
How to plough, disk or harrow?  
The type of seed?  
The quality of seed?  
The quantity of seed?  
If seed treatment was needed?  
When to plant?  
Where to plant?  
How to plant?  
How to handle weeds?  
Whether to cut weeds?  
If ditches were needed?  
If waterways were needed?  
If ditch maintenance was needed?  
If irrigation was needed?  
How to irrigate?  
Whether to plough crops under?  
Whether to replant?  
When to combine, harvest or pick  
the crop?  
How much seed to save?  
Whether to clean seed?  
Whether to bale hay?  
When to bale hay?  
Whether to sell?  
When to sell?  
How much to sell?  
Where to sell?  
Whether to hire help?  
How to hire help?  
Who was to be hired?  
How much the hired help was paid?  
How to arrange for credit for the  
farming operation?  
Whether to enter a government program?  
What supplies to purchase?  
Whether to rent equipment?  
Who to rent equipment?  
What controls or records to keep?  
How the equipment would be main-  
tained?  
Whether the stalks would be ploughed  
under after harvest?  
When it was time to detassle?  
The frequency of contact between  
the tenant and the landlord?  
How often the landlord would inspect  
the farm?  
How often the landlord and tenant  
would meet to discuss operations  
How often the landlord would call  
the tenant?

When the landlord would call the tenant?

(5) Remainder.

Remainder interests in farm realty owned by the decedent do not qualify for special-use valuation, even if a member of the decedent's family was the life tenant.

d. Election Procedures.

Guidelines are given on the requirements of the special-use valuation election documentation.

(1) Consent.

Section (18)30 of the Handbook indicates that trust or corporate consent probably will require more than the signature of the beneficiaries or shareholders. Reg. 20.2032A-8(c)(2) requires that the trustee must sign on behalf of a trust, though the Handbook does not indicate this. In Ltr. Rul. 8540003, the IRS stated that the authorization of the corporate execution of the agreement by a board of directors' resolution must be made prior to the time the election is filed. The capacity of each signatory must be indicated, according to the Handbook. The Handbook indicates that co-owners of property must consent to the collection of any possible recapture tax. This is inconsistent with a Tax Court decision invalidating the requirement of co-owner consent in the special-use valuation Regulations.

(2) Substantial Compliance.

If the election is deficient in certain respects, it must still be accepted if it substantially complies with the Regulations. Specific items which may be supplied after the initial filing include Social Security numbers, addresses, qualified heirs, written appraisals obtained prior to the filing of the return, the legal description of the property and designation of an agent.

(3) Protective Election.

The Handbook acknowledges that an executor who does not wish to make an irrevocable election at the time the return is filed may make a protective election. Implicit is the ability to make the protective election even if the estate qualifies to make the election at the time the return is filed. Section (18)30 admonishes agents that they should not shy away from auditing a return with this protective election simply because its perfection may result in a reduction in estate tax liability, because any estate tax reduction will be offset by possible recapture tax, lower income tax basis and the possible loss of estate tax deferral benefits under Section 6166. Even if an agent does not audit a return in which a protective election is made, TAM 8802010 indicates that the executor may perfect the election within 90 days after receipt of the closing letter.

e. Determination of Value.

(1) Generally.

In evaluating the proposed special-use value, agents are advised by Section (18)40 to compare crop-share figures submitted by the estate for comparable property with the indicated yields as determined by the Department of Agriculture, Agricultural Stabilization and Conservation Service. This is to determine if the rents are truly comparable. This approach is ironic given the Service's adamant position that such average figures may not be used by taxpayers for purposes of establishing comparable cash rents.

(2) Minority Interests.

The Handbook also takes the position that minority interests and undivided interests discounts are not available as to trusts, corporations and partnerships holding realty subject to a special-use valuation election. This is consistent with Ltr. Rul. 8302005.

(3) Recapture.

If the specially valued property is transferred after the decedent's death to someone who is not a member of the family of the qualified heir, recapture results. Section (18)50 of the Handbook notes that members of the decedent's family are not necessarily members of the qualified heir's family.

10. Professional Fees.

Consistent with the Service's recent position in rulings and cases, the new Handbook includes more stringent guidelines for the deductibility of attorney's and accounting fees.

a. Regulations and Case-Law.

Reg. 20.2053-2 requires that the expenses be actually and necessarily incurred in the administration of the estate. In Estate of Park, 475 F.2d 673 (CA-6, 1973), the Sixth Circuit considered only whether the expenses were allowable by the laws of the jurisdiction where the estate was being administered, holding the further limitation in the Regulations invalid. The Seventh Circuit took the same approach in Ballance, 347 F.2d 419 (CA-7, 1965). However, the Second, Fifth and Ninth Circuits have upheld the limitation in the Regulations.

The deductibility of attorney's fees has also been faced by district courts. In First National Bank of Nevada, DC Nev., 8/25/77, the Service had asserted that the reasonableness of the attorney's compensation was not a state law question, and could not be determined without considering the amount of time spent performing services for the estate. However, the court allowed a deduction on the basis that the local probate court had approved the fee and the fee had been paid. It held that the Service had no authority to disallow any part of the fee, absent fraud or collusion. The same court allowed an attorney's fee equal to 5% of the estate, in Bank of Nevada, DC Nev., 5/22/80. The award had been approved by the probate court, based on the size of the estate and the customary billing practices in the area.

More recently, the Service attempted to subpoena an attorney's time records concerning an estate in order to determine the reasonableness of the fees paid, in White, 650 F. Supp. 904 (DC N.Y., 1987). The local surrogate's court had already approved the payment of the fees, with the written consent of the heirs. The district court quashed the subpoena on the basis that the state law standard was the same as the Federal, and had been properly applied by the surrogate.

In TAM 86365100, the attorney's fees had also been approved in a probate court proceeding, after testimony by the attorney as to the services rendered, and with the heirs' written consent. The National Office, however, stated that it was not bound by the probate court decision since the state supreme court had not established a definite standard for allowing attorney's fees under state law. But, because the estate was in the Seventh Circuit the fees were deductible, given the deference shown by that circuit to state court decisions.

b. Handbook's Approach.

The deductibility of accounting and attorney's fees is given a new challenge. Under Section (15)42, accounting fees are to be disallowed as deductions if the services rendered are actually the executor's normal duties, and the executor has taken a full executor's fee. Attorney's fees are to be challenged if not reasonable, as determined under the multi-factor tests set forth in the ABA Model Code. Section (15)52 suggests that the agent obtain an affidavit stating what legal services were performed, how long the service took, and who did the work. The attorney's time records, itemized bills and fee agreements should be examined to verify the reasonableness of the fee. This instruction is consistent with the Service's litigating and ruling position, but may not succeed in the courts if the local probate court has approved the fee payment.

11. Other Estate Tax Changes.

Several other changes in the Handbook are worthy of brief mention.

a. Closely Held Corporations.

In determining the value of a closely held corporation, the 1980 Handbook urged the agent to keep an open mind. Although the agent was instructed not to compromise once a valuation decision was reached, he was urged to give the estate's position a full hearing before arriving at his figure. The 1987 version omits this section. Given that the estate now faces the possibility of an addition to tax for undervaluation under Section 6660, this apparent change in tone on valuation issues is somewhat ominous for taxpayers. The new Handbook gives virtually no guidance to agents in assessing or waiving the additional tax under Section 6660, so this important matter will be left to each agent's own discretion.

b. Joint Property.

Where property is owned jointly by the decedent and another who is not the decedent's spouse, agents are cautioned that some joint owners may intentionally not prove contribution, and instead include the full value of the property in the estate. This is done to increase basis and obtain higher depreciation deductions. Section (10)60 of the Handbook contends that the examiner may determine contribution independently, and exclude the part of the property attributable to the contributor.

c. Notes.

The valuation of notes is given additional attention. Demand notes cannot be discounted based on interest rates, according to the Handbook. In valuing term notes, the remaining payments due at death are to be discounted based on a constructed rate, rather than the IRS general valuation rate (currently 10% under Reg. 20.2031-7). This constructed rate is to be based upon rates paid by lending institutions on savings certificates, increased for negative factors such as late payments, inadequate security and amounts necessary to determine a fair rate of return.

If the note is secured, the taxpayers must also show that the collateral is insufficient to secure the debt. To the extent that discounts

are taken on receivables, the agent is to inform the taxpayer that any principal received in excess of the value will be subject to income tax. If the notes or receivables are from children or other related entities and are discounted, the agent is to determine if there was a gift when the notes were made.

d. Trust Income.

Agents are advised by Section (11)44 to include accumulated but unpaid or accrued income of a deceased trust income beneficiary in the gross estate, subject to the income distribution provision of the governing instrument. Inclusion apparently can be avoided by a trust provision granting the accumulated and accrued income to the remainder beneficiaries. The Handbook also indicates that income for this purpose includes not only dividends and interest payable in the usual way, but also income apportionable from extraordinary dividends payable from accumulated earnings on stock held in trust earned after creation of the trust. This rule is said to apply under New York law, for example.

e. Gross and Taxable Estate.

Agents are instructed by Section (12)40 to gross up net gifts for purposes of including the gift tax in the taxable estate, consistent with the recent decision in Estate of Sachs, 88 TC 769 (1987).

Sections (12)20 and (12)60 set forth the general rule under Section 2035 that if a decedent has made an incomplete transfer that would otherwise be includable under Sections 2036, 2037, 2038 or 2042, and then completes the transfer within three years of death, the assets are includable in the gross estate.

In connection with whether a gift was completed prior to death, agents are alerted to scrutinize gifts made by an attorney-in-fact pursuant to a power of attorney, or by a guardian or conservator appointed by a court. As to the former, the agent is to determine whether the power is durable, i.e., effective after disability. As to guardians and conservators, the agent is directed to determine whether state law permits the fiduciary to make gifts

under the doctrine of substituted judgment. In both cases, the agent is to determine if fiduciaries are permitted by applicable state law to make gifts to themselves, where such gifts were in fact made.

The 1980 version of the Handbook instructed the agent to exclude property which the executor incorrectly included in the gross estate under the mistaken conception that the property was subject to a general power of appointment. The 1987 version omits this instruction.

f. Annuities and Death Benefits.

In the section on annuities, the agent is instructed not to include death benefits paid pursuant to a post-death resolution by the decedent's former employer where there is no legal obligation, understanding or custom as to such death benefits. However, the Handbook characterizes such a transfer as a gift to the survivor, creating the implication that the decedent may have made a taxable gift. This is consistent with Rev. Rul. 81-31, 1981-1 CB 475, but inconsistent with at least one court opinion.

Agents are also encouraged to determine if the decedent was receiving employment benefits during life which resulted in a total arrangement which required the inclusion of survivor benefits in the gross estate under Section 2039, even if the decedent had no right to any lifetime payments under the specific survivor benefit program. This has been the litigating position of the Service, which has had mixed success. The annuity section acknowledges the excludability of a surviving spouse's community property interest in death benefits, but only as to the noncontributory portion of the qualified plan. No instructions are included in the Handbook on the application of the new excess retirement accumulation tax under Section 4981A.

g. Other Provisions.

- (1) In evaluating whether a trust qualifies for the marital deduction, the agent is to determine if there are remarriage conditions or discretion to distribute income to any beneficiary other than the



surviving spouse, either of which results in disqualification.

- (2) In determining whether reasonable cause exists for a failure to file an estate tax return on a timely basis, Section (22)22.2 of the Handbook, in accordance with Boyle, 469 U.S. 241 (1985), states that reliance on an attorney does not constitute reasonable cause.
- (3) In Section (22)40, agents are alerted to potential application of Section 6701 to representatives and third parties who advised the taxpayer with respect to the preparation of presentation of any portion of the return, and who know that their appraisal or advice will cause an underpayment of tax. The penalty is to be applied even though the taxpayer was unaware of the underpayment potential.
- (4) No guidance is given to agents in dealing with the complex new rules of Section 6166 with respect to holding companies and passive assets. The former permits an executor to elect deferral for estate tax on holding company stock if certain requirements are met, under Section 6166(b)(8). The latter generally excludes assets not used in a trade or business from being used to meet the percentage tests necessary to qualify for deferral, under Section 6166(b)(9). However, recognition is given in Section (23)65 to the method for claiming estate tax deductions for interest paid each year on deferred estate tax, in accordance with Rev. Proc. 81-27, 1981-2 CB 548. The ability of the executor to elect the new Section 6324A lien, added in 1976, in lieu of a bond or personal liability for deferred estate tax, also is recognized.

12. Gift Tax Audits.

Agents are given several suggestions for finding unreported gifts made during lifetime. They include the following:

- a. Agents are to check prior transfers of stock in a family-owned business, if the financial information discloses that the donor's family

owned interests in the business not reflected on a gift tax return for prior periods.

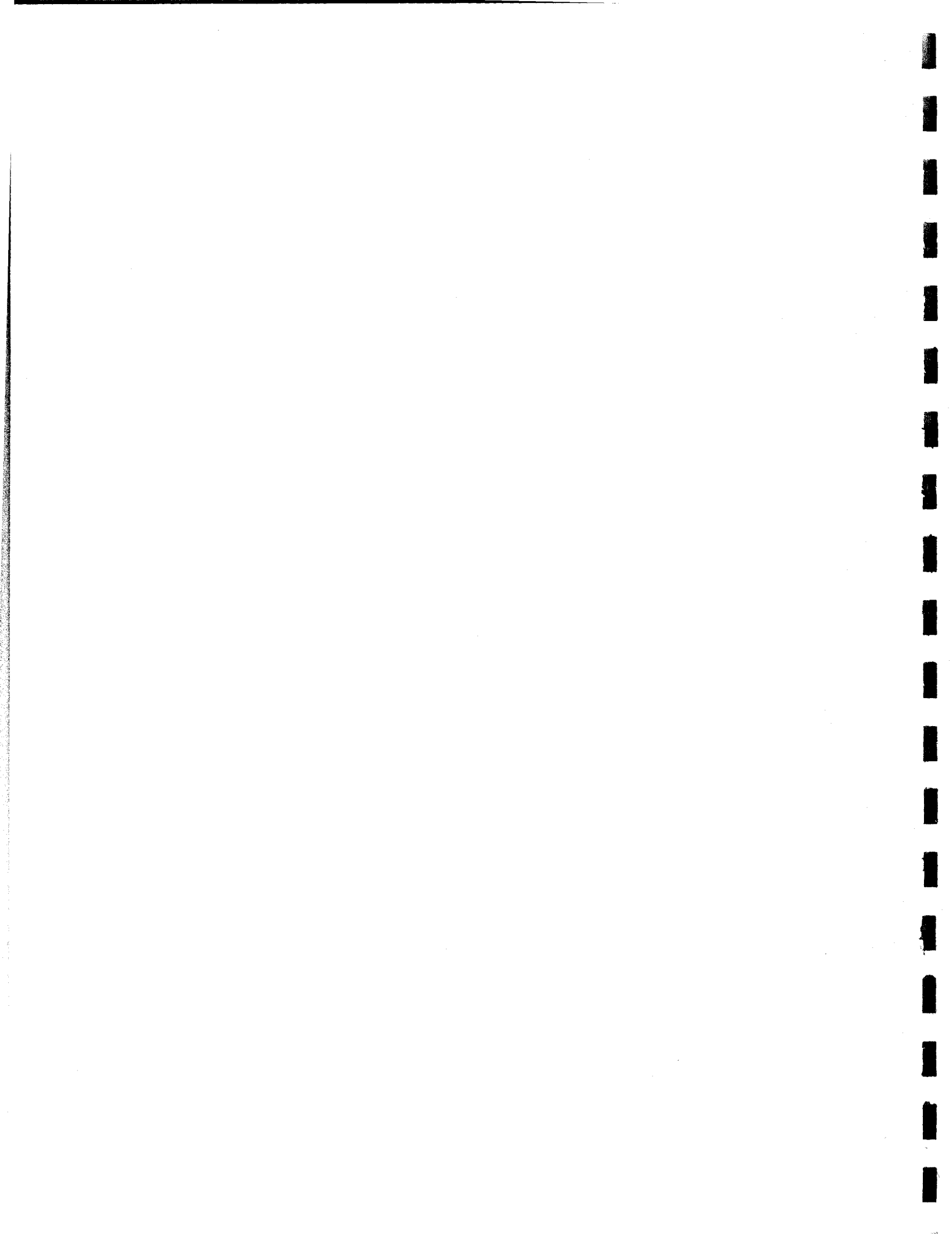
- b. Questions should be asked about any funding of gifts to a trust where the gift trust was established several years before, and no gift tax returns have been filed in the interim.
- c. Any premium payments made by the donor after transferring life insurance policies should be included as gifts.
- d. If the donor makes gifts to nieces and nephews, the gift tax returns of the donor's sibling should be examined to see if there were reciprocal gifts, in which event the annual exclusion is disallowed. This result is consistent with Rev. Rul. 85-24, 1985-1 CB 329, and Ltr. Rul. 8717003.
- e. If loans are reported on the estate tax return, agents should check to see if no interest or below-market rate interest was charged, in which event there were gifts in the intervening years.
- f. If the decedent was retired, agents are encouraged to look for a gift which occurred if the taxpayer elected to take a reduced pension, so that an annuity would be paid to the surviving spouse. This inquiry results from the recent repeal of Section 2517, but will be reversed under a provision of the proposed Technical Corrections Bill if the annuity is a required form of distribution under the Retirement Equity Act.

ESTATE PLANNING CONSIDERATIONS RELATED TO ENTITY SELECTION

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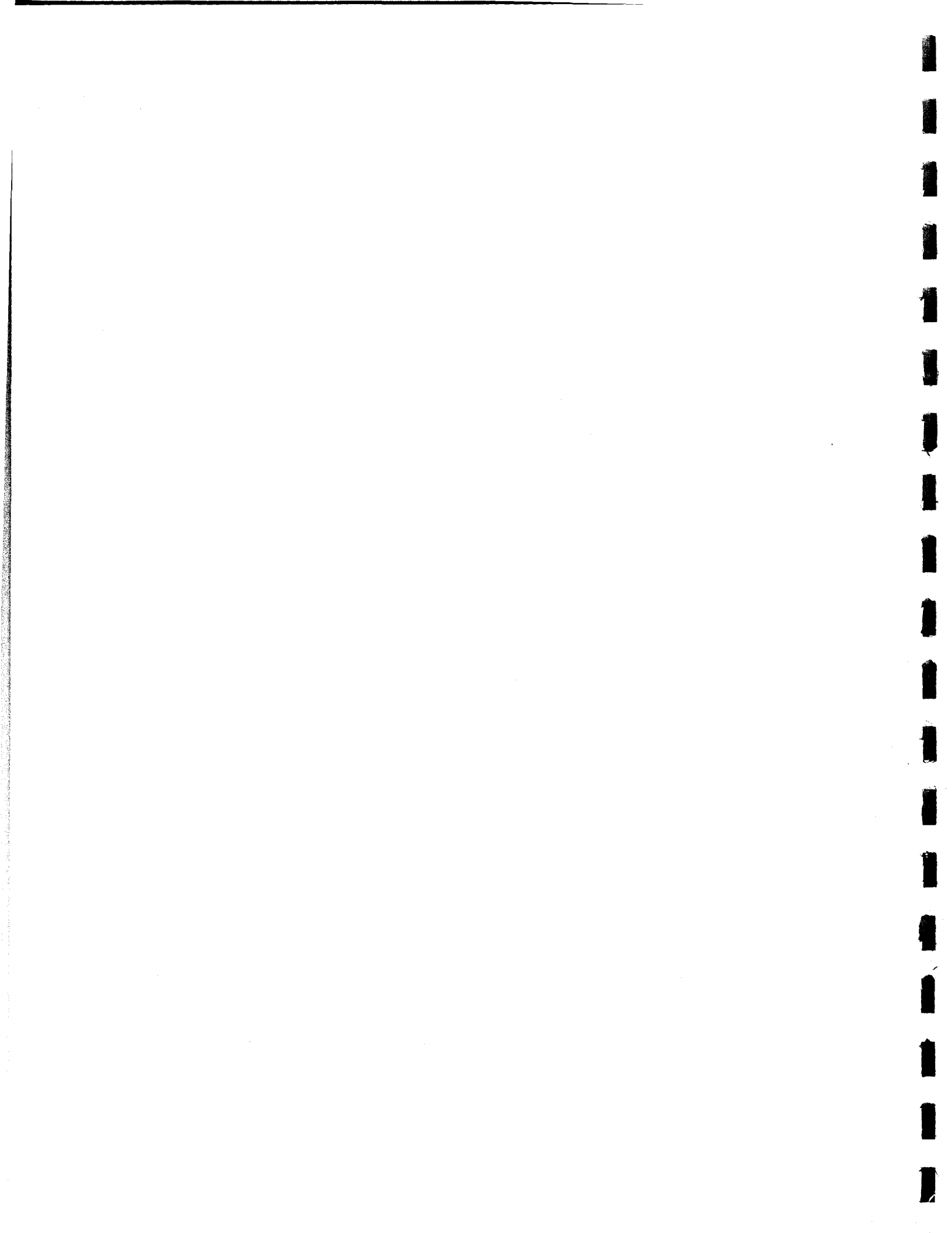
SECTION E



ESTATE PLANNING CONSIDERATIONS RELATED TO ENTITY SELECTION

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## ESTATE PLANNING CONSIDERATIONS RELATED TO ENTITY SELECTION\*

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The purpose of this outline and presentation is to examine some of the estate planning considerations related to the selection of a particular entity in the operation of a client's trade or business. It is presumed that the basics of a partnership, a C corporation and a S corporation, as well as the general reasons for selecting one from an operational and income tax standpoint, are understood with the focus of this outline being limited to the estate planning issues in the disposition of these ownership interests. It would be impossible to mention, much less adequately cover, all areas of concern so those of major importance will be highlighted with more emphasis being placed on the S corporation.

### I. Transfers by Gift

#### A. Tax Considerations

##### 1. Annual Exclusion

IRC § 2503(b) provides that the first \$10,000 of gifts to each donee per annum shall not be considered in the amount of gifts made during the taxable year.

##### a. Exceptions

The annual exclusion does not apply to gifts of future interests. IRC § 2503(b).

##### (1) Gifts to Minors

A gift to a donee under 21 at the date of the transfer will not be treated as a gift of

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a future interest if the property and the income may be expended by or on behalf of, the donee before he reaches age 21, and will to the extent not so expended pass to the donee when he reaches 21, and if he should die before that date it is payable to the donee's estate or he has a general power of appointment over the property. IRC § 2503(c).

(2) Use of Crummey Trust

In Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), the beneficiaries had the right to demand a distribution of the amount of the contributions made to the trust each year. The court held this to be a gift of a present interest even though some of the beneficiaries were minors and would have had to have guardians appointed to make the demands. The right to withdraw may be conditioned on its being exercised within 30 days of notice.

(a) Knowledge of Withdrawal Rights

The beneficiaries must have knowledge of their right to withdraw. Rev. Rul. 81-7, 1981-1 C.B. 474, and must have a reasonable opportunity to exercise these rights.



(b) Problem of Power of Appointment

Such a power to withdraw assets for the beneficiary's own benefit constitutes a general power of appointment, IRC 2514, and the lapse of such a power gives rise to a gift if the value of the withdrawal right that lapses exceeds the greater of \$5,000 or 5% of the assets out of which it could be satisfied. Hence, the trust should provide that no withdrawal will lapse if such a lapse would result in the holder of the power being treated as making a gift to the trust.

2. Gifts by Spouses

A gift by one spouse to a third party is deemed to be made one-half by the actual donor spouse and one-half by the other spouse provided that they consent to this treatment. IRC § 2513(c). Hence, the spouse may make gifts of \$20,000 per year per donee.

3. Gifts Between Spouses

A gift of an interest in property to a donee spouse shall be allowed as a deduction in computing taxable gifts. IRC § 2523. State inheritance or estate tax provisions should be checked to determine the extent of the free spousal transfer on the local level.

4. Gifts with Retained Interests

While any detailed discussion of the problems of IRC §§ 2036, 2037 and 2038 are well beyond the scope of this paper some mention should be made with regard to the obstacles these sections pose for life time transfers since the donors will often have a desire to retain some control over purported gifts.

5. Valuation Date

Any gift of property shall be valued on the date of the gift. IRC § 2512(a).

6. Unified Credit

The unified credit is now \$192,800 reduced by the sum of the amounts previously allowed as a credit for all preceding calendar periods. IRC § 2505. This translates into the ability to make transfers of otherwise taxable gifts of \$600,000 without incurring any gift tax liability.

7. Equalizing Estates

Some consideration should be given to the use of gifts for the purpose of equalizing the estates of the spouses. Much has been written on this, and more has been said, but it bears repeating lest it simply be overlooked.

B. Non-Tax Considerations

1. In General

These may be more worthy of consideration than some of the tax considerations but rather than attempt to list them collectively at this juncture they will be

interspersed throughout the outline where they may appear to have more relevance and be understood more easily.

## II. Gifts of Partnership Interests

A gift of an interest in a partnership can be structured in such a fashion that the \$10,000 annual exclusion can be obtained.

### A. Some Problem Areas

#### 1. Possible Gain to Donor

A donor may be required to recognize a gain on the gift of a partnership interest if his share of the partnership liabilities attributable to the donated interest exceeds his adjusted basis in the interest. This is caused due to the Code treating the donor as receiving a distribution of cash to the extent of these transferred liabilities. IRC § 752.

#### 2. Distributive Share where Partner's Interest Changes

A gift of a partnership interest during the taxable year will result in the distributive share of any income, gain, loss, deduction or credit being allocated between the donor and the donee according to the number of days in the partnership's taxable year before and after the gift. IRC § 706(d). The same rule would apply to a gift of S stock. IRC § 1377(a). These problems may or may not be of great magnitude but can be eliminated by making the gift at the beginning or the end of the tax year.

3. Inability to Shift Earned Income

A gift of an interest in a partnership on the cash basis, after an item of income has been earned but before it has been included in gross income, may not shift the income tax liability of that income to the donee. Rev. Rule. 60-352, 1960-2 C.B. 208.

4. Gifts of Installment Obligations

A gift of an installment obligation results "in a realization of gain by the donor to the extent of the difference between the basis of the obligation and its fair market value at the time of such disposition." Rev. Rul. 60-352, 1960-2 C.B. 208 at 209. May not be as great a problem for transfers of obligations created after 1986 because of the more stringent rules of reporting on the installment basis but they pose a trap for the unwary on previously existing installment obligations.

5. Family Partnership Problems

A donee will have to meet the requirements of IRC § 704(e) with regard to the family partnership rules before he will be deemed a partner for purposes of income taxation. In short, he will be recognized as a partner "if he owns a capital interest in a partnership which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." IRC § 704(e).

a. The Regulations Tests

The regulations set forth the basic tests for determining whether a donee of a partnership interest is a real partner. Treas. Reg. § 1.704-1(e).

(1) In General

The regulations provide that it must be ascertained from all the facts and circumstances and that isolated facts are not determinative. Treas. Reg. § 1.704-1(e)(2).

(2) Crucial Factors

Treas. Regs. § 1.704-1(e)(2).

- (a) Retained control of the donor over the distribution of income or restriction on the distributions of amounts of income.
- (b) Limitation on the right of the donee to sell or liquidate his interest at his discretion without financial detriment.
- (c) Retention of control over the assets essential to the partnership business.
- (d) Retention of management powers or voting control inconsistent with normal relations among partners.
- (e) Whether there is substantial participation by the donee in the control and management of the business.
- (f) Actual distribution to a donee of the entire amount or a major portion of his

distributive share of the business income for the sole use and benefit of the donee.

- (g) Treatment of the donee as a partner in the operation of a business.
- (h) Whether the donee is held out publicly as a partner in the conduct of the business, in relations with customers or creditors, etc.
- (i) Whether there has been compliance with local partnership, fictitious names and business registration statutes.
- (j) Whether the donee has his fair share of control over business bank accounts.
- (k) Recognition of the donee's rights in distributions of partnership property and profits.
- (l) Recognition of donee's interest in insurance policies, leases and other business contracts.
- (m) Existence of written agreements or records contemporaneous with the taxable years involved, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(n) Whether required partnership tax returns have been filed.

(3) Other Considerations

Despite a formal compliance with all of the above listed factors, other circumstances may indicate that the donor has retained such a substantial ownership of the interest purportedly given to the donee that it will be ineffective for tax purposes.

b. Supreme Court Test

Even if the above requirements are seemingly complied with or are not met, the answer is not mechanical because the safe harbor tests are not exclusive. As the Supreme Court has said, the issue "is not whether the services or capital contributed by a partner are of sufficient important to meet some objective standard..., but whether, considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present

conduct of the enterprise." Commissioner v. Culberston, 337 U.S. 733 at 742 (1949).

c. Income Taxation of the Donee Partner

Even if a donee is recognized as a partner under IRC § 704(e)(1), the distributive share of the donee will not be included in his gross income if it was determined without allowance for reasonable compensation for services performed by the donee to the partnership or if the portion of the share attributable to the donated capital is proportionately greater than the share of the donor attributable to his capital. IRC § 704(e)(2).

d. Additional Factor in Limited Partnership

In the case of a limited partnership, consideration shall be given to the fact that a general partner, unlike a limited partner, has his credit at risk in the partnership business. Treas. Reg. § 1.704-1(e)(3)(ii)(c).

B. Non-Tax Factors

A discussion of the tax consideration involved in the gift of a partnership interest, particularly those of a family partnership, highlight the non-tax factors such as loss of income, loss of control, acceptance of the new partner by other partners as well as outsiders. They will not be examined again in limbo.



### III. Gifts of S Corporation Stock

#### A. Control Issues and the S Election

A major concern of the controlling shareholder or family group is the retention of corporate control and the retention of S corporation status. The control issue and preventing the loss of the S corporation election are separate issues.

#### B. Ways of Protecting Corporate Control Without Jeopardizing the S Election

##### 1. Voting Trust

The stock of an S corporation may be placed in a voting trust under Section 1361(c)(2)-(A)(iv). However, because each beneficiary of the trust is considered to be a shareholder, care must be exercised not to exceed the 35 shareholder limit. Kentucky allows a voting trust for a period of ten years.

##### 2. Irrevocable Proxy

An irrevocable proxy may be used as a substitute for a voting trust under a pre SSRA (Sub-chapter S Revision Act of 1962) law ruling of the Tax Court. See Parker Oil Co. v. U.S., 58 T.C. 985 (1972). Kentucky law recognizes an irrevocable proxy for only three years unless it is coupled with an interest.

##### 3. Shareholder Agreements

Restrictive shareholder agreements have not been construed as a second class of stock by the Internal Revenue Service. See Rev. Rul. 73-611, 1973-2 C.B. 312. Further, since the SSRA allows for differences

in voting rights, restrictive shareholder agreements should continue to be permissible.

4. Voting and Nonvoting Common Stock

One of the best ways to shift income to family members with the retention of corporate control is the use of voting and nonvoting common stock. Such stock is permitted under § 1361(c)(4). Since each share of stock carries a proportionate amount of income, the use of two classes of common stock is an excellent way to shift income to family members without transferring corporate control. Note, however, that all shares must have equal rights with respect to the other attributes of common stock.

C. Drafting Buy/Sell Agreements

1. Scope

S corporation buy/sell agreements are an important part of estate planning for estates with significant amounts of S corporation stock. This section of the outline will cover in limited detail some of the basic considerations in drafting such agreements. For a more detailed analysis see an article by David Gray and Lorence Bravenec, Buy/Sell Agreement of S Corporation Stock Affected by Corporation's Special Tax Status, *The Journal of Taxation*, October 1985, at 202.

2. The Form of S Corporation Shareholder Agreements

a. Provisions relating to revocation and termination of the S election

- (1) The agreement should prevent transfers of stock to ineligible shareholders and transfers of stock which will cause the corporation to exceed its maximum number of shareholders (i.e., 35). To accomplish this the agreement should require prospective transferors of stock to provide the other shareholders with notice of the possible transfer and the right of first refusal to purchase the stock at fair market value or the price offered to the third party.
- (2) The agreement should state the intention of all shareholders to continue the S election and require a unanimous or high voting percentage consent to revoke the election. Without such an agreement the shareholder or shareholders holding more than fifty percent of the shares can revoke the election.
- (3) Provisions should be contained in the agreement to prevent a trust from becoming an ineligible shareholder.
- (4) The parties should consider including in the agreement a provision in each shareholder's will recognizing that the surviving shareholders receive a right of first refusal upon the death of the shareholder.

b. Adequate distribution to pay taxes

The agreement should require a corporation to distribute sufficient cash annually, so that the shareholder can pay his share of tax on the S corporation's pass through income.

c. Tax matters shareholder

The agreement should also contain a provision establishing the procedures for selecting a tax matters shareholder. This will facilitate the administration of any tax dispute between the Internal Revenue Service and the S corporation.

d. Entity v. Cross Purchase Agreements Compared

(1) Funding

Generally the funds used to purchase S corporation shares will come from the corporation. This applies whether an entity agreement or a cross purchase agreement is utilized. Because of the nature of an S corporation the double tax problem which faces shareholders of C corporations is not present.

(2) Insurance

The common method of being certain that a prospective purchaser of stock will have the necessary funds with which to purchase the stock is to acquire insurance policies on the life of each shareholder. With an S

corporation whether the entity or cross purchase approach is utilized, a corporation can be the purchaser of the stock (assuming the cross purchase plan is pro rata). In the case of a C corporation entity agreement provides for a simplification of the insurance program. Where pro rata cross purchase agreements are utilized in an S corporation context, the complexity is eliminated.

(3) Basis

The major difference in an entity and cross purchase agreement is the increase in basis of the purchased stock in the hands of the purchasing shareholder. Since losses are limited to a shareholder's basis in his S corporation stock, the cross purchase method provides an advantage to S corporation shareholders.

e. Price

Generally the purchase price for the stock is set in the agreement by formula or annually adjusted amount. Many times the value is too low creating what is known as the "russian roulette" situation. The best method for determining price is an independent appraisal. Even then it is advisable to make every effort to have the parties

periodically review the determined price to see whether it still has currency.

f. Fixing estate tax values

Determining the rights of the parties to purchase or sell S corporation stock, four possible forms of agreement exist:

- (1) Binding obligation to sell and binding obligation to purchase.
- (2) The estate "put" (i.e., the personal representative has an option to sell and the corporation or the surviving stockholders have an obligation to purchase.).
- (3) The corporate "call" agreement (i.e., An option to purchase on the part of the corporation and the personal representative is under a binding obligation to sell).
- (4) Rights of first refusal agreement (i.e., the personal representative must first offer the stock to the corporation or to the surviving shareholders.).

The tax consequences of these four types of agreements are as follows:

- (1) Binding obligation agreement normally will fix the value of the stock for federal estate tax purposes.

- (2) The "put" type of agreement is a tax disaster. It sets a minimum value but does not establish a maximum.
- (3) The "call" type of agreement may fix the estate tax values if supported by separate consideration.
- (4) Right of first refusal agreement does not fix the value.

#### IV. Gifts of C Corporation Stock

##### A. Some Problem Areas

##### 1. Type of Interests

There are more types of "preferred" interests which can be created in C corporations than in S corporations. For example, the only difference in stock permitted in as S corporation is voting and non-voting stock. IRC § 1361(b)(1) and § 1361(e)(4).

##### a. Non-Dividend Paying Stock

A gift of such stock may not qualify for the marital deduction. Treasury may argue that the donee spouse does not have a beneficial interest since there is no vote and there is no income being generated.

##### (1) Contrasted with S Corporation or Partnership

Shouldn't pose a problem because there is no separate taxpayer as in a C corporation and there should be a "distribution" of the cash flow.

2. Income Splitting

There may not be as much opportunity for income tax splitting with C corporations because you are dealing with at least two taxpayers and payouts (dividends) will be taxed twice.

a. Contrasted with S Corporation; or Partnership

Holders of S stock or partners have their distributive share of corporate or partnership income included in their gross income even if it is not distributed. IRC § 702, 1366. This may be a real incentive to give these interests to children who are in a lower tax bracket but some of that benefit may have been lost with the creation of the two bracket system in the 1986 Act.

B. Non-Tax Considerations

Most of what has been said above with regard to partnerships and S corporations is also relevant here.

C. Benefit of Familiarity

While familiarity sometimes breeds contempt there may be more certainty in the planning for dispositions of C stock than S stock simply due to the age of the two corporations and the amount of time that practitioners have devoted to each. However, don't confuse familiarity with utility.



V. Transfers at Death

A. Tax Considerations

1. Marital Deduction in General

IRC § 2056 provides for a deduction from the decedent's gross estate in an amount equal to the value of any interest in property passing on which has passed from the decedent to the surviving spouse to the extent that the interest was included in the decedent's gross estate.

a. Limitations

The marital deduction is inapplicable in the case of a life estate or other terminable interest. IRC § 2056(b).

(1) General Rule

No marital deduction where, either on the lapse of time, or the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate and an interest in such property passes or has passed from the decedent to any person other than the surviving spouse (or to the estate of such spouse), and if by reason of such passing, such person may possess or enjoy the property after such termination or failure of the interest of the interest passing to the surviving spouse. IRC § 2056(b)(1).

(2) Interest In Identified Assets

Where the interests out of which the property passing to the surviving spouse may be satisfied include any asset with respect to which no deduction would be allowed if it passed to the surviving spouse, than the value of the interest passing to the spouse shall be reduced by the aggregate of such assets. IRC § 2056(b)(2).

(3) Interest Conditioned on Survival

An interest passing to the surviving spouse will not be deemed a terminable interest which will fail on the death of the spouse if the death will cause a termination only if it occurs within 6 months after the decedent's death or only if it occurred as a result of a common disaster resulting in the death of both spouses and such failure or termination does not in fact occur. IRC § 2056(b)(3).

(4) Valuation of Interest Passing to Survivor

The value shall be determined by considering the effect which the estate or any inheritance tax has on the net value passing to the surviving spouse as well as the amount of any encumbrance assumed by the surviving spouse. IRC § 2056(b)(4).

(5) Life Estate with Power of Appointment

The terminable interest rule may be avoided by granting a life estate to the surviving spouse, with the income payable at least annually coupled with a general power of appointment. IRC § 2056(b)(5).

(6) Life Insurance with Power of Appointment

Same general as in (5) above is applicable to life insurance proceeds provided they or the interest therefrom is payable at least annually and begin not later than 13 months after the decedent's death. IRC § 2056(b)(6).

(7) QTIPs

In the case of qualified terminable interest property, it shall be treated as passing to the surviving spouse and no part shall be treated as passing to any other person. IRC § 2056(b)(7).

(a) QTIP Defined

It means property which passes from the decedent in which the surviving spouse has a qualifying income interest for life which means the survivor is entitled to all of the income, payable annually or more frequently and no person has a power to appoint any of the property to any person other than

the surviving spouse; provided, however, that this last power shall not apply to one exercisable only at or after the death of the surviving spouse. IRC § 2056(b)(7)(B). Lastly, in order to qualify the QTIP interest for the marital deduction, an election must be made by the executor on the required by § 2001. IRC § 2056(b)(7)(B)(V). This will necessitate its inclusion in the survivor's estate when he or she dies. IRC § 2044.

2. Transfers with Retained Interests

See § IA4 above where this problem was alluded to in the gift tax discussion.

3. Valuation

a. In General

The value of the gross estate is determined by the value of the property at the date of the decedent's death to the extent of his interest therein. IRC §§ 2031, 2033.

b. Alternate Valuation

The value may be determined 6 months after the date of the decedent's death if not sold or distributed before that date; at the time of the sale or distribution if made before that date; and, any interest which is affected by the mere lapse of

time shall be included at date of death value.

IRC § 2032.

c. Special-Use Valuation

A topic unto itself but it is included here because it is often used in the valuation of farm property.

IRC § 2032A. If the business is such that the decedent's relationship to it is an interest in a closely held business under IRC § 6166(b)(1), regulations indicate how the section is to apply.

4. Unified Credit

The estate tax unified credit is now \$192.80 but this must be used in connection with the gift tax credit. IRC § 2010.

5. Equalizing Estates

As was mentioned under the gift tax discussion, some consideration should be given to equalizing the estates of the spouses so as to minimize the total amount of estate taxation upon the death of both spouses.

VI. Death-Time Transfers of Partnership Interest

A. Some Problem Areas

1. Valuation of Decedent's Interest

a. Alternative Valuation

As is always the case, the possibility of the alternative valuation should not be overlooked. However, it may be even more important in the valuation of a partnership interest where the decedent was the sole partner or the one that was

the productive force in the business. In such a situation a substantial drop in value may occur between the date of death and six months thereafter.

b. Special Use Valuation

The special use valuation may be used for assets owned indirectly through the ownership of an interest in a partnership as well as in a corporation. Treas. Reg. § 20.2032(a)-3(b).

c. Valuation Discounts

(1) In General

There are not as many cases in the area of partnerships relative to discounts as there are in the corporate area but a couple of cases will be examined.

(a) Minority Partnership Interest

Harwood v. Commissioner, 82 T.C. 239 (1984) was a gift tax case but it serves as a basis for showing the court's reasoning in permitting a discount on the transfer of a minority partner's interest because of the lack of marketability and which was also subject to restrictive transfer clauses.

(b) Limited Partnership Interests

Take a look at Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) to see the factors used by the Court in granting a 15% minority discount in

determining the fair market value of the decedent's limited partnership interests.

(c) Comparison

It should be more difficult to obtain a discount in the valuation of a general partnership interest than in a limited partnership because of the powers and rights normally possessed by general partners.

(2) Use of Buy-Sell Agreements

The use of buy/sell agreements can be used to bind the service with regard to the valuation of partnership interest. Much of this was previously discussed in III C above and will not be repeated here.

2. Use of the Marital Deduction

There should be relatively few problems in qualifying the post-death transfer of a partnership interest for the marital deduction if that is desirable from an estate planning standpoint.

VII. Death-Time Transfers of S Corporation Stock

A. The Executor Holding S Corporation Stock

1. Timing - How long do you Hold The Estate Open

Since an estate is an eligible S corporation shareholder during the period of administration, the question arises as to how long can the administration period be without jeopardizing the S corporation election. If the

period of administration is extended beyond the time required to complete the ordinary steps of administration a risk exists that the Service will stop recognizing the estate as a shareholder.

It appears under Rev. Rul. 73-23, 1976-1 C.B. 264 that the administration can be prolonged solely for the purpose of making installment payments of estate taxes under § 6166 without jeopardizing the status of the estate as an S corporation shareholder.

2. Taxation Issues

a. Lack of distributable cash

If an S corporation has substantial undistributed taxable income and does not make substantial distributions, the estate may have to deplete other assets to pay the tax. Consider a shareholder agreement regarding a corporate cash distribution policy as a solution to this problem.

b. A "Phantom" income problem

Where the income beneficiary and the residuary beneficiary of S corporation stock are different individuals a residuary beneficiary may incur an unfair income tax burden if the will provides that all taxes are to be paid out of the residue. A simple solution to the problem is a special will clause addressing the issue.



c. Undistributed taxable income and distributable net income ("DNI")

Since DNI is computed on the basis of taxable income, the estate pro rata share of undistributed taxable income can effect the taxation of distributions to beneficiaries. S corporation undistributed taxable income can cause otherwise tax free distributions to be taxable. Finally, because of the per share, per day rule of income computation, the executor may not know the tax consequences of a distribution until after the fact.

B. Proper Disposition of S Corporation Stock

1. Outright Bequest

Unless such a bequest causes the requisite number of shareholders (35) to be exceeded, or is to an ineligible shareholder (such as a nonresident alien), such bequest should not jeopardize the S corporation election.

2. Use of A Marital Trust

Unless the trust is an eligible shareholder, the bequest of S corporation stock to such a trust will terminate the election. Either a QSST or a Section 678 trust must be used. Either of these types of trusts can qualify as marital deduction trust under § 2056.

a. QTIP trust

A QTIP trust will generally qualify as QSST.

Note that if the executor wants the trust to qualify as a QTIP trust and a QSST, two separate

elections must be made. The executor must elect under § 2056(b)(7). Further, the income beneficiary must make an election under § 1361(d)(2).

b. Power of appointment trust and § 678

A power of appointment trust which qualifies under § 2056(b)(5) can also be eligible to hold S corporation stock under § 678. In order to be eligible, the surviving spouse must be given an inter vivos general power of appointment or other right which would cause him/her to be treated as the deemed owner of the trust under § 678.

c. Testamentary trust as a beneficiary

A testamentary trust which is not a QSST or a § 678 trust is allowed to hold S corporation stock for up to 60 days after receipt by the trust. § 1361(c)(2)-(A)(iii) requires that the stock must have been transferred to the trust under terms of a will. The 60 day period is designed to allow the executor of an S corporation shareholder to remove the S corporation stock from an ineligible trust which is the beneficiary of a specific bequest of S corporation stock. Note that the trust need not be created under a will in order to qualify for the 60 day grace period. Thus, a specific bequest or pourover residuary device under a shareholder's will to an inter vivos trust will qualify for the 60 day grace period.

d. Grantor trust as a beneficiary

A grantor trust is also allowed a 60 day holding period to hold S corporation stock after the date of the grantor's death. If the trust's entire corpus is includable in the grantor's gross estate, the holding period is extended to two years.

3. Special planning considerations

Special powers should be given to the executor to distribute S corporation stock.

a. Non pro rata distributions

Executors should be given specific authority in the will to make non pro rata inkind distributions. This power will avoid the risk of the shareholder being required to distribute the stock to all beneficiaries and exceeding the 35 shareholder rule. Also, the executor should be given the authority to make such distributions without regard to the income tax basis of the assets distributed.

4. Powers to protect the S election

Powers should be given to the executor to prevent S corporation stock from being allocated to a disqualified trust. Example, the executor should be given the power to divest a funded trust, if necessary, to preserve the S election. Further, power given to beneficiaries, either through rights of withdrawal or powers of appointment, should be limited so that the

beneficiary cannot unilaterally terminate the election by exercising the power in a manner which causes the 35 shareholder limit to be exceeded.

5. Allocation problems

Substantial problems exist in determining whether the income from S corporation stock should be treated as "income" or "principal." Carefully defining these accounting terms can eliminate the potential conflicts among beneficiaries.

C. Changing In Status of the Corporation After the Death of a Shareholder

1. Terminating the election

In order for the executor to terminate an S corporation's status, the estate must own more than one half of the S corporation's shares in order to revoke the election without the consent of other shareholders. If the estate owns fifty percent or less of the stock, the S election can only be revoked with the consent of a sufficient number of shareholders holding (in the aggregate) more than one half of the shares of stock.

2. Executor's Role in Making an S corporation Election

a. Electing for an existing C corporation.

In order to elect S corporation status, the executor must get the unanimous consent of all shareholders. If the stock is still held in the estate, it is the executor not the beneficiaries who must consent.

b. Forming a Corporation and Making the S Corporation Election

Many times the executor is given the power to incorporate a sole proprietorship so that it may be continued for the benefit of the decedent's family. In such a case the executor may want to consider making an S corporation election. The decedent's will should give the executor express authority to make such an election. Under the TRA 86 changes an S corporation must adopt a "permitted year." A permitted year is defined in Section 1378 to be a year ending December 31, or any other accounting period for which a corporation establishes a business purpose.

The executor must consider the effect of a calendar year S corporation coupled with a fiscal year estate.

D. Effect of S Corporation Stock in a Revocable Trust

1. General Planning Scheme

Typically the tax planner will suggest the use of trusts where S corporation shares are involved. Most plans involving married shareholders will include the establishment of a QTIP trust (to take advantage of the unlimited marital deduction) and a bypass trust (to utilize the \$600,000 unified credit equivalent).

If it is assumed that a husband and wife each have a one billion dollar estate, an estate planner might suggest the use of an inter vivos trust which is revocable during the life of the husband and wife. As part of the estate plan for H & W, S corporation stock and other assets could be transferred inter vivos to the revocable family trust.

2. Division of Family Trust

Assuming the above facts, the revocable family trust might be divided into three trusts upon the death of either H & W. The surviving spouse's property would continue to be held in a revocable trust known as a "Survivor's Trust." \$600,000 of the decedent's property could be allocated to a bypass trust, with the remaining \$400,000 allocated to the QTIP trust.

3. Allocation of S Corporation Stock

a. Bypass Trust Problems

If the estate planner decides that it is beneficial to accumulate income in the bypass trust, S corporation election problems arise. In order for the bypass trust to be a qualified S corporation shareholder, the trust must qualify as a grantor trust under Section 671-678 of Subpart E, a testamentary trust, or a QSST. During the lifetime of H & W, the revocable family trust constitutes a grantor trust under Subpart E. However, after H dies the bypass trust is



established. If the trust provides for an accumulation of income, it cannot qualify as a QSST trust. Such a trust is required to distribute all of the income currently to the income beneficiary. Finally, if the trust receives a pourover of assets from the probate estate, it can qualify as a testamentary trust, but for only 60 days after receipt of S corporation stock.

b. Interim Trust Problems

In the case of a grantor trust, the 60 day period after the grantor's death during which the trust is a permissible shareholder is extended to two years if the entire principal of the trust is included in the gross estate of the grantor and the trust continues in existence.

At the death of H, H's interest in the family trust is no longer subject to revocation. Therefore, H's interest is held by an irrevocable trust which at some later date will terminate and be divided into two other trusts (QTIP trust and bypass trust). This irrevocable trust may be referred to as the "interim trust." Because of the existence of this "interim trust" it is arguable that the continued existence requirement will not be met. Thus, the QTIP and bypass trusts will



not be permissible shareholders for the two year period after H's death.

c. The Four Trust Format

There are several ways around the above problem. The easiest and safest method of avoiding the termination issue is to establish four trusts. H & W's S corporation stock should be held in a separate grantor S trust. The revocable family trust will hold all other assets of H & W. The grantor S trust can also act as a QTIP trust after H's death. A second revocable trust can continue as the bypass trust. This technique should prevent the interim trust from coming into existence by operation of law. Note that W's property would be held in a similar fashion, thus creating a "four trust format." Excess assets in the bypass trust could be allocated under a marital deduction clause to the QTIP trust. The use of the QTIP election can control the amount of S corporations stock subject to tax.

4. The QSST Election

a. Timing -- General Rule

The QSST election must be made within a two month and sixteen day period starting on the date that S corporation stock is initially transferred to the trust or the effective date of the S election, which is later. In the case of a grantor S trust

which ever continues in existence after the death of the grantor, the filing period for the QSST election will not expire until the sixteenth day and two month period has expired after the earlier of [1] the termination of the two year (or sixty day) period following the grantor's death, or [2] the date of the transfer of the S corporation stock by the trust.

Depending upon whether the four trust format or an interim trust is established, timing of the QSST election is different. If an interim trust is established, the period for filing the QSST election for the QTIP trust begins at the time of the transfer of the S corporation stock from the interim trust to the QTIP trust. If a four trust format is used, the QTIP trust will qualify as a grantor S trust which continues to be in existence after the death of H with the entire principal includable in H's gross estate. Therefore, the QSST election for the QTIP trust begins upon the expiration of the two year period after H's death.

b. Timing - The Interim Trust Problem

Many times an interim trust is not officially set up after H's death. It comes into existence by operation of law. In such a case many practitioners take the position that the assets were

transferred to the QTIP and bypass trusts on the date of H's death and that those trusts came into existence on that date. Unfortunately, consistent treatment would require a QSST election within two months and sixteen days after H's death. To the contrary, IRS could contend that the interim trust did exist and that the QTIP trust did not receive the S corporation stock until the actual allocation of assets from the interim trust. In that case the QSST election period begins when the QTIP trust receives assets. The easiest way to avoid this problem is the four trust format. If an interim trust is used, safe practice would be to make dual QSST elections.

4. Insuring the S Election

a. Use of a buy-sell or shareholder agreement

The importance of a buy-sell agreement or shareholder restriction agreement cannot be overemphasized. It is a critical document preventing the accidental termination of an S election.

b. Key terms

Buy-sell agreements have been discussed in more detail in Section IIIC., but a few key terms are reviewed here.

- (1) The agreement should provide that only grantor S trusts or QSST trusts may be recipients of S corporation stock.

- (2) The agreement could provide revocable family trusts must include the requirement that the QTIP and bypass trusts be formed within sixty days of H's death.
- (3) The agreement could also provide that S corporation stock be automatically allocated to the QTIP trust.
- (4) Finally, the agreement should provide that if all conditions of the agreement have not been met there will be an immediate and automatic buy-out of the S corporation stock at the time of the shareholder's death.

5. Inadvertent Termination

a. The Relief Provision of Section 1362(f)

The Code provides a safe harbor in the case of inadvertent terminations. The provision allows the Secretary to allow S corporation status to continue, notwithstanding that a termination event took place. In order to meet the qualifications of the Code, the IRS must determine the following:

- (1) The termination was inadvertent;
- (2) Within a reasonable period of time after the termination, the corporation has corrected the violation; and
- (3) The corporation and all of its shareholders agree to any IRS requirements to make

adjustments consistent with S corporation treatment.

b. Rev. Rul. 86-110

The Service recently issued Rev. Rul. 86-110, IRB 1986-38, 4. One of the problems with the Ruling is that it is based upon the premise that the individual would not have made the transfer, but for the advice of counsel that the transfers would not jeopardize the S election. Unfortunately, for the planning practitioner, a key element of relief appears to be improper (possible malpractice) advice of a tax advisor. Thus, reliance on the inadvertent termination relief provisions can be dangerous. It is interesting to note that the committee reports state that "the committee intends that the Internal Revenue Service be reasonable in granting waivers." One might question whether Rev. Rul. 86-110 exemplifies that intent.

Beyond the problems of the tax advisor, no assurance exists that the IRS will allow relief from inadvertent terminations. When relying upon section 1362(f) the taxpayer appear to be at the mercy of the Service. Also remember that the cost of undoing a transaction resulting in a termination can be expensive and aggravating.

Some of the above material relating to trusts is examined in more detail on an article by Gleitman and Keebanow, Designing Trusts That Will Preserve The S Election, 67 Journal of Taxation 146 (1987).

## VIII. Death Time Transfers of C Corporation Stock

### A. Some Problem Areas

#### 1. Marital Deduction

Under § 2056(b) nondividend paying nonvoting stock which is transferred to the spouse may not qualify for the marital deduction because the surviving spouse must have the beneficial enjoyment of the property during her lifetime.

#### 2. Valuation

Many of the same problems exist here that were previously discussed with regard to partnership interests and S corporation stock and will not be repeated here.

#### 3. Recapture of Special Use Valuation upon Creation of C Corporation After Death

Decedent died owning certain farm land and other assets which were valued under the special valuation procedures authorized by IRC § 2032A. It was subsequently determined that the farming operations could be more efficiently conducted through a corporate form of ownership and it was proposed that the special valued property be transferred to the corporation with the shares of stock being issued to the heirs. The

officers, directors and shareholders of the corporation are all "qualified heirs" as that term is used in the applicable section. Furthermore, all of the interested parties, including the corporation, agreed to an increase in the tax liability which would be occasioned if the property ceased to be used for farming purposes by qualified persons within the applicable time period. The issue was whether such a transfer will be treated as requiring a recapture of the additional taxes.

The ruling was in the negative. It was provided that the incorporation of the farming operation, the exchange of the specially valued real property for voting common stock of the corporation and the subsequent distribution of the stock to the heirs would not be considered either a disposition or cessation of qualified use causing a recapture. The ruling was conditioned on the agreements executed by the corporation and by the qualified heirs in their capacities as shareholders that they would be responsible for any additional tax liability if the special use property ceased to be used as such within the applicable time period. The ruling was in line with the regulations which provide "that real property that is specifically valued property may be owned directly or may be owned indirectly through ownership of an interest in a corporation. Reg. § 20.2032A-3(b)(1). Letter Ruling 8617026.

B. Non-Tax Consideration

Same as previously discussed for S corporation and partnership interests.

IX. Tax Aspects of Life Insurance Funded Buy/Sells

A. In General

IRC § 101(a)(1) provides that gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. Hence, the recipient would be able to exclude such proceeds even though they were received under a life insurance funded buy/sell agreement.

1. Exception

The above stated rule of exclusion does not apply in the case of a transfer of a life insurance contract or any interest therein; for a valuable consideration. IRC § 101(b). In that instance the amount excluded shall not exceed the sum of such consideration and the premiums subsequently paid by the transferee. For example, if the transferee paid \$40,000 to a transferor for a pre-existing \$100,000 policy and had paid an additional \$10,000 of premiums when the insured died, only \$50,000 could be excluded from gross income.

a. Exceptions to the Exception: IRC § 101(a)(2)

The normal exclusionary rule would apply even where there was a transfer for value

- (1) If the contract has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference



to such basis of the contract in the hands of the transferor.

- (2) If the transfer is to be insured.
- (3) If the transfer is to a partner of the insured.
- (4) If the transfer is to a partnership in which the insured is a partner.
- (5) If the transfer is a corporation in which the insured is a shareholder or officer.

(a) Caveat

Notice that the transferee for value rule would still apply if the transfer was to a fellow shareholder or officer and not to the corporation itself.

B. Illustrations Utilizing § 101

1. A Two Party Partnership Cross-Purchase Plan

Assume an A & B Partnership, capitalized at \$1,000,000, with a cross purchase buy/sell agreement funded by life insurance with A owing a policy on the life of B in the amount of \$500,000 and B owning a policy on A's life in the same amount.

a. Death of Either Partner

Upon the death of the first partner, the survivor would be able to exclude the \$500,000 from his/her gross income under § 101(a)(1) because it was paid as a result of the death of the insured.

b. Transfer of Policy by Decedent's Estate

As a result of the death of the first partner, his/her estate now is the owner of the policy on the life of the surviving partner. For a lot of business reasons, the survivor may wish to buy that policy. Even though there has been a transfer for a valuable consideration, the recipient of the proceeds upon the death of the second partner will still be able to exclude the entire amount of the proceeds from gross income because the transfer was to the insured. IRC § 101(a)(2)(B).

2. A Partnership Cross-Purchase Plan Where There Are More than Two Partners

Same facts as in B1 above except there are three partners in the ABC Partnership which is capitalized at \$1,500,000. A has a \$500,000 policy on the lifes of both B and C; B has a \$500,000 policy on the lifes of both A and C; and, C has a \$500,000 on the lifes of both A and B.

a. Death of Either Partner

The surviving two partners would be able to exclude the entire amount of the proceeds under IRC § 101(a)(1).

b. Transfer of Policies by Decedent's Estate

The deceased partner's (A) estate now owns a \$500,000 policy on the life of B and C. For obvious business reasons, B buys the

policy on the life of C and C buys the policy on B's life. Upon the death of either, the proceeds will be excluded from gross income because the transfer was to a partner of the insured. IRC § 101(a)(2)(B). The same result would occur if the policies had been transferred to the partnership.

3. A Partnership Entity Plan

Same facts as in B2 above except we now have an entity as opposed to a cross-purchase plan.

a. Death of Either Partner

Proceeds would still be excluded under § 101(a)(1).

b. Transfer of Policies on Survivors' Lives

There would be no transfer of the policies on the lives of the surviving partners since they are already owned by the partnership. Hence, when the remaining partners die, the proceeds would all be excluded under § 101(a)(1) because there had been no transfer for value.

4. A Corporate Cross-Purchase Plan

Same facts as in B2 above except there is a corporation and not a partnership.

a. Death of Shareholder

Entire amount of the proceeds would be excluded under § 101(a)(1).

b. Transfer of Policy

In order to avoid the transferee for value rule the transfer must be to the corporation in which the insured is a shareholder or officer. IRC § 101(a)(2)(B).

5. A Corporate Entity Plan

Same facts as in B4 above except there is a entity plan.

a. Death of First Shareholder

Same result of exclusion as in B4. IRC § 101(a)(2)(B).

b. Transfer of Policies on Survivor's Lives

Again, there would be no transfer since they are owned by the corporation and, when another shareholder dies, the proceeds would be excluded under § 101(a)(1) since there was no transfer for value.

C. New Corporation Alternative Minimum Tax

Even though the above discussion of the exclusion of life insurance proceeds is the norm, beware of changes in the corporate alternative minimum tax, IRC § 55, and in particular IRC § 56(c)(1) and (f)(1) which provides that the alternative minimum taxable income of any corporation shall be adjusted for book income. For taxable years beginning in 1987, 1988 and 1989 it shall be increased by 50 percent of the amount by which the adjusted net book income of the corporation exceeds the alternative minimum taxable income

for the taxable year. Hence, excluded life insurance proceeds may be included in the determination of the corporation's adjusted book net income but not in the alternative minimum taxable income thus causing the recognition of an alternative minimum tax even though they are excluded from gross income..

X. Conclusion

As stated at the beginning, this outline was started with no ideas of it being totally inclusive but was intended to call attention to some of the estate planning problems involved in the disposition of these various property interests. It would be unwise to close without at least calling attention to the obvious: the testator's desires should not necessarily be tax-driven. However, planning in a vacuum is just as unwise. Hopefully, the outline will call attention to some of the problem areas even if it does not always furnish absolute answers.

Acknowledgement

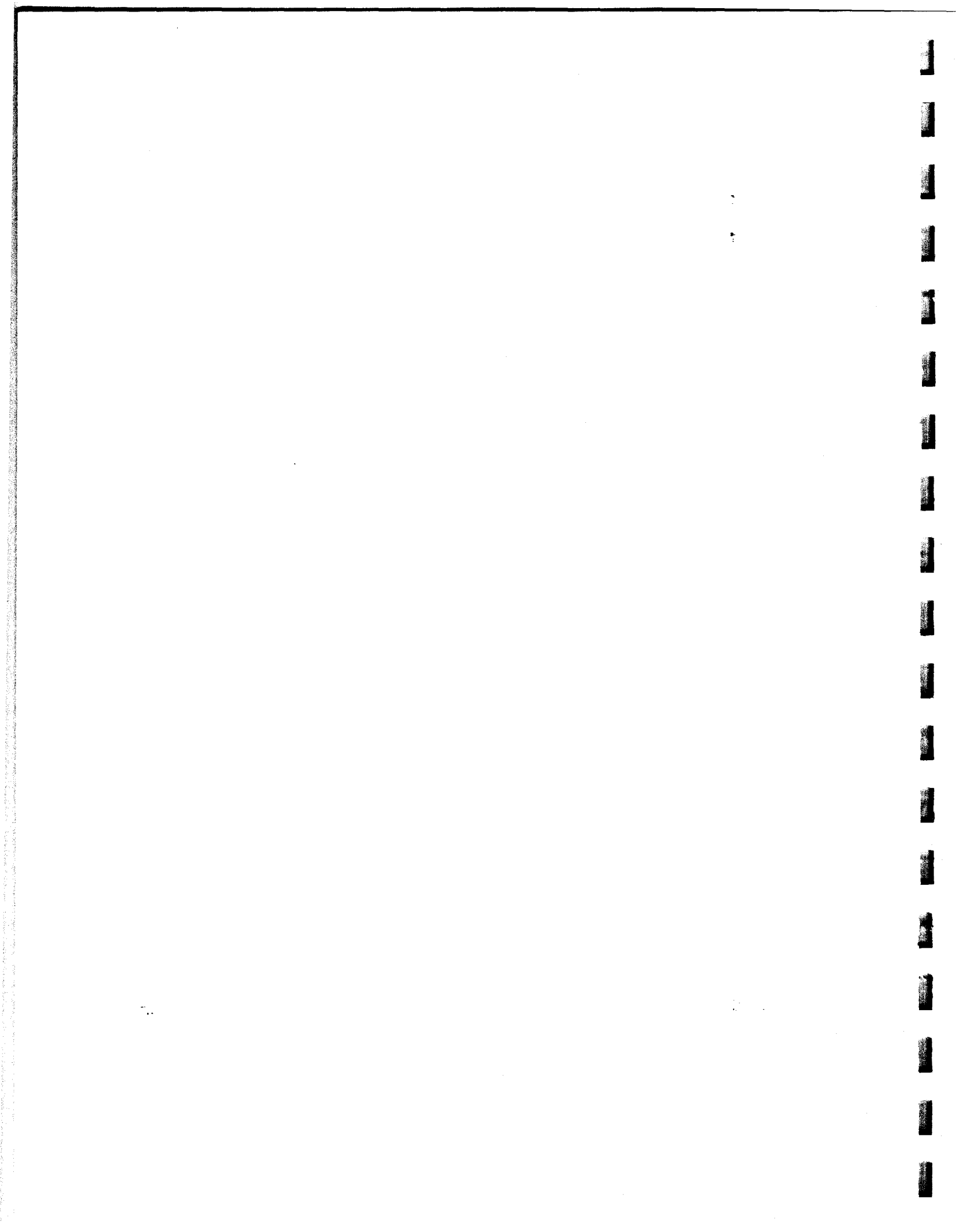
I would like to express my appreciation to Thomas J. Luber of Wyatt, Tarrant & Combs, Louisville, Kentucky for permitting me to use so freely, including some verbatim use, from an outline he prepared entitled "Estate Planning for S Corporation Stock Ownership." In particular I have reference to pages 11 to 17, and 25 to 39.

PROBLEMS IN DEALING WITH THE IMPAIRED BENEFICIARY

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SECTION F

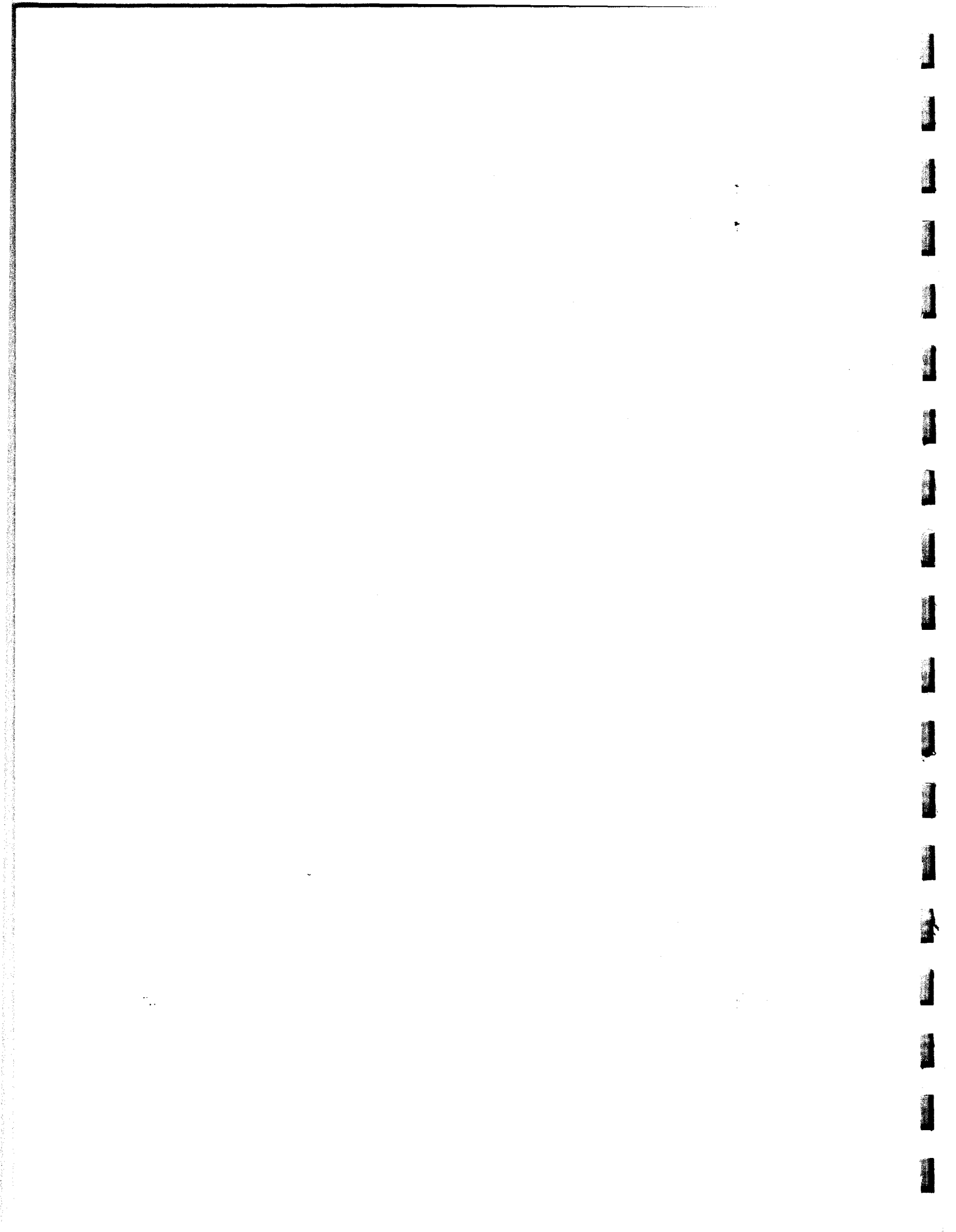


PROBLEMS IN  
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PROBLEMS IN  
DEALING WITH THE IMPAIRED BENEFICIARY

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INTRODUCTION

For the most part, Americans tend to be "eternal optimists," often reluctant to plan for tomorrow because tomorrow will take care of itself. Therefore, as a general rule, Americans do not like to plan for their futures, and are not particularly adept at doing so. The consequences of non-planning to the average, mature beneficiary may be costly and time-consuming. To the disabled beneficiary, however, because of his or her vulnerability, non-planning can be devastating.

Disabled beneficiaries need comprehensive estate and financial planning that encompasses the concerns that both the elderly and the families of disabled individuals have about the future such as housing, medical needs, extended care, educational needs, etc. As advances in medical science continue to extend life expectancy, and as governmental programs become more pervasive as well as complex, comprehensive planning, while always important, will become an absolute necessity. Although such planning cannot anticipate all contingencies or guarantee happiness, it can have

a positive influence on what happens during and after a major life change.

It almost goes without saying that almost everyone can benefit from comprehensive planning. However, the primary focus of this discussion is the disabled beneficiary. There are several different classes of disabled:

1. mentally retarded and developmentally disabled persons;
2. chronically mentally ill persons;
3. severely physically disabled individuals;
4. older individuals, particularly the frail elderly;
5. individuals with drug and alcohol dependencies;
6. persons who are at risk of becoming members of one of these groups in the near future.

Very often the thrust of planning articles is directed toward the older American; this discussion will focus primarily on the planning needs of mentally disabled children or young adults and their parents. Many of the planning concepts recommended here, however, can also be utilized for the frail elderly.

The term mentally disabled can be used to define a person suffering from a loss or lack of mental capacity to an extent that gives cause to believe that the person has or will have diminished capability to handle financial affairs. Moreover, the mental disability is likely to be permanent although subject to amelioration by education, training or rehabilitation. Mental disability is to be distinguished from mental illnesses such as depression or schizophrenia, disorders which may or may not be

curable and may or may not be permanent afflictions. Frolik, Discretionary Trusts for a Disabled Beneficiary: A Solution or a Trap for the Unwary? U. OF PITT. L. REV. 335, 336 (1985)

#### TWO FINANCIAL CONCERNS OF PARENTS

Parents with a mentally disabled child must deal with what will happen to that child when both parents are dead or unable to take care of that child because of their own disability. The parents of a disabled child have two primary financial concerns. First, they want to be sure the assets they leave or set aside for their child are appropriately invested as well as spent to provide for the child's entire lifetime. Second, they want to be sure the assets are used in a manner that will not negatively interfere with the child's right to receive governmental financial assistance or in a manner that results in the assets being exhausted by governmental or creditor claims. In other words, the parents of a disabled child want to insure they are making a gift to their child rather than a gift to their government. If there are other non-disabled children involved, there is also concern that the entire estate not be exhausted by the needs of the disabled child leaving the other children with little or no inheritance.

An additional valid concern--of equal importance--is insuring that someone will be there to look after the child's needs and to protect the child's rights. They want to insure that even after their death the child will continue to receive proper physical care as well as a generous measure of love.

Estate planning for parents of the mentally disabled requires knowledge of fundamental estate planning techniques combined with an awareness of the particular opportunities and needs of the disabled. The planner must integrate normal planning tools and techniques with the specialized planning needs of the disabled child. For instance, the planner cannot simply assume that the disabled child's condition will maintain its current degree of severity. On the contrary, the cautious planner will structure the estate plan to accommodate the possible worsening of the child's condition (for example, eventual institutionalization). Furthermore, the planner must take into account both current and future availability of governmental benefits. Governmental financial assistance available to the disabled are based upon stringent eligibility requirements. Carelessly drafted documents could result in the denial or loss of such benefits. Owens and Jordan, "Estate Planning for Parents of Mentally Disabled Children," Trusts & Estates, September 1987

#### GOVERNMENTAL BENEFITS

Since the need to integrate governmental programs with comprehensive planning arrangements is the singular feature which distinguishes the planning needs of the parent of a disabled child from the planning needs of other parents, a review of government assistance programs is necessary.

Government benefits for the disabled may be grouped into three categories. First, some government programs are available without regard to the amount of the individual's income or assets. Examples include Social Security benefits to an insured retired worker, Medicare to persons over age 65,

and an appropriate education program for any school-aged child.

**Second**, some benefit programs are available only to individuals who qualify under strict income and assets tests. These need-based benefits are not exclusively for the disabled; rather, individuals qualify on account of their poverty. If the disabled individual is poor enough, receipt of the benefit follows. Supplemental Security Income, Medical Assistance, and federal food stamps are typical of such welfare programs.

**Third**, some government programs called cost-of-care are made available to specified individuals without regard to income and assets, but the cost of these programs is charged to the individual in proportion to the individual's ability to pay. Frolik, Estate Planning for Parents of Mentally Disabled Children, U. OF PITT. L. REV. 303,315 (1979)

In Kentucky, per KRS Section 205.227 (1972), the State has a statutory right to reimbursement for the costs of institutionalized care of mentally disabled individuals. The amount of the reimbursement charge increases proportionately with the income and assets of the institutionalized individual.

Of particular concern to the estate planner are two federal, need-based assistance programs: **Supplemental Security Income (SSI)** and the **Medical Assistance Program (Medicaid)**. SSI is designed to provide a guaranteed minimum annual income to the aged, blind, and disabled. Reflecting its original conception as a supplement to Social Security insurance, SSI provides a monthly cash grant to qualifying individuals which is periodically adjusted to reflect increases in the Consumer Price Index. SSI is meant to be a "safety net," so that any other source of income will cause dollar for dollar reduction in the amount of SSI. "Income" for purposes of SSI is defined as "anything you receive in cash or in kind that you can use to meet your needs for food, clothing or shelter." Income includes both "earned income" (e.g. wages) and "unearned income" (e.g. dividends and rents). Unearned income specifically includes gifts and inheritances. An individual, for example, who received \$100 monthly from Social Security or from a trust would have his SSI reduced by \$100 per month. If an individual's income exceeds the SSI

maximum payment amount, the individual is no longer eligible for SSI. (Frolik-1985)

SSI eligibility is achieved through establishing need based on an income and a resource (asset ownership) test. A disabled single child is generally eligible for SSI benefits of up to \$4,080 annually if he or she has "income" of less than \$4,080 (after taking into account certain exclusions), and whose resources are \$1,900 or less in 1988. (Owens, Jordon. See 20 C.F.R. 416.1205. Income figures change annually based upon the CPI, 20 C.F.R. 410.405, 410.410)

It is equally as important to keep in mind that certain items are specifically excluded from the definition of income for SSI purposes. These exclusions include:

1. Real estate tax refunds;
2. Payments received under state or local programs based upon need;
3. Grants, scholarships or fellowships received for use in paying educational tuition and fees;
4. Home produce utilized by the household for its own consumption;
5. One-third of child support payments received from an absent parent;
6. Foster care payments for an ineligible child living in the home of the claimant where the child was placed in the home by a child-placement/child-care agency;
7. Disaster relief assistance;
8. Income necessary for fulfillment of a plan of self-support for a blind or disabled recipient;
9. Certain assistance based on need received to assist in meeting the costs of home energy;
10. Medical care and services paid directly to the provider by someone else;
11. The value of any support and maintenance furnished during a medical confinement.

In addition to these exclusions are two other excluded sources of receipts. The first is the receipt of property or services which cannot be utilized for food, clothing and shelter such as the payment of a telephone bill by a trustee or

personal services provided the child such as lawn care or housekeeping. Second is the receipt of small amounts of earned as well as unearned income. (Owens, Jordan)

As indicated earlier, the resources of the disabled child can also result in a disallowance of SSI. An unmarried and otherwise eligible individual cannot have over \$1,800 of non-excludable resources. A resource is defined as cash, liquid assets or any real or personal property that the individual owns and could convert to cash to use for his support and maintenance. The key is the ability to liquidate the property. The regulation states: "If the individual has the right, authority or power to liquidate the property, or his share of the property, it is considered a resource. If a property right cannot be liquidated, the property will not be considered a resource of the individual. (Frolik 1979)

If the individual is married the resources of the spouse are included in the calculation of resources, although the allowable limit is increased. Retention of non-excludable property in excess of the allowable resource limitation will result in a complete denial of SSI payments. (Frolik 1979)

However, certain assets are excluded from the determination of resources. Since these assets can affect estate planning, they need to be reviewed in detail. A home owned and occupied as a principle residence by the eligible person is excluded regardless of the value of the home. Some of the other exclusions are:

1. Household goods and personal effects whose total market value are less than \$1,900; if the value is in excess



of \$1,900, the excess will be counted against the resource limitation of \$1,900;

2. An automobile or other vehicle up to a current market value of \$4,500 (if used to provide necessary transportation to a job or to a place for regular treatment of a specific medical problem, or if modified for use by a handicapped person);
3. Life insurance policies up to a death benefit value of \$1,500 (otherwise the cash surrender value of the policy is counted as a resource);
4. Burial insurance of any value (if the terms of the policy specifically limit its use to the payment of the burial expenses of the insured);
5. Insurance proceeds used in a timely manner to repair or replace an excluded asset/resource. (Frolik 1979)

In addition, there is another exclusion defined in terms of "other assets essential to the self support of the individual." This exclusion was designed as a "catch-all" for the other illiquid assets/resources which are necessary for the disabled individual to function in life. Finally, the principal of a trust is generally an excluded resource where the beneficiary has limited access to the principal, such as an irrevocable trust in which only the trustee can invade principal. (Owens, Jordan)

Disabled individuals may also qualify for the "Medical Assistance Program, commonly known as Medicaid, a program of Federal financial assistance to States for payment of medical costs for SSI recipients and other medically needy persons.

Operating under HEW guidelines, States administer approved assistance plans for needy persons who are over 65, blind, disabled, or members of families with dependent children. Eligibility is determined by the State in accordance with Federal regulations. Many States, including Kentucky, determine Medicaid eligibility by the Federal SSI standard. (See KRS Sec. 205.520 (1982)) Thus, a Kentucky resident who qualifies for SSI is automatically eligible for Medicaid. The same eligibility standards in terms of income and resources apply to Medicaid that apply to SSI. In light of rising medical costs Medicaid may well be of greater significance to particular individuals than SSI. (Frolik 1979)

The basic direct Federal assistance programs for the mentally disabled are run by the Social Security Administration. If the disabled person is a child of an individual entitled to Social Security insurance benefits, then the child will be eligible for Social Security benefits if the disability began before the child attained the age of 22, with monthly payments to begin upon the retirement or death of the insured parent. The amount of the payment, however, is subject to an earnings test and may be reduced in proportion to the earnings of the child. The child's benefits will not be affected by gifts or accumulated assets. Although many of the disabled are employable, the monthly earnings may be too little to adversely affect their Social Security entitlement and the therapeutic benefits of employment may offset any loss of Social Security benefits.

Moreover, the employment may qualify the child for Social Security insurance as a covered employee. (Frolik 1979)

The **cost-of-care** category of government benefits those that are available to all persons who fall within specified categories, but are free only to those persons who cannot afford to pay. If a recipient has the resources to underwrite such payments, the government will seek reimbursement for its services. The most common cost-of-care program available to disabled persons is State-subsidized residential care. Such residential care is generally available regardless of the recipient's financial status. However, State statutes often require the institutionalized person, his estate or responsible relative to reimburse the State to the extent of their "financial ability". (See KRS, Chapter 205, Public Assistance Program)

This category of cost-of-care programs/benefits must be carefully considered during the drafting process. This is the area most vulnerable to careless planning and/or draftsmanship. Ineffective planning or drafting can lead to the complete exhaustion of the parent's and child's assets if the disabled child qualifies for one or more of the cost-of-care programs and such assets become reachable by the State to pay the child's maintenance costs. (Owens, Jordan)

#### SELECTED TYPES OF TRUSTS

A trust which imposes a duty on the trustee to distribute all of the income to one beneficiary is a simple **mandatory trust**. In this type of trust, the trustee has no **discretion** to choose

who will receive the income or the amount to be distributed. The beneficiary possesses an interest in the trust which may be alienated either voluntarily or involuntarily and is available to creditors for the beneficiary's debts. Restatement (2nd) of Trusts, Sections 132, 147, 182 and 186 (1959)

A trust which directs the trustee to distribute only so much of the income and/or principal as is necessary for the support and maintenance of the beneficiary is commonly referred to as a support trust. Because the settlor intended that the trust be used specifically for the beneficiary's support, both voluntary and involuntary alienation of the beneficiary's interest are ordinarily prohibited. One recognized exception to this rule provides that the beneficiary's interest can be reached by creditors to satisfy an enforceable claim against the beneficiary for necessary services or supplies furnished to him. (Restatement, Secs. 154, 157(b), 155)

The trust which gives the trustee complete freedom to distribute any amount of income and/or principal or none at all is a discretionary trust. A purely discretionary trust includes no standard in the trust instrument against which to evaluate the trustee's exercise of discretion. A beneficiary of a discretionary trust has no realizable interest in the trust until the trustee actually exercises his discretion to distribute from the trust. The limited nature of the beneficiary's interest in a discretionary trust has the effect of making trust assets unavailable to the beneficiary's creditors--at least as long as the trustee does not distribute any of the assets to the beneficiary.

Because the beneficiary cannot compel payment to himself or application of them for his own benefit, and because the creditor's rights are derivative from the beneficiary's, the beneficiary's creditors cannot compel the trustee to pay anything to them. (Restatement, Secs. 155, 187, Comment j, 128, 155(1), Comment b)

Although not necessarily related to the trustee's discretion, spendthrift provisions have an effect upon the availability of trust assets. Spendthrift trusts expressly prohibit the voluntary and involuntary alienation of a beneficiary's interest. Where recognized, spendthrift provisions will protect the trust assets from the claims of ordinary creditors. Like support trusts, however, spendthrift trusts are subject to the claims of certain creditors; the beneficiary's interest may be attached by creditors who provide the beneficiary with necessities. (Restatement, Secs. 152, 157(b))

#### MANDATORY TRUSTS

Mandatory trusts by their very definition subject the assets of the trust to State reimbursement claims. Because the distribution requirements are mandatory upon the trustee, the trustee is powerless to prevent trust distributions from displacing otherwise available State or Federal assistance.

A trust with required income distributions might cause a disabled child to be ineligible for SSI or Medicaid, while one providing education benefits might relieve the State of its financial burden to provide special education for the child. Because the distributions are mandated, a trustee who acts in

good faith has no choice but to fulfill the distribution obligations provided for in the trust instrument. Of course, if the trust proves inadequate to meet the minimum requirements of the beneficiary, assistance from the State or Federal government may still be forthcoming. However, the use of mandatory trusts leaves to happenstance whether there will be Federal or State benefits available for the child. The trust principal may be exhausted to aid the State or Federal government rather than the child. Therefore, mandatory trusts are not recommended as a planning tool when the intent is to supplement rather than supplant public assistance. (Frolik 1979)

#### SUPPORT TRUSTS

If the settlor's objective is to have the beneficiary's basic needs supplied by the government and to have the trust provide "extras", a trust for support should also be avoided. A State's claim against a trust for reimbursement of the cost of maintaining the disabled person in a State institution is more likely to succeed if the trust contains language indicating that the trust assets are to be used for support. (Mooney)

Governmental right to reimbursement from the trustee for support furnished to the beneficiary may be dependent upon the beneficiary's right to compel distribution from the trust. The beneficiary of a support trust has an enforceable claim of minimal support. Support standards impose a duty on the trustee to exercise his power to distribute or apply assets, leaving to his judgment only the extent or manner of doing so. The trustee must apply at least the minimum amount necessary for the

beneficiary's support and no more than the maximum amount considered reasonably necessary. (Restatement, Sec. 187, Comment i)

Since the beneficiary can compel distribution from the trust of amounts needed for his support and the State is a creditor which has furnished necessary support, the State may reach trust assets to the same extent as the beneficiary. (Mooney) In addition, trust language that gives the trustee discretion to determine the amount needed to provide support and maintenance for the beneficiary does not hamper the State's ability to successfully press a claim against the trust. (Mooney)

Support trusts sometimes instruct the trustee to take into consideration other resources available to the beneficiary. The beneficiary of such a trust has the right to trust distributions only to the extent that they are needed to supplement other resources available to him, so that outside resources and the trust distributions together provide at least minimal support. Courts have interpreted these provisions to not include support at public expense. Even trust language that gives the trustee of a support trust discretion, or that instructs him to take into consideration other resources available to the beneficiary, has not sufficiently attenuated the beneficiary's interest. The State may still successfully seek reimbursement from such a trust for the cost of institutional care given to the beneficiary. (Mooney)

A trust which authorizes the trustee to make distributions for the cost of a beneficiary's maintenance and support made

necessary by illness, accident or emergency conceivably gives the trustee narrower distribution authority than a pure or true support trust. Nevertheless, courts have treated such trusts like support trusts; that is, when the issue is reimbursement for care given in a State institution, the trust assets are deemed to be the beneficiary's and available for his basic maintenance. (Mooney) Therefore, presumably the use of a discretionary trust which grants the trustee authority to make distribution by reference to some standard of support, does not represent the best solution to the planning-for-a-disabled-child dilemma.

#### DISCRETIONARY TRUSTS

An absolute discretionary trust is one which grants the trustee unlimited authority to distribute income or principal without any accompanying standard. (Frolic 1979)

In theory, if the distribution powers given to the trustee are not limited by any standard against which the reasonableness of his conduct can be judged, the beneficiary has no enforceable claim to the trust assets unless the trustee's failure to distribute property is occasioned by dishonesty or an improper motive. In the absence of such improper behavior, to the extent that a State's right to recovery is derivative from the beneficiary's claim to the assets, the State cannot assert a claim to trust assets. It is reasoned, therefore, that assets in a purely discretionary trust are not available to the State. (Mooney)



Good theory, unfortunately the general rule that the assets of a discretionary trust are beyond the reach of the beneficiary's creditors has also been successfully challenged. So what's left? Cautious draftsmanship.

However, despite the general rule that the assets of a discretionary trust are beyond the reach of the beneficiary's creditors, even those who have furnished necessities, a State financial responsibility statute may make the trust assets available to the State. Presumably such statutes are based upon a strong policy that any resources available to a public welfare recipient ought to be available to reimburse the State for its expenditures on behalf of that person. On the other hand, some State statutes evidence an equally strong policy: a trust created to provide the "extras" that lend dignity to the lives of disabled, institutionalized persons ought to be allowed to continue. Clearly, individual State statutes must be consulted to determine whether or not a discretionary trust may evade the grasp of the State. (Mooney)

Unfortunately most State statutes do not address the issue of discretionary trusts; they simply state that the patient and certain other relatives are held financially responsible for the care given to the patient. Case law does not provide any clear answers either. In the absence of an explicit statutory directive, several courts have held that a State, like any other creditor, cannot compel a discretionary trust to bear the cost of the institutionalized individual's care. Others have enunciated a policy that trust assets not be allowed to remain intact when

the trust beneficiary is being supported at public expense. Many of the latter cases involve support trust or trusts where the settlor's general intent appears to be to provide for the beneficiary's basic needs. The policy, however, is not expressly limited to any particular type of trust. (Mooney)

#### BASIC PLANNING CONSIDERATIONS

Mental disabilities represent a broad range of severity, from visual dyslexic impairment to complete dysfunctional status. The estate plan needs to be tailored to the individual and specific needs of the child. The planner needs to engage the parents in a candid discussion to learn as much as possible about the evolution of the child's disability, paying particular regard to potential future changes in the child's condition. At a minimum, the planner should obtain the following data pertaining to the disabled child:

1. Nature and degree of the mental disability;
2. Educational and, if available, IQ level;
3. Functioning capabilities and autonomy of the disabled child (i.e. whether or not the child can fend for himself or herself, so to speak);
4. Medical background and special or specific needs of the child;
5. Work/earnings history of the child if any;
6. Assets (if any) of the disabled child, including the manner in which such properties are owned;
7. Special planning which has already been completed on behalf of the disabled child (e.g. irrevocable

beneficiary designations, other trusts, either living or testamentary, revocable or irrevocable, etc.);

8. Current living arrangements of the child (is the child living at home, by himself or herself, in an institution or some sort of special school, etc.). (Owens, Jordan)

#### PLANNING OPTIONS

With an understanding of the governmental programs available to assist the disabled child, the estate planner is prepared to offer meaningful planning assistance to the parents.

The available options include:

1. Disinheriting the disabled child;
2. Providing for the child through a gift and a corresponding moral obligation to a possible guardian or caretaker;
3. Leaving the child an outright gift;
4. Leaving money in trust for the child;
5. Using a sophisticated discretionary trust in an attempt to avoid or minimize the loss of Federal assistance or being charged for otherwise gratuitous State benefits.

(Frolik-1979)

For parents at either end of the financial resource spectrum the option selected and the attendant estate planning may be relatively simple. Wealthy parents are not going to be particularly concerned that an outright gift to the child may reduce the benefits available to that child under governmental assistance programs. Although careful planning is always important, wealthy

parents do not have to be overly concerned that the dispositive provisions of their estate plan avoid denial of governmental assistance.

At the other end of the spectrum, poor parents with little or no estate need little estate planning.

There is no question that most parents lack an estate of the size required to absorb completely the cost of lifetime support of a disabled child, including individualized educational programs, extensive medical care, humane living arrangements, and adequate food and shelter. Unless the parent has sufficient assets to warrant the use of trusts, the parent may conclude that the best solution is to disinherit the disabled child and to leave the estate, such as it is, to any non-handicapped children. This leaves the parents in the less-than-comfortable position of having to accept the fact that eventual responsibility for their disabled child will fall upon Federal and State government. (Frolik 1979)

A more palatable alternative to outright disinheritance frequently used by parents with other non-handicapped children is the approach of a gift coupled with a promise. The parents leave their estate to another child (in some instances another relative) with whom the parents have an informal agreement that a certain portion of the property will be used for the benefit of the disabled child. Granted, if the estate is small this type of disinheritance might be workable, nonetheless, it has several disadvantages.

In the first place, the third party has no legal obligation to use the inherited property for the benefit of the disabled child. Secondly, the informal agreement does not distinguish ownership of the property, therefore the third party will be liable for income taxes on the income produced by the property in spite of its use for the benefit of the disabled child. Thirdly, even if the client has no doubt that the third party will use the property for the benefit of the disabled child, there is always the possibility that the third party will die before the disabled child. Under these circumstances, the property will pass to the heirs of the third party, not the beneficiary. Hence, the disabled child may outlive the caretaker and simultaneously lose the use of the property. Mooney, Estate Trusts: An Estate Plan to Supplement Public Assistance for Disabled Persons, ARIZ L. REV. 939 (1983)

An outright gift to a disabled person could result in an equal loss or reduction of government benefits. If the intention was to supplement rather than replace government benefits, the outright gift to the disabled child has not been a gift to the child, but rather a gift to the government. However, an outright gift to a disabled child may have certain benefits; therefore, this option should not be automatically discounted. A modest outright gift may help the child develop or learn financial management. Such a gift should probably only be considered, however, where the child does have the capability to learn to handle money.

Another option is to leave money to a guardian or a conservator for the disabled child. This alternative does solve certain financial management problems, however, such a gift will have the same adverse impact on eligibility for governmental assistance as an outright gift since the property held by the guardian is legally the child's. (Restatement (2nd) of Trusts Section 7)

By far the best planning alternative available to the disabled child's parents is a trust. A trust is like a bolt of cloth that can be cut to whatever pattern suits the needs of a particular client. If carefully drafted, a trust can help a parent avoid the unsavory prospect of disinheritance or the uncertainty of third party goodwill.

While the design of a trust is limited only by the imagination of the draftsman, the planner must be very cautious about using classic "boilerplate" language in any trust instrument. Each provision needs to be closely examined in light of governmental limitations and requirements. As stated earlier, careless drafting could result in the loss of the assets to the State under a cost-of-care program and disqualification of the disabled child for other governmental assistance. This precaution even extends to typical testamentary bequests of the home and personal effects which the planner usually takes for granted. Remember there is a limitation on the market value of the non-excluded assets which a child can own and still qualify for SSI benefits. SSI requirements will allow the parents to leave their home to the disabled child only if it is occupied by the child as that

child's principle residence. In addition, the disabled child can only own household goods and personal effects which do not exceed a market value of \$2,000. Finally, caution should be exercised when using dispositive language such as "per stirpes", "per capita" or "heirs-at-law" to insure the disabled child does not inherit should such provisions become effective. (Owens, Jordan)

Other than these potentially dangerous provisions which must be approached with caution, the draftsman needs to be primarily concerned with the amount of discretion accorded the trustee. The extent of the trustee's discretion is the major determinant as to the accessibility of trust assets to state reimbursement claims.

Variation in the discretionary powers of a trustee over the distribution of income and principal is the factor which determines the nature of the trust. While the variations can be relatively unlimited, most trusts fall into the following patterns.

#### PRECATORY LANGUAGE

Using a purely discretionary trust may limit reimbursement claims but may create a zone of discomfort for both the settlor and the trustee. Precatory language is part and parcel of trust law; it has the advantage of putting within the trust instrument a clear definition of the purposes of the trust and the state of mind of the settlor at the time of its creation. While not legally binding it is nevertheless strong evidentiary proof of what the settlor hoped the trust would accomplish. Ideally, such language states the purpose of the trust, the factors to be

considered in making distribution and the general attitude expected of the trustee. Courts then have a built-in standard of measurement to determine whether or not a trustee has abused his discretion. Failure to use precatory language may cause difficulties in finding someone willing to serve as trustee in an absolute discretionary trust. Corporate trustees, for example, fearful of possible legal challenges to their actions, might very well be reluctant to serve as trustee under an instrument in which their duties are not clearly defined. Similarly an individual trustee may also be unwilling to accept undefined duties. (Frolik 1979)

#### THE SITUATION IN KENTUCKY

KRS Sec. 205.200 (1) states "a needy aged person, a needy blind person, a needy child, a needy permanently and totally disabled person, or a person with whom a needy child lives shall be eligible to receive a public assistance grant only if he has made proper application or an application has been made on his behalf in the manner and form prescribed by regulation."

KRS Sec. 205.010(3) defines public assistance as "money grants, assistance in kind or services to or for the benefit of needy aged, needy blind, needy permanently and totally disabled persons, needy children or persons with whom a needy child lives or a family containing a combination of these categories..."

Subsection (9) defines needy permanently and totally disabled as "a person 18 years of age or older who has a permanent physical or mental impairment, disease or loss that substantially



precludes him from engaging in useful occupations within his competence and who is unable to provide for himself and who does not have otherwise provided for him a subsistence compatible with decency and health."

KRS Sec. 205.210(1) directs that "public assistance awards be based upon consideration of individual needs as well as the resources of the individual involved and his family."

Subsection (2) goes on to define resources as

"(a) the income and any property belonging to any applicant or recipient; except the exemptions of the kind and the amount of income prescribed by regulations within the scope of public assistance titles of the Social Security Act, its amendments and other federal acts and regulations;

(b) the income and any property of the spouse living with any needy aged, needy blind or needy permanently totally disabled person;

(c) such income and resources as may be available to applicants or recipients from persons legally liable for their support."

Subsection (3) includes within the definition of resources the value of any property "voluntarily transferred by any applicant or recipient or the spouse living with any applicant or recipient for the purpose of establishing eligibility for public assistance."

Finally KRS Section 205.227(2) authorizes the State to "institute an action in circuit court against a parent or other personal legally liable for support who has failed to provide

support for the person to whom an obligation of support is owed for reimbursement of public assistance payments.

Kentucky's public assistance statutes do not define the term "other person legally liable for support", so while Kentucky's public assistance statutes definitely establish a right of reimbursement, it is not clear against whom a claim of reimbursement may be asserted. Obviously, an institutionalized adult is normally liable for reimbursement to the State for the cost of the institutionalization, as would be the parents of either a child or an unemancipated, adult incompetent child. Because most institutionalized individuals have few, if any, assets, the State has little hope of reimbursement however. Since the cost of institutionalization can be extraordinarily high, the State is naturally eager to have some other revenue source designated as the primary support. Therefore, if the individual receiving public assistance, either through institutionalization or some other form of extended care, is the beneficiary of a discretionary trust Kentucky may very well contend that the trustee should use the trust assets for reimbursement.

If the trustee refuses to pay for the cost of public assistance, under KRS Sec. 205.227 (1972) Kentucky may sue for reimbursement under the theory that even a discretionary trust is responsible for the support costs of the beneficiary. The narrow question to be litigated is whether the particular discretionary trust in question is liable for the costs of the institutionalization of the beneficiary. The broader question is whether a discretionary trust should ever be allowed to supplement State

supplied services while avoiding the burden of supporting the costs of institutionalization.

#### INTENT OF THE SETTLOR

To date, the Courts in the majority of cases have upheld the right of a trustee with discretionary powers to resist the claims of the State and to withhold distributions from an institutionalized beneficiary. Some Courts, however, have reached the conclusion that discretionary trusts have the responsibility to support the beneficiary. As such, the trust may be required to reimburse the State for the costs of institutionalization. (Frolik 1985) Those courts which have considered the issue have decided the question on the basis of the intent of the settlor of the trust. 21 ALR4th 729

Kentucky appears to only have one case wherein this specific issue was actually addressed. Under the terms of a trust providing that the beneficiary should have an amount "not to exceed \$250 each year" from the fund, the Court in Department of Public Welfare v. Meek (1936) 264 KY 771, 95 SW2d 599, held that the Department of Public Welfare, which had provided support for the beneficiary while he was a resident of a state mental institution, was entitled to reimbursement from the trust fund only to the extent of the stated limitation of \$250 per year. Noting that the Department's right to reimbursement depended upon whether the beneficiary had such an interest in the trust that he could demand it from the trustee, the Court found that the Will creating the trust clearly intended for the beneficiary to have the benefit of the trust fund so long as the amounts required by

the beneficiary did not exceed \$250 in any year and did not give the trustee absolute discretion to withhold all payments from the beneficiary. The Court additionally noted that during the short time the beneficiary had resided outside the institution, the trustee had paid claims for his support provided by a relative; the Court stating that it could not reasonably be insisted that the relative could not enforce a right to reimbursement against the trust and that there was no reason why the claim of the state hospital stood on a different footing. (21 ALR4th 729)

If Meek is Kentucky's controlling precedent, it is clear that mandatory trusts and support trusts or discretionary trusts coupled with a support standard are potentially reachable by Kentucky for reimbursement. The language of the Court in noting that the terms of the trust "did not give the trust the absolute discretion to withhold all payments from the beneficiary" appears to support the argument that in Kentucky the assets of absolute discretionary trusts are not reachable by the State of Kentucky without limitation.

The court in Meek (citing Dority v. W. E. Rogers & Co., 223 KY 238, 3 SW2d 636 (1928)) stated "the test in every case is: Has the beneficiary such an interest in the trust estate that he may demand {payment} from the trustee? If so, it is subject to his debts. If not, it is beyond the reach of his creditors, who stand in his shoes." Both Meek and Dority have been cited as controlling precedent in Calloway v. Smith 299 KY 623, 186 SW2d 640 (1945) and Huffman v. Chasteen 307 KY 1, 209 SW2d 705 (1948). Although Dority, Calloway, and Huffman deal with creditors rights

of recovery, all three cases support Meek's rule that the right of recovery against a beneficiary through trust assets is limited to the extent of the beneficiary's rights to enforce a claim against the trust.

However, Meek does support the argument that an absolute discretionary trust would be responsible to the State at least to the extent that the trustee has exercised his absolute discretion in favor of the beneficiary by making distributions to or for the trust beneficiary. Therefore, in Kentucky, if Meek is Kentucky's controlling precedent, trustees having absolute discretion should exercise caution in establishing any predictable pattern of distribution.

Kentucky is not blessed with either a wealth of case law to provide planning pointers or a clear statement of public policy. For the most part, therefore, planners can refer to the case law of other jurisdictions for drafting "pointers". A recent Pennsylvania case has improved the estate planning environment by validating the use of discretionary support trusts. In Lang v. Department of Public Welfare, Pa. Commw., 506 A2d 530 (1986), rev'd Pa., 521 A2d 1335 (1987), after a discussion of statutory policy of the State of Pennsylvania, the Court turned its attention to determining the testator's intent in establishing the trust. The Court expressed dissatisfaction with the rigid categorization of trusts utilized by many Courts in other States to ascertain the intent of a settlor: a "pure support trust" (where settlor has created a duty in the trustee, independent of any statutory duty, to provide basic support for a beneficiary)

can be depleted by the State's claims for reimbursement because the beneficiary could compel distribution for his or her basic support. On the other hand, a "pure discretionary trust" is safe from State claims for reimbursement, but the beneficiary is likewise unable to compel distribution despite standards for distributions included in the trust document.

The Court eloquently validated the use of discretionary support trusts by explaining that often neither a pure support trust nor a pure discretionary trust is appropriate:

A settlor should not be required to either bankrupt his family or run the risk of leaving a handicapped member destitute or in want because of vagueries in the requirements for public assistance or in the level of funding for such assistance. Nor should he be required to place blind faith in the uncontrolled discretion of an individual trustee, whom the beneficiary may survive, or in a corporate trustee whose ownership, management and policies may change. We believe a settlor is entitled to maintain some control by means of a support standard, and at the same time reasonable flexibility through a grant of considerable discretion to the trustee(s), to insure his purpose of providing reasonable care to the beneficiary who is or may be institutionalized without effectively disinheriting the other members of the family.

In summary the Court concluded that the intent of the testator/settlor was not to create a pure support trust in that he intended the trust to supplement other sources of support and to provide for the beneficiary's basic support only if those other resources proved inadequate or were discontinued; therefore, the settlor intended to establish a discretionary trust limited by a support standard based on the beneficiary's situation. The Court held that because the intent was to create

a trust to supplement rather than supplant other sources of support and to provide for the beneficiary's support only if other sources proved inadequate or were discontinued, the trustee had not abused its discretion by refusing to use trust income or principal to provide for the beneficiary's basic support when public funds were available and that the State of Pennsylvania did not have the right to consider the trust an available source of reimbursement for the beneficiary's care. Verbofsky, "Parents of Disabled Children Benefit From Lang Case", Trusts & Estates, December 1987

On a practical level, even for Kentucky planners, Lang is an important case because of the guidelines it provides for planners. If it is the intent to establish a discretionary support trust which will supplement, but not supplant, government benefits, that intent should be manifested by drafting into the instrument some of the specific Lang factors:

1. Trustee power to capitalize income;
2. Trustee power to distribute income and principal to individuals other than the disabled beneficiary;
3. The words "welfare" and "benefit" which indicate authority for the trustee to provide more than basic health, education, maintenance and support for the disabled beneficiary;
4. Modifiers to broaden the trustee's discretion such as "absolute", "unlimited" and "complete";
5. An expression of the settlor's intent that the trustee consider the disabled beneficiary's other resources.

At first blush, Lang appears to contradict earlier caution against using support trusts as planning devices for the disabled child's estate. Upon closer examination, however, the court in Lang is recommending neither a pure discretionary trust nor a pure support trust but rather a hybrid between the two. Rather than calling this trust a discretionary trust with a support standard or a support trust, perhaps a better term would be a **discretionary supplement trust** because the intention of the settlor (the controlling factor) is to supplement rather than to supplant public assistance. Lang is also a useful decision in that it solves the precatory language problem.

#### SELECTION OF THE TRUSTEE

Once the threshold decision to use a trust as a vehicle to provide benefits for the disabled child is made, the next question becomes who should serve as trustee. An accurate and succinct answer was given by A. James Casner in his treatise on estate planning. "No intelligent selection of a fiduciary can be made without careful consideration of the duties the fiduciary is to perform." The duties of a trustee may be divided into two categories, custodial and distributive. **Custodial** duties consist of holding and investing the assets, gathering the income, paying the taxes, selecting the investments, managing the enterprise--in short, all those acts required of the modern prudent manager of money. The **distributive** function is the other side of the coin. Rather than husbanding the assets, the trustee is expected to make distributions of income and principal to the beneficiary.



The distributive function may be mechanical, such as when the trustee is required to distribute all the income to a single, named beneficiary, or it may be discretionary. Unfortunately, the qualities of the trustee most desired in a custodian/investment manager are not necessarily the same qualities desired in the distributive manager. By their very nature the two are potentially conflicting. If the former demands prudence and caution, the latter requires imagination and sympathy, especially when the beneficiary is a disabled child. (Frolik 1979)

The trustee may be either a corporate trustee, such as a bank, or it may be an individual. Corporate trustees are almost without exception qualified to act as trustee and are particularly adept at balancing the conflicting demands of both roles. Only an exceptional individual will be as experienced and knowledgeable as a corporate trustee in the efficient management of money. In addition, the investment performance of corporate trustees is quite competitive. According to a new study of comparative performance for the period 1983-1987 by CDA Investment Technologies, stock funds managed by trust institutions averaged higher annual returns than common stock mutual funds. Trust institutions also outperformed investment advisory firms.

In addition, corporate trustees have extensive experience in balancing their primary duty of loyalty to the beneficiary with their duties to protect and conserve trust property and their duty to make trust property productive.

Finally the corporate trustee offers what no individual, no

matter how exceptional, can offer--continuity. The need for continuity is particularly important to a trust designed to last for the lifetime of a disabled child. A corporate trustee does not die or become incapacitated, nor do the pressures of personal life ever cause the corporate trustee to regret his acceptance of the fiduciary obligation; nor is the corporate trustee likely to become apathetic, bored, overworked or tired of his charge. On the contrary, because the role of the trustee is the business of the corporate trustee, one can expect and demand unflagging devotion to duty. (Frolik 1979)

Individuals are oftentimes (although not always) better or more suited to understanding the personal needs of the disabled beneficiary. In the long run, the most effective fiduciary arrangement is some combination of both corporate and individual. The individual does not necessarily have to serve as co-trustee, the settlor might want to consider appointing an advisory committee to work with the trustee in determining the personal needs of the beneficiary. The advisory committee might be given the power to remove the corporate trustee and name a successor trustee; such a power would most likely insure continued attendance to duty on the part of the corporate trustee. The point is, there are a number of different combinations which can be utilized by the settlor to insure that the physical, mental and financial needs of his disabled child are met throughout the child's lifetime. Use of a corporate trustee should not be automatically discounted because of limited personal touch nor should use of an individual be discounted because of limited management skills.

Use of the skills of both in tandem is essential to the interests of the disabled child; and the planner who fails to creatively utilize such available skills is doing a disservice to his client.

#### CONCLUSION

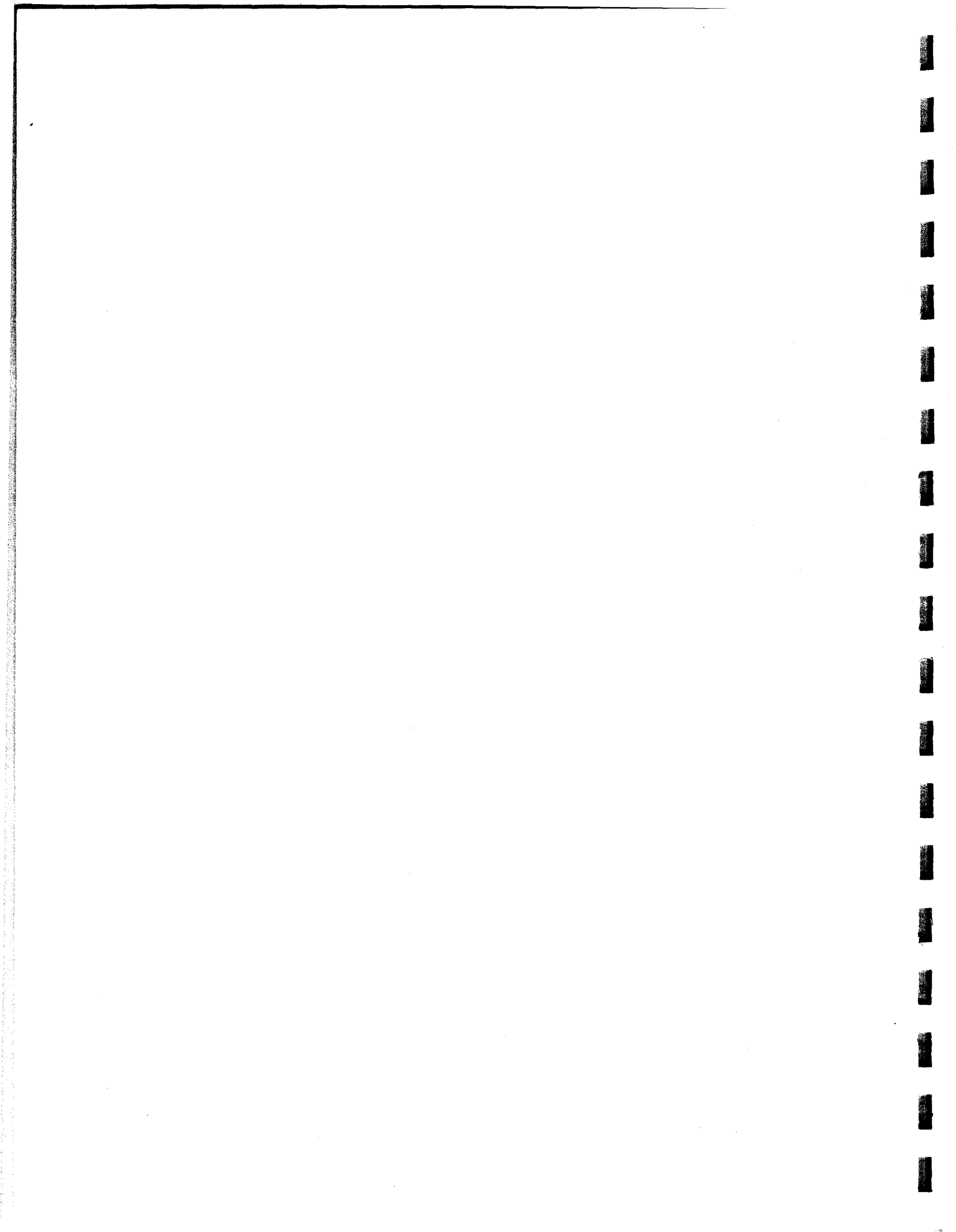
In planning for the lifetime needs of the disabled beneficiary, a discretionary trust in some form is by far the best alternative available to a planner. With creativity, imagination, and a working knowledge of governmental programs and the limitations and requirements thereof, an estate planner can create a plan for the disabled beneficiary workable both now and in the future that will truly allow the beneficiary's parents to "sleep better at night".

THE EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING

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SECTION G



THE EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING

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I. INTRODUCTION

A. Disclaimer defined.

Any person who is the intended transferee of a bequest, legacy or a lifetime gift has the ability to refuse to accept that interest in property. Such a refusal is called a disclaimer and the effect will be as though the person disclaiming has made a gift to the person to whom the property then passes. However, if the disclaimer is a "qualified disclaimer", the effect is as though the person disclaiming predeceased the transferor; the property is treated as passing directly from the original transferor to the person entitled to receive the property as a result of the disclaimer. Thus, the disclaimant is not treated as making a transfer subject to either gift or estate taxes.

B. Purposes of disclaimers.

1. Shifting income within the family unit.

A disclaimer can be used to reduce or eliminate taxes imposed on an intermediate generation. For example, a child can disclaim property passing from his parent's estate so that a distribution is made to his own children; the disclaimed property will then not be included in the child's estate at his death. Alternatively, the child may wish to disclaim some or all of his interest in his father's estate to enable his widowed mother to receive more property (consequently giving the father's estate a larger marital deduction).



2. Post-mortem uses.

As will be discussed in greater detail later in this outline, the disclaimer is a useful tool for saving estate taxes resulting from improper estate planning or poorly drafted instruments.

3. Pre-death uses.

The disclaimer can also be used as a flexible planning tool, permitting the postponement of some dispositions until the circumstances of all beneficiaries have been considered. Several planning techniques for use of the disclaimer will be discussed later in this outline.

## II. BACKGROUND

Internal Revenue Code ("IRC") Section 2518, which codifies the tax law of disclaimer, was not enacted until the Tax Reform Act of 1976. Prior to January 1, 1977, the law of disclaimer was nonstatutory and based on case law and various regulations. For example, there were four requirements under Treas. Reg. §25.2511-1(c) that a disclaimer had to satisfy in order not to be treated as a gift to the subsequent taker. The disclaimer had to be (1) recognized and effective under local law; (2) made within a reasonable time after knowledge of the existence of the transfer; (3) made before acceptance and (4) unequivocal. Kentucky law at that time provided only for disclaiming testamentary gifts in KRS 394.320 (repealed July 15, 1980). The disclaimer had to be by

deed recorded within one year after notice of probate, with a copy filed with the district court in which probate was made. It was not clear from the statute whether it applied only to interests in real estate or to dispositions of personal property as well.

Effective June 21, 1974 the Kentucky Legislature enacted the Uniform Disclaimer of Transfers by Will, Intestacy or Appointment Act, found in KRS 394.610-394.670. These provisions still limited the right to disclaim to only those interests created by testamentary instruments. In addition, the time within which to exercise the right of disclaimer was shortened to six months after the death of the decedent and the right to disclaim did not survive the death of the person holding such right.

### III. CURRENT LAW OF DISCLAIMERS

#### A. Requirements for a Qualified Disclaimer.

##### 1. Who may disclaim.

Under IRC §2518(a), any person to whom an interest in property is transferred can disclaim that interest. The person who creates the interest cannot disclaim. The executor of an estate may disclaim for the estate, if permitted under local law. PLR 8015014. Parents may disclaim on behalf of their minor children if they have been appointed guardians and the disclaimers are accepted in a proceeding in which the minors are represented by guardians ad litem. PLR 8510023. The

Internal Revenue Service ("IRS") has even ruled that guardians appointed for unborn children in probate proceedings may disclaim on behalf of those children who are potential beneficiaries of a trust. PLR 8622018.

Under KRS 394.035(a) and 394.610, a person or representative of an incapacitated or protected person may disclaim the right of transfer of property to him if he is a grantee, donee, surviving joint tenant, successor to a disclaimed interest, heir, next of kin, legatee, devisee or beneficiary under a testamentary or nontestamentary instrument or contract, or an appointee under a power of appointment exercised by a testamentary or nontestamentary instrument.

## 2. Requirements.

There are four requirements under IRC §2518 for a qualified disclaimer. Under §2518(b), a qualified disclaimer is an irrevocable and unqualified refusal to accept an interest in property that satisfies the four requirements. These requirements are discussed below.

### (a) Refusal must be in writing.

There are no specific requirements in §2518 for a written disclaimer but Reg. §25.2518-2(b)(1) states that the writing must identify the interest being disclaimed and be signed by the disclaimant or his legal representative. In PLR 8515005 a

written identification of property was waived where an examination of the estate tax returns of the disclaimant and his spouse clarified which property was disclaimed.

(b) Refusal must be received within nine months.

§2518 (b)(2) states that the written disclaimer must be received by the transferor, the transferor's legal representative, or the holder of legal title to the property no later than nine months after the later of:

- (i) the day the transfer creating the interest is made, or
- (ii) the day the disclaimant reaches age 21.

Although §2518 uses the term "received" by the transferor, the regulations state that the disclaimer must be "delivered" by the above dates. The timely mailing requirements of Regs §301.7502-1(c) apply for this purpose. With lifetime transfers, a taxable transfer (for purposes of (i) above) occurs on the date a completed gift is made; testamentary transfers occur on the date of death. With general powers of appointment, the transfer to the holder of the power

occurs at the creation of the power; transfer to appointees or takers in default occurs when the power is either exercised or lapsed. Special powers of appointment are transferred when created. Regs. §25.2518-2(c)(3).

When the state provides a shorter period within which to file the disclaimer, state law controls. State law may not, however, extend the nine-month deadline. PLR 8022021; Reg. §25.2518-2(c)(5), example (5).

(c) Acceptance must not have occurred.

If the person wishing to disclaim has already accepted the interest or any of its benefits, a qualified disclaimer cannot be made. IRC §2518 (b)(3). Proprietary actions that could indicate acceptance include:

- (i) use of property;
- (ii) acceptance of dividends, interest or rents from the property;
- (iii) acceptance of consideration for making the disclaimer;
- (iv) payment of mortgage or taxes on the property;

(v) directing beneficial enjoyment of the property. A disclaimant is treated as directing the transfer of the interest if an express or implied agreement exists that the interest is to go to a person specified by the disclaimant. A qualified disclaimer is made, however, if the disclaimant of a beneficial interest in property has a fiduciary power to distribute to designated beneficiaries as long as the disclaimant has no discretionary power to direct the enjoyment of the interest and there is fiduciary authority to make the disclaimer. Reg. §25.2518-2(e)(1).

In PLR 8702024, the intestate decedent had named his sister beneficiary of a life insurance policy. The sister received a claim form which she completed and the insurance company notified the sister that an account had been established in her name, sending her checks with which to draw upon the account. Sister attempted to disclaim one-half of the amount in the account. The Service found there was no qualified disclaimer because the sister had accepted the benefits of

the property by the act of accepting the checks and returning the completed claim form.

There is no deemed acceptance of an interest by virtue of actions taken by a beneficiary (or a custodian) before the beneficiary's twenty-first birthday. Reg. §25.2518-2(d)(3). For example, a minor who receives distributions of income from a trust, or dividends from stock gifted under the Uniform Transfers to Minors Act before the minor reaches age 21 may disclaim the shares or the interest in the trust income as long as no income or dividends are received between the date of the twenty-first birthday and the date of disclaimer. Regs. §§25.2518-2(d)(4), Examples (9)-(11).

(d) No direction by disclaimant.

The interest in property must pass, without any direction on the part of the disclaimant, to a person other than the disclaimant. However, if the disclaimant retains a power to redirect distribution of the property and is limited by an ascertainable standard, the disclaimer will not fail. Reg. §25.2518-2(e)(1). The spouse of the transferor may disclaim an interest and still retain the same interest in the property but the spouse may not retain the right to direct

beneficial enjoyment of the interest unless such right is limited by an ascertainable standard. Thus, retention of a power to invade corpus (subject to an ascertainable standard, a "5 and 5" power, or through a trustee) should not constitute a prohibited power. Reg. §25.2518-(e)(5), example (6). However, while §25.2518-2(e)(5), example (4) makes it clear that a surviving spouse can disclaim property which passes to a trust in which she has an income interest, the retention of a special power to appoint among designated beneficiaries will disqualify the disclaimer. Reg. §25.2518-2(e)(5), example (5).

B. Forms of Disclaimers.

1. Disclaimer of a partial interest.

It is possible to make a qualified disclaimer of a separate interest in property. However, the separate interest must be one that was created by the transferor; the disclaimant can't himself separate the interest received. Reg. §25.2518-3(a)(1)(i). Local law determines whether separate interests have been created; thus were principal payments to remaindermen of a residuary trust treated as separate from the remainder interest. PLR 8706066. Powers of appointment are deemed separate interests in property and



disclaimers of severable property (such as corporate stock) are considered disclaimers of separate interests in property. Regs. §25.2518-3(a)(1)(ii) and (iii).

In PLR 8702023, decedent left his entire estate in fee simple to his wife. The wife wished to disclaim all or a part of the shares of stock in a corporation she would receive under the will. In that shares of stock are severable property which can be divided into separate parts and maintain complete and independent existence after severance, the Service found the proposed disclaimer to be a qualified partial disclaimer of a separate interest in severable property.

2. Disclaimer of an undivided interest.

A disclaimer may also be made of an undivided portion of a separate interest in property. IRC § 2518(c)(1). The disclaimer must be of a percentage or fraction of each substantial interest the disclaimant owns in the property and must cover the entire term of the disclaimant's interest in that property and in property to which the property is subsequently converted. Reg. §25.2518-3(b). For example, if A is the devisee of an income interest for life from Blackacre, he may make a disclaimer of 30% of the income from that property. However, if A is the devisee of a fee simple interest in Blackacre, a disclaimer by A of a remainder

interest while retaining the life estate is not a qualified disclaimer. Regs. §2518-3(d), example (4) and 25.2518-3(b).

3. Disclaimer of a pecuniary interest.

As long as no income or other benefit inures to the benefit of the recipient of a pecuniary or nonpecuniary bequest or gift either before or after the disclaimer, a disclaimer may be made of a specific pecuniary amount out of such bequest or gift. Reg. §25.2518-3(c).

The amount disclaimed, as well as income from that amount, must be segregated from the portion of the bequest not disclaimed following the disclaimer of the specific pecuniary amount. The segregation of the disclaimed amount is made on the basis of fair market value of the assets on the date of the disclaimer or on a basis fairly representative of value changes that have occurred between the date of transfer and the date of the disclaimer. Acceptance of a distribution from the bequest or gift is considered an acceptance of a proportional amount of income earned by the bequest or gift.

C. Types of property that may be disclaimed.

1. Joint tenancies.

To qualify, a disclaimer of an interest in a joint tenancy or a tenancy by the entirety must be made no later than nine months after the date of the taxable transfer creating the tenancy. Reg. §25.2518-2(c)(4)(i); Rev. Rul. 83-35, 1983-1 CB 234.

In Gladys L. McDonald, 89 T.C. 26 (1987), the Tax Court found an untimely disclaimer when a wife's renunciation of her decedent husband's one-half interest in real property was made nine months after the decedent's death. The Court concluded that the timeliness of the disclaimer is tested at the time of the creation of the joint tenancy rather than at the death of the other owner. This case is in direct conflict with the decision in Kennedy v. Commissioner, 86-2 U.S.T.C. Section 13,699 (7th Cir. 1986). In Kennedy the Seventh Circuit Court of Appeals held that a disclaimer of a joint tenancy interest is timely if made within nine months of the death of the other joint tenant. The Court reached its conclusion by noting that the joint tenant had no vested interest in the property until the other joint tenant died; before that time, the interest of either joint tenant could be terminated by exercise of the right of partition or by divorce. The Tax Court still

refuses to follow the Seventh Circuit, however, and has recently reaffirmed its holding in McDonald in Estate of Edward O'Brien, T.C. Memo. 1988-240.

Creation of a nominal joint interest does not trigger the start of the nine-month period. This means that transfer of funds by one spouse, for example, to a joint bank account where the other spouse does not draw upon the account for his or her own benefit, will not start the nine-month disclaimer period. PLR 8619002; Reg. §25.2518-2(c)(5), example (9).

There are special rules for pre-1982 tenancies in real property between spouses. If a joint tenancy or tenancy by the entirety in real property was created between spouses before 1982 and no election was made under IRC §2515 to treat the creation of the tenancy as a gift, then the nine-month period begins on the date of the first spouse's death. Reg. §25.2518-2(c)(4)(ii). Electing gift treatment would create a taxable transfer that results with the nine-month period beginning at the time of creation of the tenancy.

2. Life insurance and death benefits.

Transfers of interests in life insurance proceeds or death benefits under employee benefit plans occur when the designation of the beneficiary becomes irrevocable -- either upon the death of the employee or

insured, or when the insurance policy is placed in an irrevocable trust. KRS 394.035 authorizes the disclaiming of these types of interests unless there is a written waiver of such a right.

3. QTIP transfers.

When an interest is transferred to a person for life with provisions for successive life interests and remainders to other persons, every beneficiary - existing or potential, vested or contingent - must make their disclaimers within nine months of the original transfer. Although the original transfer is not necessarily a "taxable transfer" since the assets of the QTIP trust qualify for the marital deduction, the Service chooses not to look at the death of the second spouse as the starting date for the disclaimer period. Reg. § 25.2518-2(c)(3).

4. Revocable Inter Vivos Trust Interests.

KRS 394.035 permits disclaimer of interests created by revocable inter vivos trust agreements. Such interests vest on the death of the settlor and that is the date which commences the running of the nine-month period. PLR 9003020.

5. Powers of Appointment.

A power of appointment is treated as a separate interest in property that may be disclaimed; it may be

disclaimed independently from other separate interests created in the property by the transferor. IRC §2518(c)(2); Reg. §§25.2518-3(a)(1)(iii). For example, if a trust beneficiary under a will receives income for life and a general testamentary power of appointment, the beneficiary may disclaim the right to appoint any or all of the principal or income from the trust while retaining the right to lifetime distributions from the trust. PLR 8603030.

D. Effect of the Disclaimer.

According to KRS 394.035(3), the effect of disclaiming property or interests under nontestamentary instruments is as though the disclaimant died before the effective date of the instrument or contract. KRS 394.630 discusses the effect of disclaimers of testamentary transfers and provides that disclaimed property or interests devolve as if the disclaimant had predeceased the decedent unless the decedent provides otherwise. Similarly, if the property or interest is one the disclaimant is designated to take under a testamentary power of appointment, the effect of the disclaimer is as though the disclaimant had predeceased the donee of the power, unless the donee provides otherwise.

A word of caution is in order, however, regarding the generation-skipping transfer tax. If the use of a disclaimer results in property passing to a person at least two

generations below that of the transferor, a generation-skipping tax will be imposed on the transfer. There is an exception to the tax when a transfer is made to a grandchild whose parents are deceased. Under those circumstances, the "predeceased child exemption", as it is called, operates to treat the grandchild as a child of the transferor so that only a transfer to the immediately following generation will be deemed to have occurred. For purposes of a transfer made by disclaimer, however, the disclaimant may not be treated as having predeceased the transferor for purposes of the generation-skipping tax exemption.

As to creditor's claims, Reg. §25.2518-1(c)(2) indicates that a creditor has the capability of voiding a disclaimer and that, if the disclaimer is so voided, it cannot be a qualified disclaimer. However, the fact that a disclaimer is merely voidable by the creditors of the disclaimant does not affect whether the disclaimer will be qualified. A disclaimer may also be subject to attack by the creditor if it is determined it was made with intent to defraud. Stein v. Brown, 480, N.E.2d 1121 (Ohio 1985).

#### IV. THE DISCLAIMER AS A CURATIVE TOOL

Disclaimers may be used effectively in post-mortem estate planning in several ways: to save estate taxes, to change be-

quests to best suit changed financial circumstances and to remedy errors in drafting will and trust documents.

A. Improper estate planning.

In situations where there is either an inadequate estate plan or lack of any estate plan, the disclaimer may be used to save estate taxes. For example, if there were no provisions in the will for utilization of the exemption equivalent for the assets of the first spouse to die, a disclaimer by the surviving spouse of an amount equal to that exemption would pass those assets to the next generation tax free. Because of the special treatment accorded spouses in IRC § 2518(b)(4), the disclaimed portion can pass into a by-pass trust in which the spouse has an income interest and the disclaimer will not fail to qualify.

B. Defective Grantor Trust.

If a grantor trust agreement were drafted improperly, for example giving a beneficiary a prohibited unrestricted right of withdrawal, the disclaimer could remedy the effect. Instead of such income being taxable to the beneficiary under IRC §678, the beneficiary could disclaim the power.

C. Defective Charitable Remainder Trust.

Charitable remainder trusts, because they must meet the strict requirements imposed on private foundations under IRC Sections 4941 through 4945, may easily fail to qualify, thereby causing a loss of a charitable deduction under IRC §



664. In such a situation, it would be possible for the noncharitable beneficiaries to disclaim their income interests and allow the trust property to pass outright to the charitable remainderman.

D. Defective QTIP Trust.

If a will contains a poorly drafted qualified terminable interest property ("QTIP") trust, the disclaimer can be utilized to cure some defects. If the trust provided for the "sprinkling" of income among the spouse and other beneficiaries, the trust would fail as a QTIP trust. The other beneficiaries could disclaim their interests and thereby save the trust. PLR 8725063. If the trustee were given a principal encroachment power for the benefit of beneficiaries other than the spouse during the spouse's lifetime, the beneficiaries might be willing to disclaim their interests in principal during the spouse's lifetime since they could still retain their remainder interests. PLR 872506; PLR 8706066; Reg. §25.2518-3(d), example (11). The trustee's disclaimer of its encroachment power would in all likelihood not constitute a qualified disclaimer. PLR 8605004; PLR 8618067.

V. THE DISCLAIMER AS A PLANNING TOOL

To achieve a flexible estate plan, it is often desirable to prepare a will or trust document for the potential use of a disclaimer. Dispositions in the event of a disclaimer should be

indicated in order to fulfill the objectives of the original transferor and the disclaimant.

The disclaimer is ideal for those couples with assets that are currently less than the unified credit but who are likely to increase their assets over their expected lifespans. The couple may wish to have wills with each leaving everything to the other. If those wills were drafted so that each spouse left his or her residuary estate to the other, a provision could be added that any portion disclaimed by the surviving spouse would pass to a credit shelter trust with income to the surviving spouse. Use of the disclaimer in this situation would permit postponement of the decision whether a credit-shelter trust was needed until after the first spouse's death.

Another use for the disclaimer is to salvage the marital deduction for the estate of the first spouse to die. In PLR 8704023, the decedent's will created a trust that paid income for the surviving spouse's life to the surviving spouse and decedent's children. The trustee had discretion to distribute principal to the spouse and the children, with primary consideration to be given to the needs of the surviving spouse. The decedent's children made a disclaimer of their rights to receive income or principal from the trust during their mother's lifetime. In that the trust would not otherwise have qualified for the marital deduction even with a QTIP election (because the spouse would not receive all of the income during her life and

the existence of the right to invade principal for the children during the spouse's life), the disclaimer saved the marital deduction.

Similarly, in Estate of Boyd v. Commissioner, 87-1 U.S.T.C. Section 13.720 (7th Cir. 1987), the decedent's son disclaimed all of his interest in his father's estate so that the estate would pass to his stepmother. In addition, the son was the beneficiary of a life insurance policy and the will stipulated that taxes on the proceeds should be paid out of the probate estate. The son disclaimed his rights to have the probate estate pay any taxes on the property passing to him outside the probate estate. The Court found that a direction in the will to pay estate taxes on property passing to the son was a further distribution of property to the son which could be disclaimed (likening it to a forgiveness of debt by a testator which an intended recipient insists on repaying). The son's disclaimer of the tax allocation clause and of his interest under the will qualified the entire estate for the marital deduction.

A third use for the disclaimer is for situations when both spouses die within a short time of each other. The disclaimer could be employed by the surviving spouse to equalize the tax burden on the two estates. The surviving spouse could make a partial disclaimer of the portion passing outright to the surviving spouse so that a greater amount would go to a credit shelter trust (and thus avoid estate tax on the survivor's death).

## VI. FINAL REGULATIONS

Ten years after the federal tax law of disclaimer became codified by the Tax Reform Act of 1976 in IRC §2518, final regulations were promulgated on August 7, 1986. Proposed regulations had been in effect since July 1980 and, in the six years of their existence, many formal hearings, articles, Private Letter Rulings and Technical Advice Memoranda have been held and issued. The final regulations clarify many issues which remained uncertain under the proposed regulations. Following are a list of issues left unanswered or unclear by the proposed regulations and an explanation of their treatment in the final regulations.

The proposed regulations failed to consider two important transfer questions. The first question was what the date of the taxable transfer would be in those instances in which there were two transfers. For example, a transferor may have made a gift of a remainder interest in a trust in which he has a life estate. There is a transfer when the gift is made (for gift tax purposes) and there is a transfer when the transferor dies (for estate tax purposes because the value of the trust is included in the estate). The final regulations make it clear that for purposes of starting the disclaimer period, it is the first transfer which starts the running of the period. Regs. §25.2518-2(c)(3).

A second transfer issue involves the transfer of interests in a QTIP trust. As discussed earlier, the final regulations stipulate that the starting date for an effective disclaimer

begins on the date the first spouse dies and leaves assets in a QTIP trust. Although the transfer is not taxed on the first spouse's death because of the marital deduction, the regulations do not defer the running of the disclaimer period until the date of death of the surviving spouse. Regs. §25.2518-2(c)(3).

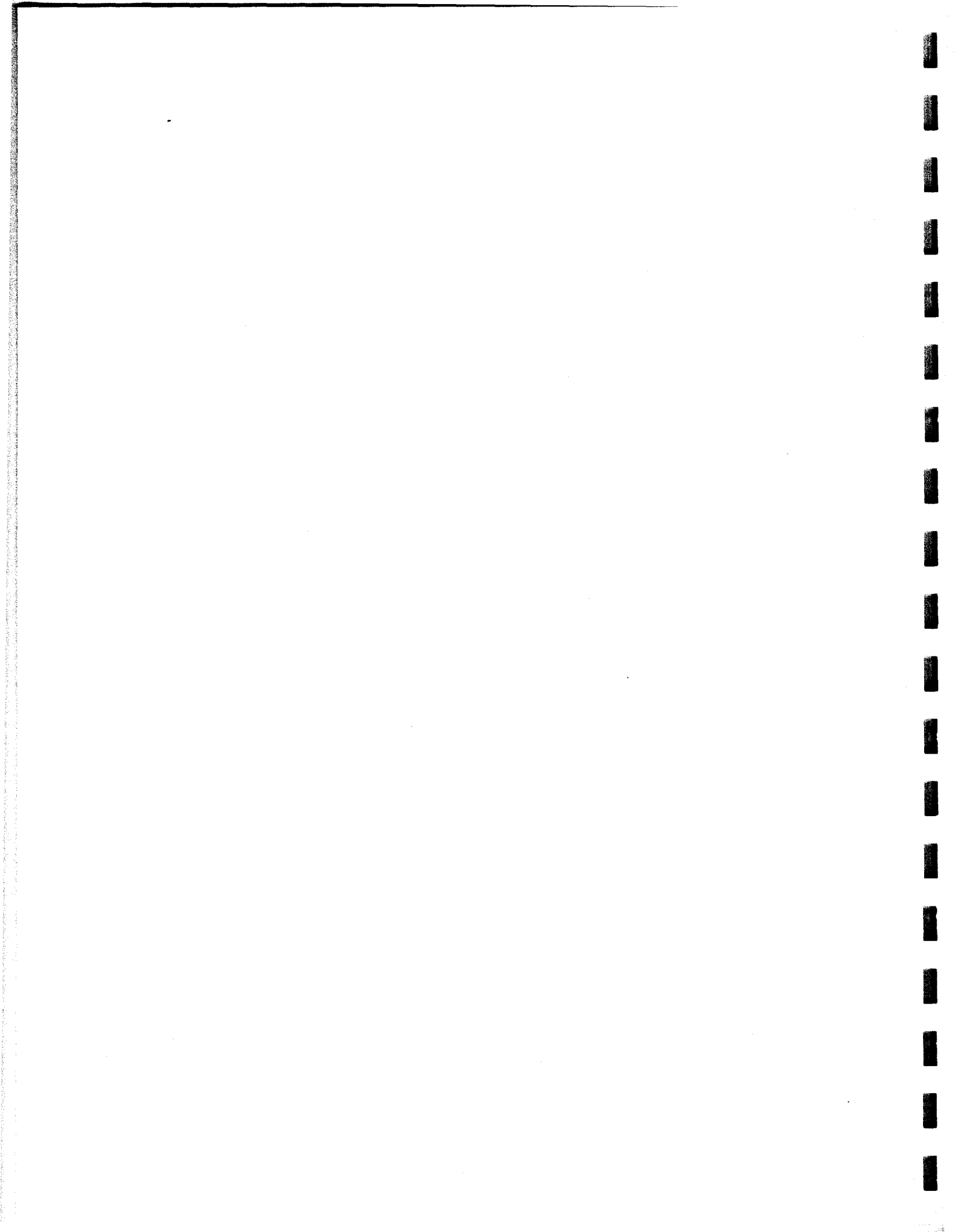
A potential problem that was not resolved by the proposed regulations was the required timing period for successive disclaimers. Both sets of regulations made it clear that both the life tenant and the remainderman had the same nine-month period within which to disclaim their interests whenever a transfer created such interests. Prop. Regs. §2518-2(c)(2); Regs. §25.2518-2(c)(3). For example, a situation may arise where the adult children of a decedent may wish to disclaim their interests in their parents' estate in order for the entire estate to pass to their surviving parent. The effect under common law in some states may then be that the children would receive an intestate interest in the parents' estate, thus necessitating a second disclaimer by the children. The regulations state that the timing for the second disclaimer is the same as for the first: nine months from the date of the decedent's death. All successive disclaimers must occur within the same time period set for the first disclaimer or that first disclaimer will not be qualified. It is important to note here that all potential disclaimants who are under age 21 at the time of the transfer have until nine months after their twenty-first birthday to disclaim. IRC §

2518(b)(2)(A) and (B). Practitioners at one time had to be wary of local laws which inadvertently would cause an acceptance of interests before a minor turned 21. For example, Kentucky's age of majority is 18 and under the state Uniform Transfer to Minors Act, custodianship ends when the donee reaches 18. Under the proposed regulations, such a donee would have had to disclaim within nine months of his eighteenth birthday. Prop. Regs. § 25.2518-2(c)(1). The final regulations remove this trap by specifically providing that such an event will not constitute acceptance of an interest. Regs. §25.2518-2(d)(3).

#### VII. SUMMARY

A disclaimer can be a very effective post-mortem estate planning tool. It can shift property to younger generations without gift tax liability; it can save those same generations estate taxes; it can save income taxes for the disclaimant himself by shifting income from disclaimed property to others; and trusts can be revised to eliminate powers that would have resulted in unnecessary taxes.

The final regulations are a welcome aid for the estate advisor, providing clarification on issues that were not addressed by the proposed regulations. The strict formalities and special timing rules for disclaimers, however, marks this a technique that must be carefully utilized.



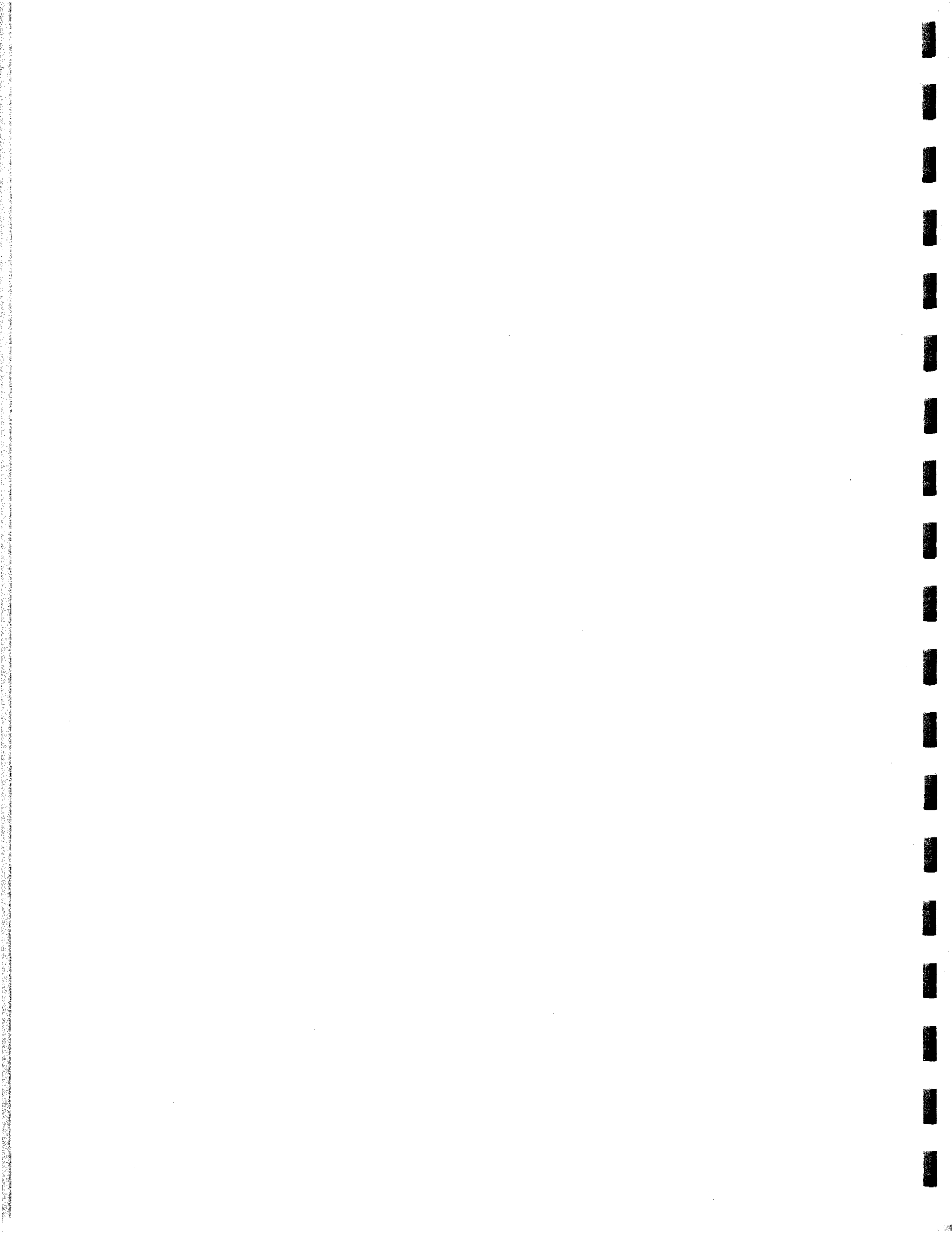
FIDUCIARY INVESTING:  
LEGAL ASPECTS

Marjorie L. Bassler  
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SECTION H

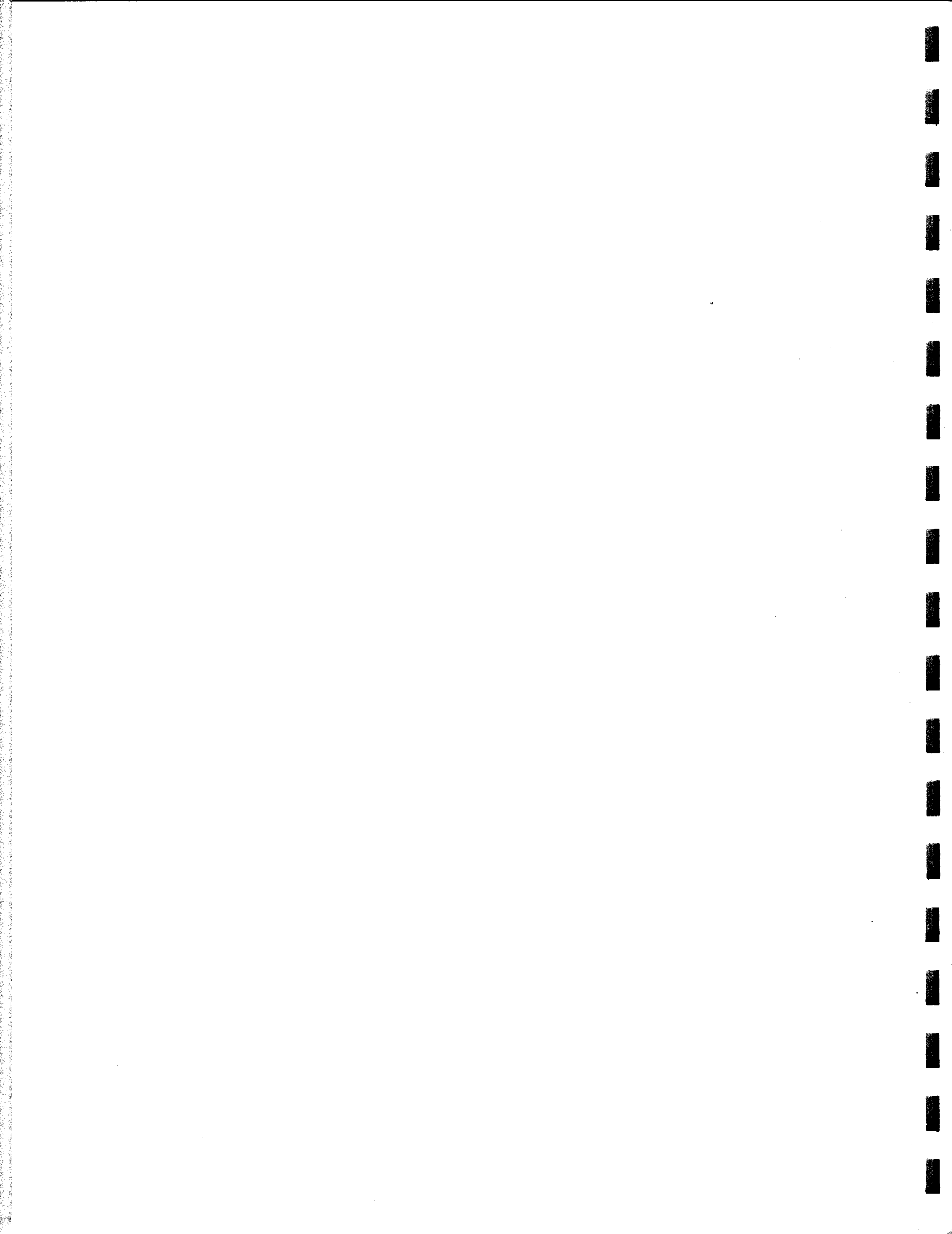




FIDUCIARY INVESTING:  
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Fiduciary Investing  
BY  
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In an article by John J. Lombard, Jr. and Raymond H. Young entitled "Fiduciary Responsibility in Investments", in the June 1985, Trust & Estates, they closed with a quote which I would like to begin with...

In light of recent legal developments, fiduciaries may do well to heed the advice of Sgt. Esterhaus from the television show Hill Street Blues, when he warned his troops, "Let's be careful out there."

Fiduciaries are faced with a great challenge in today's environment. They are challenged by laws which regulate their investments; yet, must compete in an environment where other money managers are aggressively investing and fiduciaries are viewed as stodgy and conservative by beneficiaries. It is an environment which can lead to litigation if we aren't "careful out there."

It is the duty of a trustee to preserve the trust property and to make it productive. It is ordinarily his duty to invest trust funds in such a way as to receive income without improperly risking the loss of the principal.

This is from Scott on Trusts, Topic 5. Investment of Trust Funds. In conjunction with this, we must consider what statutes regulate our investment and what the provisions of the trust documents are.

In Kentucky we are governed by both the Prudent Man Rule set forth in two statutes, KRS 386.710 and 386.810 and Kentucky Common Law and the legal list in KRS 386.020. The Prudent Man Rule states:

386.710 Standard of care and performance

Except as otherwise provided by the terms of the trust, the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man as defined in KRS 386.800 (3).

Similar to the Uniform Probate Code except for reference to KRS 386.800 (3) and deletion of provision requiring persons having special skills or expertise to use them.

Under the Uniform Trustee's Powers Act of KRS under section 386.800 Definitions:

(3) "Prudent man" means a trustee whose exercise of trust powers is reasonable and equitable in view of the interests of income or principal beneficiaries or both, and in view of the manner in which men of ordinary prudence, diligence, discretion, and judgement would act in the management of their own affairs.

The legal list of investments from Kentucky as listed in the KRS is as follows:

386.020 Authorized investments of trust funds; fiduciary to account for profits

(1) Any fiduciary holding funds for loan or investment may invest them in:

(a) Bonds or other interest-bearing obligations of the federal government;

(b) Bonds, state warrants and other interest-bearing obligations of this state;

(c) Obligations issued separately or collectively by or for federal land banks, federal intermediate credit banks and banks for cooperatives under the Act of Congress known as the Farm Credit Act of 1971, 85 Stat. 583, 12 U.S.C. Sec. 2001 and amendments thereto;

(d) Notes and bonds secured by mortgage or trust deed insured by the federal housing administrator, obligation issued or

insured by the federal housing administrator, and securities issued by national mortgage associations;

(e) Obligations representing loans and advances of credit that are eligible for credit insurance by the federal housing administrator and the fiduciary may obtain such insurance;

(f) Loans secured by real property or leasehold, that the federal housing administrator insures or makes a commitment to insure, and the fiduciary may obtain such insurance;

(g) Real estate mortgage notes, bonds and other interest-bearing or dividend-paying securities (including securities of any open-end or closed-end management type investment company or investment trust registered under the Federal Investment Company Act of 1940) which would be regarded by prudent businessmen as a safe investment. The fact that the fiduciary is providing services to the foregoing investment company or trust as investment advisor, custodian, transfer agent, registrar or otherwise shall not preclude the fiduciary from investing in the securities of such investment or trust;

(h) Real estate, after obtaining the approval of the district court for such investment;

(i) Life insurance, endowment and annuity contracts issued by legal reserve companies authorized to do business in this state, after obtaining the approval of the district court for such investment. Said fiduciary may select any optional settlement provided in a policy maturing by death or as an endowment;

(j) Notes, other interest-bearing obligations, and purchases of participations in such instruments, that are guaranteed in whole or in part by the United States of America or by any agency or instrumentality thereof;

(k) Certificates of deposit and savings accounts of any state or national bank whose deposits are insured by the federal deposit insurance corporation and whose main office is in this state, including itself, if such fiduciary is a bank. Such investments shall be insured by the federal deposit insurance corporation and the amount of the investments shall not exceed the limits of insurance of the federal deposit insurance corporation; and

(l) United States government securities or United States government agency securities, the payment of the principal and interest on which the full faith and credit of the United States is pledged, said investments being made under the terms of a repurchase agreement between the fiduciary and any state or national bank whose main office is in this

state including itself, if such fiduciary is a bank.

(2) Fiduciaries holding funds for loan or investment may make loans with the securities named in subsection (1) as collateral.

(3) The fiduciary shall account for all interest or profit received.

Further directions for trustee's with regard to investments are contained under the Uniform Trustee's Powers Act in KRS 386.810 (3), a copy of which may be found in Appendix "A".

Times change and investment techniques change but the rules of common sense and prudence will probably remain with fiduciaries for at least another 155 years.

The above quote is from an article by John W. Church, Jr. and Richard B. Seidel entitled "Rearming the Prudent Man" on page 24 in the September 1986 issue of Trust & Estates.

Turney Berry, of Greenebaum, Doll, McDonald recently prepared a research paper which he shared with us, and from his research of the history of the statutes he concludes that the legal list is permissive only in that the fiduciary "may invest" which is not restrictive or mandatory. It "provides express authority for a fiduciary to invest in the stated ways, but does not prohibit investment in other forms."

Kentucky has many cases which substantiate that it follows the prudent man rule. The provisions of the trust document will overlay the statutes, which in turn will be superimposed upon the case law.

It is possible to make an investment of an asset from the legal list, but it also must be a prudent investment. Likewise, an investment can be made in a trust in an asset which is not on the legal list, and it is still proper if it is prudent. One of the earlier Kentucky cases which deals with the prudent man rule is the case of Merriwether v. Merriwether, 11 KY. Op. 251 (1881) to one of the more recent cases of Carlick v. Keiler, 375 S.W. 2d 397 (KY 1964). A further concern of the prudent man rule is that there must be a reasonable equitable balance between the investments of the trust which will benefit the current income beneficiaries and the future principal remainderman, unless the trust document directs otherwise. KRS 386.800 (3) and 386.710.

Fiduciary investing requires three elements: care, skill and caution. When an investment is made, judgement of its prudence is as of the time it is made and not as of a later date when hind sight can be so clear. Another consideration is that we judge the propriety of the investments as a whole and not just each security. Although each asset must be proper, the fiduciary needs to consider the impact of each investment as to its affect on the account. This includes diversification and equality to both the interests of the current beneficiaries and the remaindermen.

From Scott on Trusts, Topic 5, Investment of Trust Funds, the following is taken, which lists the factors that should be considered in making an investment in addition to those relating to the safety



of the principal and the amount of regularity of the income. This listing is contained in the Restatement of Trusts, section 227.

- (1) the marketability of the particular investment;
- (2) the length of the term of the investment, for example, the maturity date, if any, the callability or redeemability, if any;
- (3) the probable duration of the trust;
- (4) the probable condition of the market with respect to the value of the particular investment at the termination of the trust, especially if at the termination of the trust the investment must be converted into money for the purpose of distribution;
- (5) the probable condition of the market with respect to reinvestment at the time when the particular investment matures;
- (6) the aggregate value of the trust estate and the nature of the other investments;
- (7) the requirements of the beneficiary or beneficiaries, particularly with respect to the amount of the income;
- (8) the other assets of the beneficiary or beneficiaries including earning capacity;
- (9) the effect of the investment in increasing or diminishing liability for taxes.

In the decision process, a fiduciary can't rely totally on the advice of others, since it is the duty of the trustee to use his own judgement. This is not to say that advice can't be sought, but the fiduciary must weigh that advice with regard to it being from a disinterested person, as well as from a knowledgeable person. The fiduciary must make a proper investigation before making an investment change. If he properly researches the investment, and at the time it is a proper investment that complies with the provisions of the trust, the statutes and law and the value declines he will not

be liable for the loss. However, if proper research isn't done, even if the investment was a proper asset for the trust to hold, the fiduciary could still be liable.

Kentucky via KRS 287.230 and 287.235 does permit the investment of trust assets in common trust funds even though the trust document does not specifically authorize it.

With the many concerns of people about the social performance of the corporation, according to Scott on Trusts, the trustee may properly consider this and

...decline to invest in, or retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.

If securities are received by a fiduciary from the testator or settlor, and the securities are not proper trust assets or become improper assets, then under KRS 386.070 Disposition of unauthorized securities, "such ineligible securities shall be sold at such time and upon such terms and conditions, or shall be held or otherwise handled in such manner as prudent businessmen would consider proper."

It is not necessary to immediately dispose of improper assets, but to do so in a reasonable time when a prudent person would. Reasonable time could depend on circumstances with regard to the asset

and the account. One consideration in such a sale would be the liability for capital gains, which might be generated by the sale. If the trust directs the fiduciary to retain a security specifically, but it does not appear proper or prudent to continue to do so, the fiduciary can apply to the court for permission to sell. According to Scott on Trusts, just because the trust terms authorize the retention of specific securities, it does not allow the trust to invest in the security. Also, if the trust terms do not authorize retention of specific securities, they can be retained even though they are not necessarily proper trust investments, if the trust permits the fiduciary to invest in the security.

From the Restatement of Trusts, section 231, as quoted in Scott on Trusts, section 230.2 Time conversion comes the following factors for consideration in determining how long to retain securities:

- (1) the character of the property and the amount of risk involved in its retention;
- (2) the amount which the trustee would receive on an immediate sale as compared with what he reasonably regards as its intrinsic value;
- (3) the amount which the trustee would receive on an immediate sale as compared with the value of the property at the time when it became a part of the trust estate;
- (4) the original value of the trust estate as a whole;
- (5) the general state of the market, as for example whether the prevailing prices are generally considered unduly low as in the case of a general depression or are considered unduly high;
- (6) the available opportunities for reinvestment;
- (7) the question of incurring tax liabilities;

(8) the purposes of the trust and the effect thereon of a possible loss on the investment in question.

If the trustee wishes to escape surcharge because of a loss that occurs when there is a delay in selling or failure to sell securities that were not proper trust investments, he needs to be able to show he exercised good prudent judgement and fully considered the facts and conditions at the time. If this can be shown then he is not subject to surcharge, just because he made an error in judgement.

As I mentioned earlier, we are competing in a new investment arena, but we are relying on the prudent man rule from the 1830 case of Harvard College vs. Amory, 26 Mass. (9 Pick.) 446 (1830). It may be time to look at this rule and decide if it also means that if we intend to be a prudent fiduciary that we will not ignore the new investment tools and techniques. In the Trust & Estates, September 1986 article on page 24, entitled "Rearming the Prudent Man" John Church Jr. and Richard B. Seidel pose these questions for the prudent fiduciary:

At what point in time do economic changes become so fundamental that it is imprudent not to develop new investment strategies? At what point in time do new investment vehicles become so tried and true that it is imprudent not to use them? At what point in time is the fiduciary making his decisions out of a fear of being surcharged rather than acting in the best interest of his beneficiaries?

Because we have advanced so in our abilities to analyze companies and investments and measure risks, just holding blue chip securities may not exempt a fiduciary from surcharge, because we can

measure the risk of investments. No investment is totally free of risk. With period of inflation and the eroding value of money, even an investment in a government security can have risk which would be associated with inflation and change of interest rates. The fiduciary still has to determine how much risk is acceptable and there is not currently a guideline for this other than the prudent man rule. The prudent investor will have to weigh the risk versus the reward to determine what is appropriate at the point in time when the investment is to be made and based on the skill available to the fiduciary.

Another problem area for the fiduciary through which he can open up the possibility of a surcharge is through the lack of communication. In several articles and through my own experience, more problems can result when communication with the beneficiary is not often and understandable. Not only do you need to communicate what you are doing with the trust and its investments, but you also must develop a customer relationship with the beneficiary so that you feel comfortable communicating with each other. Many times the beneficiary may feel inhibited in asking a person who appears to be a stranger to them, the trustee, some questions or to express what their needs really are. We must become communicators, but we also must become good listeners too! In the February 1988 issue of Trust & Estates, in an article on page 62 entitled, "Protecting the Corporate Fiduciary's Tender Backside" the author, Rohan Kelley develops a Fiduciary Creed which is an excerpt from an article by William J. Wilkie

It is also essential for trustees to avoid all appearances of professional arrogance. There is nothing to be gained by trustees, in the exercise of responsibilities that are solely theirs, not communicating regularly with beneficiaries and remaindermen. This is especially important when unusual assets are involved. Obtaining their written wishes and acquiescence may not always help, but it should not hurt either. It is essential to communicate, communicate, communicate.

Another element for communicating is that we have a new breed of customer and they want more sophisticated investments, reports and information. We have to be ready to adapt to their changing needs if we hope to service them as trust customers and avoid litigation. The future of the trust industry rests with this new aggressive customer and we must be prepared to make the necessary changes in our environment to meet these challenges. We must remember that the beneficiary and remaindermen have objectives and those must be continually considered in the management of the trust.

Thus, in summation, the fiduciary has to know the trust document and understand it thoroughly. He has to be able to relate those provisions to the beneficiaries and remaindermen, understand the law which governs the investments of the trust, be able to document the process by which investment decisions are made, be knowledgeable in the investment arena or have access to someone who is. Furthermore, the fiduciary must understand the beneficiary needs, concerns, and listen to his questions. The fiduciary must be able to communicate with the beneficiary frequently and involve them in

the account management process, so that they understand what is happening to their money. We must communicate, communicate, communicate.

## APPENDIX "A"

### 386.810 Powers of trustees conferred by this chapter

(1) From time of creation of the trust until final distribution of the assets of the trust, a trustee has the power to perform, without court authorization, every act which a prudent man would perform for the purposes of the trust including but not limited to the powers specified in subsection (3).

(2) In the exercise of his powers including the powers granted by this chapter, a trustee has a duty to act with due regard to his obligation as a fiduciary, including a duty to give consideration to available tax exemptions, deductions, or credits for tax purposes. "Tax" includes, but is not limited to, any federal, state, or local income, gift, estate, or inheritance tax.

(3) A trustee has the power, subject to subsections (1) and (2) of this section:

(a) To collect, hold, and retain trust assets received from a trustor until, in the judgment of the trustee, disposition of the assets should be made; and the assets may be retained even though they include an asset in which the trustee is personally interested;

(b) To receive additions to the assets of the trust;

(c) To continue or participate in the operation of any business or other enterprise, and to effect incorporation, dissolution, or other change in the form of the organization of the business or enterprise;

(d) To acquire an undivided interest in a trust asset in which the trustee, in any trust capacity, holds an undivided interest;

(e) To invest and reinvest trust assets in accordance with the provisions of the trust or as provided by law;

(f) To deposit trust funds in a bank, including a bank operated by the trustee;

(g) To acquire or dispose of an asset, for cash or on credit, at public or private sale; and to manage, develop, improve, exchange, partition, change the character of, or abandon a trust asset or any interest therein; and to encumber, mortgage, or pledge a trust asset for a term within or extending beyond the term of the trust, in connection with the exercise of any power vested in the trustee;

(h) To make ordinary or extraordinary repairs or alterations in buildings or other structures, to demolish any improvements, to raze existing or erect new party walls or buildings;

(i) To subdivide, develop, or dedicate land to public use; or to make or obtain the vacation of plats and adjust boundaries; or to adjust differences in valuation on exchange or partition by giving or receiving consideration; or to dedicate easements to public use without consideration;

(j) To enter for any purpose into a lease as lessor or lessee with or without option to purchase or renew for a term within or extending beyond the term of the trust;

(k) To enter into a lease or arrangement for exploration and removal of minerals or other natural resources or enter into a pooling or unitization agreement;

(l) To grant an option involving disposition of a trust asset, or to take an option for the acquisition of any asset;

(m) To vote a security, in person or by general or limited proxy;

(n) To pay calls, assessments, and any other sums chargeable or accruing against or on account of securities;

(o) To sell or exercise stock subscription or conversion rights; to consent, directly or through a committee or other agent, to the reorganization, consolidation, merger, dissolution, or liquidation of a corporation or other business enterprise;

(p) To hold a security in the name of a nominee or in other form without disclosure of the trust, so that title to the security may pass by delivery, but the trustee is liable for any act of the nominee in connection with the stock so held;

(q) To insure the assets of the trust against damage or loss, and the trustee against liability with respect to third persons;

(r) To borrow money to be repaid from trust assets or otherwise; to advance money for the protection of the trust, and for all expenses, losses, and liability sustained in the administration of the trust or because of the holding or ownership of any trust assets, for which advances with any interest the trustee has a lien on the trust assets as against the beneficiary;

(s) To pay or contest any claim; to settle a claim by or against the trust by compromise, arbitration, or otherwise; and to release, in whole or in part, any claim belonging to the trust to the extent that the claim is uncollectible;

(t) To pay taxes, assessments, compensation of the trustee, and other expenses incurred in the collection, care, administration, and protection of the trust;

(u) To allocate items of income or expense to either trust income or principal, as provided by law, including creation of reserves out of income for depreciation, obsolescence, or amortization, or for depletion in mineral or timber properties;

(v) To pay any sum distributable to a beneficiary under legal disability, without liability to the trustee, by paying the sum to the beneficiary or by paying the sum for the use of the beneficiary either to a legal representative appointed by the court, or if none, to a relative;

(w) To effect distribution of property and money in divided or undivided interests and to adjust resulting differences in valuation;

(x) To employ persons, including attorneys, auditors, investment advisors, or agents to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary;

(y) To prosecute or defend actions, claims, or proceedings for the protection of trust assets and of the trustee in the performance of his duties;

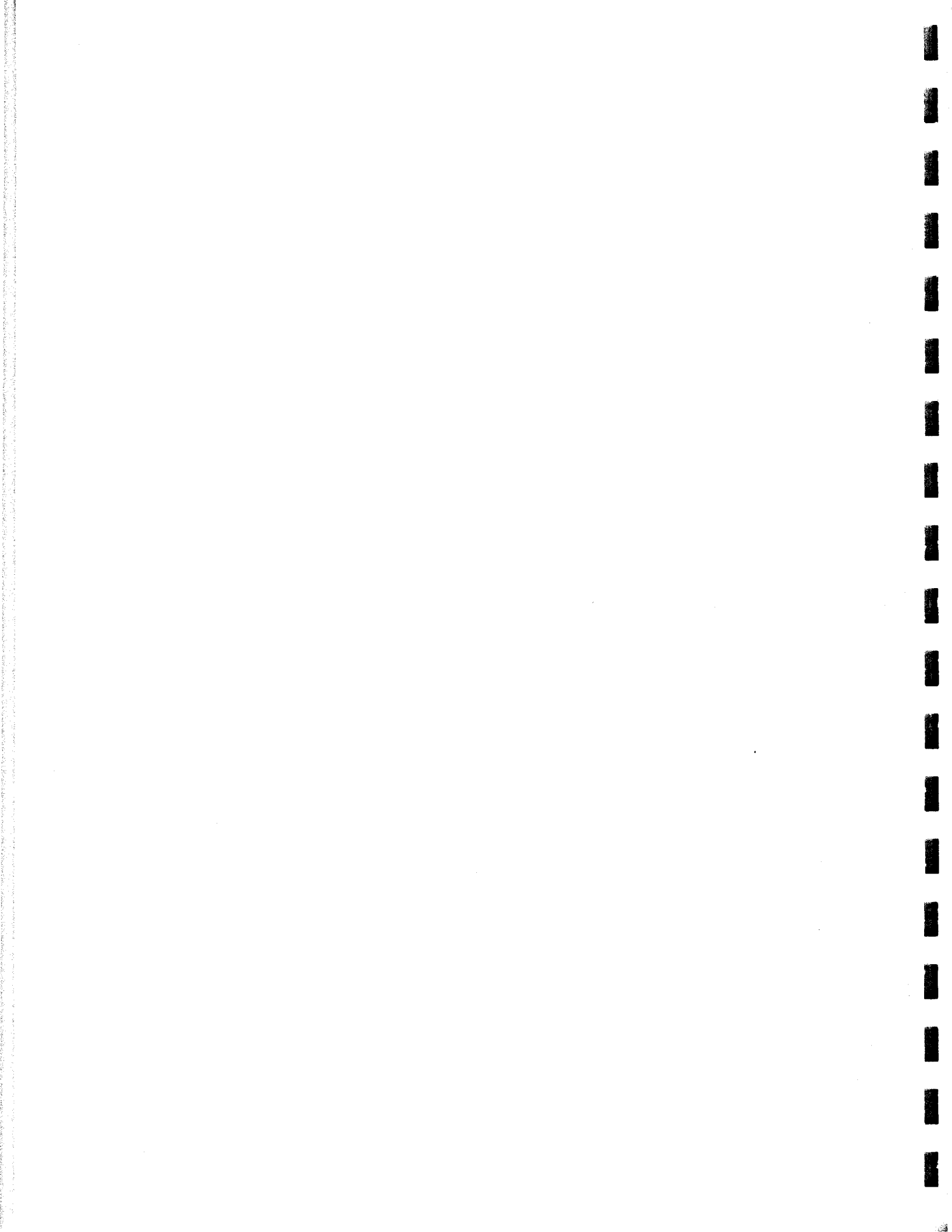
(z) To execute and deliver all instruments which will accomplish or facilitate the exercise of the powers vested in the trustee.

HISTORY: 1976 H 98, § 46, eff. 6-19-76

SOURCE NOTE (1976)

Virtually identical to the Uniform Trustees' Powers Act § 3.



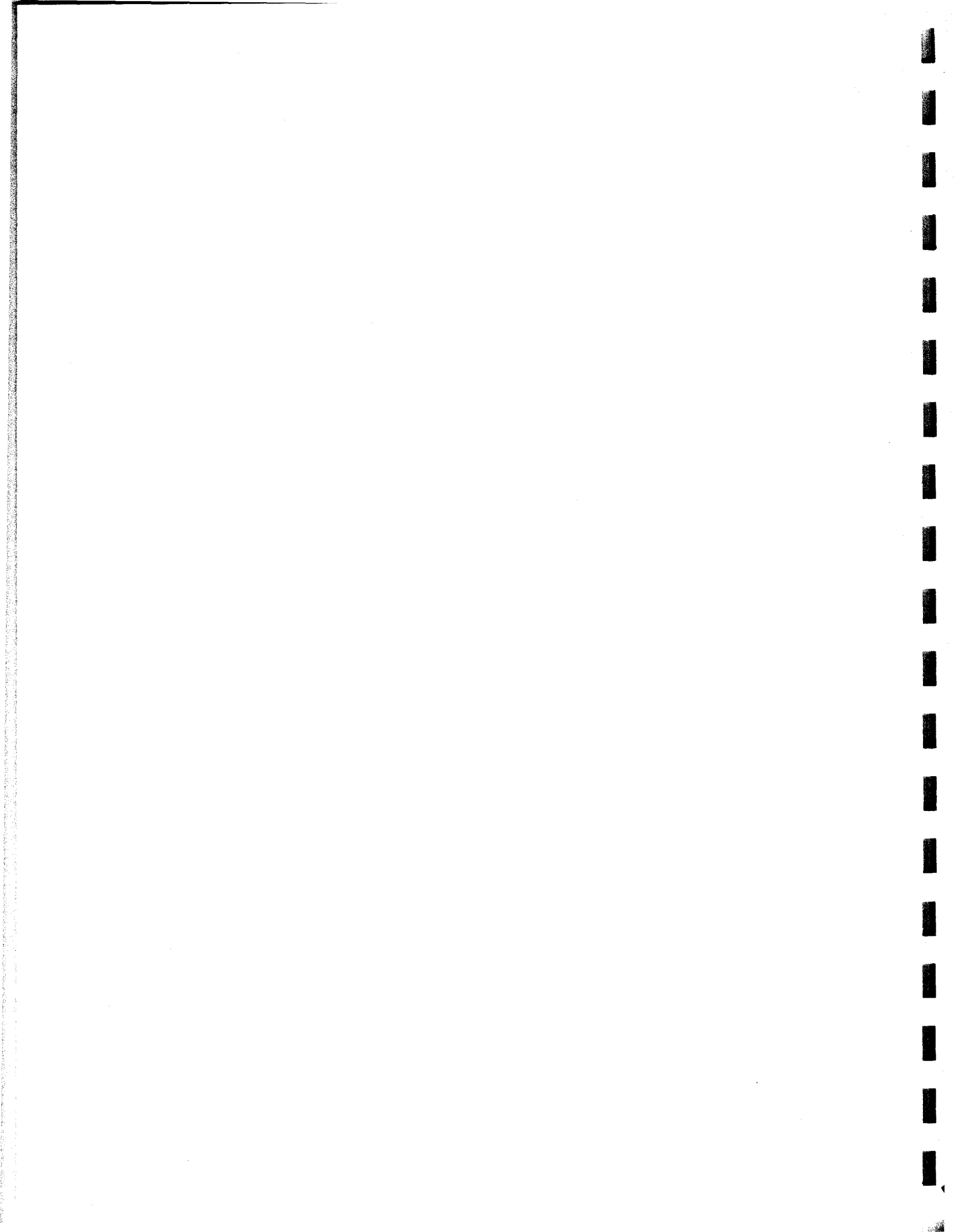


FIDUCIARY INVESTING: THE INVESTMENT PROCESS

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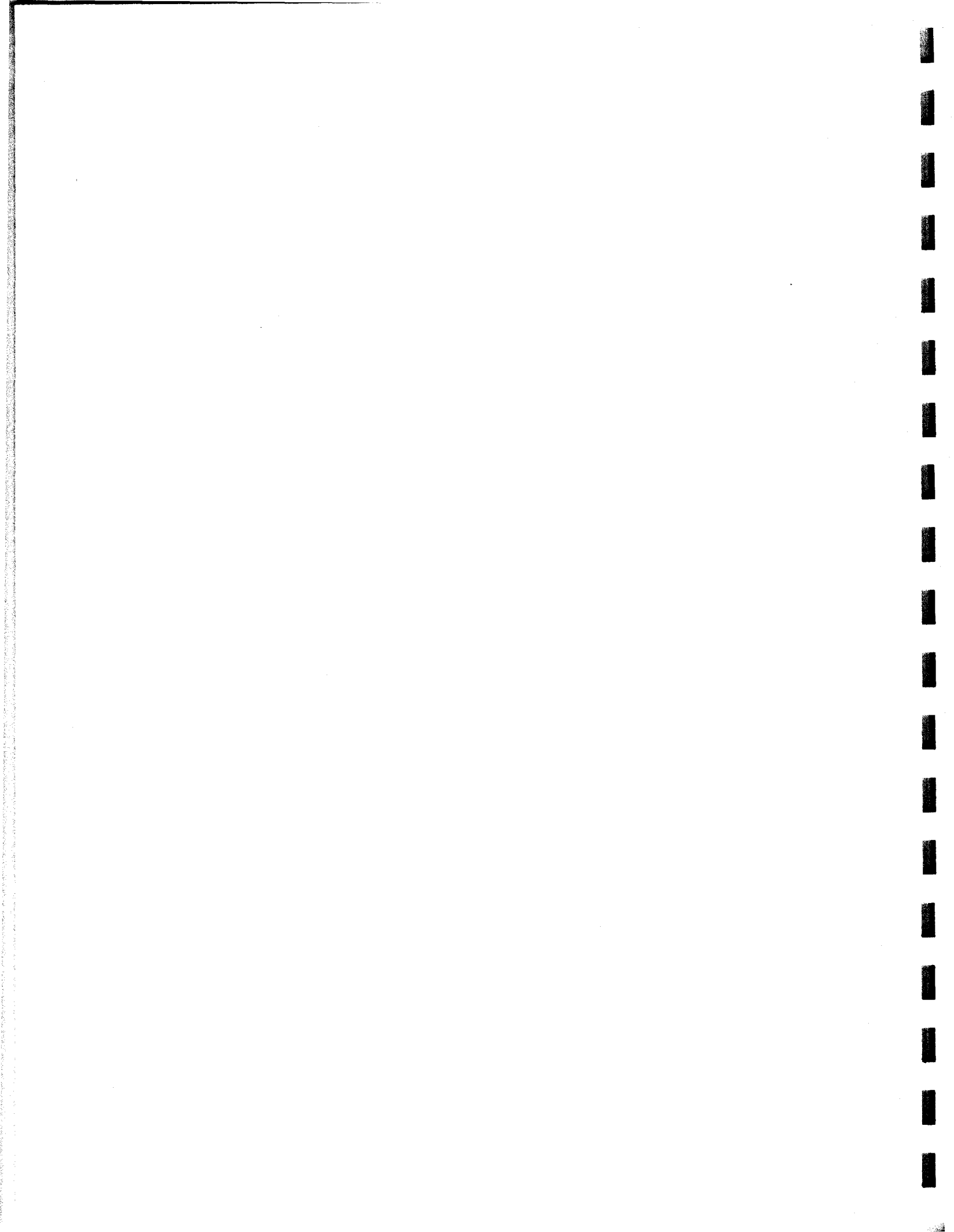
SECTION I



FIDUCIARY INVESTING: THE INVESTMENT PROCESS

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Now that the legal framework of statutes and cases has been established, I would like to describe the investment process. How do we actually go about investing the dollars we hold as a fiduciary? What are the guidelines? How do we accomplish the goals of our trust customers by investing in financial assets?

There are, of course, many different capacities in which we serve as a fiduciary, and the investments we choose for an account will vary accordingly. For instance, if we are serving as Executor of an estate which, after administration, will go out free we are charged primarily with:

- (a) selling enough assets to raise cash for the expenses of administration; and
- (b) preserving capital until distribution.

As Executor in this situation, we don't take on the long term management role of maximizing investment returns and protecting the dollars under management against the effects of inflation. With trusts, on the other hand, be they revocable or irrevocable, we do take on a long term management role and make invest-

ments appropriate to the objectives of the individual beneficiary or beneficiaries involved.

When we are taking on the job of Trustee and long term management of assets, we start by setting investment objectives. Each account must have a documented and updated investment objective. To arrive at an objective, we analyze the return we desire. Return is a combination of the:

1. income produced by the assets (i.e. dividends or interest); and
2. the capital appreciation or depreciation over the period.

We also analyze the level of risk we can tolerate. We measure risk by "standard deviation" or variability of returns over time.<sup>1</sup> The following chart shows historical return and risk information for asset classes:

<sup>1</sup>Maginn, John and Tuttle, Donald, Managing Investment Portfolios, Milne, Robert, "Determination of Portfolio Policies: Individual Investors," p. 130-31

Summary Statistics of Annual Returns  
1926-1987

| <u>Series</u>                         | <u>Geometric<br/>Mean</u> | <u>Standard<br/>Deviation</u> |
|---------------------------------------|---------------------------|-------------------------------|
| Common stocks (%)                     | 9.9                       | 21.1                          |
| Small-company stocks                  | 12.1                      | 35.9                          |
| Long-term corporate bonds             | 4.9                       | 8.5                           |
| Long-term government bonds            | 4.3                       | 8.5                           |
| Intermediate-term<br>government bonds | 4.8                       | 5.5                           |
| U. S. Treasury Bills                  | 3.5                       | 3.4                           |
| Inflation Rates                       | 3.0                       | 4.8                           |

Source: Ibbotson, Roger G., and Rex A. Sinquefeld, Stocks, Bonds, Bills and Inflation, (SBBI), 1982, updated in SBBI 1988 Yearbook, Ibbotson Associates, Chicago

As you can see from the chart, stocks have historically afforded the highest return, but also involve the highest standard deviation, or risk. Monday, October 19, 1987, served as a harsh reminder of this. Bonds, as you can see, have historically offered less return, but have involved less risk. So, we consider the risk/return trade off when setting investment objectives.



In setting investment objectives and beginning the investment process for trusts, we have five basic investment constraints to consider:

1. Time horizon - What is our time frame for the investments? Are we dealing with a 99-year-old who has a very short time frame and thus calls for very conservative investments and little risk? Or we are investing for a 30-year-old who has a long life ahead of him and has just inherited money? With the longer time horizon of the 30-year-old, we can take more risk and achieve greater returns over the years.
2. Liquidity needs - How much liquidity will be needed in the trust? How much should be set aside in a safe, liquid asset such as a money market fund for quick withdrawals? Revocable trust customers will usually let us know how much to keep on hand. Irrevocable or testamentary trusts may need money for encroachments or taxes. These liquidity needs must be considered.

3. Regulatory and legal constraints must be considered. What are "legal" investments in the state? The "prudent man" rule must be considered.
  
4. Taxes - What is the tax situation of our beneficiaries? What is their income tax bracket? Do we need taxable or tax-free bonds? In a revocable trust, all of the tax effects of our investments will flow through to the personal income tax return of the Grantor. Usually, in an irrevocable or testamentary trust, the trust as a separate taxpayer will report and pay tax on capital gains and the income beneficiary will report and pay tax on the income generated by the trust.
  
5. The last constraint we consider in establishing investment objectives and beginning the investment process is the special needs and circumstances of the beneficiaries or trust.  
For example:

- a. Do we have a concentration in one stock or asset which will have to be slowly diversified over time?
  
- b. Does the trust customer have emotional or sentimental ties with the assets? Often, beneficiaries ask that certain stocks not be sold. Perhaps it is a stock inherited from a relative or a stock "Daddy gave me and told me never to sell."<sup>2</sup>

After setting an investment objective for the trust, by considering the return needed, the risk tolerance, and the investment constraints in the situation, we decide upon an asset allocation. That is, how much money will be invested in, typically, bonds, stocks, and cash.

For example, if we have an elderly nursing home patient who has established a living trust, we would allocate more dollars to bonds than stocks. If we have a young professional who has just inherited money and

<sup>2</sup>Maginn, John and Tuttle, Donald, Managing Investment Portfolios, Milne, Robert, "Determination of Portfolio Policies: Individual Investors," p. 134-140

established a living trust, we would allocate more dollars to common stocks than bonds.

Asset allocation is a challenge in the so-called "split interest trust". For example, a trust under will established for the life of one person, remainder to a different individual. The income is paid out to the life tenant during his or her life. Upon death of the life tenant, the corpus of the trust goes out in fee to the remaindermen.

Here we are investing money to meet the needs of two different trust customers. The life tenant, income beneficiary, wants as much income to be generated by the trust as possible. The life tenant, since he is usually entitled to only the income, would love to see us invest the entire trust in high yielding bonds. The remainderman on the other hand, wants us to achieve growth in the assets over time. He will inherit the assets at the death of the life tenant. The remainderman is happy if the trust has a high allocation to common stocks for growth of principal.

The Trustee has to deal with this conflict between beneficiaries. KRS 386.800 (3) speaks to this in defining the "Prudent Man." The "Prudent Man" means a

trustee whose exercise of trust powers is reasonable and equitable in view of the interest of income or principal beneficiaries or both..." The remaindermen or income beneficiary could potentially take legal action against the Trustee if their interests are ignored. A happy median must be found between an all-stock or all-bond allocation.

Now that we've set our investment objective, considered our constraints and come up with an appropriate asset allocation, we are ready to choose individual assets. A Kentucky case, Peoples State Bank & Trust Co. v. Wade, 106 SW 2nd 74 (KY 1937) gives some guidelines, and reads as follows:

"The tests by which a Trustee should ordinarily measure the advisability of a particular investment are thus stated in the Restatement of the Law of Trusts, vol. 1, § 227, subsec. (m):

"Among the matters which the Trustee should consider in selecting a given investment in addition to those relating to the safety of the fund invested and the amount and regularity of the income, are: (1) the marketability of the particular investment; (2) the length

of the term of the investment, for example, the maturity date, if any, the callability or redeemability, if any; (3) the probable duration of the trust; (4) the probable condition of the market with respect to the value of the particular investment at the termination of the trust especially if at the termination of the trust the investment must be converted into money for the purpose of distribution; (5) the probable condition of the market with respect to reinvestment at the time when the particular investment matures; (6) the aggregate value of the trust estate and the nature of the other investments; (7) the requirements of the beneficiary or beneficiaries, particularly with respect to the amount of the income; (8) the other assets of the beneficiary or beneficiaries including earning capacity; (9) the effect of the investment in increasing or diminishing liability for taxes."

In addition to the above, it may be added that the Trustee should consider the advisability of diversifying his investments in order to insure against adverse conditions in any particular field."

As the case states, a key point in posturing the account will be to diversify the investments, so that we don't have all of our "eggs in one basket." This is an important tenent in portfolio management. In the bond portion of the portfolio, we will diversify as to maturity and perhaps issuer. We will stagger maturities so that we will have bonds maturing at different times and in different interest rate environments. In the stock portion of our portfolio, we will diversify by purchasing stocks of different industry sectors. By diversifying, we can eliminate much of the "non-systematic" risk of the companies. When one industry is doing poorly, perhaps another will be at its peak. We cannot eliminate "systematic risk," however, or the risk that the the stocks will move together as the overall market moves.

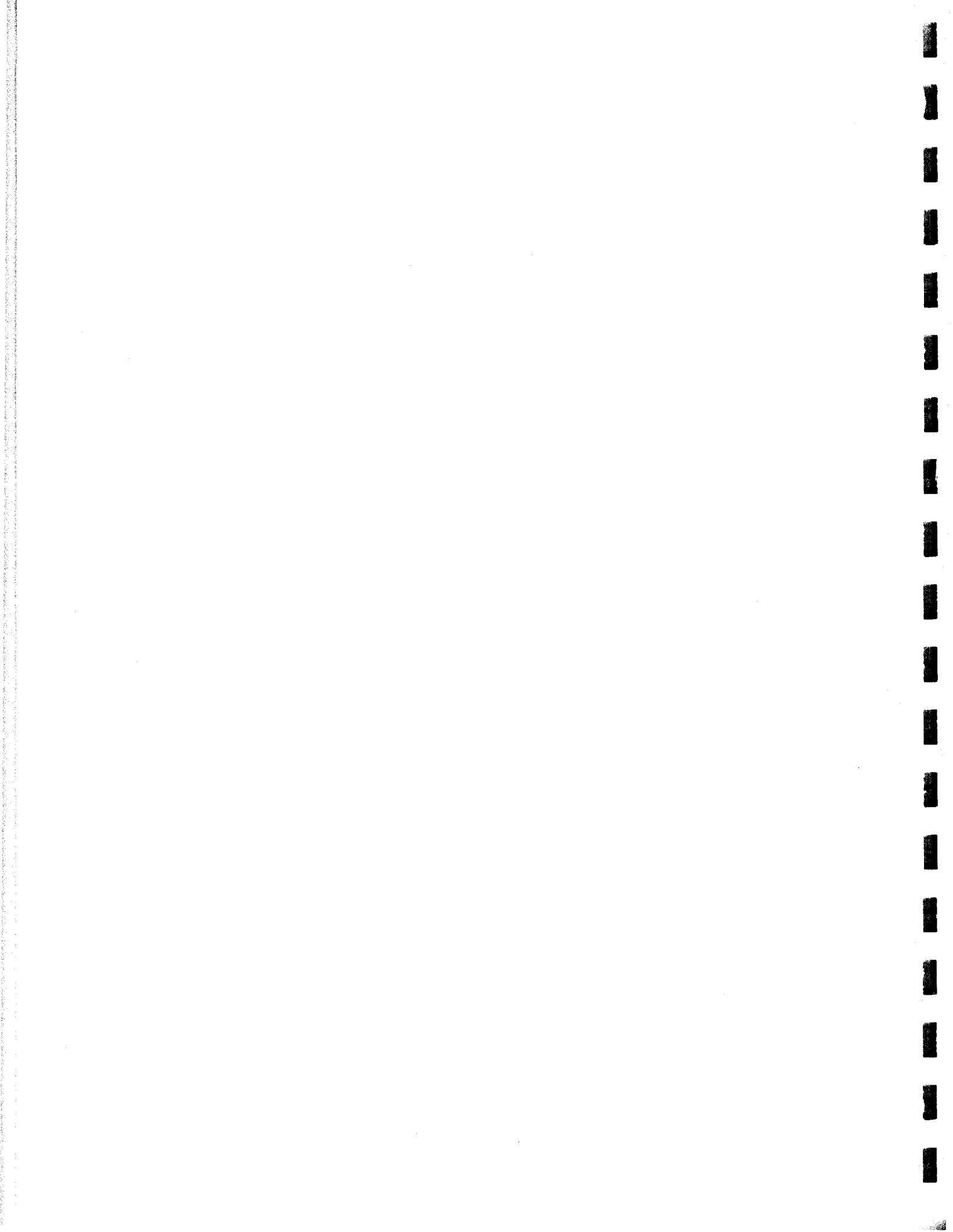
As we invest and reinvest the assets, who calls the shots? Who makes the decisions? Usually, when we act as Trustee, we are given investment discretion to act as we see fit. We usually do not have to consult with anyone for prior approval. Even in these circumstances, however, we try to communicate with our beneficiaries and inform them of the whys and hows of our investments. In some circumstances, however, the trust document requires that we consult an individual

advisor or advisory committee and obtain official approval before making investment changes. We are perfectly comfortable with either a discretionary or advisory set-up. However, practically speaking, the advisory set-up can be cumbersome. Sometimes the advisors are hard to find when time is of the essence!

As you have seen, there is a definite procedure which we, as a fiduciary, follow in investing money. The process is an ongoing one. Our investment objectives and constraints may change as the needs and circumstances of the beneficiaries we serve change. The end result, our goal, is solid and successful management of assets.

Thank you.





ASSET TRANSFERS AFTER "DICKMAN"

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SECTION J



ASSET TRANSFERS AFTER "DICKMAN"

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ASSET TRANSFERS AFTER "DICKMAN"

I. Dickman - The Decision.

In Dickman v Commissioner, 84-1 USTC (CCH) ¶13,560 (1984), the Supreme Court, by a majority of seven, determined that an interest-free demand loan results in a transfer subject to the federal gift tax. The Court indicated that the "property" interest involved is the right of the borrower to use the funds loaned for an undetermined period of time. The holding was buttressed by the Court's feeling that the result was necessary to avoid undermining the federal estate and income tax laws. The Court rejected the petitioner's argument that the holding could be applied in an absurd manner to everyday transactions such as the loan of a cup of sugar to a neighbor or lunch money to a colleague ("When the government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case." Id. at 84,430).

In two footnotes, the Court very briefly touched on the issue of valuation in the demand loan context. The Court indicated that the lender's failure over time to call the loan would cause the gift to become complete and that this component of the transaction, i.e., completeness over time, would affect the value of the gift. Id. at 84,429 n. 7. In addition, the Court stressed that the IRS would not be required to establish that the loaned funds produced a certain amount of revenue; instead, it would be sufficient to prove that a

particular yield could have been secured by the borrower and that the reasonable value of the use of the funds can be readily ascertained. Id. at 84,431 n. 14. Of course, since the valuation question was not before the Court, both of these footnotes constituted nothing more than dictum.

In his dissent, Justice Powell, who was joined by Justice Rehnquist, criticized the opinion of the majority because of the reliance of taxpayers on the Service's past inaction regarding this issue and the belief that Congress would be the appropriate forum for enactment of any substantive law change. Most importantly, however, Justice Powell predicted that the broad scope of the holding might result in the future in unanticipated application of Dickman to other fact situations. He wrote:

The Court, aware of the potential for abuse of its new interpretation, "assume[s]" that the Internal Revenue Service will exercise the power conferred on it in a reasonable way. Ante, at 10. This assumption is not likely to afford much comfort to taxpayers and the lawyers and accountants who advise them. The Commissioner, acting with utmost goodwill, is confronted with a dilemma. This Court today holds that the plain language of the statute mandates, and that Congress intended, the "gift tax statute to reach all gratuitous transfers of any valuable interest in property." Ante, at 3. No discretion is given the Commissioner and the IRS to read "all" and "any" as meaning only such valuable interests in property that it seems reasonable to tax. The Court identifies no statutory basis for such discretion, and even if the Court itself undertook to confer it I am not aware that we have ever before "assumed" that tax laws would be enforced---not according to their letter--but reasonably. Id. at 84,434. (Emphasis in original.)

II. Essence of Dickman.

The barebones essence of Dickman involves the concept of forbearance or the forgoing of an opportunity that results in some benefit (resulting from the use of an interest in property) accruing to another. This proposition is fairly clear in the context of interest-free demand loans. However, it is much less so where other somewhat analogous facts are involved. Unfortunately, the concerns of the Dickman dissenters regarding the scope of the opinion appear to have been justified because the IRS has cited Dickman in various fact settings not involving demand loans.

III. The Aftermath of Dickman.

Following the decision of the Supreme Court, the IRS announced that it would apply Dickman retroactively, and the rules regarding valuation of demand loan gifts for years prior to 1984 were set forth in Rev. Proc. 85-46, 1985-2 C.B. 507.

Subsequently, Congress enacted Section 7872 of the Internal Revenue Code (IRC) as a part of the Deficit Reduction Act of 1984. This statute contains comprehensive rules regarding valuation of low interest and interest-free loans for gift and income tax purposes. IRC Section 7872 also contains several very important exceptions.



Finally (or is it only the beginning), in 1987, the IRS began applying the Dickman rationale to fact settings involving GRITs and the rights of shareholders in closely held corporations. The balance of this outline will address these matters.

IV. Applicability of Dickman to a GRIT.

A GRIT (Grantor Retained Income Trust) is an irrevocable transfer of assets to a trust in which the grantor retains an income interest for a term certain. The gift involved is that of the remainder interest. The tax advantage of a GRIT is derived from the 10% valuation tables that the Service promulgated in 1983 under IRC Sections 2031 and 2512. These tables inflate the value of the grantor's retained interest, which has the effect of reducing substantially the value of the gift of the remainder interest for gift tax purposes. If the grantor survives the term certain, then he has successfully transferred at a low gift tax cost (1) the assets originally transferred to the trust and (2) all appreciation in value of such assets after the transfer. At the same time, the grantor has benefitted from the income earned on the assets during the term certain.

A client may desire to transfer to a GRIT shares of stock in a closely held corporation, the dividend history of which has been low. In such a case, many tax advisors have felt that inclusion of a provision permitting the grantor to compel the trustee to convert nonproductive

or underproductive assets to income-producing property is necessary to assure that the Service will permit the use of the advantageous 10% valuation tables (See Letter Ruling 8642028).

The IRS has recently applied Dickman to this type of provision in Letter Ruling 8806082. There, the grantor had transferred closely held stock to a GRIT in which he retained an eight-year income interest. The dividend rate of the stock during the 10 years preceding the transfer had ranged from zero to .9%. The trust instrument included language permitting the grantor to direct the trustee to dispose of unproductive or underproductive trust assets. The Service determined that (1) a completed gift had been made and (2) that the advantageous 10% valuation tables could be used in the valuation formula (in spite of the low yield of the stock). However, the Service also ruled, in reliance upon Dickman, that additional gifts would be effected in years following the creation of the GRIT if the grantor failed to direct the trustee to dispose of underproductive assets. The Service stated:

If, after the initial funding, you fail to exercise the right to make the corpus of the trust normally productive under the standards usually applicable to simple trusts, you may lose a continuing stream of your entitled income and such a loss would cause a continuing increase in the value of the corpus (in the form of capital appreciation that results from the retention of earnings) for the benefit of the remainder and reversionary interests. As in the case of the lost income on the demand loan money in Dickman, the lost income on the trust corpus in the present case would be recognizable as a taxable gift for each year in which you fail to protect your right to receive a reasonable rate of income. The valuation of any gifts made through loss of income after the initial

funding of the trust should be calculated on a basis that is consistent with the calculation of the value of the gift of the remainder interest at the time of the initial funding. Thus, to be consistent, the valuation of future annual remainder interest gifts resulting from lost income of the trust would be based on the assumption of a 10 percent imputed rate of return for those years in which the 10 percent rate continues to remain in effect.

The result of this Letter Ruling is not particularly surprising in view of the Service's obvious distaste of GRITs. The most troublesome aspect of the Letter Ruling involves the valuation of the future gifts. Although the Service indicated in the cited language that a 10% assumed rate of return will be used to determine the value of any future gift, it also referred in another portion of the ruling to the use of a state law standard for purposes of determining whether the trust asset is underproductive. These two standards are difficult to reconcile in that the spread between the "state law standard" and a 10% return may be substantial. As an example, an unproductive asset under Kentucky law is one that produces less than 1% per year. KRS 386.290(1).

The scope of Letter Ruling 8806082 is disconcerting. For example, its rationale could be applied to the power of the spouse who is the beneficiary of a marital deduction trust to compel investment in income-producing property. (This power is typically included in marital deduction trusts pursuant to Treas. Reg. 20.2056(b)-4.) No doubt, the motivation of the IRS on this issue would not be as great, since the full value of the marital deduction trust will be included in

the surviving spouse's estate for federal estate tax purposes at his or her death. (The same is true with respect to the grantor's retained interest in a GRIT only if he dies before the expiration of the term certain.) However, if the trust were quite large in value, the amount of the gift might exceed the spouse's remaining exemption equivalent, with the result that a transfer tax would be due sooner rather than later. This analysis likely would apply only to a QTIP trust, since any power of appointment trust would always be subject to a changed disposition and the spouse's failure to "compel" therefore could not be considered a completed gift for federal gift tax purposes.

With respect to GRITs and the matter of underproductive or nonproductive assets, the IRS reached similar conclusions in Letter Rulings 8805029 and 8801008.

V. Applicability of Dickman in the Corporate Setting.

Thus far, the IRS has applied Dickman in two situations involving the "activities" of an owner of preferred shares in a closely held corporation.

A. Failure to Declare a Dividend.

In Technical Advice Memorandum 8723007, the taxpayer was the owner of 21,325 shares of 10% non-cumulative voting preferred stock.

This number of shares represented 100% of the outstanding preferred shares and voting control of the corporation. The taxpayer previously had owned 100% of the voting common stock, but transferred all of those shares in trust for the benefit of his grandchildren in 1980.

The corporation paid dividends on the preferred stock of 1.5% and .2% in 1981 and 1982, respectively, but no preferred stock dividends were paid in 1983 and 1984. No dividends were paid on the common stock during these years. During the years in issue, the corporation maintained large cash and short-term investment balances.

The issue addressed was whether the taxpayer had made gifts in the years in question to the owners of the common stock as a result of his failure to compel as the controlling shareholder (although he was only one of two members of the Board of Directors) the declaration of dividends on the preferred shares. The IRS concluded, in reliance to a fair extent on the Dickman rationale, that indirect gifts had been made because the taxpayer had failed to take any steps to protect his interest in the earnings of the corporation. In reaching this conclusion, the IRS observed:

The basic questions presented in the present case are (1) whether the donor as the controlling shareholder (over 70% of voting power at all times) of the corporation has adequately protected his economic position against encroachment by the other minority shareholders, and (2) if not, whether his

acquiescence or negligence in failing to protect his position results in a gift to the other shareholders. To properly consider these questions, it is necessary to verify that (a) there has been a measurable shift in value from the donor's stockholdings to the other stockholdings, and (b) that the donor had the right or power to stop or at least diminish such shift in value.

In the present case, the earnings of the corporation totaled \$1,195,000 over the last five years. An 83% share of this total for all of the preferred stock is \$988,333. If the donor had held common stock instead of preferred stock, he would have realized a fair pro rata (majority share) benefit of the \$1,195,000 earnings total. The realization would have been in the form of enhanced value of his common stock through its representative share of the total earnings. As preferred shareholder, the donor received only \$36,905. Moreover, even if the corporation continues at its recent rate of profitability (earnings more than the maximum \$213,250 annual preferred dividend), the donor as a preferred shareholder will never be able to recover the dividends not paid in the prior years.

By foregoing his preferred dividend, the donor has waived his right as a preferred shareholder to his fair share of earned surplus. This has resulted in a steady and progressive shift in value from the donor's shareholdings to the shareholdings of the present common shareholders.

The Service acknowledged that valid business purposes could support the decision of a corporation not to declare a dividend; however, it did not base its decision on this analysis. (The taxpayer had argued that large cash reserves were necessary to meet the corporation's bonding requirements [and those of its subsidiaries].) Instead, the Service concluded readily that the taxpayer could have protected his interests by alternative means such as having the corporation (1) declare and pay a dividend and then loan the payment back to the corporation; (2) distribute its

promissory note to him; or (3) declare and not pay the dividend, thus making the unpaid dividend a liability on the corporation's books. The Service also noted that the corporation had paid a dividend when cash and cash equivalents were \$894,000, but had not done so when cash and cash equivalents were \$2,484,000.

B. Failure to Convert Preferred Stock to Common Stock.

Technical Advice Memorandum 8726005 involved a taxpayer who had received in a recapitalization 50% of the outstanding 13% non-cumulative preferred stock (that was convertible to common stock at his option) and 50% of the shares of common stock. The preferred shares were nonparticipating and non-voting. The other 50% was owned by an unrelated third party. The taxpayer also owned 50% of the shares of another class of preferred shares which carried the voting rights. (During the period in question, the common stock was non-voting.)

In 1983, the taxpayer gave all of his common shares to his children. Also in that year, the taxpayer entered into an agreement with the third party shareholder to purchase his shares through a redemption by the corporation. The purchase price was paid with cash and notes. As part of the redemption agreement, the corporation was prohibited from declaring any dividends so

long as any of the notes remained unpaid, and the taxpayer was required to pledge his preferred shares as security for payment of the notes.

In the calendar years following the redemption, the corporation realized substantial earnings. However, the taxpayer did not at any time convert his preferred shares to common stock.

The Service, in concluding that gifts to the common shareholders had been made, said:

The thrust of Dickman is that the gift tax extends to all gratuitous transfers of property and property interests having significant value. The broad sweep of the tax is necessary to preserve the integrity of the estate tax. Although the instant case is factually distinguishable from Dickman in that it does not involve a demand loan, it is analogous to this case in four significant ways.

Firstly, there is a transfer. Taxpayer, by contracting away for an extended period his right to preferred dividends and by failing to exercise his conversion rights for the years in question, has assured that the earnings for those years were credited to retained earnings where they would increase the value of the common shares which Taxpayer had given to his children.

In short, Taxpayer's failure to convert to common stock effectively diverted the corporate earnings over a two year period from Taxpayer's capital interest to that of his children.

Secondly, the consequent increase in value of the common stock is, like the use of money in Dickman, an interest recognized under law.

Thirdly, the transfer was gratuitous in that the individuals to whom the retained earnings accreted paid nothing for their



stock in Corporation X or for Taxpayer's decision not to convert his Class A preferred shares to common stock.

Fourthly, this transfer of value from Taxpayer's capital interest to that of his children, like the use of money transferred in Dickman, represents a significant sum. Thus, failure to subject the transfer to gift tax would violate the scheme of subtitle B of the Code.

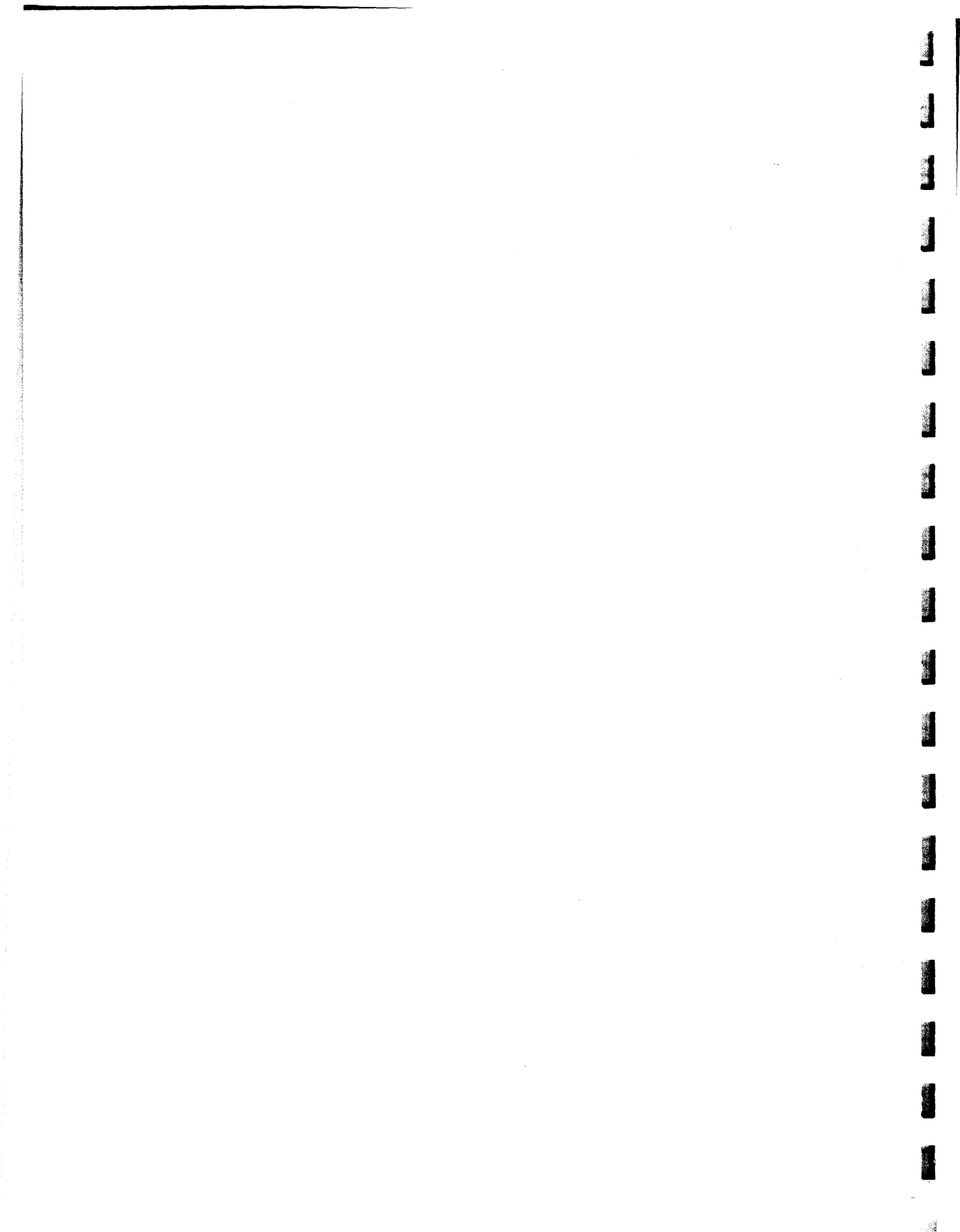
The Service did not determine the value of the gifts. Instead, the resolution of that issue was left to the District Office. The taxpayer had contended that valuation would be too difficult and that the gift tax therefore should not be imposed, but the Service rejected this argument.

VI. Conclusion - The Common Thread.

The IRS seems ready to extend the rationale of Dickman far beyond the interest-free demand loan scenario. In particular, it seems quite willing to characterize various transactions involving closely held stock as indirect transfers that are subject to the federal gift tax laws. However, it seems to fall short in analyzing the whole transaction, particularly with respect to any underlying business purposes or corporate law obligations that may exist. The only IRS mention of business purposes is included in TAM 8723007. However, the IRS there saw no need to analyze the subject in reaching its conclusion. Instead, it merely relied upon a list of acts that the taxpayer could have undertaken to "protect" his right to dividends. Of course, there are many situations in the closely held corporate setting where valid

reasons would exist to support a decision one way or the other to further the corporation as an entity to the benefit of all of the shareholders.

Beyond the fact situations of the rulings discussed herein, caution should be exercised in any transaction where it can be seen that a taxpayer could, at some future time, be placed in the position of forgoing some right or opportunity which could benefit another taxpayer. This is the gist of Dickman.

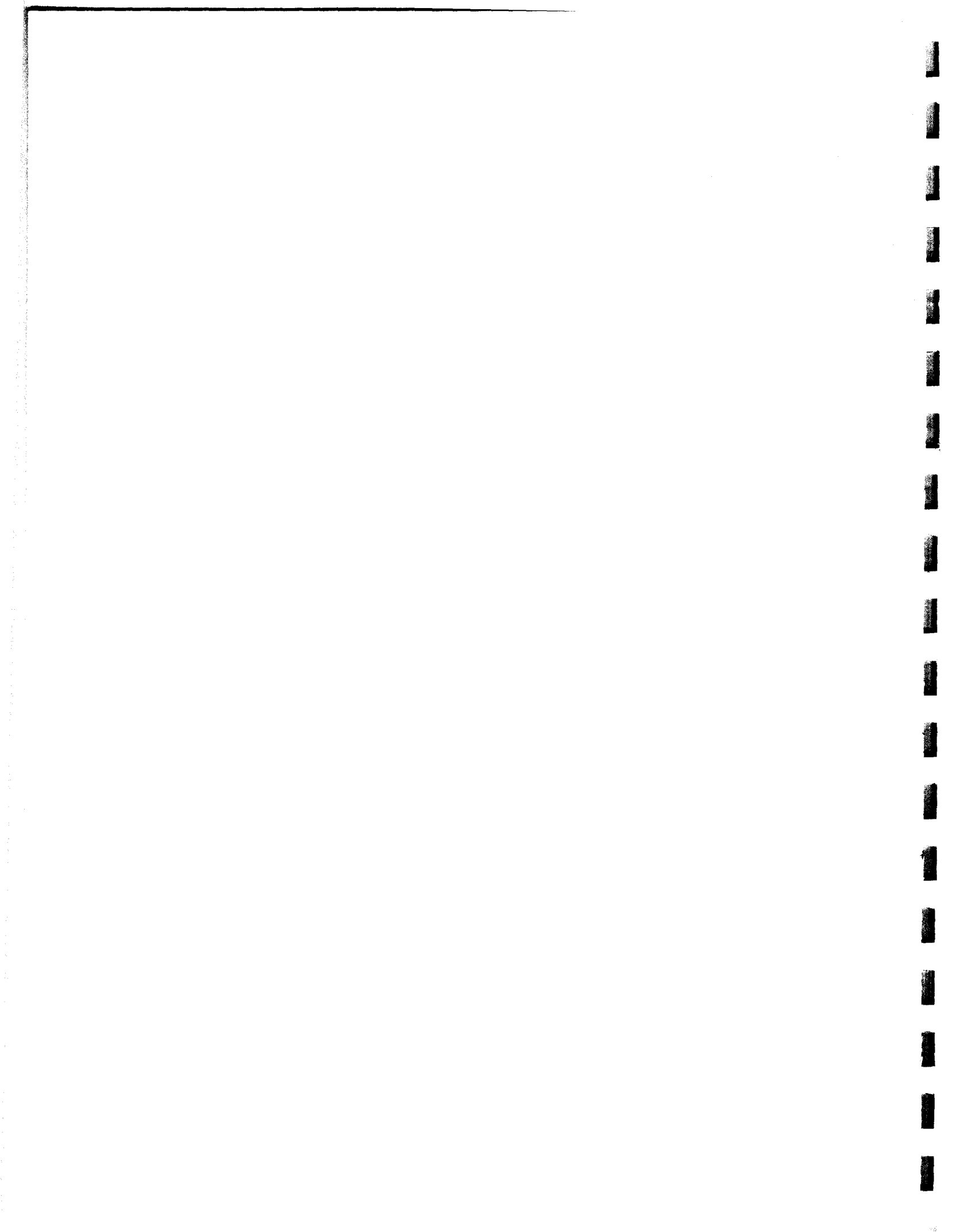


RETIREMENT PLAN DISTRIBUTION OPTIONS

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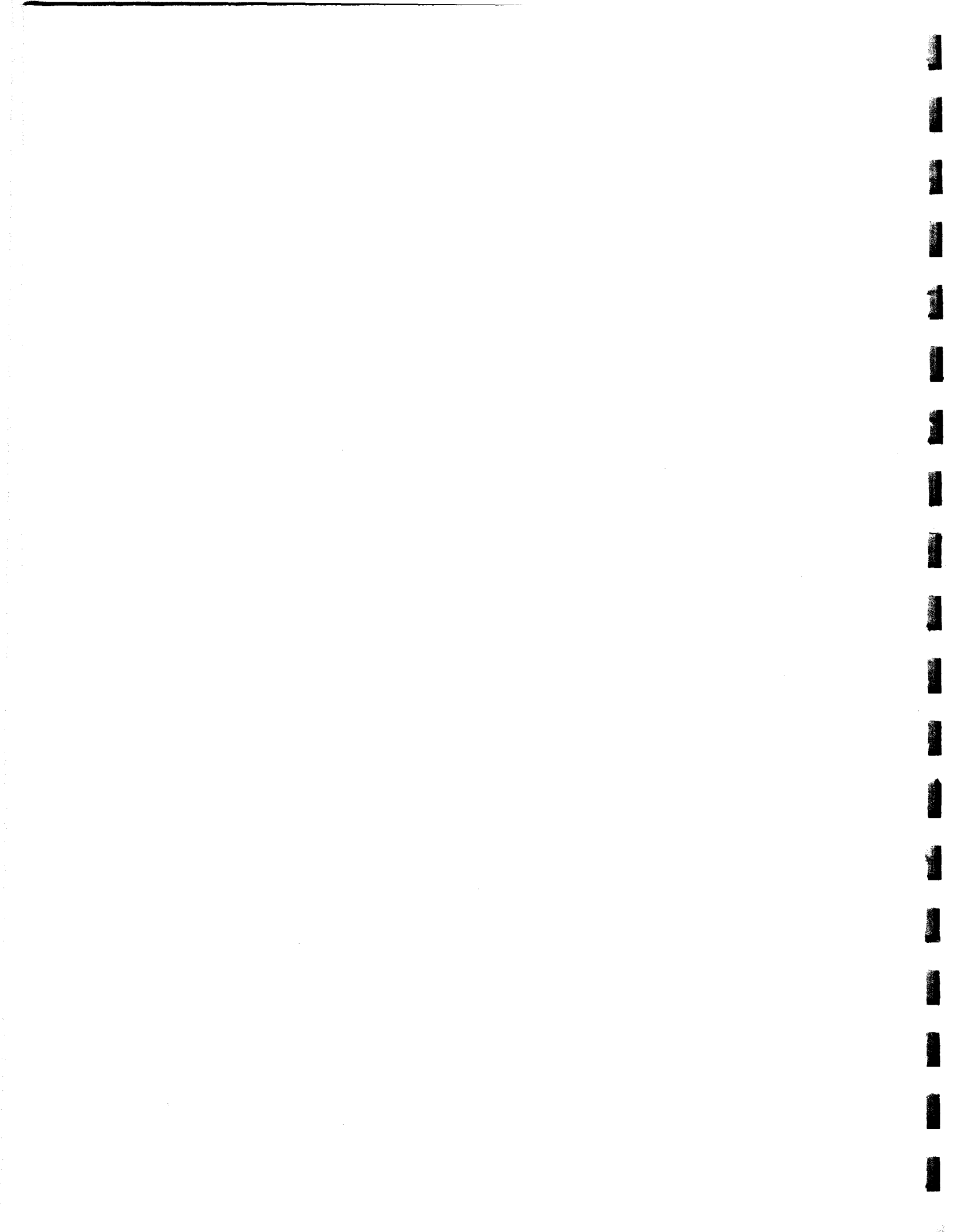
SECTION K



RETIREMENT PLAN DISTRIBUTION OPTIONS

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UNIVERSITY OF KENTUCKY  
ESTATE PLANNING SEMINAR

1988

RETIREMENT PLAN DISTRIBUTION OPTIONS

BY

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I. INTRODUCTION TO TYPES OF RETIREMENT PLANS

A. Qualified Plans Meeting IRS Requirements for Favorable  
Tax Treatment [IRC Section 401(a)]

- (1) Two basic types of employer-sponsored retirement plans: defined contribution plans provide for annual contributions to a participant's account with any distribution equal to the participant's vested account balance; defined benefit plans contribute amount each year as necessary to fund participant's actuarially predetermined benefit; participant does not have account balance in a defined benefit plan, but rather an accrued benefit.



(2) Qualified status refers to qualification under IRC Section 401(a) such that employer contributions are deductible under IRC Section 404 and contributions and earnings are not taxed to participants until distributed; Plan is filed with the IRS which issues a favorable determination letter following review process.

(3) Forms of distribution:

(a) Defined contribution plans, which are subject to minimum funding standards, and all defined benefit plans are subject to joint and survivor annuity requirements [IRC Section 401(a)(11)].

(b) Defined contribution plans which are not subject to minimum funding standards and provide that a participant's vested benefit at death shall be paid in full to his or her surviving spouse, are generally not subject to joint and survivor annuity requirements, and normally distribute in lump sum payment or installments.

**B. Other Types of "Tax Qualified" Plans**

(1) Individual retirement accounts/annuities (IRC Section 408).

(2) Simplified employee pension plans (IRC Section 408).

(3) Tax-sheltered annuities (IRC Section 403).

C. Non-Qualified Plans.

(1) Types- encompasses all types of deferred payment/executive compensation plans: e.g., noncontractual pensions, rabbi trusts.

(2) Contributions not deductible by employer until paid or made available to recipient; recipient is generally taxed at time of distribution.

II. UNIFORM MINIMUM DISTRIBUTION RULES APPLICABLE TO QUALIFIED PLANS [IRC Section 401(a)(9)]

A. Uniform required beginning date of April 1 of calendar year following calendar year in which employee attains age 70-1/2. [IRC Section 401(a)(9)(C)].

(1) Uniform required beginning date in (A) above is effective for years beginning after 12/31/88; prior to 1989, same general rule applied for 5% shareholders only, with other individuals subject to required beginning date of April 1 following later of calendar year in which employee attained age 70-1/2 or retired.

(2) Exception to general rule for person who attained age 70-1/2 prior to 1/1/88 and was not 5% shareholder in year he attained age 66-1/2 or

later year, or for person with pre-1/1/84 beneficiary election under Section 242(b)(2) of TEFRA. [Section 1121(d)(4)(B) of Tax Reform Act of 1986].

B. Distributions also subject to "incidental death benefit" requirements [IRC Section 401(a)(9)(G)].

(1) In general terms, plan distributions must be structured to pay plan participant rather than beneficiary over 50% of present value of benefit.

(2) Exception for surviving spouse.

C. Distributions commencing before participant's death.

(1) If distributions have commenced, and the participant dies prior to required beginning date, beneficiary has some flexibility (if permitted by the plan) as to the timing and distribution of remaining benefit prior to required beginning date.

(2) If distributions have commenced and participant dies after his required beginning date, the remaining benefit must be distributed at least at rapidly as the payment method utilized by the participant [IRC Section 401(a)(9)(B)(i)].

D. Distributions commencing after participant's death.

(1) Two methods of distribution by which to satisfy IRC Section 401(a)(9): Five year rule or exception.

(a) Five year rule- the entire interest of the participant must be distributed within five years of the participant's death regardless of to whom or to what entity the distribution is made. [IRC Section 401(a)(9)(B)(ii)].

(b) Exception to five year rule- the benefit or any portion of the benefit which is payable to a designated beneficiary must be distributed, commencing within one year of the participant's death, over the life of the designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary).

[IRC Section 401(a)(9)(B)(iii)].

(i) Nonspouse beneficiary- distributions must commence by 12/31 of calendar year following calendar year of participant's death. [Prop.Reg.Sec.1.401(a)(9)-1,C-3].

(ii) Spousal beneficiary- distributions must commence on or before the later of date in (i) above or 12/31 of calendar year in which participant would have attained

age 70-1/2; provided that if the surviving spouse dies before such distributions commence, the distribution rules are applied as if the surviving spouse were the participant. [Prop.Reg. Sec.1.401(a)(9)-1,C-3,C-5].

(2) Determination of designated beneficiary.

(a) Use individual designated by participant or by the terms of the plan, if no beneficiary has been designated.

(b) Only an individual may be a "designated beneficiary"; therefore if a trust is designated, the beneficiaries of the trust will be treated as having been designated as beneficiaries if the following requirements are met:

(i) The trust is valid under state law, or would be but for the fact that there is no corpus.

(ii) The trust is irrevocable.

(iii) The beneficiaries of the trust are identifiable from the trust instrument.

(iv) A copy of the trust is provided to the plan. [Prop.Reg.Sec.1-401(a)(9)-1,D-5].

(c) If special trust requirements are not met, treated as having no designated beneficiary and five year rule must be used. [Prop.Reg. Sec.1.401(a)(9)-1,D-6].

(d) If a participant has multiple designated beneficiaries, the beneficiary with the shortest life expectancy is used as the designated beneficiary for purposes of computing the distribution period. [Prop. Reg.Sec.1.401(a)(9)-1,E-5].

### III. INCOME TAXATION OF RETIREMENT PLAN DISTRIBUTIONS TO PARTICIPANT OR BENEFICIARY

A. Income Averaging of lump sum distribution from Section 401(a) qualified plan or Section 403(a) annuity plan.

(1) Effective for distributions received after 12/31/86 ten year forward averaging has been essentially eliminated in favor of five year averaging once after age 59-1/2. [IRC Section 402(e)].

(a) Lump sum distribution refers to a distribution or payment within one taxable year of the recipient of the balance to the credit of an employee from all plans of the same type of employer becoming payable to the recipient:

- (i) on account of the employee's death;
- (ii) after the employee attains age 59 1/2;
- (iii) on account of a common law employee's separation from service; or
- (iv) after a self-employed individual or owner-employee has become disabled.

[IRC Section 402(e)(4)].

- (b) Averaging permitted once with respect to an employee only if the employee had been a participant in the plan for at least five years before the tax year of the distribution (unless the distribution was as a result of the employee's death), and the taxpayer-recipient has attained age 59-1/2. [IRC Section 402(e)(4)(B)].

- (i) Election may be made by individual, estate or trust on federal form 4972 (copy - Attachment No. 1).
- (ii) Distribution to two or more trusts treated as a single lump sum distribution if meets above requirements; personal representative of employee makes election.

- (c) Taxable amount.

±

- (i) Total taxable amount refers to amount of distribution less voluntary nondeductible employee contributions, amount payable to alternate payee under a qualified domestic relations order, and net unrealized appreciation attributable to employer securities distributed; provided effective for distributions after 12/31/86, recipient may elect to include in income net unrealized appreciation attributable to employer securities. [IRC Section 402(e)(4)].
- (ii) Tax imposed on lump sum distribution to two or more trusts is apportioned between trusts based on respective interests. [IRC Section 402(e)(2)].
- (d) Exceptions providing for use of ten year averaging.
  - (i) If participant had attained age 50 by 1/1/86, recipient may still elect ten year averaging at 1986 tax rates (if meet other requirements for averaging treatment). [Sec. 1122(h)(5) of TRA'86].



(ii) If recipient received lump sum distribution after 12/31/86 and before 3/16/87 because of employee's separation from service or disability, distribution may be treated as received in 1986 and therefore eligible for ten year averaging; recipient must have filed amended return with Form 4972 by due date of 1987 tax return (including extensions). [Section 1124(a) of TRA'86].

(2) Income averaging is not available with respect to distributions from individual retirement accounts.

(3) Phase-out of long-term capital gains treatment for portion of lump sum distribution attributable to pre-1974 plan participation by employee. [IRC Section 402(e)(4)(L)].

(i) Five year phase-out of amount of distribution eligible for long-term capital gains treatment based on the following schedule:

| <u>Year</u> | <u>Applicable Percentage</u> |
|-------------|------------------------------|
| 1987        | 100%                         |
| 1988        | 95%                          |
| 1989        | 75%                          |
| 1990        | 50%                          |
| 1991        | 25%                          |

(ii) One time election (with respect to any employee) available to recipient who had attained age 50 before 1/1/86, to tax capital gains portion at flat 20% rate.

B. Tax-free rollover treatment.

(1) Participant may rollover distribution to another qualified plan, IRA or qualified annuity; However, spouse receiving distribution after death of employee may rollover distribution tax-free to individual retirement account or individual retirement annuity only. [IRC Section 402(a)(7)].

(a) Rollover must be made within sixty days of receipt. [IRC Section 402(a)(5)(C)].

(b) Rollover amount is reduced by any nondeductible employee contributions. [IRC Section 402(a)(5)(B)].

(c) Required minimum distributions under Section 401(a)(9) are not eligible for rollover treatment. [IRC Section 402(a)(5)(G)].

(2) Recipient of distribution eligible for rollover treatment must be notified in writing by the plan of rollover option. [IRC Section 402(f)].

C. Taxation of annuities. (IRC Section 72).

(1) Inclusion in gross income.

- (a) General rule under Section 72 that periodic annuity payments or installments are taxed to recipient at ordinary rates. [IRC Section 72(a)].
  - (b) Recipient may exclude portion of each payment which bears same ratio as investment in annuity (as of annuity starting date) bears to expected return under the annuity contract (as of such date)- the exclusion ratio. [IRC Section 72(b)(1)].
- (2) Treatment of annuity contract not held by natural person. [IRC Section 72(u)].
- (a) Annuity contract owned by other than natural person is not annuity for federal income tax purposes and as a result the income is taxed to owner currently without benefit of the exclusion ratio.
    - (i) Exceptions for annuity contract:
      - (AA) Acquired by estate of decedent by reason of decedent's death;
      - (BB) Held by qualified plan, tax sheltered annuity program, or IRA;
      - (CC) Which is purchased by an employer at the termination of a qualified

plan and held until the employee separates from service; and

(DD) Which is an immediate annuity (single premium with starting date within one year of purchase).

D. Special death benefit. [IRC Section 101(b)].

(1) Beneficiaries or estate of an employee are entitled to an exclusion from gross income of up to \$5,000 of amounts paid by or on behalf of an employer by reason of an employee's death. [IRC Section 101(b)(1), (2)].

(2) Death benefit exclusion does not apply to amounts in which employee had a nonforfeitable right to receive while living; provided that this limitation does not apply to a lump sum distribution:

(a) by a retirement plan qualified under Section 401(a);

(b) under an annuity contract from a 403(a) qualified annuity program; or

(c) under an annuity contract purchased by a Section 501(c)(3) organization pursuant to Section 403(b).

E. Income in respect of decedent. (IRC Section 691).

- (1) Qualified plan benefits paid to beneficiaries as result of employee's death have been held to be taxable as income in respect of a decedent under Section 691(a). [See Hess v. Comr., 271 F.2d 104 (3d Cir. 1959).].
- (2) Nonqualified deferred compensation may or may not be an IRD receivable based on specifics of situation.
  - (a) If deferred compensation arrangement provides that compensation or benefits will be paid directly to employee, with income tax liability of employee deferred until payment date, and employee dies prior to such time as all benefits have been distributed, the benefits remaining unpaid constitute IRD receivable. [Reg. Sec. 1.691(a)-2(b)(1)].
  - (b) If deferred compensation arrangement provides that compensation or benefits will be paid to employee's estate or designated beneficiary, some question whether employee had right to receive benefit such that benefit may not be IRD receivable.
- (3) Deduction for estate tax. [IRC Section 691(c)].
  - (a) General rule- recipient of decedent's qualified benefit or deferred compensation

which constitutes income in respect of decedent may (in year taxed on amount) deduct amount equal to tax imposed on decedent's estate as result of distribution. [Reg. Sec.1.691(c)-1(a)].

(b) In computing deduction for estate or trust, exclude from gross income of estate or trust amount of benefits or deferred compensation which is distributed to beneficiaries. [IRC Sec. 691(c)(1)(B)].

IV. ESTATE TAX TREATMENT OF RETIREMENT PLAN DISTRIBUTIONS AND ANNUITIES. (Section 2039).

A. Gross estate includes value of annuity or other payment receivable by any beneficiary under a qualified plan, tax sheltered annuity, or similar plan if decedent had right to receive during his life. [IRC Section 2039(a)].

(1) Amount includible is the value of the annuity or payment receivable as is proportionate to the part of the purchase price contributed by the decedent. [IRC Section 2039(b)].

(2) Any portion contributed by the employer of decedent by reason of his employment is considered to be contributed by the decedent. [IRC Section 2039(b)].

V. EXCISE TAX ON EXCESS DISTRIBUTIONS AND EXCESS ACCUMULATIONS.  
(IRC Section 4981A).

A. Excess distribution tax imposed on individual during  
lifetime.

(1) Tax equal to 15% of excess distributions with  
respect to individual during any calendar year.

(2) Term "Excess distributions" refers to excess of  
aggregate amount of distributions received by or  
with respect to an individual during a calendar  
year over the greater of \$150,000 (unindexed) or  
\$112,500 [indexed for cost-of-living increases;  
\$117,529 in 1988 pursuant to I.R. 88-23 (Feb. 5,  
1988)]. (Temp. Reg. Sec. 54.4981A-1T, a-2A).

(a) Retirement distributions aggregated for  
purposes of computing excess distributions  
include distributions from:

- (i) Plan qualified under 401(a);
- (ii) Section 403(a) annuity plan;
- (iii) Annuity contract or account described  
in Sections 403(b)(1), (7) or (9); and
- (iv) IRA under Section 408. (Temp. Reg.  
Sec. 54.4981A-1T, a-3).

(b) Exclusions from retirement distributions  
considered to compute excess distributions,  
include:

- (i) Distribution received as a result of the death of another individual;
  - (ii) Distribution received by and taxable to an alternate payee pursuant to a QDRO;
  - (iii) Distribution attributable to an individual's investment in an annuity or insurance contract such as after-tax nondeductible employee contributions;
  - (iv) Distribution which has been rolled over to another qualified plan or IRA such that excludible from income; and
  - (v) Distribution of medical benefits. (Temp. Reg. Sec. 54.4981A-1T, a-4, a-7).
- (3) Special grandfather election available to exempt accrued benefits as of 8/1/86.
- (a) Election available to individual with accrued benefits on 8/1/86 of \$562,500 or more. [IRC Section 4981A(c)(5)].
    - (i) Benefits as of 8/1/86 include both vested and nonvested benefits. (Temp. Reg. Sec. 54.4981A-1T, b-6).
    - (ii) Defined contribution plan- use account balance; defined benefit plan- use present value of accrued benefit. (Temp. Reg. Sec. 54.4981A-1T, b-5).



(b) Individual must elect to use special grandfather rule by filing Form 5329 (copy - Attachment No. 2) with individual's income tax return for a taxable year beginning after 12/31/86 and before 1/1/89; personal representative of a deceased individual may file as part of final income tax return. [Temp. Reg. Sec. 54.4981A-1T, b-3A(a)].

(c) Grandfather rule exempts from excise tax portion of distributions treated as recovery of individual's total benefits accrued on or before 8/1/86 (grandfathered amount); Note, however, that distributions treated as recovery of grandfathered amount are taken into account in determining extent to which other distributions are excess distributions. (Temp. Reg. Sec. 54.4981A-1T, b-1)

(d) Two methods of recovery:

(i) Discretionary method - 10% of total distributions received by individual during any calendar year is treated as recovery of grandfathered amount; Individual may accelerate to 100% in any

year and then required for all years thereafter (Temp. Reg. Sec. 54.4981A-1T, b-12).

- (ii) Attained age method - (for use by individual whose 35th birthday occurs on or before 8/1/86) compute portion of total distributions received during any year that is treated as recovery of grandfathered amount by multiplying aggregate distributions for year by fraction, numerator of which is difference between individual's attained age in completed months on 8/1/86 and individual's attained age in months at age 35 (420 months) and denominator of which is difference between individual's attained age in completed months on 12/31 of calendar year and individual's attained age in months at age 35 (420 months). (Temp. Reg. Sec. 54.4981A-1T, b-13)
- (e) If an individual does not elect to use the special grandfather rule, the \$112,500 limitation will be replaced by \$150,000 limitation (unless \$112,500 as

indexed exceeds \$150,000 limitation).

[IRS Sec. 4981A(c)(5)]

- (f) Special rule where taxpayer elects income averaging. [IRS Sec. 4981(c)(4)]- Individual may exempt lump sum distribution amount up to five times of the applicable limitation (\$150,000 for threshold exempt amount of \$750,000 or \$112,500 as indexed for threshold exempt amount of \$562,500). (Temp. Reg. Sec. 54.4981A-1T, c-1)

(SEE EXAMPLES - ATTACHMENT NO. 3)

B. Estate tax imposed equal to 15% of decedent's excess retirement accumulation [IRS Sec 4981A(d)].

- (1) Excess retirement accumulation refers to excess, if any, of value of decedent's interests in all qualified employer plans and IRA's as of date of decedent's death over amount equal to present value of a hypothetical life annuity. [IRS Sec. 4981A(d)(3)]
- (2) Hypothetical life annuity is a single life annuity contract, providing for equal annual payments commencing on the decedent's date of death for the life of an individual who is the same age as the decedent at date of death.

- (a) Amount of each annual payment is equal to greater of \$150,000 or \$112,500 (as indexed on date of death).
- (b) However, if special grandfather rule had been elected, amount of each annual payment is equal to \$112,500 (as indexed on the date of death). (Temp. Reg. Sec. 54.4981A-1T,d-7)
- (3) No credits allowable as offset. (Temp. Reg. Sec. 54.4981A-1T, d-8)
- (4) Estate is liable for excise tax on excess retirement accumulations, so need some provision in Will to enable executor to recover amount from property to which Section 4981A applies. (Temp. Reg. Sec. 54.4981A-1T, d-8A)

(SEE EXAMPLES - ATTACHMENT NO. 4)

VI. TAX ON EARLY DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS -  
[IRC SECTION 72(t)]

- A. 10% excise tax on early (pre-age 59 1/2) distributions from qualified plans (including IRA's).
- B. Exceptions include -
  - (1) Distribution on or after employee's age 59 1/2.
  - (2) Distribution due to employee's disability.
  - (3) Distribution to a beneficiary or estate on or after an employee's death.

- (4) Distribution paid in substantially equal installments over life of employee (who had separated from service) or beneficiary.
- (5) Distribution to terminated employee meeting early retirement under plan after age 55 (N/A to IRA's)
- (6) Distribution of deductible dividends from tax credit ESOP.
- (7) Distribution to employee for deductible medical care expenses (N/A to IRA's).
- (8) Distribution before 1990 from ESOP if assets have been invested in employer stock for five prior plan years.
- (9) Distribution to alternate payee pursuant to QDRO.

ATTACHMENT 1

1987 IRS FORM 4972 and INSTURCTIONS:  
TAX ON LUMP SUM DISTRIBUTIONS

**Tax on Lump-Sum Distributions**  
 (Use This Form Only for Lump-Sum Distributions From  
 Qualified Retirement Plans)

Department of the Treasury  
 Internal Revenue Service

▶ Attach to Form 1040 or Form 1041. ▶ See separate instructions.

Name(s) as shown on return

Identifying number

**Part I** Complete this part to see if you qualify to use Form 4972

|   | Yes | No |
|---|-----|----|
| 1 Did you rollover any part of the distribution?<br>If "yes," do not complete rest of this form.  | 1   |    |
| 2 Were you age 50 or over on January 1, 1986?   | 2   |    |
| 3 Was this a lump-sum distribution from a qualifying pension, profit-sharing or stock bonus plan?<br>If you answered "no" to 2 or 3, do not complete rest of this form. | 3   |    |
| 4 Was the participant a member of the plan for at least 5 years preceding the year of the distribution?   | 4   |    |
| 5 Is this a distribution paid to a beneficiary of an employee who died?<br>If you answered "no" to 4 and 5, do not complete rest of this form.                          | 5   |    |
| 6 Did you quit, retire, get laid off, or get fired from your job before receiving the distribution?   | 6   |    |
| 7 Were you self-employed or an owner-employee and became disabled? (see instructions)   | 7   |    |
| 8 Were you 59½ or over at the time of the distribution?<br>If you answered "no" to ALL questions 5 through 8, do not complete rest of this form.                        | 8   |    |

If you qualify to use this form, you may elect to use Part II, Part III, or Part IV; or elect to use Part II and Part III, or Part II and Part IV.

**Part II** Use Part II to make the capital gain election

|   |   |
|---|---|
| <input type="checkbox"/> Check this box if you elect to treat the part of your distribution from pre-74 participation, as capital gain.                           |   |
| 1 Capital gain part from box 2 of Form 1099-R. If you did not check the box above, enter zero   | 1 |
| 2 Multiply line 1 by 20% (.20) and enter here. If you do not elect to use Part III or Part IV, also enter the amount on Form 1040, line 38 or Form 1041, line 22b | 2 |

**Part III** Use Part III to elect the 5-year averaging method

|   |    |
|---|----|
| 1 Ordinary income part from box 3 of Form 1099-R. If you did not check the box in Part II, enter the amount from box 1 of Form 1099-R (ordinary income plus capital gain)                 | 1  |
| 2 Death benefit exclusion (see instructions)  | 2  |
| 3 Total taxable amount (subtract line 2 from line 1)  | 3  |
| 4 Current actuarial value of annuity, if applicable (from Form 1099-R, box 9).  | 4  |
| 5 Adjusted total taxable amount (add lines 3 and 4). If this amount is \$70,000 or more, skip lines 6 through 9, and enter this amount on line 10.  | 5  |
| 6 Multiply line 5 by 50% but do not enter more than \$10,000.   | 6  |
| 7 Subtract \$20,000 from line 5. Enter difference.<br>If line 5 is \$20,000 or less, enter zero.  | 7  |
| 8 Multiply line 7 by 20% (.20)  | 8  |
| 9 Minimum distribution allowance (subtract line 8 from line 6)  | 9  |
| 10 Subtract line 9 from line 5  | 10 |
| 11 Federal estate tax attributable to lump-sum distribution. Do not deduct on Form 1040 or Form 1041 the amount attributable to the ordinary income entered on line 1. (see instructions) | 11 |
| 12 Subtract line 11 from line 10  | 12 |
| 13 Multiply line 12 by 20% (.20)  | 13 |
| 14 Tax on amount on line 13. Use Tax Rate Schedule X (Single Taxpayers) in Form 1040 Instructions   | 14 |
| 15 Multiply line 14 by 5. If no entry on line 4, skip lines 16 through 21, and enter this amount on line 22   | 15 |
| 16 Divide line 4 by line 5 (carry to four decimal places)   | 16 |
| 17 Multiply line 9 by line 16   | 17 |
| 18 Subtract line 17 from line 4   | 18 |
| 19 Multiply line 18 by 20% (.20)  | 19 |
| 20 Tax on amount on line 19. Use Tax Rate Schedule X (Single Taxpayers) in Form 1040 Instructions   | 20 |
| 21 Multiply line 20 by 5  | 21 |
| 22 Subtract line 21 from line 15  | 22 |
| 23 Tax on lump-sum distribution (add Part II, line 2 and Part III, line 22). Enter on Form 1040, line 38, or Form 1041, line 22b  | 23 |

For Paperwork Reduction Act Notice, see separate instructions.

**Part IV Use Part IV to elect the 10-year averaging method**

|    |  |    |  |
|----|--|----|--|
| 1  | Ordinary income part from box 3 of Form 1099-R. If you did not check the box in Part II, enter the amount from box 1 of Form 1099-R (ordinary income plus capital gain)                | 1  |  |
| 2  | Death benefit exclusion (see instructions)   | 2  |  |
| 3  | Total taxable amount (subtract line 2 from line 1)   | 3  |  |
| 4  | Current actuarial value of annuity if applicable (from Form 1099-R, box 9)   | 4  |  |
| 5  | Adjusted total taxable amount (add lines 3 and 4). If this amount is \$70,000 or more, skip lines 6 through 9, and enter this amount on line 10.                                       | 5  |  |
| 6  | Multiply line 5 by 50% (.50), but do not enter more than \$10,000  | 6  |  |
| 7  | Subtract \$20,000 from line 5. Enter difference.<br>If line 5 is \$20,000 or less, enter zero.   | 7  |  |
| 8  | Multiply line 7 by 20% (.20)   | 8  |  |
| 9  | Minimum distribution allowance (subtract line 8 from line 6)   | 9  |  |
| 10 | Subtract line 9 from line 5  | 10 |  |
| 11 | Federal estate tax attributable to lump-sum distribution. Do not deduct on Form 1040 or Form 1041 the amount attributable to the ordinary income entered on line 1. (see instructions) | 11 |  |
| 12 | Subtract line 11 from line 10  | 12 |  |
| 13 | Multiply line 12 by 10% (.10)  | 13 |  |
| 14 | Tax on amount on line 13. Use Tax Rate Schedule in Form 4972 instructions  | 14 |  |
| 15 | Multiply line 14 by 10. If no entry on line 4, skip lines 16 through 21, and enter this amount on line 22  | 15 |  |
| 16 | Divide line 4 by line 5 (carry to four decimal places)   | 16 |  |
| 17 | Multiply line 9 by line 16   | 17 |  |
| 18 | Subtract line 17 from line 4   | 18 |  |
| 19 | Multiply line 18 by 10% (.10)  | 19 |  |
| 20 | Tax on amount on line 19. Use Tax Rate Schedule in Form 4972 Instructions  | 20 |  |
| 21 | Multiply line 20 by 10   | 21 |  |
| 22 | Subtract line 21 from line 15  | 22 |  |
| 23 | Tax on lump-sum distribution (add Part II, line 2 and Part IV, line 22). Enter on Form 1040, line 38, or Form 1041, line 22b   | 23 |  |



## Instructions for Form 4972

### Tax on Lump-Sum Distributions

(Section references are to the Internal Revenue Code.)

#### General Instructions

**Paperwork Reduction Act Notice.**—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

#### Changes You Should Note

- The Tax Reform Act of 1986 changed the tax computation for lump-sum distributions from qualified retirement plans. The computation is now made by averaging over 5 years instead of 10 years. However, if you were age 50 or over on January 1, 1986, and otherwise qualify, you may elect the 10-year averaging method, using the tax rates in effect for 1986. (See Part IV of the form.) In addition, if you were age 50 or over on January 1, 1986, you can elect a capital gain method, to tax at a 20% rate that part of your distribution attributable to your participation in the plan from before 1974. To make this election, check the box in Part II and complete that part. Do not use Schedule D for that election.
- Part III from last year, which was used to combine prior year distributions with current year distributions, has been eliminated. See instruction G for more information.
- Form 5544, Multiple Recipient Special 10-Year Averaging Method, has been eliminated. If you shared a lump-sum distribution from a qualified retirement plan when not all recipients were trusts, use Form 4972 to figure your tax, together with the special computation and worksheet in instruction H.

#### Items To Note

- If you received a lump-sum distribution after December 31, 1986, and before March 16, 1987, because you left your job or became disabled in 1986, you may elect to treat such lump-sum distribution as if received in 1986. Do this by filing a Form 1040X (individuals) or an amended return (estates and trusts) for 1986, and attach a Form 4972 for that year. On the dotted line of line 3 of Parts II or III, of that Form 4972, write "Section 1124 Election." You must file the Form 1040X or amended return by the due date of your 1987 tax return (including extensions).
- Instead of the 20% capital gain method mentioned in the instructions under Changes You Should Note, you may elect to treat as a long-term capital gain that part of your distribution from participation in the plan before 1974. This is shown in box 2 of Form 1099-R. If this capital gain method is elected, enter the amount from box 2 of Form 1099-R on Schedule D, Part II. Enter the amount from box 3 on Form 1040, line 16b. Do not use Form 4972 for this election.

**Purpose of Form.**—You may find Form 4972 helpful if you received a lump-sum distribution and can make the capital gain election, or 5 or 10-year averaging election to figure some of your tax at a lower rate. With the 5 or 10-year averaging method, the ordinary income part of the lump sum is taxed as if you were to receive it in equal parts over 5 or 10 years.

Form 4972 is for use with Form 1040 (if you are an individual) or Form 1041 (if you are an estate or trust). Form 4972 is used for three purposes:

- (1) To choose, by filing the completed form, to use the 5 or 10-year averaging method;
- (2) To choose the 20% capital gain method by checking the box in, and completing Part II;
- (3) To figure tax with the 5 or 10-year averaging method.

If you use any method mentioned above, you must use it for all lump-sum distributions you receive in one tax year.

If you do not use the 5 or 10-year averaging method, report the ordinary income part of the lump sum on Form 1040, line 16b, or on Form 1041, line 8. If you do not make either capital gain

election for the capital gain part of the distribution (pre-74 participation), combine the capital gain amount from Form 1099-R, box 2 with the ordinary income amount. If you are using the 5 or 10-year averaging method, add the capital gain part to the ordinary income part for purposes of Parts III or IV.

The payer should have given you a Form 1099-R or other statement that shows the separate parts of your distribution. The amounts you will use from Form 1099-R in filling out Form 4972 are capital gain (box 2); ordinary income (box 3); total of ordinary income plus capital gain (box 1); and, if it applies, the current actuarial value of an annuity (box 9). If you do not have a statement that shows this information, ask the payer for one that does show it. Also, if applicable, get the Federal estate tax attributable to the taxable part of the lump-sum distribution from the person administering the deceased employee's or self-employed individual's estate.

If you need more information, get Publication 575, Pension and Annuity Income. This publication is available from the Internal Revenue Service.

**A. Filing Form 4972 After Employee's Death.**—If a lump-sum distribution is paid out after the employee's death, the recipient of the distribution chooses the capital gain, or 5 or 10-year averaging method.

**B. Distributions That Qualify.**—For you to use the 5 or 10-year averaging method, the lump sum must have been distributed under all the following circumstances.

- (1) It came from a qualified pension, profit-sharing, or stock bonus plan.
- (2) It came from all the employer's qualified plans of one kind (pension, profit-sharing, or stock bonus) in which the employee had funds.
- (3) It was for the full amount credited to the employee. For this purpose, the balance to the credit of the employee does not include the accumulated deductible employee contributions under the plan or amounts payable to an alternate payee under a qualified domestic relations order.
- (4) It was paid within a single tax year.
- (5) It was paid in any of the following cases:
  - a. The employee died.
  - b. The employee was age 59½ or over at the time of the distribution.
  - c. The employee, who was a common-law employee, quit, retired, was laid off, or was fired from the job. A common-law employee is anyone who performs services that an employer has the right to control (what will be done and how) and whom the employer has the right to fire.
  - d. The self-employed individual or owner-employee became disabled as defined in section 72(m)(7).

**C. Distributions That Do Not Qualify.**—The following distributions do not qualify for the 5 or 10-year averaging method:

- (1) U.S. Retirement Bonds distributed with the lump sum;
- (2) Any distribution made before the employee has been a participant in the plan for 5 tax years before the tax year of the distribution, unless it was paid because the employee died;
- (3) The current actuarial value of any annuity contract included in the lump sum (the payer's statement should show this amount, which you should use only to figure tax on the ordinary income part of the distribution);
- (4) Any distribution to a 5-percent owner which is subject to penalties under section 72(m)(5)(A);
- (5) A distribution, described in section 402(a)(6)(E), from any other pension plan maintained by an employer, if the recipient elected after December 31, 1978, to roll over a total distribution from the employer's money purchase plan into an Individual Retirement Arrangement (IRA) or another qualified plan;
- (6) A distribution from an Individual Retirement Arrangement (IRA);
- (7) Redemption proceeds of bonds rolled over tax free to a qualified pension, etc., plan from a qualified bond purchase plan; and
- (8) A distribution from a qualified pension or annuity plan when the employee or the employee's surviving spouse received a partial distribution from the same plan (or another plan of the employer required to be aggregated for the lump-sum distribution rules), and the proceeds of the previous distribution were rolled over tax free to an Individual Retirement Arrangement (IRA).

**D. How Many Times the Capital Gain or 5 or 10-Year Averaging Method Can Be Chosen.**—If you make an election this year, you cannot make an election another year with respect to another lump-sum distribution. For example, if you elect the 5 or 10-year averaging method this year, you cannot elect the capital gain or 5 or 10-year averaging method another year with respect to another distribution. Similarly, if you make the capital gain election only, you cannot make the capital gain or 5 or 10-year averaging election in another year with respect to another lump-sum distribution.

**E. When To Choose.**—To choose the 5 or 10-year averaging method, file Form 4972 with your original or amended return. Generally, you have 3 years from the later of the due date of your tax return or the date you filed your return to choose this method.

**F. Capital Gain Election for Pre-74 Participation.**—If your distribution includes both capital gain and ordinary income, see the instructions above for making an election to treat the capital gain part (pre-74 participation) as capital gain. You have the same time to make the capital gain election as you do the 5 or 10-year averaging election. This election applies to all qualifying distributions received for a particular employee.

**G. Tax on Prior Year Lump-Sum Distributions.**—If you received another lump-sum distribution or an annuity contract for any year after 1981 and before 1987, and used Form 4972 or Form 5544 for that year, add those distributions to your 1987 distribution and figure your tax on Form 4972 for 1987, using the combined distributions. From that result, subtract the tax you paid on the lump-sum distributions on Forms 4972 or 5544 for the earlier years. Show the subtraction under the applicable line. For example, subtract the tax you paid for the earlier years from the tax reported on the combined distributions on Part III or Part IV, line 13.

**H. Multiple Recipient of Lump-Sum Distribution.**—If you shared a lump-sum distribution from a qualified retirement plan when not all recipients were trusts, figure your tax on Form 4972 as follows:

- Step 1.—On a separate sheet of paper, divide each of the amounts shown on Form 1099-R, boxes 1, 2, 3, and 9 by your percentage of total distribution shown on Form 1099-R under box 10;
- Step 2.—Complete Form 4972. However, where amount from boxes 1, 2, 3, and 9 of Form 1099-R are requested on Form 4972, use the results obtained in step 1 for those amounts.
- Step 3.—Complete the worksheet below:

(a) Subtract your percentage of total distribution from 100% and enter the result \_\_\_\_\_ %

(b) Multiply line (a) by the amount on line 2, Part II, Form 4972. Enter the result here \_\_\_\_\_

(c) Multiply line (a) by the amount on line 23, Part III or IV, Form 4972. Enter the result here \_\_\_\_\_

(d) Subtract line (b) from the amount on line 2, Part II, Form 4972. Enter the result here \_\_\_\_\_

(e) Subtract line (c) from the amount on line 23, Part III or IV, Form 4972. Enter the result here \_\_\_\_\_

(f) Add lines (d) and (e). Enter here and on Form 1040, line 38, or Form 1041, line 22b \_\_\_\_\_

**Line-by-Line Instructions**

**In General**

If you received more than one distribution, add them and figure the tax on the total amount.

If you and your spouse are filing a joint return and each has received a lump-sum distribution, complete and file a different Form 4972 for each spouse's election, and combine them on Form 1040, line 38.

If you are filing for a trust that shared the distribution only with other trusts, figure the tax on the whole lump sum first. The trusts then share the tax in the same proportion that they shared the distribution.

**Part II**

**Line 1.**—If you have no capital gain from the lump sum, or if you are using the 5 or 10-year averaging method to figure tax on the capital gain part, enter zero on line 1.

If you take the death benefit exclusion and are making the capital gain election, reduce the capital gain on Part II, line 1 as follows: Divide the capital gain part from box 2 of Form 1099-R by the capital gain plus ordinary income part from box 1 of Form 1099-R, and multiply the result by the death benefit exclusion. The balance of the death benefit exclusion should be entered on line 2 of Part III or IV, if you elect the 5 or 10-year averaging method.

If you paid Federal estate tax on the lump-sum distribution, and are making the capital gain election, figure the amount you will have to reduce your capital gain and your entry on line 11, in the same manner as above. If the capital gain election is not made, the Federal estate tax attributable to it, and the Federal estate tax attributable to the ordinary income part of the lump-sum distribution is entered on line 11.

**Parts III and IV**

**Line 1.**—Community property laws do not apply to figuring tax on the amount you report on line 1.

**Line 2.**—If you received the distribution because of the employee's death, you can exclude up to \$5,000 of the lump sum from your gross income. If the trust for which you are filing shared the lump sum with other trusts, it will share the exclusion in the same proportion as it shared the distribution. This exclusion applies to the beneficiaries or estates of common-law employees, self-employed individuals, and shareholder-employees who owned more than 2% of an S corporation. Publication 575 gives more information about the death benefit exclusion.

**Line 11.**—A beneficiary who receives a lump-sum distribution because of an employee's death must reduce the taxable part of the distribution by any Federal estate tax on the part included in the estate. The reduction is made by entering on line 11 the Federal estate tax attributable to the lump-sum distribution. However, see the instructions for Part II, line 1.

**Part III, Lines 14 and 20.**—Use Tax Rate Schedule X (single taxpayers) in Form 1040 instructions for this purpose no matter what method you use to figure the tax on your other income, and no matter whether you are filing Form 1041.

**Parts III and IV, Line 16.**—Decimals should be carried to four places. For example, if you divide \$10,000 by \$30,000, the result would be .3333.

**Part IV, Lines 14 and 20.**—Use this tax rate schedule to complete Part IV, lines 14 and 20:

*If the amount on Part IV, line 13 or 19 is:*

| <i>Enter on Part IV, line 14 or 20 of the amount over—</i> |                      |                 |        |
|--|----------------------|-----------------|--------|
| <i>Over—</i>   | <i>But Not Over—</i> |                 |        |
| \$-0-  | \$1,190              | ..... 11%       | \$-0-  |
| 1,190  | 2,270                | \$130.90 + 12%  | 1,190  |
| 2,270  | 4,530                | 260.50 + 14%    | 2,270  |
| 4,530  | 6,690                | 576.90 + 15%    | 4,530  |
| 6,690  | 9,170                | 900.90 + 16%    | 6,690  |
| 9,170  | 11,440               | 1,297.70 + 18%  | 9,170  |
| 11,440   | 13,710               | 1,706.30 + 20%  | 11,440 |
| 13,710   | 17,160               | 2,160.30 + 23%  | 13,710 |
| 17,160   | 22,880               | 2,953.80 + 26%  | 17,160 |
| 22,880   | 28,600               | 4,441.00 + 30%  | 22,880 |
| 28,600   | 34,320               | 6,157.00 + 34%  | 28,600 |
| 34,320   | 42,300               | 8,101.80 + 38%  | 34,320 |
| 42,300   | 57,190               | 11,134.20 + 42% | 42,300 |
| 57,190   | 85,790               | 17,388.00 + 48% | 57,190 |
| 85,790   | -----                | 31,116.00 + 50% | 85,790 |

ATTACHMENT 2

1987 IRS FORM 5329 and INSTRUCTIONS:  
RETURN FOR INDIVIDUAL RETIREMENT ARRANGEMENT AND QUALIFIED  
RETIREMENT PLAN TAXES

**Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes**

Department of the Treasury  
Internal Revenue Service

(Under Sections 72, 4973, 4974 and 4981A of the Internal Revenue Code)

▶ Attach to Form 1040.

**1987**  
Attachment  
Sequence No **29**

Name \_\_\_\_\_ Your social security number \_\_\_\_\_

Address (number and street) \_\_\_\_\_

City or town, state, and ZIP code \_\_\_\_\_

**Part I Excess Contributions Tax for Individual Retirement Arrangements (Section 4973)**

Complete this part if, either in this year or in earlier years, you have contributed more to your IRA than is or was allowable as a deduction and you have an excess contribution subject to tax.

|    |  |    |  |  |
|----|--|----|--|--|
| 1  | Excess contributions for 1987 (see instructions). Do not include this amount on Form 1040, lines 24a or b  | 1  |  |  |
| 2  | Earlier year excess contributions not previously eliminated (see instructions)   | 2  |  |  |
| 3  | Contribution credit. (If your maximum allowable deduction for 1987 is more than your actual contribution, see instructions for line 3; otherwise, enter zero.)                                       | 3  |  |  |
| 4a | 1987 distributions from your IRA account that are included in taxable income   | 4a |  |  |
| 4b | 1986 tax year excess contributions (if any) withdrawn after the due date (including extensions) of your 1986 income tax return, and 1985 and earlier tax year excess contributions withdrawn in 1987 | 4b |  |  |
| 4c | Add lines 3 through 4b   | 4c |  |  |
| 5  | Adjusted earlier year excess contributions (Subtract line 4c from line 2. Enter the result, but not less than zero.)   | 5  |  |  |
| 6  | Total excess contributions (add lines 1 and 5)   | 6  |  |  |
| 7  | Tax (Enter 6% of line 6 or 6% of the value of your IRA on the last day of 1987, whichever is smaller). Enter here and on Form 1040, line 52  | 7  |  |  |

**Part II Tax on Premature Distributions (Section 72)**

Complete this part if you received a distribution from your IRA, other qualified retirement plans and annuity contracts before you reached age 59½. Also, enter the amount of the distribution on Form 1040, line 16a.

|     |  |     |  |  |
|-----|--|-----|--|--|
| 8   | Amount of premature distributions you received from a qualified retirement plan included in gross income | 8   |  |  |
| 9a  | Distributions received that are attributable to prohibited transactions                                  | 9a  |  |  |
| 9b  | Distributions received that are attributable to the pledging of account as security for a loan           | 9b  |  |  |
| 9c  | Investments in collectibles treated as distributions   | 9c  |  |  |
| 9d  | Total (add lines 9a through 9c)  | 9d  |  |  |
| 10a | Total amount of premature distributions included in gross income (add lines 8 and 9d)                    | 10a |  |  |
| 10b | Amount excluded from additional tax (Complete Question 1 in Part IV under "Other Information")           | 10b |  |  |
| 10c | Balance (subtract line 10b from 10a)   | 10c |  |  |
| 11a | Section 72(t) tax (multiply line 10c by 10% (.10))   | 11a |  |  |
| 11b | Section 72(q) tax (see instructions)   | 11b |  |  |
| 11c | Total section 72 tax due (add lines 11a and b). Enter here and on Form 1040, line 52                     | 11c |  |  |

For Paperwork Reduction Act Notice, see page 1 of Instructions.

**Part III Tax on Excess Accumulation in Individual Retirement Plans (Section 4974)**

|    |  |    |  |
|----|--|----|--|
| 12 | Minimum required distribution. . . . .   | 12 |  |
|    | If a transition method was used to determine the minimum required distribution, check the appropriate box: <input type="checkbox"/> Life expectancy method; <input type="checkbox"/> Percentage method |    |  |
| 13 | Amount actually distributed to you . . . . .   | 13 |  |
| 14 | Subtract line 13 from line 12. If line 13 is greater than line 12, enter zero . . . . .  | 14 |  |
| 15 | Tax due (multiply line 14 by 50% (.50)). Enter here and on Form 1040, line 52 . . . . .  | 15 |  |

**Part IV Tax on Excess Distributions From Qualified Retirement Plans (Section 4981A)**

|  |  |     |  |
|--|--|-----|--|
| <i>Lines 16 through 19c are to be completed for regular distributions ONLY.</i>  |  |     |  |
| 16   | Enter the aggregate amount of regular retirement distributions . . . . .                         | 16  |  |
| 17a  | Enter the applicable threshold amount (\$112,500 or \$150,000) (see instructions) . . . . .      | 17a |  |
| 17b  | b Recovery of grandfather amount (Complete Question 2 below under "Other Information") . . . . . | 17b |  |
| 17c  | c Enter the greater of line 17a or 17b . . . . .   | 17c |  |
| 18   | Excess distributions (subtract line 17c from line 16) . . . . .                                  | 18  |  |
| 19a  | Tentative tax. (multiply line 18 by 15% (.15)) . . . . .   | 19a |  |
| 19b  | b Section 72(t) tax offset (see instructions) . . . . .  | 19b |  |
| 19c  | c Tax due (subtract line 19b from line 19a). Enter here and on Form 1040, line 52 . . . . .      | 19c |  |
| <i>Lines 20 through 23c are to be completed for lump-sum distributions ONLY.</i> |  |     |  |
| 20   | Enter the aggregate amount of your lump-sum distributions . . . . .                              | 20  |  |
| 21a  | Enter the applicable threshold amount (\$562,500 or \$750,000) (see instructions) . . . . .      | 21a |  |
| 21b  | b Recovery of grandfather amount (Complete Question 2 below under "Other Information") . . . . . | 21b |  |
| 21c  | c Enter the greater of line 21a or 21b . . . . .   | 21c |  |
| 22   | Excess distributions (subtract line 21c from line 20) . . . . .                                  | 22  |  |
| 23a  | Tentative tax. (multiply line 22 by 15% (.15)) . . . . .   | 23a |  |
| 23b  | b Section 72(t) tax offset (see instructions) . . . . .  | 23b |  |
| 23c  | c Tax due (subtract line 23b from line 23a). Enter here and on Form 1040, line 52 . . . . .      | 23c |  |

**Other Information**

|  | Yes | No |
|--|-----|----|
| 1 Did you receive any premature distributions from a qualified retirement plan (as defined in section 4974(c)) that are excludable from the additional tax? . . . . .<br>If "Yes," enter the amount to be excluded on line 10b and the appropriate No. for the corresponding code section contained in the instructions that allows the exception here ▶ . . . . .   |     |    |
| 2 Do you elect the special grandfather rule under Regulations section 54.4981A-1T to exempt from tax the portion of distributions treated as a recovery of benefits accrued on or before August 1, 1986? (See Part IV Instructions) . . . . .<br>If "Yes," enter: (a) your initial grandfather amount ▶ \$ . . . . . ; and (b) check the grandfather recovery method you are electing: <input type="checkbox"/> Discretionary method; <input type="checkbox"/> Attained age method |     |    |

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

|                         |  |   |                |                                      |
|-------------------------|--|---|----------------|--------------------------------------|
| <b>Please Sign Here</b> | Your signature _____                                       |   | Date _____     |                                      |
|                         | <b>Paid Preparer's Use Only</b>                            | Preparer's signature _____                      | Date _____     | Preparer's social security no. _____ |
|                         | Firm's name (or yours, if self-employed) and address _____ | Check if self-employed <input type="checkbox"/> | E.I. No. _____ | ZIP code _____                       |

# 1987



Department of the Treasury  
Internal Revenue Service

## Instructions for Form 5329

### Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes

(Section references are to the Internal Revenue Code.)

#### Changes You Should Note

- Beginning in 1987, certain U.S. gold and silver coins may be used as IRA investments.
- You may be subject to an additional 10 percent tax on distributions you receive from a qualified retirement plan if you are under age 59½.
- Excess retirement distributions are subject to a new 15 percent excise tax.

#### General Instructions

**Paperwork Reduction Act Notice.**—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

**Purpose of Form.**—Use this form to report any excise tax or additional income tax you may owe in connection with your individual retirement account or other qualified retirement plan.

**Who Must File.**—You must file a Form 5329 if you owe taxes on:

- (1) Excess contributions to your IRA;
- (2) Premature distributions from your IRA or other qualified retirement plan;
- (3) Excess accumulations in your individual retirement plan; or
- (4) Excess distributions from qualified retirement plans.

These items are explained in detail later in these instructions.

Do not file Form 5329 to report your deduction for contributions to your IRA. Report this deduction on your Form 1040 or Form 1040A, U.S. Individual Income Tax Return. If you make a nondeductible contribution to your IRA, you must file Form 8606, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions.

If you need any information about your IRA not covered in these instructions, see Publication 590, Individual Retirement Arrangements (IRAs).

Also, individuals who redeem their individual retirement bonds, see Publication 590.

**When and Where To File.**—Your 1987 Form 5329 should be attached to and filed at the same time (including extensions) with your 1987 Form 1040. If you are paying tax for prior years, use a separate Form 5329 for the year you are paying tax.

If you do not have to file Form 1040 because you do not have enough income to require filing an income tax return or you

are filing for prior years, file only a completed Form 5329 with the Internal Revenue Service at the time and place you are required to file Form 1040. Include a check or money order payable to the Internal Revenue Service for any tax due shown on lines 7, 11c, 15, 19c, or 23c.

**Sign and Date Form 5329.**—This form must be signed if it is being filed separately.

**Preparer's Number.**—The paid preparer's number is needed only if you owe a tax on premature distributions. For further information about a paid preparer's signing responsibilities, see instructions for Form 1040.

#### Definitions

**Compensation.**—Compensation includes wages, salaries, professional fees, and other pay you receive for services you perform. It also includes sales commissions, commissions on insurance premiums, pay based on percent of profit, tips, and bonuses. It includes *net earnings* from self-employment, but only for a trade or business in which your personal services are a material income-producing factor. In addition for IRAs, all taxable alimony received by a former or current spouse under a decree of divorce or separate maintenance is treated as compensation.

The term "compensation" does not include any amounts received as a pension or annuity and does not include any amount received as deferred compensation.

**Rollover Contribution.**—A rollover contribution is a contribution of assets that comes from one qualified retirement plan to another. Generally, a qualified distribution that is rolled over is treated as a tax-free distribution, only if such distribution is contributed to another qualified retirement plan within 60 days following the distribution. For more information (and additional requirements) regarding rollover contributions to an IRA, distributions made pursuant to a "qualified domestic relations order," and rollover of partial distributions from qualified plans, see Publication 590.

**Note:** If you instruct the trustee of your IRA to transfer funds directly to another IRA, the transfer is not considered a rollover. Do not include the amount transferred in income and do not deduct the amount transferred as a contribution to your IRA.

**Premature Distribution.**—Generally, any distribution from your IRA or other qualified retirement plan that you receive before you attain age 59½ is a premature distribution.

See Specific Instructions, Part II, for the tax on premature distributions and exceptions.

**Prohibited Transactions.**—Generally, transactions such as borrowing from your individual retirement account or annuity or using your individual retirement account as a basis for obtaining a benefit are prohibited transactions. They cause the individual retirement account or annuity to no longer be considered an individual retirement account or annuity under section 408 as of the first day of your tax year in which the transaction occurs. Further, the entire value of your account or annuity is considered distributed to you as of the first day of your tax year. See Specific Instructions, Part II, line 9a.

#### Pledging of Account.

(1) If, during the tax year, you use any part of your account as security for a loan, that part is treated as being distributed to you.

(2) If, during the tax year, you use all or any part of your individual retirement annuity contract as security for a loan, the total value of that contract is treated as being distributed to you as of the first day of your tax year.

Also, if you are under age 59½ at the time the account or annuity is treated as being distributed to you, these distributions are subject to the tax on premature distributions. See Specific Instructions, Part II, line 9b.

**Note:** Report any distributions received or considered to be received from your IRA as a fully taxable pension on Form 1040, line 16b, except:

(a) Rollover contributions to another plan or IRA.

(b) Excess current year contributions that you withdraw from your IRA before the due date of your income tax return for the year the excess contributions were made and for which you took no deduction.

(c) Any excess contributions from earlier years that you withdraw, if the total contributions for the year in which the excess contributions were made are not more than \$2,250 (or if the total contributions for the year include employer contributions to a SEP, increased by the lesser of the amount of the employer contributions to the SEP or \$30,000) and you took no deduction for the excess contributions.

(d) Amounts transferred (by transfer of ownership of an IRA) to a former spouse under a divorce decree or current spouse under a separate maintenance agreement.

(e) Any individual retirement annuity contracts distributed to you. However, report on your income tax return any payments you received from these annuities as fully taxable annuity payments.

# Specific Instructions

## Part I—Excess Contributions Tax for Individual Retirement Arrangements

If you have contributed, either this year or in earlier years, more to your IRA than is allowable as a deduction on your Form 1040 or Form 1040A, you may have to pay an excess contributions tax.

However, if you withdrew your current year excess IRA contributions before the due date (including extensions) of your current year's income tax return, the excess will not be taxable as excess IRA contributions if:

(1) you do not claim a deduction for the amount of the excess contributions withdrawn, and

(2) the withdrawal from your IRA includes any income earned on the excess contributions.

Do not include such withdrawn excess contributions on line 1, Form 5329.

However, you must include the income earned on the excess contributions withdrawn before the due date of your income tax return on Form 1040 for the year in which the contribution was made. Also report the income on line 8, Form 5329, for the year of the distribution if you have not reached age 59½ at the time you received the distribution of income.

**Line 1.**—Enter the excess contributions you made in 1987. You can figure this amount from the worksheet in the instructions for line 24a or 24b of Form 1040. The amount of taxable excess contributions is the difference you get by subtracting your limitation, as computed from either IRA Worksheet 1 or 2, from your actual contributions. Do not include on this line any rollover contributions or any contributions designated as nondeductible contributions on Form 8606. Any distribution of current year excess contributions will not be subject to the tax on premature distributions (see Part II) if you withdraw it and any income earned on it before the due date of your income tax return and you do not take a deduction for it. The income earned on the excess contributions must be included in your gross income in the year the excess contribution was made. Also, such income is subject to the 10% additional tax and is to be included in line 8, Part II.

All other withdrawals of excess contributions will not be subject to the tax on premature distributions if the total contribution for the year in which the excess contributions were made is not more than \$2,250 (or if the total contributions for the year include employer contributions to a SEP, increased by the lesser of the amount of the employer contributions to the SEP or \$30,000) and you did not take a deduction for the excess contributions.

**Line 2.**—Enter the amount of 1986 excess contributions not withdrawn from your IRA before the due date of your 1986 income tax return. Also enter 1985 and earlier excess contributions not withdrawn or otherwise eliminated before January 1, 1987.

**Line 3.**—If your limitation is more than the amount actually contributed to your IRA, and you have excess contributions from earlier years which have not been eliminated, complete the worksheet below to see if you have a contribution credit.

**Line 4a.**—If you have withdrawn any money from your IRA in 1987 that must be included in your income for 1987, write the amount on line 4a. Do not include in this amount any excess contributions withdrawn that will be reported on line 4b.

**Line 4b.**—Enter on this line any excess contributions to your IRA for 1976 through 1985 that you withdrew in 1987 and also enter any 1986 excess contributions that you withdrew after the due date (including any extensions) for your 1986 income tax return.

Do not include any withdrawn excess contributions for which:

(1) you did not claim a deduction, and

(2) the total contributions to your IRA for the tax year for which the excess contributions were made were not more than \$2,250 (or if the total contributions for the year include employer contributions to a SEP, increased by the lesser of the amount of the employer contributions to the SEP or \$30,000).

## Part II—Tax on Premature Distributions (Section 72)

In general, the Tax Reform Act of 1986 extended the 10 percent additional tax on premature distributions from IRAs to include any "qualified retirement plan." Such plans include a qualified pension, profit-sharing or stock bonus plan, qualified annuity, or section 403(b) tax sheltered annuity contract. The tax does not apply to amounts distributed from unfunded deferred compensation plans of tax-exempt or State and local government employers. See the instructions for line 10b for distributions which are excluded from the tax.

**Line 8.**—Enter the amount of distributions you received from a qualified pension plan, including your IRAs, before you reached age 59½. Also, be sure to include on line 16a, Form 1040.

The following distributions are not to be taken into account on line 8:

(1) 1987 excess contributions withdrawn during the year or 1986 excess contributions withdrawn in 1987 before the filing date (including extensions) of your 1986 income tax return;

(2) "Rollover contributions" to another retirement arrangement or plan;

(3) Amount from an arrangement for which you make an entry on line 9 below;

(4) Amount distributed from an arrangement because it was pledged as security for a loan (use this amount for line 9b purposes);

(5) 1976 and 1977 excess contributions withdrawn in 1987 if no deduction was allowed for the excess contributions; or

(6) 1978 through 1985 excess contributions withdrawn in 1987 and 1986 excess contributions withdrawn after the due date (including extensions) of your 1986 income tax return if no deduction was allowed for the excess contributions, and the total IRA contributions for the tax year for which the excess contributions were made were not more than \$2,250 (or if the total contributions for the year include employer contributions to a SEP, increased by the lesser of the amount of the employer contributions to the SEP or \$30,000).

**Line 9a.**—If you engage in a prohibited transaction (see description on page 1), such as borrowing any amount from your individual retirement annuity or pledging any or all of your annuity contract as security for a loan, the account or annuity ceases to be an IRA as of the first day of the tax year. You are considered to have received a distribution of the entire value of your account or annuity as of the first day of the year in which any of these transactions take place. If you are under age 59½ on the first day of the year, report the entire distribution on line 9a. If you enter an amount on line 9a, do not fill in line 8 or 9b for this IRA.

**Line 9b.**—If you pledged any portion of your individual retirement account as security for a loan, enter the amount pledged here and on Form 1040, line 16b.

**Line 9c.**—The cost of any collectible (defined below) in which you invested funds of your IRA in 1987 is deemed to be a distribution to you in 1987. The cost is includible in your 1987 income. Enter the total cost of the collectible on Form 1040, line 16b. If you are under age 59½ when the funds were invested, enter the cost of the collectible on line 9c.

For this tax a collectible is:

- (1) any work of art,
- (2) any rug or antique,
- (3) any metal or gem,

### Worksheet for line 3

|   |  |  |
|---|--|--|
| 1 | Enter amount from line 2, IRA worksheet 1, or line 7, IRA worksheet 2, in Form 1040 Instructions for line 24, but not more than \$2,000 (\$2,250 if you contributed to your non-working spouse's account). . . . .   |  |
| 2 | Enter amount that is deductible under section 219 and is contributed either to your account or to your and your nonworking spouse's accounts. (Do not include contributions under section 219(f)(6) or any designated nondeductible contributions.). . . . .   |  |
| 3 | Contribution credit—subtract line 2 from line 1. Enter this amount on line 3 of Form 5329. Also include on line 4 or 8, IRA worksheet 1; or line 9, IRA worksheet 2, whichever is applicable, contained in Form 1040 Instructions for line 24 either: (i) this amount; or (ii) your earlier years' excess contributions not previously eliminated, whichever is smaller (see section 219(f)(6)). . . . . |  |



(4) any stamp or coin (see "Exception" below).

(5) any alcoholic beverage, or

(6) any other tangible personal property specified by regulations under section 408(m).

**Exception:** For acquisitions made after 1986, the Tax Reform Act of 1986 allows an IRA to invest in one, one-half, one-quarter, or one-tenth ounce gold coins, or one ounce silver coins that were minted by the U.S. beginning October 1, 1986.

**Line 10b.**—The 10 percent additional tax does not apply to certain distributions which are specifically excepted by the Code. Enter the amount which is excluded from the additional tax on line 10b. Also, be sure to answer Question 1 under "Other Information." In the space provided next to Question 1, enter the number of the applicable Code section from the chart below:

| No. | Code section     | Exception   |
|-----|------------------|---|
| 01  | 72(t)(2)(A)(ii)  | Distribution made after death of the employee   |
| 02  | 72(t)(2)(A)(iii) | Distribution made due to disability   |
| 03  | 72(t)(2)(A)(iv)  | Distribution is part of a scheduled series of substantially equal periodic payments for the life of the participant (or joint lives of the participant and the participant's beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's beneficiary) |
| 04  | 72(t)(2)(A)(v)   | Distribution made to an employee who has attained age 55, separated from service, and meets the requirements for early retirement under the plan (not applicable to IRAs)   |
| 05  | 72(t)(2)(B)      | Distribution used to pay medical expenses to the extent such expenses are deductible under section 213 (not applicable to IRAs)   |
| 06  | 72(t)(2)(C)      | Certain dividend distributions from employee stock ownership plans (ESOPs) (not applicable to IRAs)   |
| 07  | 72(t)(2)(D)      | Distributions made pursuant to a qualified domestic relations order   |

**Line 11b.**—If you receive any amounts under an annuity contract before reaching age 59½, such amount may also be subject to an additional 10 percent tax on the portion which is includible in gross income.

The additional tax does not apply to certain distributions (e.g., distributions allocable to investment in the contract before August 14, 1982).

See section 72(q) for details.

Also, enter the amount of any distributions excluded from the tax to the left of the entry space with the notation, "Amount excluded."

### Part III—Tax on Excess Accumulations in Individual Retirement Accounts and Annuities (Section 4974)

Generally, if you have an IRA and your 70th birthday was before July 1, 1986, you must begin to receive distributions in 1987. If you are the beneficiary of an IRA owner who died before January 1, 1987, you may also have to receive minimum distributions in 1987. If you do not receive the minimum required distribution, you must pay an additional 50 percent tax on the amount of any excess accumulations in your IRA. In addition, minimum distributions under section 401(a)(9) received during 1987 for calendar years 1985 and 1986 are taken into account in determining excess retirement distributions under section 4981A.

**Publication 930, 1987 Required Distributions from Individual Retirement Arrangements (IRAs)**, highlights some of the rules concerning required distributions from IRAs for 1985, 1986, and 1987. Distributions for these years may be made either under the regular method, or according to special transition rules.

Under the regular method, the account balances for 1985, 1986, and 1987, with appropriate adjustments, are determined separately for each of your IRAs.

Under the special transition rules, there are two alternative methods: (1) the life expectancy method; and (2) the percentage method. Both methods require you to aggregate all of your IRAs as of December 31, 1986.

You may also be able to take credit for amounts distributed to you during 1985 through 1987 if you were at least 70½ in the year of the distribution.

To determine the minimum required distribution to be entered on line 12, see Publication 930.

**Note:** *The IRS may waive this tax on excess accumulations. The waiver of the tax is conditional upon evidence you submit that any shortfall in the amount of withdrawals from your IRA was due to reasonable error, and that appropriate steps have been or are being taken to remedy the shortfall. If you believe you qualify for this waiver, file Form 5329, pay this excise tax, and attach your letter of explanation. If your waiver request is granted, we will send you a refund.*

### Part IV—Tax on Excess Distributions From Qualified Retirement Plans

The Tax Reform Act of 1986 imposes a new excise tax of 15 percent on individuals who receive excess distributions from qualified employer plans and IRAs. Generally, an excess distribution is the amount of retirement distributions that you receive during the calendar year over the applicable threshold amount (see lines 17a and 21a).

A qualified retirement plan includes a qualified pension, profit-sharing or stock bonus plan, annuity plan described in section 403(a), section 403(b) tax-sheltered annuity contract or custodial account, or an IRA (including a SEP-IRA).

**Special Grandfather Rule.**—If your total accrued benefits in all qualified plans and IRAs on August 1, 1986, have a value of at least \$562,500, you may elect to use a special grandfather rule which exempts from the excise tax the portion of distributions treated as a recovery of benefits accrued on or before August 1, 1986.

To make the election, answer Question 2 under "Other Information." Enter your initial grandfather amount in the space provided, and check the grandfather recovery method you are electing (discretionary or attained age).

See Regulations section 54.4981A-1T for an explanation of when to make the special grandfather election, how to determine your initial grandfather amount, the two grandfather recovery methods, and recordkeeping requirements.

If you are electing the discretionary method and wish to accelerate the rate of recovery beginning with calendar year 1987, attach a statement to Form 5329 stating that you are making such acceleration.

**Lines 16 and 20.**—All retirement distributions are divided into two categories: (1) regular retirement distributions; and (2) lump-sum distributions. To be treated as a lump-sum distribution, you must make certain elections under section 402 or 403, such as 5-year averaging, with respect to that distribution. See Form 4972, Tax on Lump-Sum Distributions.

The following distributions are not to be included on lines 16 or 20:

(1) distributions excluded from income because of rollover contributions;

(2) distributions which are a return of employee contributions or nondeductible IRA contributions;

(3) certain payments made to a spouse or former spouse under a qualified domestic relations order; and

(4) distributions made as a result of death.

See section 4981A(c)(2).

**Lines 17a and 21a.**—The threshold amount depends on whether you have made a grandfather election. If you do not elect to use the special grandfather rule, use the \$150,000 threshold amount. If you make a special grandfather election, enter \$112,500 for 1987. For lump-sum distributions, enter 5 times the applicable threshold amount.

**Lines 19b and 23b.**—The 15 percent excise tax on excess distributions may be offset by the 10 percent tax on early distributions under section 72(t) (line 11a, Part II) to the extent that the 10 percent tax is applied to excess distributions. If you have an amount entered on line 11a, subtract line 17c, or 21c, from line 10c. If the result is zero or less, you are not eligible for an offset. If the result is greater than zero, multiply the result by 10% (the rate of the section 72(t) tax), and enter that result on line 19b or 23b.



EXAMPLES OF RETIREMENT PLAN DISTRIBUTION ELECTIONS

**Example 1. (a)** An individual (A) who participates in two retirement plans, a qualified defined contribution plan and a qualified defined benefit plan, has a total value of accrued benefits on August 1, 1986 under both plans of \$1,000,000. Because this amount exceeds \$562,000, A is eligible to elect to use the special grandfather rule to calculate the portion of subsequent distributions that are exempt from tax. A elects to use the discretionary grandfather recovery method and attaches a valid election to the 1987 income tax return. A does not elect to accelerate the rate of recovery for 1987. On October 1, 1986, A receives a distribution of \$200,000. On February 1, 1987, A receives a distribution of \$45,000 and, on November 1, 1987, receives a distribution of \$200,000. The 15 percent excise tax applicable to aggregate distributions in 1987 is calculated as follows:

|  |             |
|--|-------------|
| (1) Value of grandfather amount on 8/1/86  | \$1,000,000 |
| (2) Grandfather amounts recovered in 1986 but after 8/1/86                                       | \$ 200,000  |
| (3) Value of grandfather amount on 12/31/86 ((1) - (2))  | \$ 800,000  |
| (4) Grandfather recovery percentage  | 10%         |
| (5) Distributions between 1/1/87 and 12/31/87 (\$45,000 + \$200,000)                             | \$ 245,000  |
| (6) Portion of (5) exempt from tax ((4) × (5))   | \$ 24,500   |
| (7) Amount potentially subject to tax ((5) - (6))  | \$ 220,500  |
| (8) Portion of aggregate distributions in excess of \$112,500 (\$45,000 + \$200,000 - \$112,500) | \$ 132,500  |
| (9) Amount subject to tax (lesser of (7) and (8))  | \$ 132,500  |
| (10) Amount of tax (15% of (9))  | \$ 19,875   |
| (11) Remaining undistributed value of grandfather amount as of 12/31/87 ((3) - (6))              | \$ 775,500  |

**(b)** In 1988, A receives no distributions from either plan. On February 1, 1989, A receives a distribution of \$300,000 and on December 31, 1989, receives a distribution of \$75,000. A makes a valid acceleration election for the 1989 taxable year, whereby A accelerates the rate of grandfather recovery that will apply for calendar years after 1988 to 100 percent. Assume the annual threshold amount for the 1989 calendar year is \$125,000 (i.e., 112,500 indexed). The 15 percent excess tax applicable to distributions in 1989 is calculated as follows:

|  |           |
|--|-----------|
| (1) Value of grandfather amount on 1/1/89  | \$775,500 |
| (2) Grandfather recovery percentage designated for 1989 calendar year                            | 100%      |
| (3) Distributions between 1/1/89 and 12/31/89 (\$300,000 + \$75,000)                             | \$375,000 |
| (4) Portion of (3) exempt from tax ((2) × (3))   | \$375,000 |
| (5) Amount potentially subject to tax ((3) - (4))  | \$ 0      |
| (6) Portion of aggregate distributions in excess of \$125,000 (\$300,000 + \$75,000 - \$125,000) | \$250,000 |
| (7) Amount subject to tax (lesser of (5) and (6))  | \$ 0      |
| (8) Amount of tax (15% of (7))   | \$ 0      |
| (9) Remaining undistributed value of grandfather amount as of 12/31/89 ((1) - (4))               | \$400,500 |

The entire amount of any distribution for subsequent calendar years will be treated as a recovery of the grandfather amount and applied against the grandfather amount until the unrecovered grandfather amount is reduced to zero.

**Example 2.** The facts are the same as in **Example 1** except that A elects to use the attained age recovery method and A makes a valid election for the 1967 taxable year. Further assume that A's attained age in months on August 1, 1966 is 462 months and on December 31, 1967 is 476 months. The 15 percent excise tax applicable to aggregate distributions in 1967 is calculated as follows:

|   |               |
|---|---------------|
| (1) Value of grandfather amount on 8/1/66 .....   | \$1,000,000   |
| (2) Grandfather amounts recovered in 1966 but after 8/1/66 ..   | \$ 200,000    |
| (3) Value of grandfather amount on 12/31/66 ((1) - (2)) .....   | \$ 800,000    |
| (4) Completed months of age in excess of 420 on 8/1/66 .....  | 42            |
| (5) Completed months of age in excess of 420 on 12/31/67 .....  | 56            |
| (6) Grandfather fraction as of 12/31/66 ((4) divided by (5)) ...  | $\frac{3}{4}$ |
| (7) Distributions between 1/1/67 and 12/31/67 (\$45,000 + \$200,000) .....                              | \$ 245,000    |
| (8) Portion of (7) exempt from tax ((6) x (7)) .....  | \$ 183,750    |
| (9) Amount potentially subject to tax ((7) - (8)) .....   | \$ 61,250     |
| (10) Portion of aggregate distributions in excess of \$112,500 (\$45,000 + \$200,000 - \$112,500) ..... | \$ 132,500    |
| (11) Amount subject to tax (lesser of (9) and (10)) .....   | \$ 61,250     |
| (12) Amount of tax (15% of (11)) .....  | \$ 9,187      |
| (13) Unrecovered grandfather amount as of 12/31/67 ((3) - (8)) .....                                    | \$ 616,250    |

14968K Reg. § 54.4981A-1T

EXAMPLES OF ESTATE TAX/EXCISE TAX TREATMENT OF RETIREMENT  
PLAN ACCUMULATIONS

**Example 1.** (a) An individual (A) dies on February 1, 199X at age 70 and 9 months. As of A's date of death, A has an interest in a defined benefit plan described in section 401(a) (Plan X). Plan X has never provided for employer contributions. A has no section 72(f) investment in Plan X. A does not have any interest in any other qualified employer plan or individual retirement plan. The alternate valuation date in section 2032 does not apply. A did not elect to have the special grandfather rule apply. A's interest in Plan X is the form of a qualified joint and survivor annuity. The value of the remaining payments under the joint and survivor annuity as of A's date of death (determined under D-5) is \$2,000,000.

(b) Because A is age 70 and 9 months on A's date of death, A's life expectancy as of A's date of death is calculated using age 70 (A's attained age in whole years on A's date of death). The factor from Table A of § 20.2031-7(f) used to determine the present value of a single life annuity for an individual age 70 is 6.0522. The greater of \$150,000 or \$112,500 indexed for 199X is \$150,000. The present value of the hypothetical single life annuity is \$907,530 ( $\$150,000 \times 6.0522$ ).

(c) The amount of A's excess accumulation is \$1,092,170, determined as follows: \$2,000,000 (value of A's interest in Plan X) minus \$907,530 (value of hypothetical single life annuity contract) equals \$1,092,170.

(d) The increase in the estate tax under section 4981A(d) is \$163,525 (15 percent of \$1,092,170).

**Example 2.** (a) The facts are the same as in Example 1, except that A's interest in Plan X consists of the following:

(1) \$2,000,000, value of employer-provided portion of a qualified joint and survivor annuity determined as of A's date of death using the interest and mortality assumptions in § 20.2031-7.

(2) \$200,000, proceeds of a term life insurance contract (no cash surrender value before death).

(3) \$100,000, amount (employer-provided portion) payable to A's former spouse pursuant to a QDRO.

(4) \$100,000, amount of A's investment in Plan X.

(b) The value of A's interest in Plan X for purposes of calculating A's excess accumulation is still \$2,000,000. The proceeds of the term life insurance contract, the amount payable under the QDRO, and the amount of A's investment in Plan X are excluded from such value.

**Example 3.** (a) The facts are the same as in Example 1, except that A elected the special grandfather rule. A's initial grandfather amount was \$1,100,000. As of A's date of death, A had received \$500,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is \$600,000 ( $\$1,100,000 - \$500,000$ ). In 199X, assume that \$112,500 indexed is still \$112,500.

(b) A's excess retirement accumulation is determined as follows: \$2,000,000 minus the greater of (1) \$500,000 or (2) the present value of a period certain annuity of \$112,500 a year for 16 years. The present value of a single life annuity of \$112,500 a year for an individual age 70 is determined as follows:  $\$112,500 \times 6.0522 = \$680,527.25$ . \$680,527.25 is greater than \$600,000. Thus the amount of the excess retirement accumulation is \$1,319,173 ( $\$2,000,000$  minus \$680,527).

(c) The additional estate tax under section 4981A(d) is \$197,575 (15 percent of \$1,319,173).

**Example 4.** (a) The facts are the same as in Example 3 except that, as of A's date of death, A received \$90,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is \$1,010,000 ( $\$1,100,000 - \$90,000$ ).

(b) A's excess retirement accumulation is determined as follows: \$2,000,000 minus the greater of (1) \$1,010,000 (A's unused grandfather amount) or (2) \$680,527.25 (the present value of a single life annuity of \$112,500 a year for an individual age 70). A's unused grandfather amount is greater than the present value of the hypothetical life annuity. Thus, the amount of the excess retirement accumulation is \$990,000 ( $\$2,000,000 - \$1,010,000$ ).

(c) The additional estate tax under section 4981A(d) is \$148,500 (15 percent of \$990,000).

4968K Reg. § 54.4981A-1T