



7-1999

26th Annual Midwest/Midsouth Estate Planning Institute

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

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26th Annual

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**Presented by the
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Printed in the United States of America

26th Annual
MIDWEST/MIDSOUTH
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26th Annual
**MIDWEST MIDSOUTH
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**NOTABLE DEVELOPMENTS
OF INTEREST TO ESTATE PLANNERS
1998-1999**

**Turney P. Berry
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Louisville, Kentucky**



**NOTABLE DEVELOPMENTS OF INTEREST
TO ESTATE PLANNERS, 1998 - 1999**

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**NOTABLE DEVELOPMENTS OF INTEREST
TO ESTATE PLANNERS, 1998 - 1999**

A. INCOME TAX MATTERS

1. **Miscellaneous Deduction Limitation - Revocable Trusts.** In O'Neill v. Commissioner, 994 F.2d 302 (6th cir. 1993), revg. 98 T.C. 227 (1992), the court held that expenses necessary for trust administration were not subject to the 2% limit on miscellaneous itemized deductions under section 67. The trust considered in O'Neill was not a grantor trust. Are the considerations the same?

The issue arose in Susan L. Bay v. Commissioner, T.C. Memo. 1998-411, and the Court answered no:

We turn our attention first to the status of the trust for Federal income tax purposes. In petitioner's brief, as a general criticism of respondent's position, and with reference to the trust restrictions on the distribution of corpus, petitioner states: [respondent] fails to note that in the instant case although the form of * * * [the trust] is that of a grantor's trust, in substance it is similar to an irrevocable trust or mutual fund." According to petitioner, we should consider the trust as other than a grantor trust. Petitioner's reliance upon section 67(e) and O'Neill v. Commissioner, supra, is consistent with treating the trust as other than a grantor trust. However, such treatment is inconsistent with the stipulation of facts, in which petitioner agreed not only that the trust "is a grantor trust," but further, in apparent reliance upon section 671, that "each item of income and expense [of the trust] is reported individually by the grantor." Considering the trust as other than a grantor trust is also inconsistent with the manner in which petitioner reported the items of income and deductions attributable to the trust on her 1993 and 1994 Federal income tax returns. Furthermore, the restrictions on the distribution of trust corpus, do not, as petitioner suggests, remove the trust from the provisions of section 671. See Sec. 677. The trust is a grantor trust, and the positions of the parties will be considered accordingly.

Contrary to petitioner's argument, section 67(e) does not and cannot apply to grantor trusts. Because the items of income and deductions are passed through to the grantor, the adjusted gross income of a grantor trust, in effect, is not a viable notion either conceptually under the relevant statutory scheme, or for reporting purposes. Pursuant to section 671, petitioner, as a grantor of the trust, is required to include in the computation of her taxable income, the items of income, deductions and credits of the trust that are attributable to her proportionate share of the trust. See sec. 1.671-4, Income Tax Regs. This, in fact, is what she did on her 1993 and 1994 Federal income tax returns. These items are treated as though received or paid by her, instead of by the trust. Sec. 1.671-2(c), Income Tax Regs. Because the deductions here under consideration constitute "Miscellaneous Itemized Deductions" within the meaning of section 67(b), the provisions of section 67(a) are applicable.

2. **Taxable Income Upon Termination of Life Insurance Policies.** In Stephen L. Atwood, et ux. v. Commissioner, T.C. Memo. 1999-61, the tax court held that the taxpayers received taxable income when insurance

companies terminated life insurance policies where the taxpayers had borrowed amounts in excess of the premiums they had paid. The taxpayers had borrowed the maximum available against the policies and then had not paid the interest. The companies terminated the policies and sent the taxpayers Forms 1099.

3. **Separate Share Rules Relating to Estates.** REG-114841-98 (January 6, 1999) contains proposed regulations dealing with the application of the separate share rules to estates. In general, they provide the basic definition of separate shares as applied to estates but specifically do not deal with revocable trusts that elect to be treated as part of the decedent's estate under section 646 (other than stating that such a revocable trust is created as a separate share in the estate). The proposed regulations also deal specifically with the elective share of a surviving spouse in an estate.

The general separate share rule, and examples, is as follows:

Section 1.663(c)-4 Applicability of separate share rule to estates.

(a) **General rule.** The applicability of the separate share rule to estates provided by section 663(c) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries are not affected by economic interests accruing to another beneficiary or class of beneficiaries. A separate share should be allocated only the share of the estate's income and deductions that the beneficiary (or beneficiaries) of such separate share is (or are) entitled to (if any) under the terms of the governing instrument or local law. The separate share rule does not affect rules under section 663(a) concerning specific gifts and bequests.

(b) **Examples of separate shares.** Separate shares include --

(1) A surviving spouse's elective share;

(2) A revocable trust that elects to be part of the decedent's estate under section 645;

(3) The residuary estate, or some portion of the residuary estate, if the requirements of paragraph (a) of this section are met; and

(4) A gift or bequest of a specific sum of money or of specific property that is paid or credited in more than three installments, if the requirements of paragraph (a) of this section are met.

(c) **Shares with multiple beneficiaries and beneficiaries of multiple shares.** A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an

interest. Moreover, the same person may be a beneficiary of more than one separate share.

The explanation of the provision discusses the issue of a spousal elective share as follows:

Most non-community property states have some form of elective share statute which replaces common law dower and curtesy (the common law protection for surviving spouses). Generally, an elective share statute gives the surviving spouse the right to claim a share of the deceased spouse's estate if the surviving spouse is disinherited or dissatisfied with what the spouse would have received under the will or otherwise. In most states the elective share consists of a fraction, ranging from one-fourth to one-half of the decedent's estate. Elective share statutes vary as to when the share vests and whether the share includes a portion of the estate income, as well as whether the share participates in the appreciation or depreciation of the estate's assets.

Rev. Rul. 64-101 (1964-1 C.B. 77) addresses the Florida statutory dower interest which, at the time of the revenue ruling, entitled the widow to the dower interest and mesne profits thereon. The ruling holds that the value of assets transferred to the widow as dower is not a distribution to a beneficiary subject to sections 661(a) and 662(a) of the Code. Instead, the transfer of assets is governed by section 102.

Rev. Rul. 71-167 (1971-1 C.B. 163) modifies Rev. Rul. 64-101 by holding that the amount distributed to the widow representing mesne profits is subject to sections 661(a) and 662(a) of the Code. Therefore, an amount corresponding to the allowable deduction to the estate under section 661(a) is includable in the gross income of the widow under section 662(a).

Recently, two cases, Deutsch v. Commissioner, TCM 1997-470, and Brigham v. United States, 983 F. Supp. 46, (D. Mass. 1997), have addressed how to treat payments to the surviving spouse in satisfaction of the spouse's elective share amount. In Deutsch, the surviving spouse elected to take against the decedent's will as provided by the Florida elective share statute. Under the statute, the surviving spouse was entitled to 30 percent of the net estate based upon date of death values, but was not entitled to any income of the estate, and did not participate in appreciation or depreciation of the estate assets. The Tax Court, noting Rev. Rul. 64-101, held that payments to the surviving spouse in satisfaction of her elective share amount were not subject to sections 661(a) and 662(a). Rather, the payments were governed by section 102.

In Brigham, the surviving spouse elected to take against the decedent's will as provided by the New Hampshire elective share statute. Under the statute, the surviving spouse was entitled to one-third of the personalty and one-third of the real estate. The court held that the payments made to the surviving spouse in satisfaction of her elective share amount were subject to sections 661(a) and 662(a). Thus, the court held that all of the estate's distributable net income was taxable to the surviving spouse because she was the only beneficiary to receive a distribution for the year in question and her distribution exceeded the amount of the estate's distributable net income.

In light of the uncertainty concerning the proper treatment of payments in satisfaction of a surviving spouse's elective share, and also given that Rev. Ruls.

64-101 and 71-167 are outdated because dower has been replaced by elective share statutes in most states, the Internal Revenue Service and Treasury have concluded that regulatory guidance is needed to provide uniform treatment.

These proposed regulations provide that the surviving spouse's elective share constitutes a separate share of the estate for the sole purpose of determining the amount of distributable net income in application of sections 661(a) and 662(a). Therefore, only the income that is (1) allocable to the surviving spouse's separate share for a taxable year, and (2) distributed to the surviving spouse in satisfaction of the elective share will be treated as a distribution subject to sections 661(a) and 662(a). This approach results in the surviving spouse being taxed on the estate's income earned during administration only to the extent of the surviving spouse's right to share in the estate's income under state law. Comments are requested on whether there are situations in which an elective share or dower interest would not be a separate share under the separate economic interest test set forth in the proposed regulations.

B. CHARITABLE AND TAX-EXEMPT MATTERS - Sections 170, 642, 664, 501, 509, 2055, 2522, and 4940-4947

1. Gain on Stock Taxable to Donor When Gift is Not Made Soon Enough. The tax court opinion in Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999) has been upheld by the Ninth Circuit. This is an important case that must be considered when advising clients about funding charitable gifts including charitable remainder trusts.

On July 18, 1988 American Health Companies, Inc. ("AHC") entered into a merger agreement with CDI Holding, Inc. through its wholly owned subsidiary DC Acquisition Corp. The plan was for DC Acquisition to purchase the majority of the AHC stock through a tender offer and then have DC Acquisition merge into AHC leaving AHC as a wholly owned subsidiary of CDI. The tender offer, and merger, were conditioned on the acquisition by DC Acquisition of at least 85% of the outstanding shares of AHC by August 30, 1988, but that condition was waivable at the sole discretion of DC Acquisition, and was in fact extended to September 9, 1988. On September 12, 1988 DC Acquisition announced its acceptance of all tendered or guaranteed AHC shares and on October 14, 1988 the merger was effectuated.

Between August 9, 1988 and August 26, 1988 the Fergusons "transferred" AHC shares to certain charitable organizations. The date was a matter of dispute before the court. The Ninth Circuit affirmed the tax court factual findings that there was no completed delivery to the charities until September 9, 1988. The specific facts are worth quoting in detail:

The evidence shows that Brett Floyd was not acting on behalf of the Charities (as their agent, as the trustee of a voluntary trust created for their benefit, or in any

other capacity) until the time that the Merrill Lynch clearance process had been completed, the AHC stock had been transferred on the books of Merrill Lynch from the Fergusons' account to the Charities' account, and the Fergusons had authorized the transfer, finally and effectively. Even if Brett Floyd had ceased to be acting under the control of the Fergusons at any time, not until Merrill Lynch's legal department had completed its two-week clearance process, would he even have been capable of acting at the Charities' behest with respect to any disposition of the AHC stock, which still remained in the Fergusons' personal accounts. Moreover, in the memorandum disposition cited by the Fergusons as support for their contentions, the Tax Court there held that, under Montana law, a voluntary trust would not be formed without some sign, some overt act, which demonstrated that, after receiving stock on behalf of a named beneficiary, the recipient bank had accepted its position as trustee for the benefit of the named beneficiaries. See Richardson v. Commissioner, T.C.M. (P-H) P 84,595 (T.C. Nov. 9, 1984). In that case, the contribution thus was not completed for tax purposes until the recipient bank had tendered the received shares on behalf of the named beneficiaries. See id. Likewise, in the present case, although controlled as to the formation of a voluntary trust by Idaho law (which does not address this issue), logic and common sense dictate that the Fergusons' gift could not be completed until Merrill Lynch, through its legal department and Brett Floyd, finally had decided that it was willing to transfer the shares according to the Fergusons' wishes and to tender the shares on behalf of the Charities.

Furthermore, contrary to the Fergusons' assertion, Brett Floyd's testimony as to the existence of the original letters of execution and as to the intended purpose of those letters, if they indeed existed, was not uncontroverted. The total absence of any trace of the original letters and the "substantial documentary evidence" that the Tax Court relied upon in its decision, easily could have supported a finding that Brett Floyd was not a credible supporting witness. This documentary evidence included: (1) the donation-in-kind records completed and dated "9-9-88" by Brett Floyd himself; (2) the donation-in-kind receipts submitted and dated September 9, 1988, by the Church; (3) the sole existence of "final versions" (as opposed to "new copies") of the signed letters of authorization; and (4) the disclosure documents dated September 9, 1988, submitted to the Securities and Exchange Commission and completed by Billy G. DuPree, Jr., AHC's very own vice president of legal affairs and secretary. Thus, the evidence in the record clearly supports the Tax Court's implicit finding that there were no original letters of authorization that were intended to be anything other than rough drafts, mere working copies, which in fact were thrown away once they had been replaced by final versions.

Therefore, in the absence of Brett Floyd's role as anything other than an agent of the Fergusons or Merrill Lynch, there could have been no contribution until the delivery of the AHC stock to the Charities' account had been completed. And in the absence of any earlier letters of authorization that were intended to be final and effective, there was no completed delivery to the Charities, no transfer that was legally binding and irrevocable, until the date that the Fergusons' letters of authorization were finally and effectively executed -- September 9, 1988.

The next issue before the court was whether a contribution on September 9, 1988 was too late to avoid the assignment of income doctrine. The tax court had found that by August 31, 1988 over 50% of the AHC stock had been

tendered and, thus, that it was "quite unlikely" that any of the relevant parties would back out of the tender offer for the merger or that the requisite number of shares could not be tendered by the close of the tender offer window. In particular, the court stated:

Third, the Fergusons and at least one commentator, see Note, Taxpayers Liable for Gain in Stock Donated to Charity During a Tender Offer: Ferguson v. Commissioner, 51 Tax Law. 441 (1998), contend that the Tax Court's analysis of the likelihood that as of August 31, 1988, the merger would proceed, was fundamentally flawed because it failed to take into account the bilateral nature of a merger. More specifically, they claim that as of August 31, 1988, even though more than 50% of the AHC shareholders had expressed their tacit approval of the pending merger by tendering their shares, there was still a significant possibility that DC Acquisition's own shareholders might not approve of the merger -- a threat until 90% ownership had been obtained by DC Acquisition, thereby eliminating the need for any formal shareholder vote. However, further analysis shows that it is the Fergusons' and the one commentator's analyses that are fundamentally flawed. Both make it sound as if there was much uncertainty as to how the many shareholders of DC Acquisition would vote. Both seem to have completely forgotten that DC Acquisition's sole shareholder was CDI, and that CDI's board of directors (along with DC Acquisition's single director -- another corporate insider) therefore effectively could approve the merger without turning to any outside shareholders. And for the reasons discussed above, it was most unlikely as of August 31, 1988, that CDI's board of directors was not fully committed to approving the merger once the tender offer had been completed. Thus, the Tax Court's analysis was sound.

* * *

On a final note, the Fergusons raise two policy considerations, but these considerations do not support their contentions. First, the Fergusons rightly point out that there is a distinction between tax evasion (i.e., choosing an impermissible path) and tax avoidance (i.e., choosing the least costly permissible path) and that so long as they are acting in accordance with the existing tax laws, the motives for their actions should not dictate the consequences of their actions. However, simply because the Fergusons have the right to choose the least costly path (from a tax perspective) upon which to walk, they do not have the right to be free from taxation if they decide to walk the line between what is and what is not permissible, and happen to stray across it, as they have here. Second, the Fergusons note that the logic of the Tax Court's decision implies that their AHC stock already might have ripened by some date even earlier than August 31, 1988. In essence, they note that there is no clear line demarcating the first date upon which a taxpayer's appreciated stock has ripened into a fixed right to receive cash pursuant to a pending merger. However, from the perspective of taxpayers, walking the line between tax evasion and tax avoidance seems to be a patently dangerous business. Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor. See, e.g., Gain on Tendered Stock Taxable Despite Charitable Donation, 26 Tax'n for Law. 114 (1997). Therefore, we will not go out of our way to make this dangerous business any easier for taxpayers who knowingly assume its risks. Moreover, from the perspective of judging such cases, there is no special reason that we should curtail the application of this

doctrine simply because it requires "engaging in an exercise in line drawing, a difficult task which nevertheless is part of the daily grist of judicial life." Badger Pipe Line Co. v. Commissioner, 74 T.C.M. (CCH) P 856 (T.C. Oct. 8, 1997) (Tannenwald, J.) (discussing generally the determination of the character of a transferred interest).

[Emphasis added.]

2. **Interpretation of Religious Liberty and Charitable Donation Protection Act.** Section 707(b) of the Bankruptcy Code provides that in determining whether to give Chapter 13 bankruptcy relief the bankruptcy court may not consider whether a debtor had made, or continues to make, charitable contributions to religious or charitable organizations. Before the bankruptcy court in In re: James A. Shmihula, et ux., 83 AFTR2d ¶ 99-889 was the effect of section 548(a)(1) of the Bankruptcy Code which allows bankruptcy court to recover any transfer of assets on the eve of bankruptcy if the transfer was made to delay or hinder a creditor, with section 707(b). Here, the bankruptcy petitioners began making charitable contributions after the bankruptcy petition was filed. The court denied relief stating:

While these Debtors emphasize that they did not commence charitable giving with the actual intent to hinder, delay or defraud creditors, and that they have in fact continued giving to various charities throughout the pendency of this litigation, the effect of their actions cannot be overlooked. What these Debtors are doing, regardless of their stated intent, is to rewrite the law in accordance with their personal wishes, to the detriment of creditors who, under section 707(b), have a vested interest in their disposable income. Based upon the clear language of the statute in question and the reported history, it is the ruling of this Court that the issue of timing, i.e., JUST WHEN a debtor commences charitable giving, is very relevant to the 707(b) inquiry. Where the debtor's charitable giving instinct arises shortly pre-petition, and surely where it arises post-petition, as here, it is unthinkable that the Court would not have the authority to examine such circumstances.

3. **Charitable Split-Dollar Life Insurance.** Notice 99-36, 1999-26 IRB 1, warns taxpayers and exempt organizations not to engage in charitable split-dollar life insurance transactions. The Service has concluded that tax exempt organizations may be challenged on private inurement for private benefit grounds, and individuals will be challenged on their income tax deductions.

The Service's position is that the transaction should be described as one in which the taxpayer obtains an insurance policy, pays premiums with respect to that policy, and transfers some of the rights under that policy to the trust and the remaining rights to charity. The taxpayer is treated as dividing the rights of any insurance policy between the

trust and the charity, and thus transferring a partial interest rather than an entire interest, and without being within any of the partial interest exceptions under section 170.

4. **Transfer of EE Income Tax Bonds to Charity.** In PLR 9845026 the decedent's residuary estate was bequeathed to various charities. The estate included EE savings bonds as to which no §454(a) election to recognize as income the annual increase in redemption value was made. The IRS ruled that transfer of the bonds to the charity would enable the income tax on the incremental increase to be avoided.

5. **Division of Charitable Remainder Trust.** PLRs 9851006 and 9851007 deal with the division of a charitable remainder trust created by husband and wife for their joint benefit. Husband and wife subsequently were divorced and desired to divide the trust in equal shares.

6. **Disclaimer Followed by Reformation to Create Charitable Remainder Trust.** PLR 9852034 discusses an interesting way to change a defective charitable trust. A decedent created a trust the income and principal of which was to be paid by the trustee for the decedent's sister's "proper care, comfort, health, and support." At the sister's death, the trust was to be distributed to a charity. The sister disclaimed her interest as a discretionary beneficiary of trust principal and the trustee then petitioned to reform the trust under section 2055(e)(3) to transform the sister's income interest into a unitrust interest. The IRS allowed the transaction even though as a unitrust interest the sister did, implicitly, have an interest in principal, presumably an interest which had been disclaimed. The ruling does not discuss this peculiarity.

7. **Generosity In Allowing Reformation for Scrivener's Error.** PLR 199923013 allowed the proposed reformation of a charitable remainder unitrust where the drafting attorney provided a sworn affidavit that various disqualifying provisions were the result of drafting errors. The drafting errors were substantial: among other things, the trust gave the grantor a power of acquisition described in section 675(4)(C), allowed the trustee to pay death taxes from the trust assets, and allowed the trustee to terminate the trust if after the death of both of the grantors was not economically feasible to continue the trusts existence.

8. **Special Needs Arrangement.** PLR 199903001 deals with an interesting planning situation. At a grantor's death, one-half of the grantor's residence was to be distributed outright to a charity with the other half being distributed to a special needs trust that provided a life estate to the grantor's child, with remainder to the charity. The

remaining assets in the grantor's estate would, for the most part, pass into a charitable remainder annuity trust that would pay the annuity to the special needs trust during the child's lifetime.

The grantor requested the trustee of the special needs trust and the charity enter into a use agreement with respect to the residence that would allow the child, during the child's lifetime, to have complete use of the first floor, back yard, and pool located in the back yard as well as access to the second floor for any reasonable purpose. The charity would have complete use of the second floor and access to the first floor for any reasonable purpose. The issue was whether the use agreement would disqualify the gift of the residence to charity for the charitable deduction in section 2055.

The ruling concluded that the transfer of the half interest in the residence would be deductible because the interest passed outright to charity and there would be no binding obligation on the charity. Because the child had a general power of appointment over the assets of the special needs trust, the ruling also concluded that the annuity interest could be paid to the special needs trust.

9. **Retirement Plan Payable to Charitable Remainder Unitrust.** PLR 199901023 describes the tax results of a retirement plan payable to a charitable remainder unitrust in a lump sum immediately following the participant's death. Section 691(a)(1)(B) provides that income in respect of a decedent that is not payable to an estate on account of the decedent's death is taxable to the person who, by reason of the death of the decedent, acquires the right to receive the IRD. The retirement plan proceeds are IRD and thus, the ruling concludes, are IRD to the charitable remainder trust. Because the charitable remainder trust is tax-exempt, the IRD will not be taxable to the trust. However, the ruling concludes that the ordinary income character of the IRD will be retained under section 691(a)(3) which generally provides that the right to receive an item of income in respect of a decedent shall be treated in the hands of the person who acquired such rights by reason of the death of the decedent as if it had been acquired by such person in the transaction from which the right to receive the income was originally derived. Thus, the IRD would be "first tier" income to be distributed to the unitrust beneficiary.

The ruling also concluded the effect of the 691(c) deduction and concluded that the trust would be entitled to the deduction rather than the beneficiary. The deduction would reduce, therefore, the amount of first tier income. When the amount of the section 691(c) deduction is calculated, the hypothetical estate tax calculation (the calculation that

excludes the IRD items) will also exclude the charitable deduction resulting from the contribution of the qualified retirement plan amounts to the trust to avoid a "double deduction."

10. **Insurance Policy in Charitable Remainder Trust.** PLR 199915045 approved the transfer of a life insurance policy to a charitable remainder unitrust. A husband would create the trust for the benefit of his stepdaughter, purchase an insurance policy on his wife's life, and transfer the policy to the trust. The trust would be a net income with makeup unitrust described in section 664(d)(3).

The first issue for the Service was whether the trust would be a grantor trust because of the trustee's powers to pay premiums on the life of the wife of the grantor under section 677(a)(3). A trust that is a grantor trust may not be a charitable remainder trust. Section 677(a)(3) provides that a grantor is treated as the owner of any portion of the trust whose income, without the approval or consent of any adverse party, is, or in the discretion of the grantor, a non-adverse party, or both, may be, applied to the payment of premiums on insurance policies on the life of the grantor and the grantor's spouse, except with respect to policies irrevocably payable for a purpose specified in section 170(c). The trust provided that the insurance proceeds would be allocated to trust principal and not income. Thus, because the trust was a net income unitrust, the Service concluded that the insurance proceeds would never be payable to a non-charitable beneficiary and thus that the insurance policies would be irrevocably payable for a charitable purpose.

The ruling also concluded that the husband would be entitled to an income tax charitable contribution deduction for the present fair market value of the remainder interest in the insurance policy, and for a similar gift tax charitable deduction, and that the trust would not be included in the grantor's estate. Neither the grantor nor the grantor's spouse was trustee of the trust.

11. **S Corporation Stock in a Charitable Lead Trust.** PLR 199908002 discusses a plan in which S corporation stock is transferred to two charitable lead trusts. One of the trusts would be exempt from the generation skipping tax and the other would not be. The trust would be a grantor trust, the taxpayer proposes, because the grantor's brother would have a power under section 675(4)(C) to reacquire trust property by substituting property of equivalent value, exercisable in a non-fiduciary capacity. After the grantor's death, the trust would be eligible to elect as an electing small business trust under section 1361(e)(1). The ruling notes whether the exercise of the section 675(4)(C) power is in a non-fiduciary capacity is a facts and circumstances test which is not eligible for the court ruling. The

Service's ruling position on who may have section 675(4)(C) power continues to be broader than, arguably, the statute -- which uses the term reacquire -- or the regulations which refers only to the grantor.

The beneficiary of the charitable lead trust payments was a private foundation and the grantor was to be excluded from having any control over the lead trust payments so that the lead trust would not be included in the grantor's estate under section 2036.

12. **Failed Charitable Trust.** In Lynn E. Zabel v. United States, 995 F.Supp. 1036 (D. Neb. 1998) the court disallowed any charitable deduction for one trust that paid 50% of the income to charity and 50% to individuals.

The opinion states:

The plaintiff, through his able trial counsel, argues that it makes little sense to reject the charitable deduction for 50 percent of the trust. He argues that, as a practical matter, no harm can befall the charities, though the trust does not employ one of the three devices specified in section 2055(e)(2)(A). He stresses that, although there is only one trust, the trustee maintains separate accounts. The charities will not be harmed, he states, because the income and principal interests in 50 percent of the trust have effectively (but not legally /7/) merged and belong to the charities.

I reject this argument because even if it were true, it is irrelevant. As Judge Wisdom has said in a similar case, "We consider the pertinent statutory language unambiguous. There is no justification for a judicial divination of an unstated congressional intent to make an exception for the bequest in this case." Estate of Johnson v. United States, 941 F.2d 1318, 1319-21 (5th Cir. 1991) (holding that a trust to support the testator's sisters, to maintain graves of family members, and to pay for religious education in certain Catholic parishes did not qualify for a deduction under section 2055(e)(2) because the trust was not a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund).

[Footnote omitted.]

13. **Specificity of Charitable Beneficiaries.** At issue in Estate of Kenneth E. Starkey v. United States, 83 AFTR2d ¶ 99-843 (U.S. S.D. IN 1999) was whether the following disposition of residue created a charitable trust:

All of the rest, residue and remainder of my property, I give and bequeath to Norma Jeanne Starkey, Cynthia Starkey Robinson, Christopher Kenneth Starkey, Theresa Carole Starkey, and Carrie Jeanne Starkey, whom I nominate and appoint as Trustees, to be held by said Trustees, in trust for the uses and purposes herein set forth.

Half of the income from the trust is to go to Lawndale Community Church in Chicago, Illinois provided that Wayne Gordon is still the pastor of it at the time of my death and that church will receive this until the time that he is no longer pastor. The Trustees are to manage the property of the Trust for the benefit of this beneficiary, missionaries preaching the Gospel of Christ, and Milligan College.

Subject to the provisions . . . relative to the termination of this trust and the provisions for distribution, the Trustees may distribute to a beneficiary or apply for such beneficiary's sole benefit, so much of the net income and corpus of the trust at any time and from time to time as the Trustees deem advisable. Any income which is not distributed may be accumulated as income or added to the trust.

The court held that it did not. The Will had been drafted by the decedent's son who was not an estate planning attorney. After death, the estate filed for section 501(c)(3) status for the trust and the application was rejected by the IRS. The estate attempted to "reform" the trust in Indiana Probate Court. The United States was not a party to the action. The court declined to give effect to the reformation because, the court determined, that the court did not receive "the type of full and fair presentation of the issues that is the hallmark of adversarial proceedings."

The court also determined that the post mortem reformation would not relate back to the date of death citing the case of Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir.), Cert. Denied, 393 U.S. 953 (1968) in which the 7th Circuit stated that "not even judicial reformation can operate to change the federal tax consequences of a completed transaction."

14. **No Income Tax Deduction Available to an Estate for a Charitable Bequest.** In Crestar Bank, et al. v. IRS, et al., 83 AFTR2d ¶ 99-839 (U. Va. 1999) the District Court determined that an estate was not entitled to an income tax deduction for a charitable bequest. The decedent died in 1989 bequeathing half of certain closely-held stock to a charitable trust. The estate claimed an estate tax deduction under section 2055 for the bequest. Some years later, the estate claimed an income tax deduction for the value of the bequest, approximately \$1 million, under section 642(c). The court found that the stock was not part of the estate's gross income and thus no income tax deduction would be allowed.

15. **Disclaimer to a Charitable Fund.** This topic has been discussed in previous years. Another example was presented in PLR 199903019 in which the IRS confirmed that a child could disclaim and have the assets pass to a charitable trust so long as the child did not retain any control over distributions from the disclaimed portion. In the ruling, the disclaimed property was to be retained in a separate fund and managed and distributed by a separate subcommittee of the charitable trust.

16. **Private Inurement.** In an important case to the tax-exempt community, the 7th Circuit has held that there was no private inurement in the relationship of a fund raiser to the charity where about 90% of the contributions

received by the charity during the period the fund raiser was employed were paid to the fund raiser for fund raising costs. United Cancer Council, Inc. v. Commissioner, 83 AFTR2d ¶ 99-416 (7th Cir. 1999). In a very direct opinion, Judge Posner stated that the private inurement prohibition was designed "to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm's length contracts made by charitable organizations with the firms that supply them with essential inputs." The Tax Court had not considered the private benefit claim made by the IRS so the court did not either, although the opinion suggests that the court might view such a claim favorably.

17. **Tax on Investment Income; Retirement Plan Benefits.** Section 4940 imposes a tax on the net investment income of a private foundation. Suppose retirement plan distributions are paid to a private foundation. Are those distributions net investment income? PLR 9838028 says no. The ruling construed section 4940(c) narrowly:

Section 4940(c)(2) of the Code defines a private foundation's "net investment income," in pertinent part, to be its "income from interest, dividends, rents, and royalties."

Section 4940(c)(2) of the Code states, in pertinent part that "there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties."

The statutory language of section 4940 of the Code indicates that this tax is a limited excise tax that applies only to the specific types of income listed in that section. Amounts from retirement accounts are deferred compensation income. Neither section 4940(c) of the Code nor section 1.512(b)-1(a) of the regulations on unrelated business income tax lists deferred compensation as an item that is included in the gross investment income of a foundation.

18. **Charitable Remainder Trust Final Regulations.** Final regulations dealing with certain aspects of a charitable remainder trust have been issued. T.D. 8791.

(1) **Flip Unitrusts.** A charitable remainder unitrust may change from a net income unitrust (with or without makeup) and a fixed percentage unitrust, upon a date or event outside the control of the trustee or any other person. Examples given include marriage, divorce, death or birth of a child, or the sale of an unmarketable asset. The conversion is effective for the tax year following the tax year in which the conversion event occurs. Upon conversion any makeup amount, under section 664(d)(3)(b), will be forfeited.

An unmarketable asset is an asset other than cash or cash equivalents, or other assets that can readily be sold for cash or cash equivalents. Examples include real property, closely-held stock, an unregistered stock exemption which would allow a public sale.

The existing charitable remainder trust may be reformed if proceedings are begun by June 8, 1999, or, as extended, completed by June 30, 2000.

(2) Time of Payment of Unitrust or Annuity Amount. Applicable for tax years ending after April 18, 1997, an annuity or unitrust amount may be paid in a reasonable time after the close of the year for which it is due so long as the character of the amount in the recipient's hands is income under section 664(b)(1), (2), or (3) or the trust distributes other property that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects to treat any income generated by the distribution as occurring on the last day of the tax year for which the amount is due. Such an election is made on a Form 5227, trust Information Return.

For a trust created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time up to the close of the tax year for which is due if the original percentage used to calculate the annuity, or the annual unitrust percentage, is 15% or less.

A "reasonable time" will normally be up until the time required to file the trust information return, Form 5227.

(3) Appraising Unmarketable Assets. If a charitable remainder unitrust has unmarketable assets and the only trustee is the grantor, a non-charitable beneficiary, or a related insubordinate party to the grantor, grantor's spouse, or non-charitable beneficiary (as defined in section 672(c)), the trustee must value those assets using a current qualified appraisal from a qualified appraiser, as both are defined in Treas. Reg. §1.170A-13. A co-trustee who is an independent trustee may value the trust in marketable assets.

The rules for valuing unmarketable assets are effective for trusts created on or after December 10, 1998.

(4) Application of Section 2702 to NIMCRUTs. The abuse that the regulations are attempting to prevent may be illustrated as follows. Suppose a parent creates a NIMCRUT for herself for five years with subsequent payments to child for life. The trust is to pay the lesser of net income or 5% each year. If the trust is invested during the parents' term to produce 1% it will generate a 4% arrearage annually. After the child becomes the

beneficiary the trust could be reinvested to produce a greater than 5% return, with the arrearage being paid to the child. The valuation of the parent's retained interest would have been overstated, and the gift to the child understated.

The regulations provide that unitrust interest in a NIMCRUT that are retained by the donor or any applicable family member will be valued at zero when a non-charitable beneficiary of the trust is someone other than the donor, the donor's spouse who is a U.S. citizen, or both.

(5) Allocation of Pre-contribution Gain to Trust Income and Makeup Amount as liability. The regulations prohibit allocation of pre-contribution gain to trust income for a NIMCRUT. However, the governing instrument may, if allowable under applicable state law, allow the trustee to allocate post-contribution capital gains to trust income. The makeup amount in a NIMCRUT does not need to be taken into consideration as a liability when valuing the assets of the NIMCRUT. PLR 199907013 continues the Service's ruling position that a trust provision may allow the trustee to allocate capital gain to income so long as the trust provision is not directly adverse to applicable state law and that it pertains only to post-contribution appreciation.

C. SECTION 408 -- IRAs AND RETIREMENT PLANS

1. Section 2057(b)(7) Trust Not a Designated Beneficiary. In PLR 9820021 the Service held that a QTIP trust with charitable remainderman was not a designated beneficiary within the meaning of section 401. The ruling states:

Trust M elected to receive installment payments in accordance with the terms of Plan X. Under these terms, Plan X must distribute an amount not less than all of the income of the plan prior to the end of the year in which Individual A would have attained age 70 1/2, and on or after that date, the greater of the income or the required minimum distribution amount under section 401(a)(9). The election provides that Trust M may receive a larger amount upon request.

Trust M does not provide that Individual B must receive all amounts that are distributed from Plan X to Trust M. Although Individual B is entitled to income, and principal subject to a standard, Trust M does not require Individual B to receive any minimum distribution amount under section 401(a)(9) that has been distributed to Trust M, if greater than annual income. Further, any larger amounts requested by Trust M from Plan X that are allowed by Trust M's election are not required to be distributed to Individual B. Thus, Plan X may distribute to Trust M an amount greater than Individual B is entitled to receive under Trust M during Individual B's lifetime.

Because additional amounts that are distributed from Plan X could remain in Trust M during Individual B's lifetime, three organizations (not individuals), University Q, School R and Reservation S, are entitled to benefits while Individual B is alive

unless the trustee of Trust M considers the amounts necessary for Individual B's health and medical needs, even though access to these amounts may be delayed until after Individual B's death. Absent the occurrence of this contingency, the death of Individual B affects the timing rather than the availability of their benefits. Thus, the entitlement of University Q, School R and Reservation S is not contingent on the death of Individual B. As a result, these beneficiaries are designated beneficiaries for purposes of applying the rules in section 1.401(a)(9)-1, Q & A E-5 and Individual B is not treated as the sole beneficiary. Pursuant to section 1.401(a)(9)-1 Q & A D-2A(b) of the proposed regulations Individual A is treated as having no designated beneficiary for purposes of section 401(a)(9) of the Code, since persons other than individuals are designated as beneficiaries of Individual A's account.

D. SECTIONS 671-678 -- GRANTOR TRUST RULES

1. **Grantor Trusts; Trust Created by Guardian for Incompetent.** PLR 9831005 determined that the creation of a revocable trust by co-guardians on behalf of an incompetent would be a grantor trust. The creation was pursuant to court order. The trust was revocable by the co-guardians and the ruling also determined that the transfers to the trust would not be a completed gift.

The Service also ruled that the incompetent's brother did not have a general power of appointment:

In this case, there will always be at least two trustees, the family trustee and the independent trustee who is not a beneficiary. During the period of Taxpayer's incapacity, the independent trustee will have sole discretion to expend income and principal for Taxpayer's benefit, to revest funds in the guardianship estate for the purpose of making gifts to members of Taxpayer's family, and make annual donations to Charities. Although the family trustee will have the exclusive right, power, and authority to remove any other trustee then serving at any time "for cause," an independent trustee may not be removed for the reason that the independent trustee disagrees with the family trustee on the making of a distribution to a beneficiary. In addition, an individual or corporate successor trustee must not be related to or subordinate to the family trustee within the meaning of section 672(c).

Accordingly, based on the information submitted and the representations made, we conclude: (1) Brother 1, in this role as family trustee of the trust and/or co-guardian of Taxpayer's estate, will not be treated as having a general power of appointment over the trust assets; and (2) the family trustee will not be treated as having a general power of appointment over the trust assets by virtue of the special removal powers.

Several issues were not ruled upon:

In particular, we express or imply no opinion concerning the estate, gift, or generation-skipping transfer tax consequences of: (1) the independent trustee's authority, to the extent authorized by the court of competent jurisdiction, to withdraw funds and/or assets from the trust, and to revest those funds and/or assets in the guardianship estate to enable the co-guardians to make gifts, or (2) the co-

guardians authority to make gifts from funds and/or assets revested in the guardianship estate by the independent trustee.

E. SECTION 1361 - S CORPORATIONS

F. SECTIONS 2031 and 2512 -- VALUATION

1. **Lottery Payments in Gross Estate.** TAM 199909001 discusses the valuation of lottery payments under section 7520. The lottery tickets had been purchased by a decedent and her sister in law as partners in a limited partnership. In valuing the decedent's partnership interest the estate discounted the lottery payments using a discount rate based on AAA bonds taking into consideration applicable income taxes. The estate also took a discount for a minority interest and lack of marketability.

The TAM concludes that the estate improperly used the bond yield rather than the section 7520 rate. The Service also concluded that another discount for lack of marketability or for income taxes was available in valuing the payments, although the ruling does not address whether a discount for lack of marketability or minority interest should be taken at the partnership level.

In Estate of Thomas J. Shackelford v. United States, 82 AFTR2d 98-5538 (E.D. Cal. 1998), the court held that lottery payments were included in a decedent's gross estate under section 2039. The court also held that the value could not be determined as if the payments were a commercial annuity. Must the IRS tables be used:

Plaintiffs contend that the question of whether the tables "produce such an unrealistic and unreasonable result that they should not be used," is a factual question. The government contends that it is a legal question whether the result is so unreasonable that departure from the tables is warranted. Although determination of a realistic value of the interest is a factual question, the court agrees with the government that whether the value calculated by the tables is sufficiently unrealistic that departure is warranted is a legal question.

Neither the case law nor the interim regulations establish clear guidelines for determining when the value calculated by the tables is sufficiently unrealistic that departure is warranted. In O'Reilly, the Eighth Circuit concluded that departure from the tables was warranted where the history of payments from the annuity was one fiftieth of the amount that the tables assumed the interest to be worth. In contrast, the taxpayer did not satisfy his burden of demonstrating that the tables were sufficiently unrealistic in Estate of Christ v. Commissioner of Internal Revenue, 480 F.2d 171 (9th Cir. 1973), where the tables used a rate of 3.5% and the actual gross yield during the relevant period was 5.48%.

Applying these principles in the case at bar, the court concludes that if plaintiffs succeed in demonstrating that as a factual matter \$2.4 million is the realistic value of plaintiffs' interest in the lottery payments, this difference is sufficient to establish

that departure from the tables valuing plaintiffs' interest at more than \$4 million is warranted. Accordingly, because disputed factual issues preclude the court from determining that it is appropriate to value plaintiffs' interest by reference to the annuity tables, defendant's motion for summary judgment will be denied. [Footnotes Omitted]

2. Shares Subject to Buy-Sell Agreement. The Second Circuit has reversed the Tax Court in Estate of Frederick Carl Gloeckner v. Commissioner, 82 AFTR2d Par. 98-5172 No. 97-4007. The decedent owned most of a company and arranged for the company to redeem his shares at his death. The result was that an employee, Joseph Simone, would own the only outstanding shares.

The redemption price was set at \$440 per share at the time the agreement was entered into based on an independent appraisal. The issue was framed by the court as follows:

The IRS has refined the use of these restrictive agreements through its regulations. Not all restrictive agreements are controlling with respect to estate tax valuation. "The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case." Treas. Reg. section 20.2031-2(h). While the regulation calls for a case-by-case evaluation of the totality of the circumstances, essentially four requirements have evolved for a redemption price to be considered binding for estate tax purposes.

First, the price of the stock must be fixed or determinable by a formula within the agreement. See Estate of Lauder v. Commissioner, 64 T.C.M. (CCH) 1643, 1656 (1992). Second, the estate must be obligated to sell the stock at this fixed price upon the shareholder's death. See United States v. Land, 303 F.2d 170, 175 (5th Cir. 1962) (holding that because purchase restrictions expired upon the shareholder's death, forcing remaining partners to purchase those shares at full value, then full fair market value at the time of death was controlling for estate tax purposes). Third, in the event the decedent shareholder chose to sell his shares during his lifetime, he must have been obligated to sell them at the price fixed by the agreement, and not at any price he otherwise might have chosen. See Treas. Reg. section 20.2031-2(h); Estate of Carpenter v. Commissioner, 64 T.C.M. (CCH) 1274, 1278 (1992); Estate of Weil v. Commissioner, 22 T.C. 1267, 1273-74 (1954). Fourth, the agreement must "represent[] a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." Treas. Reg. section 20.2031-2(h).

The Commissioner does not dispute that the restrictive agreement affecting Gloeckner's shares meets the first three requirements. That is, it concedes the stock price at issue was fixed within the redemption agreement and binding upon both the estate at decedent's death and Gloeckner during his lifetime. Thus, the crux of the Commissioner's argument is that Gloeckner drafted the agreement as a testamentary device to transfer the stock to the natural objects of his bounty without full consideration, and therefore Treas. Reg. section 20.2031-2(h) mandates that

the price fixed within the agreement be disregarded in computing what estate taxes are owed.

On the record, the court concluded that Simone was not a natural object of the decedent's bounty and thus that the redemption agreement was not a testamentary devise:

None of the evidence in the case at hand supports such an inference that Simone -- to whom decedent's shares were passed -- enjoyed an especially close relationship with decedent. The tax court characterized the relationship between Simone and Gloeckner simply as a "close personal" one. Although Gloeckner made two loans to Simone in different years totaling \$175,000 and named his "friend" Simone a minor beneficiary in his will, we have no other information about decedent's feelings toward this associate beyond this small glimpse. What IS in the record is Simone's uncontradicted testimony that the two of them maintained a "business relationship." The tax court does not suggest that Simone held a place in decedent's life similar to that held by his kin. Nor did the Commissioner introduce evidence to support such a theory, even though it advised the trial court it would do so. As a consequence, Gloeckner's relationship with Simone strikes us as "a little more than kind," but certainly "less than kin."

3. **Valuation of Voting Stock of Closely-Held Corporation.** The case of the Estate of Richard R. Simplot v. Commissioner, 112 T.C. No. 13 (1999), is very important. In 1993 Richard Simplot died owning 18 of the 76.445 shares of the Class A voting stock, and 3,942.48 of the 141,288.584 shares of the Class B non-voting stocks of J.R. Simplot Co., a closely-held corporation best known for being the primary supplier of potatoes to McDonalds but also operating in a variety of other businesses. At issue was the value of the decedent's stock.

After determining the underlying value of the company as a whole, the court calculated the per share value of the Class A and Class B shares. The court then applied to the Class A shares a 3% premium of the value of the whole company. Finally the court applied a 35% discount for the Class A shares, and a 40% discount for the Class B shares, based on the lack of marketability. That result was a value for a Class A share of \$215,539.01 and the value of a Class B share of \$3,417.05.

The rationale for the 3% premium for the voting stock was not entirely clear. An important consideration was the ratio of the number of Class A shares to the number of Class B shares, which was approximately 1 to 1,848. The opinion states:

We recognize that on the valuation date the hypothetical buyer of decedent's 18 shares of class A voting stock would not have the ability to control the Company's management and would be subject to the philosophy of the other three class A shareholders, all of whom were related and had family interests to protect. And obviously, an investor would pay more for a block of stock that represents control

than for a block of stock that is only a minority interest in the Company. On the other hand, here, no one individual had a controlling block of voting stock.

We also recognize that Don, Gay, and Scott [the other voting Shareholders] would want to maximize their children's interest in the Company and that if a sale or liquidation of J.R. Simplot Co. occurred or if the Company merged with or into another, the benefits derived therefrom would probably be distributed not by class of stock, but rather on an equal per-share basis, regardless of class. In other words, after having paid for voting privileges, if on or after June 24, 1993, the Company were merged, sold, or liquidated, the hypothetical buyer would suffer a loss if the proceeds of the sale, merger, or liquidation were to be distributed among all shareholders of J.R. Simplot Co. on a pro rata share basis, rather than on a class basis.

On the other hand, we agree with Mr. Matthews [one of the IRS experts] that although on the valuation date decedent's class A voting shares constituted a minority interest in J.R. Simplot Co., it was foreseeable that one day (but NOT ON the valuation date) the voting characteristics associated with them could have "swing vote" potential if the hypothetical buyer combined his 18 class A voting shares with Scott's 22.445 shares or joined with Don and Gay (combined having 36 class A voting shares) to form a control group.

Considering and weighing all of these factors, we adopt Mr. Matthews' lower range figure of 3 percent of J.R. Simplot Co.'s equity value as the fair premium for the voting privileges (NOT voting control) associated with the class A stock of J.R. Simplot Co. We have adopted Mr. Matthews' 3-percent premium for voting privileges because we give the greatest weight to the fact that Don, Gay, and Scott would be inclined to vote in a manner that would maximize their children's interests. Thus, we believe the collective premium for the voting privileges of the 76.445 shares of class A stock of J.R. Simplot Co. as of the valuation date is \$24.9 million (3 percent x \$830 million), or \$325,724.38 per share.

The court appeared uncomfortable with its decision:

A few final words before leaving the valuation issues. We recognize the disparate ratio of our determined value before consideration of a liquidity discount of the class A voting stock (\$331,595.70 per share) to that of the class B nonvoting stock (\$5,695.09 per share), that is a ratio of approximately 58 to 1. This disparity is the consequence of the unique capital structure of J.R. Simplot Co. and the skewed ratio of the number of class A voting shares to the class B nonvoting shares, that is, approximately 1 to 1,848.

The decision is unprecedented and can be criticized. In the real world would a buyer pay more unless acquiring control? The benefit of being a director, for instance, seems ephemeral as an economic matter.

If the Simplot rationale were followed with respect to transfers of general partnership interests, significant taxable gifts could result. To illustrate, suppose a family limited partnership were formed with 100 general partnership units and 9,900 limited partnership units and owned \$10 million in marketable securities. If a 3% premium were

attributed to the general partnership units then the value of the 100 general partnership units would increase from \$100,000 to \$400,000.

4. **General Partnership Interest.** The value of a 25% assignee interest in a Texas general partnership that automatically dissolved upon the decedent's death was entitled to a 5.4% discount for selling expenses in Patricia M. Adams, et al. v. United States, 83 AFTR2d ¶ 99-691 (U.S. N.D. Tx. 1999). The decedent created a general partnership with her siblings which had a net asset value of approximately \$33 million at her death which consisted of ranch land, marketable securities, and mineral interests. At the decedent's death, the partnership dissolved according to Texas law because the partnership agreement did not provide for it to continue and, also by operation of Texas law, the decedent's heirs became assignees of her interest. Texas law allows the remaining partners to either wind up the partnership or continue it as a new partnership.

The court concluded that a hypothetical buyer would choose to receive 25% of the partnership's net assets rather than continuing as an assignee because of the limited rights an assignee has. The estate argued that a hypothetical buyer would not pay full value for the interest. The court disagreed noting that the existing partners had a strict fiduciary duty to the assignee while liquidating and valuing the assets to determine the assignee's share. Thus the court did not apply a lack of marketability or minority interest discount.

The court also rejected a "portfolio discount" even though the partnership had a mix of assets because, again, the purchaser would receive actual assets not a partnership interest. The estate also argued that a hypothetical buyer would pay less for an interest that has uncertain rights and obligations or carry the high potential for litigation but the court did not find any such potential because it found that estate law was very clear.

The court did conclude that a discount for the cost of selling the assets was appropriate and found the discount to be 5.4%.

5. **Aggregation of Stock.** The holding in Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996) was followed in a case appealable to the Ninth Circuit by the Tax Court in Estate of Harriett R. Mellinger v. Commissioner, 112 T.C. No. 4 (1999). The decedent and her husband originally owned, as community property, 4.9 million shares of Frederick's of Hollywood, Inc. Frederick died first and left his community property interest of 2.46

million shares in a QTIP trust for the benefit of Harriett. The remaining 2.46 million shares were owned by Harriett in her own revocable trust.

Together the two blocks of stock represented 55.7% of the stock. The estate valued these shares as separate 27.8% interests using a discount of about 30%.

The court valued the interests separately but applied a 25% discount. The court rejected the IRS argument that the decedent should be treated as the owner of the QTIP property for valuation purposes under section 2044. The court noted that neither decedent had any power of disposition over the assets of the QTIP trust.

Estate of Ethel S. Nowell v. Commissioner, T.C. Memo. 1999-15, came to the same conclusion as Mellinger with respect to a partnership interest. Chief Judge Mary Ann Cohen wrote the opinion in both Nowell and Mellinger.

Also at issue in Nowell was whether the interest in the partnerships passing at the death of the decedent should be valued as an assignee interest or as partnership interest. The Tax Court determined that the interest should be valued as an assignee interest because the estate tax is levied on the property interests that were transferred at decedent's death as determined by applicable state law.

The partnership was created under the Arizona limited partnership act which provided that a limited partner could not transfer the partner's interest without the consent of the general partner unless the partnership agreement provided otherwise. Here, the partnership agreement did not provide otherwise. The court noted that whether general partners will consent is a subjective factor that would not be taken into consideration under the objective standard of the hypothetical buyer, hypothetical seller analysis, citing Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), Estate of Andrews v. Commissioner, 79 T.C. 938 (1982), and Kolom v. Commissioner, 71 T.C. 235 (1978), affd. 644 F.2d 1282 (9th Cir. 1981).

The opinion did not state whether the previous practice of the partnership had been to admit assignees as limited partners.

6. **Valuation of Construction Company Using Discounted Cash Flow Method.** The Tax Court adopted the discounted cash-flow method to determine the value of a construction business in May T. Rakow v. Commissioner, T.C. Memo, 1999-177, finding that a 31% minority discount was appropriate. The taxpayer argued that future cash flows were too uncertain in the construction business to be a basis for valuation because of the risk inherent

in the business -- such as poor estimates, delays, litigation over accidents, defects, non-performance, and cyclical demands -- but the court rejected that argument because this particular construction company did not suffer disproportionately from any of those risks. On the other hand, the court rejected the use of an asset base valuation approach because the construction company was not a holding or an investment company.

The gift involved 1,780 shares of common stock out of a total of \$6,340. The taxpayer's original value was \$354.89 per share, and the IRS assessed value was \$606.65 per share. The court determined the value to be \$413.59 per share.

7. **Importance of Reliable Experts.** The case of Estate of Alice Friedlander Kaufman v. Commissioner, T.C. Memo. 1999-119, illustrates the importance of having a competent and credible appraiser. At issue was the value of almost 20% of the stock in a closely-held company, Seminole Manufacturing Co., a maker of uniforms. The taxpayer contended that the value of the shares was \$29.77 based on sales two months after the valuation date of two blocks, one of 4.7% and another of 3.25%, sold to other family members. The court found that those sales were not truly at arm's length because the sellers were not reasonably informed about the facts relating to the stocks' value before they sold.

The estate had engaged an expert as had the IRS. However, the IRS' expert's report used the wrong valuation date and made other mistakes and thus was held irrelevant other than as a rebuttal to the taxpayer's expert.

The court found that the taxpayer's expert was unpersuasive, and the taxpayer's expert testimony was unsupported by the record, so that the court gave no weight to the taxpayer's expert and accepted the IRS determination of the stock which was \$56.50 per share. The case contains a lengthy discussion of the inadequacy of the taxpayer's expert, ranging from confusion about the expert's assumptions, to mistakes in the interpretation of valuation methods. The case should be reviewed by any expert preparing valuation opinions.

On the other hand, in William J. Desmond v. Commissioner, T.C. Memo. 1999-76, the court largely accepted the estate's expert in valuing Deft, Inc. The court looked at two methods to determine value, what is described as the income method, the discounted cash-flow method, and the market method, comparing the stock to public companies. The chart shows the calculations of the court, following the taxpayer's expert:

	<u>Income</u>	<u>Market</u>
Unadjusted Value	\$8,109,000	\$10,410,000

Less Marketability Discount:					
Nonenvironmental	20%	(1,621,800)	20%	(2,082,000)	
Environmental	10%	(810,900)	0%		
Add Control Premium	25%	<u>2,027,250</u>	0%		
Fair Market Value of 100 percent Interest		7,703,550			8,328,000
x Decedent's Interest	81.93%	<u>6,311,519</u>	81.93%		<u>6,823,130</u>
x Weight Given	50%	<u>3,155,759</u>	50%		<u>3,411,565</u>
Fair Market Value of Decedent's Interest		3,155,759 + 3,411,565 =			<u>6,567,324</u>

As the chart shows, there was a significant environmental liability potential in the company because it was a manufacturer of paints, and that went into the lack of marketability discount when value was determined using the cash-flow method. In addition, because the decedent owned a majority of the stock the decedent could liquidate the company, which was an S corporation, at any time. Thus the court found that a control premium should be added in the discounted cash flow method. A control premium had already been added in the market method when reaching the \$10,410,000 value.

With respect to calculating the amount of the lack of marketability discount, the court stated:

The following factors favor a high lack of marketability discount: (1) There was no public market for Deft's stock; (2) Deft's profit margins were below the industry average; (3) all stock in Deft was subject to a restrictive share agreement which provided that a shareholder could transfer his or her stock to a nonshareholder only after the shareholder offered the shares to the remaining shareholders; (4) given the size and low profitability of Deft, a public offering of the stock was unlikely in the future; (5) the size of the interest is so large that it may be hard to find potential buyers in the future who could finance such a purchase; and (6) where not already considered, Deft has large potential environmental liabilities.

Only one factor favors a low lack of marketability discount: Deft had an historical favorable distribution policy (it distributed most of the company's earnings to its shareholders through higher-than-market compensation in the past).

We conclude that a 30-percent lack of marketability discount is appropriate for the Deft stock. Of this 30-percent discount, 10 percent is attributable to Deft's potential environmental liabilities. We shall apply the 30-percent lack of marketability discount to the unadjusted value we determined under the income method. We however shall apply only a 20-percent lack of marketability discount to the unadjusted value we determined under the market method because as discussed

supra, the environmental liabilities have already been included in the unadjusted value under that method.

8. **Discount for Built-in Capital Gains.** Last year we saw the Davis case, which, for the first time, allowed a reduction in fair market value for built-in capital gains based on the theory that a hypothetical willing buyer would take into consideration and realize capital gains when valuing assets after the repeal of the General Utilities doctrine. How the reduction for built-in gains needs to be calculated is only beginning to be worked out. In Davis the court considered the reduction as part of a lack of marketability discount.

The Second Circuit held that built-in capital gains must be considered when valuing a C corporation, even if the corporation has no plan to liquidate. Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1998). The IRS has acquiesced in the decision. 1999-4 IRB 4. The only asset of the corporation was a rental building. The opinion states:

We disagree with the Commissioner's reasoning that the critical point in this case is that there was no indication a liquidation was imminent or that "a hypothetical willing buyer would desire to purchase the stock with the view toward liquidating the corporation or selling the assets, such that the potential tax liability would be of material and significant concern." Eisenberg v. Commissioner, 74 T.C.M. (CCH) 1046, 1048-49 (1997). The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the TRA any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute the fact that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer's inability to eliminate the contingent tax liability. See John Gilbert, *After the Repeal of General Utilities: Business Valuations and Contingent Income Taxes on Appreciated Assets*, Mont. Law, Nov. 1995, at 5 (citing a 1994 study that analyzed the impact of contingent tax liability on a buyer of a private, closely-held corporation and concluded a large majority of buyers would discount the stock and negotiate a lower purchase price due to the existence of a contingent tax liability on the corporation's appreciated property).

* * *

Further, we believe, contrary to the opinion of the Tax Court, since the General Utilities doctrine has been revoked by statute, a tax liability upon liquidation or sale for built-in capital gains is not too speculative in this case. Courts previously have allowed discounts for built-in capital gains if, among other factors, payment of tax on a capital gain is likely. See, e.g., Obermer v. United States, 238 F. Supp. 29, 34-36 (D. Haw. 1964) (finding expert testimony showed built-in capital gains tax would necessarily adversely affect value of stock at issue to willing buyer, and in allowing discount, contrasted the facts with Estate of Cruikshank, 9 T.C. 162, a case relied on by appellee); see generally Clark v. United States, No. 1309, 1309, 1975 WL 610, at *4,5 (E.D.N.C. May 16, 1975) (stating a well-informed willing buyer of stock in corporation would consider that underlying assets of corporation

included inactive investment portfolio that, upon liquidation, would incur substantial capital gains tax liability).

Although the Tax Court in this case held that "the primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative," Eisenberg, 74 T.C.M. (CCH) at 1048, we disagree. We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. We therefore remand this matter to the Tax Court to ascertain the gift tax to be paid by the taxpayer consistent with this opinion.

The only guidance given by the court for the way in which the potential capital gains tax should be considered is provided by footnote 16:

Where there is a relatively sizable number of potential buyers who can avoid or defer the tax, the fair market value of the shares might well approach the pre-tax market value of the real estate. Potential buyers who could avoid or defer the tax would compete to purchase the shares, albeit in a market that would include similar real estate that was not owned by a corporation. However, where the number of potential buyers who can avoid or defer the tax is small, the fair market value of the shares might be only slightly above the value of the real estate net of taxes. In any event, all of these circumstances should be determined as a question of valuation for tax purposes.

More recently, in Estate of Helen Bolton Jameson v. Commissioner, T.C. Memo. 1999-43, the court calculated the discount as the net present value of the capital gains tax liability as the court estimated it would be incurred. The company at issue was a timber company. The estate valued the stock on the basis of income not assets but the court disagreed and accepted the IRS's expert opinion as valuing the assets as a holding company was more appropriate.

As a holding company, the court found that the company would recognize its built-in gain as it cuts timber over time based on four variables: (1) the rate at which the timber grows, (2) the effects of inflation, (3) capital gains tax rates, and (4) the discount rate. The court selected variables within the range of figures offered by the various experts and assumed annual timber growth of 10%, 4% inflation, 34% in capital gains tax rate, and 20% discount rate. The court assumed 9 years of timber sales on a sustainable yield basis.

The estate owned virtually all of the company stock and the court rejected a 10% lack of marketability discount in favor of a 3% lack of marketability discount primarily because no expert testimony was offered by the taxpayer on that subject. The court found that approximately 3% of the company's total assets were completely unmarketable.

The court also rejected the estate's argument that having a small -- 2 or 3 percent minority shareholder -- should give rise to a nuisance discount.

The IRS had claimed a value of \$77.00 per share, the estate \$50.94 per share, and the court \$71.00 per share.

9. **Blockage Discount.** In general, blockage discounts have been decreasing over many years because of the increased volume. The appropriate blockage discount to apply to 2.2% of the common stock of Applied Power, Inc. was before the Tax Court in Estate of Dorothy B. Foote v. Commissioner, T.C. Memo. 1999-37. The taxpayer's expert argued for a 22.5% discount and the IRS' expert for a 2.3% discount.

The court accepted the IRS' expert's opinion. The IRS' expert determined that there were 8 days in 1993, after the date of death, where more than 50,000 shares of Applied Power stock were traded and that the largest decrease on one of those trading days was 2.5% stock all for one of the largest trading volume days there was an increase in value of 1.5%. In contrast, the taxpayer's expert had concluded the stock could best be disposed of in 7,000 shares per day increments over a period of 40 days.

Of particular interest was the court's discussion of post-death events:

We are mindful that as a general rule only facts known at the valuation date are considered in determining the property's value. However, subsequent market activities may provide helpful comparable sales. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 n.15 (1990). Here, we believe the three sales by the Trust within 3-1/2 months of decedent's death to be relevant and reasonably proximate to the valuation date. This 3-1/2-month period was, in our opinion, a reasonable period of time following the valuation date.

Petitioner failed to show that the market price of the stock on the valuation date was an inaccurate reflection of the true value of the Trust's block of stock. The relative size of the block of stock at issue in relation to the amount of Applied Power stock outstanding, plus the monthly and yearly trading volumes for the stock of Applied Power, plus the fact that the entire block of stock was sold within an acceptable period of time after the valuation date (and on 3 trading days) suggest that only a minimal blockage discount is warranted. In our opinion, the depressing effect on the market of the Trust's sale of its stock is not commensurate with the 22.5- percent blockage discount estimate of Mr. Kleeman [taxpayer's expert].

10. **Real Estate Corporation.** The tax court relied primarily on a discounted cash flow analysis, allowing for market absorption discounts, to conclude that the fair market value of the decedent's one-third interest in a closely-held corporation involved in real estate development was approximately book value. Estate of Lynn M. Rodgers v. Commissioner, T.C. Memo. 1999-129.

11. **Actuarial Factors.** Section 7520 provides that the value of an annuity, life interest, interest for a term of years, and remainder and reversionary interests, for transfers after April 30, 1989, are to be determined using a discount rate, rounded to the nearest 2/10ths of one percent, equal to 120% of the applicable federal mid-term rate in effect under section 1274(d)(1) for the month in which the transfer occurs. Section 7520(c)(3) directed the Secretary of the Treasury to issue tables not later than December 31, 1989, using the then most recent mortality experience and to revise the table with respect to mortality experience not less frequently than every 10 years. T.D. 8819, REG-103851-99 contains the new tables for the most recent mortality experience available and is effective as of May 1, 1999. The new mortality tables are referred to as Life Table 90CM. The mortality tables indicate that for the most part individuals are living longer, except in the very oldest ages where life expectancies have actually declined since the 1980 tables. Life expectancies are attached to these materials as an Appendix to Appendix B.

G. SECTION 2032 -- ALTERNATE VALUATION AND SECTION 2032A -- SPECIAL USE VALUATION

1. **Protective Election of Alternate Valuation.** A protective election under section 2032 was allowed by TAM 9846002. The estate wanted to use the alternate valuation date only if the surviving spouse agreed to an elective share, which she did after the estate tax return was filed. In Estate of Mapes v. Commissioner, 99 T.C. 511 (1992), the Tax Court allowed a protective election that was conditional on section 2032A treatment not being allowed by the IRS.

There are other situations in which a protective election could be desirable. For example, suppose certain assets that have decreased in value may be includable in the gross estate (e.g. because of what could be a power of appointment), but the value of the other assets in the estate has increased.

2. **Minority Interest.** A minority interest discount may be taken for assets that then qualify for special use valuation. The IRS has acquiesced in Estate of Clara K. Hoover v. Commissioner, 69 F.3d 1044 (10th Cir. 1995). The assets there were a minority interest in a partnership for which a 30% discount was claimed.

3. **Use of Comparables.** In Estate of Lewis S. Thompson, III v. Commissioner, T.C. Memo. 1998-325 Tax Ct. Dkt. No. 14929-96, the Tax Court held that taxpayer's expert did not meet the regulatory requirements for a valid section 2032A election:

Section 20.2032A-4(b)(2), Estate Tax Regs., describes the documentation required from the executor in order to value property under section 2032A(e)(7)(A). The regulation states that "The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property" for each of the 5 calendar years preceding the year of the decedent's death. Sec. 20.2032A-4(b)(2)(i) and (iv), Estate Tax Regs.

The determination of whether property is comparable is a factual one and is made according to "generally accepted real property valuation rules". Sec. 20.2032A-4(d), Estate Tax Regs. Factors to be considered in such a determination include, but are not limited to, whether the property is situated in the same locality as the specially valued property; whether the property is segmented or unified; whether the property is subject to flooding; and, in the case of timberlands, the comparability of the timber to the timber located on the property to be specially valued. Sec. 20.2032A-4(d), Estate Tax Regs.

Frazer [taxpayer's expert] utilized 8 timberland properties as comparables in his report. The report identified the lessor and lessee, the location of the property, the initial year of the lease, and the cash consideration paid for each of the 8 properties used as comparables. The report also listed the "Adjusted Net Lease Income/Acre" for the 8 properties and the "Average" thereof (\$15). The report indicated no adjustments to any of the 8 properties used as comparables based on the factors set forth in section 20.2032A-4(d), Estate Tax Regs.

For the following reasons, we conclude that the report is completely unreliable as to whether any of the 8 properties were indeed comparable to the subject property. The putative comparables ranged in size from 44 acres to 34,365 acres, yet no adjustment to any of them was made for size even though the substantially disparate sizes of the properties would appear to have some significance in terms of economies of scale. Frazer also did not make any adjustments for location, land quality, or timber type/maturity in his report. Moreover, no description of the properties was contained in the report, from which Frazer appears implausibly to be inferring that they were sufficiently similar so as to warrant none of the above adjustments.

We are also not convinced that the special use valuation of the subject property was based on actual cash rents of the putative comparables as is called for under the regulations. Section 20.2032A-4(b)(2)(iii), Estate Tax Regs., provides that "appraisals or other statements regarding rental value as well as area-wide averages of rentals * * * may not be used under section 2032A(e)(7) because they are not true measures of the ACTUAL CASH RENTAL VALUE OF COMPARABLE PROPERTY in the same locality as the specially valued property." (Emphasis added.)

Although in effect for the 5 years preceding decedent's death in 1992, the 8 timberland leases were entered into over the 27-year period from 1957 through 1984. For those leases which did not contain rent escalation clauses, Frazer claimed to have applied the "Producer Price Index" (PPI) to the consideration stated therein in an effort to calculate the market rental value of those properties for the 5-year period preceding decedent's death. The result was termed the "Adjusted Net Lease Income/Acre" in his report.

4. **Grant of Development Easement is a Disposition.** In Estate of James C. Gibbs, Sr. v. United States, 82 AFTR2d ¶ 98-5557 (3rd Cir. 1998) the court held that granting a development easement to the state of New Jersey was a disposition of qualified farm property that triggered recapture of estate tax under section 2032A(c)(1). The court's rationale was that the heir benefitted from the property's "highest and best use" through the grant of the easement. Stated differently, the court viewed the land as a bundle of two rights -- the land's agricultural use, plus non-agricultural development rights. In order to obtain special use valuation the estate had to warrant that only agricultural use would be made during the 10-year recapture. By granting the easement the owner benefitted from the development value of the land.

H. **SECTIONS 2035-2038 -- RETAINED INTERESTS**

1. **Requirement that Trustees Pay Grantor's Income Taxes.** PLR 199922062 dealt with an interesting issue. A grantor intended to create a foreign trust that would be a grantor trust for income tax purposes. The trust would require the trustee to pay, on behalf of the grantor, to the IRS or to a state revenue authority, income or principal to satisfy the grantor's income tax liability attributable to the trust. The issue presented in the ruling was whether such requirement constituted a retained interest under section 2036. The Service concluded that such direction would not be a retained interest; however, if the trustee were required to make distributions to reimburse to grantor for any tax liabilities not attributable to the trust the grantor would have retained section 2036 power.

The ruling did not state why the payments would not be made to the grantor directly, but presumably the ruling would have been the same had the payments been so made. The payment provision itself was a direction to the trustee to distribute an amount by which the personal income tax liability of the grantor exceeded what the grantor's personal income tax liability would be if he were not the owner of any portion of the trust.

2. **Ability of Creditors to Reach Trust Assets.** TAM 199917001 considered a decedent who created an inter vivos trust under California law for the decedent's own benefit. The trust provided that the income and principal could be paid to or for the benefit of the decedent as determined by the trustees in their absolute uncontrolled discretion but only upon the spouse's written consent. Upon the decedent's death the trust was for the benefit of the decedent's spouse.

The TAM relied on Rev. Rul. 76-103, 1976-1 C.B. 293, which held that where under applicable state law the trust is a discretionary trust and the entire trust corpus may be subject to the claims of the grantor's creditors, the trust corpus would be included in the grantor's gross estate under section 2038 because the grantor has retained the power, in effect, to terminate the trust by giving it to the grantor's creditors. The TAM also relied on Outwin v. Commissioner, 76 T.C. 153 (1981) which had the same analysis under Massachusetts law, and section 156(2) of the Restatement (2d) of Trusts.

The IRS determined that the California Probate Code had adopted the Restatement rule cited above and that various California decisions had noted that it was against public policy to allow a person to "tie up" property in such a way that the person can enjoy the preventatives creditors from reaching it.

The estate made much of the "spousal veto" relying on German v. Commissioner, 7 Cl.Ct. 641 (1985), decided under Maryland law. There the decedent's children were trustees and had discretionary authority to distribute trust assets to the decedent provided the remainderman, also the decedent's children, consented. The ruling noted that there was Maryland law to the effect that a discretionary trust where the remainder passes to persons other than the decedent's estate on termination could not be reached by creditors. The IRS found that California law was not consistent with Maryland law. Another factor in the ruling may have been that the decedent was trustee of a trust for the spouse as well and thus the spouses had reciprocal vetoes.

Presumably, the decision is limited to applicable state law. The issue, then, with respect to a trust created under Delaware or Alaska law, is whether the creditors of a grantor in some other state may reach the assets in such trust.

PLR 9837007 deals with a transfer to a trust created under Alaska or Delaware law where the donor continues as a beneficiary. The trust was described as follows:

According to the facts submitted, Donor, a resident of State, proposes to create an irrevocable trust (Trust) for the benefit of herself and her descendants. Trustee will be appointed as the only trustee. Trustee is to pay, during the Donor's lifetime, any part or all of the income and/or principal in such amounts and at such times, as the Trustee, in its sole and absolute discretion determines, among one or more of the class consisting of the Donor and the Donor's living descendants. Any income that is not distributed is to be added to the corpus of the trust. Upon the Donor's death, the corpus is to be divided into separate trusts for each then living child of Donor, and a separate trust for each child who died leaving issue. The Trustee is to distribute the income and principal, in its discretion, among the beneficiaries. If no descendant of Donor is living at the time of Donor's death, the income and principal of the Trust is to be distributed to one or more organizations described in

sections 170(c), 2055(a), and 2522(a) of the Internal Revenue Code, as the trustee may determine.

Under Articles SIXTH and NINTH of the Trust, Donor, her descendants, or any person related or subordinate to these persons (within the meaning of section 672(c) of the Code) are precluded from serving as trustee. Donor will not have the power to remove or replace the trustee or to appoint a successor trustee. It is represented that Donor is not a shareholder, director, officer, or employee of Trustee. If Trustee should cease to serve as trustee, Donor's authorized representative will name a successor trustee.

It is represented that there is no agreement, express or implied, between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries.

The donor had no known or anticipated debts, other than a home mortgage and was not obligated to pay child support. The trust contained a spendthrift clause. The applicable state statute was described:

State Statute provides that a person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before the payment or delivery of the interest to the beneficiary by the trustee. If a trust contains this transfer restriction, the restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or any other person from satisfying a claim out of the beneficiary's interest in the trust unless:

1. the transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons;
2. the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust;
3. the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or
4. at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a child support order.

The ruling states that the donor made a completed gift when funding the trust. The Service specifically declined to rule on the inclusion or exclusion of the trust assets from the donor's estate.

3. **Retention of Powers By Grantor**. Section 2042 includes in a decedent's estate all life insurance over which the decedent has an incident of ownership in any capacity, including as trustee. Thus, we are trained not to have the grantor/insured of an irrevocable life insurance trust be the trustee of that trust. That training is often applied to other gift trusts, perhaps unnecessarily.

PLR 199903025 considered with the creation of an irrevocable trust by grantor and spouse, one for each child. Grantor and spouse were co-trustees of each trust along with the child for whom the trust has been established. The trustees had discretionary authority to distribute income and principal to or for the benefit of the child and the child's descendants for an ascertainable standard.

The ruling states that powers limited by an ascertainable standard will not cause inclusion of the trust assets in the grantor's estate under sections 2036 or 2038.

A separate issue was whether gifts by the spouse of shares of a closely-held corporation would be included under section 2036(b) and the ruling concluded that the spouse could give up her ability to vote the stock and thus avoid inclusion under that provision. The ruling states:

Spouse transferred shares of Corporation to each of the trusts established for her four children and Spouse was designated as a co-trustee of each of the trusts. Corporation is a controlled corporation within the meaning of section 2036(b) because Spouse as trustee, with other members of her family, retained and continued to hold the right to vote stock that is at least 20 percent of the total combined voting power of all classes of stock. Spouse's retained right, as a fiduciary, to vote the stock constitutes the right to vote stock for purposes of section 2036(b).

Spouse proposes to relinquish her power to vote the stock in Corporation by judicially modifying each of the trusts in a manner that will prohibit her from participating, as trustee, in the right to vote each Trust's shares in Corporation. Spouse, has represented that she has not and will not enter into either an expressed or implied agreement with the other trustees that would enable her to direct or influence the manner in which the other trustees vote the stock. If Spouse retains the power to vote the shares in Corporation, the value of the shares would be includable in her gross estate under section 2036.

Based on the facts submitted and the representations made and assuming the State District Court approves the amendment of each trust in the manner described, we conclude that, if Spouse's death does not occur within three years of the effective date of the amendment to each of the four trusts, then the stock in Corporation that is held by the four trusts will not be included in Spouse's gross estate under section 2035(a) or section 2036(b).

Is it possible for the Internal Revenue Service to review a standard such as "health, education, maintenance, and support" under the facts and circumstances to determine whether it is truly ascertainable? The answer would seem to be yes. Thus, in many instances it may still be desirable to have an institution or other person serve as trustee rather than the grantor.

4. **Gifts by Attorney-in-Fact.** The IRS has been aggressive in including gifts made by an attorney-in-fact in a decedent's estate, typically on the grounds that the gifts were voidable by the decedent because they were not authorized by the instrument creating the attorney-in-fact relationship for applicable state law. In Estate of Marie S. Hubberd v. Commissioner, T.C. Memo. 1998-428, the estate stipulated that gifts of limited partnership interest to trusts for nieces and a nephew were voidable under Texas law. However, the estate argued that until the transfers were actually voided they were effective and thus the gifts should be effective. The contention was rejected by the IRS and by the Tax Court. The opinion states:

Petitioner's focus on the transferees legal title to the disputed property is misplaced. To the contrary, the question posed under section 2033 is whether the decedent, at the time of her death, possessed a beneficial interest in the property. If the transfers in question constituted voidable transfers, we are satisfied that the decedent possessed a beneficial interest in the property; i.e., the right to avoid the transfers and regain legal title to the property, within the meaning of section 2033.

The court further held that section 2038 applied.

The rejected the estate's analogy to voidable charitable transfers and distinguished Longue Vue Found. v. Commissioner, 90 T.C. 150 (1988) and Estate of Varrick v. Commissioner, 10 T.C. 318 (1948) which had allowed the charitable deduction for voidable charitable transfers holding that those cases created a very narrow rule that a voidable charitable transfer is a contingency that is not so remote as to be negligible under section 2055.

5. **Gifts Under Court Order.** Gifts made by guardians pursuant to court order under a state statute allowing guardians to make gifts were not includable in a decedent's estate under section 2038 in PLR 9839018. The decedent's estate went to his private foundation which consented to the gifts; the consent was not an act of self-dealing.

6. **Inclusion of Death-Bed Checks.** Checks drawn and given to donees shortly before a donor's death, often by an attorney-in-fact, continue to cause problems for taxpayers. In Estate of Newman v. Commissioner, 111 T.C. No. 3 (1998), the checks were drawn and delivered on September 23 and 24 and cashed on October 2. The decedent died on September 28. The IRS argued no completed gift because the decedent could have stopped payment on the checks. The opinion described applicable state law this way:

Prior to the time that a drawee bank accepts a check, a customer may order the bank to stop payment by telephone, which would be effective for a period of 24 hours. D.C. Code Ann. sec. 28:4-303(1) and (2) (1981). After that time, a written stop payment order made by the customer would be effective for 6 months. D.C. Code Ann. sec. 28:4-403(2) (1981). Although testimony was presented which portrays

decedent as "bedridden" prior to her death, there is no evidence that she had absolutely no access to a telephone. Further, because Mark [the attorney-in-fact] was also a customer on the account in question, he could have ordered CFB to stop payment at decedent's request.

Petitioner does not direct us to, nor have we found, any State that recognizes delivery of a check to be a completed gift of the underlying funds. See 38A C.J.S., Gifts, sec. 56 (1996) ("The gift of the donor's own check is but the promise of a gift and does not amount to a completed gift until payment or acceptance by the drawee."). Furthermore, mere possession of a power to revoke, not the ability to exercise it, is controlling. Estate of Alperstein v. Commissioner, 71 T.C. 351, 353-354 (1978), affd. 613 F.2d 1213 (2d Cir. 1979). Accordingly, we find that decedent possessed the power to revoke the checks until accepted or paid by CFB. Because CFB did not accept or pay the checks until after decedent's death, they were not completed gifts under the law of the District of Columbia. (footnote

omitted)

The court rejected the estate's argument that the relation-back doctrine, applicable to charitable gifts, should apply:

The Court of Appeals for the Fourth Circuit, affirming our decision in Estate of Metzger [100 T.C. 204 (1993)], recognized the important distinction between the facts of that case and those in McCarthy v. United States [806 F.2d 129 (7th Cir. 1986)], supra, and Estate of Gagliardi v. Commissioner, [89 T.C. 1207 (1987)] supra, stating:

We do not dispute the wisdom of declining to extend the relation-back doctrine in the circumstances presented in McCarthy and Gagliardi, when the donor died while the checks were still outstanding. Clearly there is a very real danger of fostering estate tax avoidance in cases in which checks are not cashed until after the donor dies. However, that is not the situation in this case. [Estate of Metzger v. Commissioner, 38 F.3d at 122.]

Unlike decedent here, the donor in Estate of Metzger v. Commissioner, supra, was alive at the time the checks were presented and paid by the drawee. The facts in the case before us are more analogous to those presented in McCarthy v. United States, supra, and Estate of Gagliardi v. Commissioner, supra. Therefore, we hold that the relation-back doctrine does not apply to checks representing noncharitable gifts which were accepted and paid by the drawee after decedent's death.

Accordingly, the checks in issue were not completed gifts during decedent's lifetime, and the value of the underlying funds is includable in decedent's gross estate. Because our holding resolves the sole issue before us, we need not address the merits of respondent's other arguments.

I. SECTION 2040 -- JOINT INTERESTS

1. **No Discount for Joint Interests.** Estate of Young v. Commissioner, 110 T.C. 297 (1998), was followed in Estate of Albert Fratini v. Commissioner, T.C. Memo. 1998-308 Tax Ct. Dkt. No. 18921-96, to the effect that no fractional interest discount was allowed for property held in joint tenancy with right of survivorship. Section 2040 was determined to be an inclusion statute not a valuation statute.

2. **Contribution of Consideration.** Estate of Max L. Van Tine v. Commissioner, T.C. Memo. 1998-344 Tax Ct. Dkt. No. 20054-96, held the following:

Decedent conveyed joint tenancies to three parcels of real property to his daughter several years before he died. The sole issue for decision is whether decedent's daughter contributed consideration equal to at least one-half of the total consideration that decedent and his spouse paid for the three parcels of real property. If so, one-half of the value of the three properties is excluded from decedent's estate under section 2040. Ann Van Tine performed valuable services for her father's construction business from 1955 to the 1970's, but the record does not show how much consideration decedent and his wife paid to buy and improve the three parcels. As a result, we have no basis to decide what part of the parcels' value that is attributable to Ann Van Tine's services. Thus, on this record, we hold for respondent.

J. SECTIONS 2041 AND 2514 -- GENERAL POWERS OF APPOINTMENT

1. **Trust for Incompetent.** PLR 9831005 - see D-1.

K. SECTION 2042 - LIFE INSURANCE

1. **Trust Reformation.** In PLR 9847025 the IRS ruled that the reformation of a life insurance trust to prevent the insureds from serving as trustee was effective for tax purposes. The reformation was with court approval and occurred prior to the death of either insured.

2. **Change in Trust Document.** In PLR 9832039 an irrevocable insurance trust was created in which husband and wife had the unrestricted right to remove the trustee and appoint another trustee, other than themselves.

One spouse died and the issue was whether this right was an incident of ownership. The ruling states:

Section 20.2042-1(c)(4) provides that a decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or section 2038 of other property transferred to the trust if, for example, the decedent has the power to surrender the policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

* * *

Rev. Rul. 79-353, 1979-2 C.B. 325, held that when a grantor retains the right to remove and replace the corporate trustee with another trustee, the grantor is treated as having the powers of the trustee. Accordingly, if the Trustee's powers are sufficiently broad, the trust property will be included in the grantor's gross estate under section 2036 and 2038. Rev. Rul. 81-51, 1981-1 C.B. 458, modified Rev. Rul. 79-353 so that it did not apply to a transfer or an addition to a trust made before October 29, 1979, if the trust was irrevocable on October 28, 1979.

Rev. Rul. 95-58, 1995-2 C.B. 191, revokes Rev. Rul. 79-353 and Rev. Rul. 81-51. Rev. Rul. 95-58 concludes that an individual is not treated as possessing the trustee's powers when the individual can remove and replace a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the individual (within the meaning of section 672(c)).

Here the decedent's estate went to court to reform the trust because the words "for cause" had been inadvertently omitted from the trustee removal section. The court agreed and reformed the trust retroactive to its creation. The IRS acquiesced in the reformation. The ruling is significant because the IRS views post-death reformation with suspicion.

3. **Revised Uniform Premium Table for Group-Term Life Insurance.** T.D. 8821, 64 F.R. 29788-29790, contains revised uniform premium tables used to calculate the cost of employer provided group-term life insurance. The new table is as follows:

TABLE I. - UNIFORM PREMIUMS FOR \$1,000 OF GROUP-TERM LIFE INSURANCE PROTECTION

5-year age bracket	Cost per \$1,000 of protection for one month
Under 25	\$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

The effective date was July 1, 1999, with several exceptions.

4. **Division of Life Insurance Policies Not a Transfer for Value.** PLR 9852041 dealt with an unusual situation. A trust had been created for the benefit of taxpayer and taxpayer's brother, the assets of which consisted primarily of the policies. The trust was terminated by order of the state court and the trust assets were distributed equally between taxpayer and taxpayer's brother so that they became joint owners of each of the policies. For administrative convenience, the brothers proposed to have the insurance companies issue two separate policies, one owned by each, to replace each of the policies currently owned jointly. Each of the new policies would insure the same life as one of the old policies and would have one-half of the death benefit, cash value, and indebtedness of the policy it replaced. An administrative fee would be paid to the insurance companies equally by each brother.

At issue was whether the acquisition of the separate policies would be a transfer for value. The IRS analogized the transaction to a division of joint property and concluded that the deemed transferable portion of the brother's joint interest in the new policies to the taxpayer would not affect a significant change in the beneficial ownership of the policies and thus would not be a transfer for value under section 101.

L. **SECTION 2053 and 2054 - DEBTS AND ADMINISTRATION EXPENSES**

1. **Deduction for Income Taxes.** In Estate of McMorris v. Commissioner, T.C. Memo 1999-82, the court determined that where a decedent took an estate tax deduction for income taxes which were owed, and subsequent developments produced an income tax refund, the estate tax deduction must also be reduced. In April 1990, Donn McMorris died and a few months later Evelyn McMorris received a partial distribution of certain closely-held stock from his estate which was redeemed in September, 1990. Evelyn McMorris died in March, 1991 and a deduction was taken on her estate tax return for a significant income tax. A significant part of the income was gain resulting from the redemption of stock because it was redeemed at considerably more than the value placed on it in Donn McMorris' estate. Subsequently, the Donn McMorris estate and the IRS reached a settlement which increased the value of the stock in his estate, which in turn increased the basis of Evelyn McMorris in the stock and eliminated the income. Whereupon, she filed a claim for an income tax refund.

The issue was whether the original estate tax deduction in the Evelyn McMorris estate should be adjusted. The court determined that it should be because:

a claim that is valid and enforceable at the date of a decedent's death must remain enforceable in order for the estate to deduct the claim. Technical claims that disappear in the light of subsequent circumstances should not be allowed. Thus, postdeath events must be taken into consideration in determining the enforceability of a claim that a creditor fails to make and preserve within the time allowed by local law.

The court distinguished Estate of Sachs v. Commissioner, 88 T.C. 769 (1987), rev'd, 856 F.2d 1158 (8th Cir. 1988), which dealt with a post-death, retroactive, change in the tax laws.

2. **Deduction for Interest.** Section 2053(c)(1)(B) provides that for decedents dying after December 31, 1997, no deduction is allowable for any interest payable under section 6601 on any unpaid portion of the federal estate tax for the period during which an extension of time for payment is in effect under section 6166. What if an estate does not elect section 6166 but merely arranges for a loan to pay the estate tax? Is that interest deductible?

Revenue Ruling 84-75, 1984-1 C.B. 193, states that if a loan is reasonably and necessarily incurred in administering the estate (e.g., to avoid a forced sale of estate assets) then the interest is deductible as an expense of administration under section 2053(a)(2). However, if the amount of interest the estate might pay is uncertain, because, for example, the estate's obligation to make payments could be accelerated either through pre-payment or through

default, the ruling concludes that the interest is deductible by the estate only after it accrues and any future estimated accrual is not deductible. This presents a significant problem with loans that last for longer than the applicable statute of limitations.

PLR 199903038 considered an estate in which the estate proposed to borrow, with appropriate court approval as required by applicable state law, from a bank. The loan would provide for an annual payment of both interest and principal over a specified term of years not to exceed seven at a fixed rate of interest. The note would also provide that neither principal nor interest could be prepaid and that in the event of default the entire interest that would have been paid under the full term of the note would be accelerated. Stated differently, the loan was designed to set forth a strictly ascertainable amount of interest that would be paid. The IRS has determined that the interest was deductible prior to payment relying on Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, which dealt with a similar situation except that the lender was the decedent's closely-held corporation.

The IRS noted that whether the expense was necessarily incurred was a factual determination. As such it was not part of the ruling.

Suppose an estate includes only limited partnership interests. The Executor requests that the general partner distribute funds to the estate for payment of tax. The partnership declines to do so but is willing to make a loan to the estate. If that loan is structured properly the interest should be deductible. Such would be desirable because of a spread between income tax rates and estate tax rates.

3. **Claim for Refund Based on Retroactive Tax Change.** Section 2032A(c)(7)(E) was added in 1988, effective for leases entered into after December 31, 1976, and provides that a decedent's surviving spouse will not be treated as failing to use the qualified real property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. TAM 9843001 considered a taxpayer who pays recapture tax in 1991 because the taxpayer was a spouse who entered into the activity which was subsequently protected by section 2032A (c)(7)(E). At issue was whether the taxpayer could claim a refund for the recapture tax. The IRS concluded that the new provision did not constitute a waiver of the period of limitations relying on United States v. Zacks, 375 U.S. 528 (1963), in which the U.S. Supreme Court held that a change in the income tax treatment of royalty payments received for the transfer of patent rights would not give rise to a claim for refund otherwise barred by the applicable

statute of limitations. The taxpayer was allowed a claim for refund with respect to interest because a claim was filed within two years of the time interest was paid on the tax.

M. SECTIONS 2056 AND 2056A - MARITAL DEDUCTION

1. **Reformation to Create QDOT.** PLR 9848007 discusses the requirements for reforming a QTIP to create a QDOT. A reformation pursuant to a power granted in the governing instrument must be completed by the date for filing the federal estate tax return (with extension). A reformation pursuant to court order must be begun by that date. See also PLR 199904023.

2. **Relief to Unelect Not Available.** In PLR 9848041 the Service denied section 9100 relief to an estate that elected QTIP for both the marital trust and the credit shelter trust and tried to "unelect" with respect to the latter. Section 2056(b)(7)(B)(v) provides that a QTIP election is irrevocable once made. Section 9100 relief is limited to making late elections.

3. **Contingent QTIP.** Final Regulations under section 2056(b)(7) allowing a contingent QTIP trust have been issued. T.D. 8779 (August 19, 1998).

Section 20.2056(b)-(7) Election with respect to life estate for surviving spouse.

* * * * *

(d) * * *

(3) Contingent income interests. (i) An income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage), is not a qualifying income interest for life. However, a qualifying income interest for life that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse. This paragraph (d)(3)(i) applies with respect to estates of decedents whose estate tax returns are due after February 18, 1997. This paragraph (d)(3)(i) also applies to estates of decedents whose estate tax returns were due on or before February 18, 1997, that meet the requirements of paragraph (d)(3)(ii) of this section.

(ii) Estates of decedents whose estate tax returns were due on or before February 18, 1997, that did not make the election under section 2056(b)(7)(B)(v) because the surviving spouse's income interest in the property was contingent upon the election or because the nonelected portion of the property was to pass to a beneficiary other than the surviving spouse are granted an extension of time to make the QTIP election if the following requirements are satisfied:

(A) The period of limitations on filing a claim for credit or refund under section 6511(a) has not expired.

(B) A claim for credit or refund is filed on Form 843 with a revised Recapitulation and Schedule M, Form 706 (or 706NA) that signifies the QTIP election. Reference to this section should be made on the Form 843.

(C) The following statement is included with the Form 843: "The undersigned certifies that the property with respect to which the QTIP election is being made will be included in the gross estate of the surviving spouse as provided in section 2044 of the Internal Revenue Code, in determining the federal estate tax liability on the spouse's death." The statement must be signed, under penalties of perjury, by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is legally incompetent), or the surviving spouse's executor (if the surviving spouse is deceased).

* * * * *

(h) * * *

Example 6. Spouse's qualifying income interest for life contingent on executor's election. D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. The portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts, the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life.

4. **Invalid Election.** The Federal Circuit has affirmed the Tax Court in Estate of Rinaldi v. United States, 82 A.F.T.R.2d 98-5526 (1998).

5. **Coordination With Tax Payment Clause.** The Eighth Circuit has reversed the District Court in Patterson, et al. v. United States, 83 A.F.T.R.2d 99-2476 (8th Cir. 1999). The estate poured into a revocable trust. The decedent's Will directed the executor to pay from the residue all death taxes but also provided that if there were a trust in existence at the decedent's death, any part of the death taxes could be paid from the trust assets in the trustee's discretion. The trust provided that 10% of the trust assets, unreduced by any death taxes, were to be set aside in a QTIP trust.

The IRS claimed that 10% of the probate assets which the estate had qualified for the marital deduction were not in fact eligible for the marital deduction because they would not have existed if the trustee had not paid the estate taxes. Stated differently, the IRS contention was that the wording of the tax payment clauses was not sufficient to protect the marital deduction with respect to the estate assets. The Ninth Circuit rejected that position, holding, in essence, that if the assets actually pass to the QTIP trust that is sufficient, relying on Estate of Spencer v. Commissioner,

43 F.3d 226 (6th Cir. 1995); Estate of Robertson v. Commissioner, 15 F.3d 779 (8th Cir. 1994); Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992).

The case underscores the importance of coordinated tax clauses when a Will and a revocable trust are involved.

6. **Distribution of Delayed Income is Not a Disposition.** PLR 199915052 confirms that a spouse has not disposed of the spouse's qualifying income interest for purposes of section 2519 -- and thus made any gift of the entire property in the QTIP trust -- where the state's Principal and Income Act requires a lump sum payment to the spouse to compensate for underpayments of income from prior years. The facts arose out of an exchange of closely-held stock or publicly-traded stock.

7. **Importance of Lifetime QTIP Election.** PLR 199903040 determined that where a QTIP election was not made for a lifetime QTIP, in fact it did not qualify.

8. **Miscalculation of QTIP.** PLR 199902014 is a ruling in which the estate incorrectly calculated a marital deduction as if the QTIP election would be made for property that was in fact not supposed to be QTIP'ed. The IRS allowed the estate to correct the mistake because it determined that the governing instrument was clear.

9. **Termination of QTIP Trust as a Gift.** PLR 199908033 is very important. At issue were the tax consequences of terminating a QTIP trust and distributing the trust assets to the spouse. This could be done under applicable state law with the consent of the spouse, the trustee, and the remainder beneficiaries who were the children of the decedent and the spouse.

The ruling determined that the children, through consenting to the termination of the trust, made a gift just as if the children transferred the remainder interest in the QTIP to a third party other than the spouse. The ruling states that the "fact that the receipt of the remainder interest by Spouse will not increase the value of Spouse's potential taxable estate is not pertinent to the determination of the federal tax consequences to Taxpayer with respect to Taxpayer's proposed transfer."

The taxpayer argued that this result was inconsistent with Revenue Ruling 98-8, 1998-7 I.R.B. 24, which held that where a surviving spouse purchased from the trust remainderman a remainder interest in the QTIP for an amount equal to the actuarial value of the remainder interest, the spouse made a gift. Here the taxpayer's position was that under Rev. Rul. 98-8 a remainder interest is, essentially, accorded a value of zero when received by the spouse because it is

already included in the spouse's estate for transfer tax purposes. Thus, the taxpayer argued, the transfer should not be subject to gift tax. The IRS said that Rev. Rul. 98-8 did not state that the remainder interest of a QTIP should be valued at zero but whether that Revenue Ruling focused on what constituted adequate consideration for transfer tax purposes and concluded that the receipt of the remainder interest by the spouse does not constitute adequate consideration. Most commentators believe the IRS positions are inconsistent.

The issues in the PLR arise in another context. Suppose a QTIP trust invested in a family limited partnership and received both a general interest and a limited interest. There should be no gift because the QTIP could liquidate the partnership immediately after the investment. Suppose that sometime later the QTIP trust distributed or sold the general partnership interest to the surviving spouse. The surviving spouse's estate, to this point, has not changed, one could argue, because the surviving spouse has the ability to liquidate the partnership as general partner. However, under a Bonner analysis, the QTIP assets and the spouse's individual assets are not aggregated. In addition, the diminution of the QTIP assets, without protest by the children, could be viewed as a gift by the children.

10. **QTIP Regulations: Effect of Estate Expenses.** Proposed regulations on the effect of administration expenses on the marital deduction have been issued. REG-114663-97 (December 15, 1998). The regulation distinguishes between estate transmission expenses which will reduce the marital deduction, and estate management expenses which will not reduce the marital deduction. For drafting purposes, the marital deduction/exemption equivalent formula clause should be revised to take into consideration estate management expenses that are not taken as income tax deductions. The regulations provide as follows:

SECTION 20.2056(B)-4 MARITAL DEDUCTION;
VALUATION OF INTEREST PASSING TO SURVIVING SPOUSE

* * * * *

(e) EFFECT OF CERTAIN ADMINISTRATION EXPENSES -- (1) ESTATE TRANSMISSION EXPENSES. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of estate transmission expenses incurred during the administration of the decedent's estate and paid from the principal of the property interest or the income produced by the property interest. For purposes of this subsection, the term estate transmission expenses means all estate administration expenses that are not estate management expenses (as defined in paragraph (e)(2) of this section). Estate transmission expenses include expenses incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property to those who

are entitled to receive it. Examples of these expenses include executor commissions and attorney fees (except to the extent specifically related to investment, preservation, and maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

(2) ESTATE MANAGEMENT EXPENSES -- (i) IN GENERAL. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall not be reduced by the amount of estate management expenses incurred in connection with the property interest during the administration of the decedent's estate and paid from the principal of the property interest or the income produced by the property interest. For marital deduction purposes, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of any estate management expenses incurred in connection with property that passed to a beneficiary other than the surviving spouse if a beneficiary other than the surviving spouse is entitled to the income from the property and the expenses are charged to the deductible property interest which passed to the surviving spouse. For purposes of this subsection, the term estate management expenses means expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

(ii) SPECIAL RULE WHERE ESTATE MANAGEMENT EXPENSES ARE DEDUCTED ON THE FEDERAL ESTATE TAX RETURN. For purposes of determining the marital deduction, the value of the deductible property interest which passed from the decedent to the surviving spouse is not increased as a result of the decrease in the federal estate tax liability attributable to any estate management expenses that are deducted as expenses of administration under section 2053 on the federal estate tax return.

The effective date is for decedents dying after the date the regulations become final. The regulations have come under considerable criticism either for being too complicated, or too uncertain, and, in general, for not dealing with charitable matters.

N. **SECTIONS 2501 TO 2524 - GIFTS**

1. **Power of Modification Prevents Completed Gift.** In 1989 Kathryn O. Neal released her contingent reversion in a grantor retained income trust because of advice given her under then section 2036(c). She paid gift tax. Subsequently section 2036(c) was retroactively repealed and the taxpayer wanted her gift tax back. In Neal v. United States, 82 A.F.T.R.2d 98-5429, (W.D. Pa. 1998), the court determined that the release had not been a gift because of the right under applicable state law (Pennsylvania) of Mrs. Neal to revoke the release. The opinion states:

A gift upon a trust with the power reserved in the donor to revoke it is not taxable as a "gift" because the transfer remains incomplete. Sanford's Estate v. Commissioner of Internal Revenue, 308 U.S. 39 (1930). Moreover, powers of

revocation reserved to the settlor by operation of state law may also render the gift incomplete and non-taxable. In Commissioner of Internal Revenue v. Allen, 108 F.2d 961 (3d Cir. 1939), cert. denied 309 U.S. 680 (1940), the Court of Appeals for the Third Circuit applied the rule in Sanford's Estate to a gift by a minor which remained revocable under Pennsylvania law for a reasonable time after the minor attained the age of twenty-one.

* * *

In the instant case, plaintiff did not specifically reserve a power to revoke or modify her releases of reversionary interests in the GRIT. However, that power was reserved to her by operation of Pennsylvania law, and she has lawfully exercised that power by rescinding her releases on the grounds of a clear unilateral mistake of law. The government concedes that "in some very limited circumstances, an irrevocable transfer may be legally reformed into a revocable transfer . . . and that such revocation abrogated the federal gift tax which accrued as a result of the transfer" in Berger v. United States, 487 F.Supp. 49 (W.D. Pa. 1980). United States' Memorandum of Law in Support of Summary Judgment, at 7. The government also recognizes Allen held "incomplete transfers that can be rescinded are not completed taxable gifts for Federal gift tax purposes." Id. The government asserts, however, that plaintiff cannot prove she properly rescinded her releases of reversionary interests in the GRIT in accordance with Pennsylvania law. Nevertheless, the government states "if Mrs. Neal could prove that she properly rescinded her releases in accordance with Pennsylvania law, her gifts would be incomplete and non-taxable." Id. at 8. The Court finds that Mrs. Neal HAS -- proven, to the satisfaction of the Orphan's Court and of this Court, that she properly rescinded her releases in accordance with Pennsylvania law -- and her "gifts" WERE -- incomplete, and non-taxable.

The court rejected the government's argument that Pennsylvania law allowed revocations only if the mistake were about present law, not future law:

By its nunc pro tunc repeal of section 2036(c), Congress ELIMINATED the tax liability plaintiff sought to avoid in 1989 by her releases, and EXPLICITLY made said elimination retroactive. That clear expression of Congressional intent must mean SOMETHING. After all, the Internal Revenue Code is "not a promise," and the government does not have a "vested right in the Internal Revenue Code." Just as Congress may IMPOSE tax liability retroactively AT ITS PLEASURE, Congress may WITHDRAW tax liability AT ITS PLEASURE, [Louisiana v. Mayor of New Orleans, 109 U.S. 285 (1883)], and it has done just that. The sampling of retroactivity cases set forth above demonstrates that the government does not hesitate to apply retroactive legislation to collect increased tax liability upon transactions and events preceding their actual enactment dates, yet it balks in this case at respecting the intent of Congress which explicitly repealed section 2036(c) retroactively.

Importantly, it is not merely upon the repeal of section 2036(c) that plaintiff seeks a refund, but upon her mistake of law in believing section 2036(c) was valid and enforceable and her obtaining a Pennsylvania Orphan's Court ruling, after notice to the IRS and active opposition by one of the beneficiaries to the GRIT, recognizing her rescission for unilateral mistake pursuant to Pennsylvania law

which demonstrates, clearly and convincingly, that her "gift" was incomplete in 1989.

2. **Gift Tax Disclosure Proposed Regulations.** REG. 106177-98 sets forth proposed regulations relating to the gift tax statute of limitations. The proposed regulations add a new paragraph (f) to section 301.6501(c)-1.

If a gift is not adequately disclosed on a timely filed gift tax return, then gift tax may be assessed at any time.

Adequate disclosure is described by (f)(2) as follows:

Adequate disclosure of transfers of property reported as gifts. A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f) only if the return provides a complete and accurate description of the transaction including --

(i) A description of the transferred property and any consideration received by the transferor;

(ii) The identity of, and relationship between, the transferor and the transferee;

(iii) A detailed description of the method used to determine the fair market value of property transferred, including any relevant financial data and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of the transfer of an interest in an entity (e.g., a corporation or partnership) that is not actively traded, a description of any discount claimed in valuing the entity or any assets owned by such entity, including a statement regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iii) must be provided for each entity and the assets owned by each entity;

(iv) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust;

(v) Any restrictions on the transferred property that were considered in determining the fair market value of the property; and

(vi) A statement of the relevant facts affecting the gift tax treatment of the transfer that reasonably may be expected to apprise the Internal Revenue Service of the nature of any potential controversy concerning the gift tax treatment of the transfer, or in lieu of this statement, a concise description of the legal issue presented by the facts. In addition, a statement describing any position taken that is contrary to any temporary or final Treasury regulations or revenue rulings.

If a completed gift is mistakenly reported as incomplete, the statute of limitations does not run. The proposed regulations state that if an incomplete gift is reported as a completed gift the statute does run.

A quality appraisal would normally satisfy the requirements of (f)(2)(iii). However, a recital of facts in an appraisal may not satisfy (f)(2)(vi). The provision requiring disclosure if a position taken contrary to a revenue ruling will require additional diligence from return preparers.

3. **No Annual Exclusion for Gifts to Corporation.** The U. S. District Court for the Northern District of Indiana concluded in Estate of Stinson v. United States, 82 A.F.T.R.2d 98-6944 (N.D. Ind. 1998), that a donor's forgiveness of corporate debt did not qualify as an annual exclusion gift to the corporation's shareholders because the gifts were not present interests. The court stated that "it is the shareholder's inability to use, possess, or enjoy any of the corporation's assets, including the gift, without joint actions by the directors that renders their interest in the gift to the corporation's 'future interests.'" Revenue Ruling 71-443, 1971-2 C.B. 337, sets forth the same position relying on Chanin v. United States, 183 Ct. Cl. 840, 393 F.2d 972 (1968)(a gift from one closely held corporation made to another closely held corporation would be a future interest gift to the shareholders of the recipient corporation).

4. **Use of Section 483 Interest Rate.** The U.S. District Court for the Northern District of New York has followed Krabbenhof v. Commissioner, 939 F.2d 529 (8th Cir. 1991), and Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995), and rejected Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988) and held that the safe harbor interest rate of section 483 does not apply in determining the present value of installment payments for gift tax purposes. Lundquist v. United States, 83 A.F.T.R.2d ¶ 99-1471 (N.D.N.Y. 1999).

5. **Gift of Discretionary Life Interest.** PLR 199908060 dealt with a widow's gift of her discretionary life interest in her husband's pension plan. The beneficiary designation provided as follows:

So long as my wife, Taxpayer B, herein referred to as "my wife", shall live, I direct that the Trustee of this Plan shall continue to hold all death benefits due to me or my designated beneficiary, and if my wife's own income, when consumed, is not sufficient to provide for her support, maintenance, care and health during her life in a reasonable standard of living (not to exceed that which we maintain at the time of my death), then the Trustee of this Plan shall periodically distribute to my wife as much of my death benefits under this Plan as shall be necessary to provide for her support, maintenance, care and health in such standard of living. Upon the death of my wife any and all amounts which she or her estate might have in any then remaining undistributed benefits due to me or my designated beneficiary under this Plan shall terminate, and all such then remaining undistributed benefits shall thereafter be payable equally to my two sons, Taxpayer C and Taxpayer D.

The ruling concludes that the spouse's discretionary life interest has value and that the invasion power of a trustee is limited by definite and ascertainable fixed standards. A representation was made that the taxpayer would not need any distributions of income or principal because of her separate income and assets.

6. **Gift Created on Formation of Family Partnership.** TAM 9842003 found that a gift was made when a decedent and her children formed a family partnership where the decedent did not have control after the partnership was formed. See complete discussion under Section Q.

7. **Transfer of Partnership Interests and the Annual Exclusion.** PLR 199905010 dealt with the transfer of limited partnership interests and qualification for the annual exclusion under section 2503(b). The partnership was formed, and the interests transferred in order to facilitate the sale of a life insurance policy from a corporation to the recipients of the partnership interest. In pertinent part, the ruling states:

the management powers possessed by A and B, as the general partners, authorize A and B, in determining Partnership distributions, to withhold only amounts that the general partners reasonably deem necessary or appropriate for the proper operation of the Partnership business or its winding up in liquidation. The general partners from this exercise such powers in a fiduciary capacity and are held to a high standard of conduct toward the limited partners.

In TAM9751003 the fiduciary duties of the general partners had been overridden by the partnership agreement.

8. **Exchange of Voting for Non-Voting Shares.** The Tax Court determined that the exchange of voting for non-voting shares in a closely-held corporation was a gift to the other shareholders (the sons of the donor). Estate of Bosca v. Commissioner, T.C. Memo 1990-251. The court also held that the gift should be valued as two blocks of stock because two sons were the indirect donees:

The final issue is whether the voting common stock that the decedent transferred to HBC should be valued as a single block of 50 percent of the stock of the corporation or as two blocks of 25 percent. As mentioned above, if the decedent's voting stock is valued as a single block, then the parties have stipulated that each share of stock was worth \$11,827 immediately before the recapitalization. In that event, the difference between what the decedent transferred to HBC and what he received in return is \$2,412, and the decedent's gifts to his sons will be valued in the aggregate amount of \$970,830. On the other hand, if the stock is valued as two 25-percent blocks, then the parties have stipulated that each share of stock was worth \$9,671 immediately before the recapitalization. In that event, the difference between what the decedent transferred to HBC and what he received is \$256 and the gifts will be valued in the aggregate amount of \$103,040. In passing, we note respondent does not take the position that, for purposes of valuing decedent's stock, we must take into account the voting stock transferred to the corporation by Ms. Baker.

Generally, the gift tax applies to a transfer of property by way of gift. Secs. 25.2501-1(a)(1), 25.2511-1(a), Gift Tax Regs. As mentioned above, the value of the property at the date of the gift is considered the amount of the gift. Sec. 2512(a). Thus, for purposes of computing the gift tax, each separate gift must be valued separately. [Citations omitted.] For example, we have rejected attempts by taxpayers to aggregate separate gifts of stock made on the same day in order to claim a blockage discount, and we have held that each separate gift must be valued separately. See, e.g., Rushton v. Commissioner, 60 T.C. 272 (1973); Phipps v. Commissioner, supra. Similarly, we have rejected an attempt by the Commissioner to aggregate separate gifts of stock made on the same day by a majority stockholder to members of his family in order to value the gifts as "control stock". See Estate of Heppenstall v. Commissioner, a Memorandum Opinion of this Court dated Jan. 31, 1949.

* * *

As mentioned above, a transfer of property to a corporation for less than adequate and full consideration generally represents gifts by the donor to the individual shareholders of the corporation to the extent of their proportionate interests in the corporation. Kincaid v. United States, supra at 1224, 1226; Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956); CTUW Georgia Ketteman Hollingsworth v. Commissioner, 86 T.C. at 96-97; sec. 25.2511-1(h) (1), Gift Tax Regs. Applying the principle that separate gifts must be valued separately, it follows that each such gift to a stockholder of a corporation must be valued separately. Cf. Estate of Hitchon v. Commissioner, 45 T.C. 96 (1965).

In these cases, the decedent through his participation in the recapitalization indirectly made gifts to his two sons. In valuing the gifts, respondent takes the position that the stock transferred by the decedent to the corporation should be treated as a single block of stock and should be valued accordingly. Thus, respondent has aggregated the decedent's stock for purposes of valuing the gifts he made to his sons. In our view, this approach violates the principle that separate gifts should be valued separately. We agree that the decedent surrendered stock in the recapitalization that represented 50 percent of the voting stock of the corporation. However, the decedent did not convey 50 percent of the voting stock of the corporation to either of the donees or to both of them jointly. See Estate of Heppenstall v. Commissioner, supra. Respondent has committed error by valuing the decedent's stock as if he had. Cf. Estate of Bright v. United States, 658 F.2d 999, 1003 (5th Cir. 1981)

O. SECTION 2518 - DISCLAIMERS

P. SECTIONS 2601-2654 - GENERATION-SKIPPING TRANSFER TAX

1. **Change of Trust Situs By Reason of Change of Corporate Trustee.** It is often desirable to change trustees and an issue arises when a trustee in a state different from the state in which the trust has been administered is made. Does the change in trust situs, and potentially applicable state law, affect the trust's generation-skipping tax exemption?

PLR 199922044 suggests not. There the trust provided that the situs of the trust would be deemed to be at the principal office of the corporate trustee and the trust was to be governed by the laws of the state of the situs and to be administered in accordance with the laws of the state of the situs. The ruling concluded that the primary beneficiary of the trust had the power to replace the corporate trustee according to the governing instrument and thus that the change in situs and applicable law occurred pursuant to the terms of the governing instrument. Thus “the proposed modifications do not confer additional powers or beneficial interest upon any current or new trustee or upon any of the trust beneficiaries. Moreover, these modifications will not create any additional generation-skipping transfers or increase the amount of any generation-skipping transfers.”

Where concern has arisen, it may be possible to arrange for the initial governing law to continue to govern the trust even after the trustee has changed.

2. **Adopted Beneficiaries.** PLR 199907015 considers whether the adoption of a grandchild by the grandchild’s aunt following the death of the grandchild’s parents would make the grandchild a skip person with regard to a transfer in trust from the grandparents. The Service determined that because the transfers occurred after the grandchild’s parent died, section 2651 treats the grandchild as if he were a member of the generation that is one generation below the generation of the grandparents. The adoption of the grandchild by his aunt will not affect the relationship between the grandparents and the grandchild and thus would not cause the grandchild to become a skip person.

In PLR 199915038 a trust was construed by the court having jurisdiction over the trust to include adopted children. The Service held that the court order was not a modification that would affect the trust’s grandfathered status for generation skipping tax purposes.

3. **Partition of a Trust into Subtrusts.** PLR 199912034 approves the division of an irrevocable trust into two subtrusts for the benefit of each of the grantor’s children and their heirs. Each subtrust will have substantive terms identical to the original trust and the parties beneficial interest would not change. The division would not cause the existing trust, or the subtrust, or any of the beneficiaries, to realize a gain or loss from the disposition of property.

The Service’s ruling position is that if the rights of beneficiaries are actually cut off by the creation of a subtrust, that division will cause recognition of gain or loss.

PLR 199922030 is to the same effect. See also PLR 9830017.

4. **Substantial Compliance When Allocating GST Exemption on a Form 709.** PLR 199909034

allowed a taxpayer to substantially comply with allocation of a GST exemption. The facts and holding are as follows:

In this case, it appears that Taxpayer did not literally comply with the instructions on Form 709. Taxpayer reported the 1987 gifts to the Trust on Schedule A, Part 2 (Gifts Subject to Both Gift and GST Tax) and completed portions of Schedule C. However, Taxpayer did not attach to the 1987 return a Notice of Allocation of GST exemption. However, literal compliance with the procedural instructions to make an election is not always required. Elections may be held to be effective where the taxpayer complied with the essential requirements of a regulation even though the taxpayer failed to comply with certain procedural directions therein. See Hewlett-Packard Company v. Commissioner, 67 T.C. 736, 748 (1977), acq. in result, 1979-1 C.B. 1. The allocation will be deemed valid if there are enough facts and circumstances to indicate that the Taxpayer intended to allocate part of his exemption to the Trust.

We believe that there is sufficient information provided on Taxpayer's 1987 gift tax return to conclude that Taxpayer intended to allocate part of his exemption to the Trust established under the Trust Agreement. Taxpayer reported the 1987 transfer on Schedule C of the Form 709. On Schedule C, Part 3 (GST Exemption Reconciliation), line 4 (Exemption Claimed on This Return) Taxpayer entered z, for the 1987 transfer. On Schedule C, Part 4, line 1 (GST Exemption Allocated), Taxpayer entered the same amount. In addition, Taxpayer attached a statement to his 1987 return which provided the trust identification number and the value of the property transferred to the trust. We note that Taxpayer did not complete the GST portions of the form correctly, in view of the fact that the transfer was not a direct skip. However, based on the information provided on the return, we conclude that Taxpayer substantially complied with the requirements for making an allocation of GST exemption for the transfer reported on the 1987 gift tax return. Taxpayer is, therefore, deemed to have allocated the exemption as described above for the 1987 transfer to the Trust.

In PLR 199922045 spouses created identical GRITs having an irrevocable trust as the remainder beneficiary. The spouses each filed timely gift tax returns allocating generation skipping tax exemption to the GRITs but not to the irrevocable trust. Because the spouses had allocated their GST exemptions to property subject to an estate inclusion (ETIP) prior to the promulgation of Treas. Reg. §26.2631-1(c)(1) the Service concluded that the allocations were void. Thus, the spouses were allowed to reallocate their exemption on amended gift tax returns.

Q. **SECTIONS 2701-2704 - SPECIAL VALUATION RULES**

1. **Application to Family Limited Partnerships.** TAM 9842003 deals with the creation of limited partnerships. Mother contributed 99% of the assets and received a 99% limited partnership interest; each of two

children contributed 0.5% and received a one-half general partnership interest. The partnership was formed six weeks before Mother died, primarily with marketable securities. Mother's estate claimed a 60% discount.

The IRS advanced the following arguments:

1. Estate of Murphy v. Commissioner, T.C. Memo. 1990-472.

We believe the instant case is similar to Estate of Murphy, in that the sole or primary purpose for the transaction was the reduction of federal transfer taxes. The only discernible purpose for the transfers to the partnership was to depress the value of the Decedent's assets as these assets passed through Decedent's gross estate, into the control of her children, via the partnership. The arrangement merely operated to convey the assets to the same individuals who would have received the assets in any event under the testamentary instruments. "Nothing of substance" was intended to change as a result of the transactions and, indeed, the transactions did nothing to affect Decedent's or her children's interests in the underlying assets "except to reduce federal transfer taxes." The control exercised by Decedent and her children over the assets did not change at all as a result of the transactions.

2. Section 2703.

Under section 2703(a)(2), the value of "property" transferred is determined without regard to any restriction relating to the "property". In the instant case, we believe the "property" subject to Decedent's transfers was the underlying partnership property. Any reduction in value of the underlying assets caused by the partnership agreement is disregarded under section 2703(a)(2) in determining the value of the transfers. The steps of the transaction (the creation and funding of the partnership within six weeks of Decedent's death, and the transfer of the partnership interests through the trust) should be collapsed and viewed as a single integrated transaction; the transfer at her death of the underlying trust assets subject to the partnership agreement. See, Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149, (donor's gifts of minority stock interests to shareholders followed by a redemption of donor's remaining shares treated as single transfer of a controlling interest); Estate of Murphy v. Commissioner, supra, (decedent's inter vivos transfer of a minority interest followed by a testamentary transfer of his remaining shares treated as a single transfer of a controlling interest); Griffin v. United States, No. A96-CA-760 SS (W.D. Texas June 2, 1998), (transfer of 1/2 of donor's stock to donor's spouse followed by a transfer by spouse and donor of all their stock to a trust for the benefit of their child treated as one gift by donor of the entire block). In Griffin, the court distinguished a Tax Court decision, Estate of Frank v. Commissioner, T.C. Memo. 1995-132, where the court declined to integrate the steps of the transaction. Thus, the partnership assets are properly viewed as the subject matter of the transfers.

Further, we do not believe the transaction qualifies for the section 2703(b) exception to the application of section 2703(a).

* * *

It is inconceivable that Decedent would have accepted, if dealing at arm's length, a partnership interest purportedly worth only a fraction of the value of the assets

she transferred. This is especially the case given the Decedent's age and health, because it was impossible for her to ever recoup this immediate loss. Further, it is inconceivable that Decedent (or her representative) would transfer such a large portion of her liquid assets to a partnership, in exchange for a limited interest that terminated her control over the assets and their income stream, if the other partners had not been family members. See Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121, where, based on the facts presented in that case, the court found "incredible" the executrix' assertion that the decedent's transfer of property to a family corporation in exchange for stock was in the ordinary course of business. We believe it is clear that the primary, if not the sole, purpose of the partnership was to artificially depress the value of Decedent's assets for a brief period as the assets passed through Decedent's estate to her children.

Applied within the context of section 2703(a)(2), which focuses on restrictions on the right to sell or use property, we believe that a "device" under section 2703(b)(2) is reasonably viewed as including any restriction that has the effect of artificially reducing the value of the transferred interest for transfer tax purposes without ultimately reducing the value of the interest in the hands of the transferee-family member. We believe the partnership arrangement, under the circumstances presented, satisfies this description.

In the instant case, based on the facts presented, even assuming the transactional steps are not collapsed and the partnership interest is recognized as the subject matter of the transfer, section 2703(a)(2) would still apply.

Thus, the IRS ignored all restrictions on rights of the limited partner.

3. Section 2704(b) - Existence of Applicable Restrictions

In the instant case, the estate argues that any restrictions in the partnership agreement are not "applicable restrictions" because they are no more restrictive than state law. We do not agree. Under the terms of the partnership agreement, the Decedent could not withdraw from the partnership and liquidate her interest. However, under New York law, absent a prohibition in the partnership agreement, the Decedent could have withdrawn and liquidated on six months notice. The prohibition on Decedent's right to liquidate her interest contained in the partnership agreement is more restrictive than New York law, and thus, is an applicable restriction under section 2704(b)(2)(A).

The estate argues that section 2704(b) only applies to a restriction on the ability of the PARTNERSHIP as a whole to liquidate, and does not apply to a restriction on a limited partner's ability to liquidate the partner's interest. The regulations do not support such a conclusion. Section 25.2704-2(b) defines an applicable restriction as a limitation on the ability to liquidate the entity "in whole or in part". Section 25.2704-2(d), Example 5, considers a situation where a donor transfers common stock in a corporation and retains preferred stock that carries a put right that is not exercisable for 4 years. The example concludes that the restriction on the right to put the preferred stock to the corporation and liquidate that interest is an applicable restriction for purposes of a section 2704(b) (i.e., a limitation on the ability to liquidate the entity "in part") that is disregarded in valuing the retained preferred stock for purposes of section 2701.

Thus, under the regulations, section 2704 applies to restrictions on a limited partner's ability to liquidate the partner's interest. See, section 2704(b)(4), authorizing regulations prescribing restrictions that may be disregarded in determining the value of a transferred interest in a partnership or corporation. Indeed, it would seem incongruous to interpret the statute as precluding a discount for a family controlled restriction limiting the ability to liquidate the entire partnership, while permitting a discount for a family controlled restriction limiting the ability to liquidate the partnership interest transferred.

The provisions of the partnership agreement prohibiting Decedent from liquidating her interest constitute an applicable restriction under section 2704(b) and should be disregarded in valuing the Decedent's partnership interest for estate and gift tax purposes.

4. Section 2512 - Gift on Formation

The estate contends that the formation of and transfers to the partnership did not result in any gifts by the Decedent. The Decedent held a partnership interest representing a proportionate interest in the value of the property transferred to the partnership. Thus, any difference between the value of the property transferred and the partnership interest results as a consequence of the partnership form; the value of the other partners' interests were not enhanced. Rather, the net worth of each partner decreased as a result of their respective transfers to the partnership. In the absence of any increase in a partner's net worth, there was no donee and therefore, no basis for asserting that a gift was made. The estate further argues that any attempt by the Service to tax the decrease in wealth experienced by the Decedent would be an impermissible direct "wealth tax" on property, rather than an indirect excise tax on the transfer of property.

Initially, we disagree that the parties held proportionate interests in the partnership. Rather, in the instant case, the Decedent supplied 99 percent of the value of the partnership assets in exchange for a 99 percent LIMITED partnership interest, and Child A and Child B supplied the remaining 1 percent of the value of the partnership assets in exchange for a 1 percent GENERAL partnership interest. By taking back a LIMITED partnership interest, the Decedent relinquished control over partnership assets. According to the estate, this lack of control, in part, resulted in a 40 percent reduction in the value of Decedent's interest. On the other hand, the general partnership interests of Child A and Child B enable them to effectively control the entire partnership, not just the \$10,050 that each contributed. This control element should necessarily enhance the value of their interests. Thus, in this case, the parties (the Decedent, compared with Child A and Child B) did not each receive partnership interests that were proportionate in value to the assets each contributed.

Further, we don't agree that the difference in value between the assets transferred and the partnership interest received, should be characterized, in this case, as "disappearing" as a natural consequence of the partnership form. Rather, the entire transaction (i.e., the creation of the partnership, the subsequent death of the Decedent, and the passage of the partnership interests to the family members) must be viewed as an integrated donative plan. The Decedent intentionally transferred assets in exchange for a partnership interest worth significantly less than the assets transferred, enabling the other partners, in conjunction with other family members,

to ultimately realize the full value of the underlying assets on the death of the Decedent, when the Decedent's retained partnership interest passed to her beneficiaries. Thus, there was no "disappearance" of value when Decedent transferred assets to the partnership. Rather, the difference in value between the Decedent's assets and Decedent's partnership interest was transferred by the Decedent to the other partners and to the testamentary beneficiaries of Decedent's partnership interest, to be ultimately realized in the future.

In any event, under the regulations, it is neither necessary to demonstrate that any person's net worth increased as a result of the transfers by Decedent, nor is it necessary to identify the donee or donees at the time of the transfer. Rather, once it is determined that the Decedent's transfer was not in the ordinary course of business, section 2512 statutorily mandates that the unequal exchange results in a gift. See section 25.2511-2(a).

2. **Spousal Annuity Interest.** The Service's position is that an annuity interest that is paid to the annuitant's estate is not a qualified interest nor is an annuity interest that becomes payable to the annuitant's spouse after the annuitant's death. The result is that the chance that the annuitant might die before the term of the annuity ends always reduces the value of the annuity with the result that a GRAT produces a taxable gift.

In TAM 9848004 spouses each created GRATs to pay the annuity to the grantor for seven years or prior death; if death occurred within seven years the remaining annuity payments would be payable to the grantor's spouse (whose rights the grantor could revoke). The TAM states:

However, in the present case, with respect to each trust, the Spouse's right to receive annuity payments is contingent on the grantor's death prior to the expiration of the seven-year term. This is the same interest considered in section 25.2702-3(e), Example 5 and Example 6. As discussed above, these examples illustrate that the right to receive annuity payments contingent on the grantor's death prior to the expiration of the grantor's retained term interest, is not a qualified interest. Accordingly, as is the case in Example 5 and Example 6, the spouse's interest in each trust is not a qualified interest for purposes of section 2702(b).

Furthermore, the spouse's interest does not satisfy the requirements of section 25.2702-3(d)(3). That is, under section 25.2702-3(d)(3), the term of the annuity interest must be for the life of the term holder, for a specified terms of years, or for the shorter (but not the longer) of those periods. In the instant case, the spouse's annuity is not payable for the life of the spouse, a specified term of years, or for the shorter of those periods. Rather, the annuity is payable, if at all, for an unspecified period dependent on whether the grantor dies during the term of the trust and the term of the trust remaining at that time.

The taxpayers also argued, unsuccessfully, that the Service's position should not be applied to them:

Section 301.7805-1(b) of the Income Tax Regulations provides that the Commissioner may prescribe the extent, if any, to which any ruling relating to the

internal revenue laws, issued by or pursuant to authorization from the Commissioner, shall be applied without retroactive effect.

Taxpayers contend that in structuring the transaction they relied on private letter rulings issued by the Service and Example 7 of section 25.2702-2(d). Further, taxpayers argue they would have used an alternative estate plan had they known that the plan they did utilize did not produce the desired tax results.

The taxpayers [sic] reliance on the letter rulings is not a sufficient basis for relief. Section 6110(j)(3) provides that the letter rulings are not to be used or cited as precedent. Further, as discussed above, the regulation does not support the taxpayers' position. The spousal interest described in section 25.2702-2(d), Example 7, is different from the spousal interest in the taxpayers' trust. As discussed above, other examples in the regulations indicate the spousal interest used by the taxpayers is not a qualified interest.

The fact that the taxpayers would have structured the transaction differently had they been aware that their transaction did not produce a favorable tax result is not a basis for section 7805(b) relief, in the absence of appropriate and justifiable reliance on published Service guidance.

Accordingly, the conclusion of this Technical Advice Memorandum applies retroactively to the taxpayers' transaction.

Two docketed cases in the Tax Court deal with various aspects of GRAT calculations. Walton v. Commissioner, Tax Ct. Dkt. No. 3824-99, deals with the issue of whether an annuity payable to the decedent's estate is a qualified interest, and Cook, et ux. v. Commissioner, Tax Ct. Dkt. No. 257-99, deals with both the valuation issues on a corporation with significant dollars involved (the IRS argues the value of \$622 million; the taxpayer argues a value of \$290 million) and the issue of whether a spousal interest revocable by the grantor has value.

3. Use of Notes in GRATs. The IRS has confirmed its regulatory position that notes may not be used to make annuity payments from a GRAT. REG-108287-98. The explanation states:

Accordingly, these proposed regulations amend the regulations under section 2702 to provide that issuance of a note, other debt instrument, option or similar financial arrangement does not constitute payment for purposes of section 2702. A retained interest that can be satisfied with such instruments is not a qualified annuity interest or a qualified unitrust interest. In examining all of these transactions, the Service will apply the step transaction doctrine where more than one step is used to achieve similar results. In addition, a retained interest is not a qualified interest under section 2702, unless the trust instrument expressly prohibits the use of notes, other debt instruments, options or similar financial arrangements that effectively delay receipt by the grantor of the annual payment necessary to satisfy the annuity or unitrust interest amount. Under these provisions, in order to satisfy the annuity or unitrust payment obligation under section 2702(b), the annuity or unitrust payment must be made with either cash or other assets held by the trust.

The proposed regulations provide a transition rule for trusts created before September 20, 1999. If a trust created before September 20, 1999, does not prohibit a trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation, the interest will be treated as a qualified interest under section 2702(b) if notes, etc. are not used after September 20, 1999, to satisfy the obligation and any note or notes or other debt instruments issued on or prior to September 20, 1999, to satisfy the annual payment obligation are paid in full by December 31, 1999, and any option or similar financial arrangement is terminated by December 31, 1999, such that the grantor actually receives cash or other trust assets in satisfaction of the payment obligation. For purposes of this section, an option will be considered terminated if the grantor is paid the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Code, or the fair market value of the option.

4. **Definition of Personal Residence.** The Internal Revenue Service continues to be generous in its definition of personal residence. In PLR 199916030 the Service determined that property consisting of a main house and a leased caretaker residence would be a personal residence even though the caretaker residence is leased to an unrelated third party. In PLR 199906014 a vacation home that included a rental apartment was allowed to be placed in a qualified personal residence trust. The ruling determined that under the facts the rental of the apartment was incidental to the use of the property as a residence.

5. **Creation of 50% Ownership.** PLR 199908032 approved the creation of two QPRTs, one each by a husband and wife, for a vacation home. The vacation home was held as community property and the spouses wanted to put each of their respective halves of the community property into separate QPRTs.

This would work as well for tenants-in-common property and could enable the spouses to achieve a discount.

6. **Joint QPRT.** PLR 9829002 dealt with a Qualified Personal Residence Trust (a QPRT) funded with a residence by both spouses. If one of them died during the QPRT term, half the residence would be distributed to the deceased spouse's estate. After the QPRT term the residence would be rented by the spouses. The Service granted the following ruling requests:

1. During the Trust term, the taxpayers, or the survivor, will be considered the owner of the income and corpus of the Trust for federal income tax purposes and will be entitled to deductions for mortgage interest, taxes, and other deductions applicable to the residential real estate during the Trust term, whether the taxpayers make the payments directly or the Trust makes the payments;

2. The provisions of the Trust satisfy the requirements of section 25.2702-5(c) of the Gift Tax Regulations, and therefore the transfer of the taxpayers' right, title, and interest in the residential real estate qualifies for the

exception to the valuation rules of Internal Revenue Code section 2702(a)(1) and (2) contained in section 2702(a)(3)(A)(ii);

3. The transfer of the residence by the taxpayers is a completed gift for gift tax purposes.

4. The taxpayers' right to rent the property at its fair market value, and the taxpayers' exercise of such right, after the trust term has expired, will not cause the property to be included in either taxpayer's gross estate under section 2036(a)(1);

5. At the death of the first grantor prior to the expiration of the Trust term, any amount of the Trust property includible in the estate of such grantor passes to the surviving grantor and will qualify for the marital deduction in determining any estate tax due by the estate of the deceased grantor.

With respect to the section 2036 issue the ruling states:

In Estate of McNichol v Commissioner, 265 F.2d 667 (3rd Cir. 1959), cert. den. 361 U.S. 829 (1960), the court held that "enjoyment" as used in the predecessor statute to section 2036 is not a term of art, but is synonymous with substantial present economic benefit. In McNichol, the decedent purportedly conveyed income producing real estate to his children nine years before his death. Pursuant to an oral understanding with his children, the decedent continued to receive the rents from the properties until his death. The court held that the properties were includible in his gross estate under the predecessor to section 2036.

In Estate of Barlow v. Commissioner, 55 T.C. 666 (1971), acq., 1972-2 C.B. 1, the decedent and his spouse transferred a farm to their children and contemporaneously leased the property from the children at fair market value rent. The decedent and his spouse were legally obligated as tenants to pay this rent and the children were entitled, as landlords, to terminate the lease and oust the decedent and his spouse from the property if the rent was not paid. Although the decedent paid the rent for the first two years, the family agreed that, because of certain medical problems, the decedent need not continue to pay the rent, and the decedent did not pay the rent until his death four years later. The court found that the decedent was obligated to pay fair market value rent from the date of the transfer and there was no express or implied agreement at the date of the transfer that the decedent could avoid this rent obligation. The court held that the property was not includible in the decedent's gross estate under section 2036.

Rev. Rul. 70-155, 1970-1 C.B. 189, holds that a donor's continued occupancy of a transferred residence rent free until his death is as much an economic benefit as if he had rented the property and obtained the income therefrom.

In the present case, Husband and Wife propose to transfer their personal residence to the Trust. After the Trust term expires, Husband and Wife have the option to rent the real property covered by the Trust at fair market rental value. Based upon the information submitted and representations made, we conclude that because the property will be leased at fair market value, Husband and Wife will not receive an economic benefit from the property and their retained economic enjoyment of the property will cease when they begin paying the rental.

We conclude that Husband and Wife's right to rent the property at fair market value, and their exercise of such right, after the Trust term has expired, will not cause the property to be included in either of their gross estates under section 2036(a)(1), assuming there is no implied agreement or understanding that the parties can remain in the residence even if they do not pay rent.

By using one trust the ability to leverage the gift by claiming a discount for the transfer of a one-half interest to each of two trusts was lost.

7. **Creation of QPRT by Joint Purchase.** PLR 9841017 dealt with the creation of a QPRT without gift tax cost to the parents. A QPRT was created and parents and child contributed to the trust. The child had an independent source of funds. The terms of the trust were that of a standard QPRT. The ruling concludes that the contribution to the trust of the value of the child's remainder interest was sufficient for there to be no gift by the parents. In all other respects, the QPRT operated normally.

8. **Availability of Section 121.** PLR 199912026 confirms that new section 121 will be treated the same as old section 121 with respect to a QPRT so long as the QPRT is a grantor trust for income tax purposes.

9. **Disposition of Personal Residence After QPRT Term Ends.** In PLR 199916030 the Service approved a rental agreement which would allow the grantor to lease the residence after the expiration of the trust, paying fair market value rent. The ruling states that the rental arrangement would not cause the property to be included in the grantor's estate under section 2036. In PLR 199906014 the residence passed into a trust for the benefit of the grantor's spouse after the end of the QPRT term. The Service relied on Rev. Rul. 70-155, 1970-1 C.B. 189, to determine that co-occupancy by the grantor with the grantor's spouse does not of itself support an inference of an agreement or understanding as to retain possession or enjoyment by the donor. Thus, unless the grantor had an implied understanding with the spouse, outside of what would normally arise through the spousal relationship, sections 2036 and 2038 would not apply.

10. **Meaning of Family Member for Purposes of Section 2703.** TAM 9841005 states that for purposes of section 2703 family members include the descendants of a decedent's deceased spouse. The ruling does not discuss whether such would be the result on all circumstances. For example, what if the decedent had remarried prior to death?

R. **SECTION 6166 -- EXTENSION OF TIME TO PAY TAX**

1. **Estate Tax Refund Limited to Installments Paid in the Last Two Years.** Revenue Procedure 81-27, 1981-2 C.B. 548, sets forth a procedure in which a supplemental Form 706 is filed by an estate to claim interest and other expenses incurred in the administration of the estate during the time in which the estate had made a section 6166 election. The reason for the procedure is that section 6511(b)(2)(B) limits refunds to amounts paid within two years of the date the refund claim was filed if the claim is not filed within the three year period of section 6511(a). PLR 9828002 is a harsh ruling, acknowledged to be so by the IRS, which denies an estate a refund where the estate waited until the two years after the final installment was paid under section 6166 to file a claim.

S. **TAX ADMINISTRATION**

1. **Calculation of Fraud Penalty.** Estate of Trompeter v. Commissioner, 111 T.C. No. 2 (1998), dealt with the calculation of the fraud penalty under section 6663(a). The issue, and holding of the majority, was stated as follows:

[1] The dispute herein involves the Rule 155 computation mandated by the Court's Memorandum Opinion filed as Estate of Trompeter v. Commissioner, T.C. Memo. 1998-35. The issue before the Court is one of first impression; namely, whether an estate's underpayment for purposes of computing the fraud penalty is determined based solely on expenses which are included on the Federal estate tax return, or based on all deductible expenses including deficiency interest and professional fees which arise after the filing of the return.

[2] We hold that the underpayment is determined by taking into account all expenses. Unless otherwise stated, section references are to the applicable provisions of the Internal Revenue Code. Rule references are to the Tax Court Rules of Practice and Procedure. Estate references are to the Estate of Emanuel Trompeter. Mr. Trompeter (the decedent) resided in Thousand Oaks, California, when he died on March 18, 1992. The estate's coexecutors, Robin Carol Trompeter Gonzalez and Janet Ilene Trompeter Polachek, resided in Florida and California, respectively, when the petition was filed.

[3] In Estate of Trompeter v. Commissioner, supra, we held that the estate was subject to the fraud penalty under section 6663(a). The estate computes the amount of this penalty based on an underpayment that takes into account all deductible expenses, including expenses for trustee's fees, attorney's fees, and deficiency interest that were incurred after the filing of the estate tax return. Respondent challenges the estate's ability to compute its underpayment by deducting the latter expenses. Respondent asserts that the estate must compute its underpayment based solely on the expenses which were reported on its estate tax return.

[4] We agree with petitioner.

The Court was heavily divided -- there were three concurring opinions and a dissent.

2. No Collection Against Tenancy by the Entirety Property. The case of United States v. Simpson, et. ux., 82 A.F.T.R.2d 98-5306 (N.D. Fla. 1998), is interesting. Husband owed taxes and the government attempted to collect on real estate owned with wife as tenants by the entireties. The court held that it could not. Wife had subsequently been given title to the property to her children retaining a life estate. The court held:

In the instant case, there simply was no opportunity for Plaintiff to reach the individual interest of Defendant Wilford Simpson. As a tenant by the entireties under the laws of Florida, his interest was unreachable by any creditor. United States v. 15621 S.W. 209th Avenue, 894 F.2d 1511, 1514-15 (11th Cir. 1990). Moreover, because the property was then conveyed to only Janet Simpson in fee simple, Wilford Simpson had absolutely no interest at the time the tenancy by the entireties was destroyed:

No persons except husband and wife have a present interest in an estate by the entireties when such estate is unencumbered by any lien existing prior to the creation of such estate and is unencumbered by any lien created jointly by the husband and wife after the estate by entireties came into being. It is not subject to execution for the debt of the husband. It is not subject to partition; it is not subject to devise by will; neither it is subject to the laws of descent and distribution. It is, therefore, an estate over which the husband and wife have absolute disposition and as to which each, in the fiction of the law, holds the entire estate as one person. Therefore, there appears to be no plausible reason why the law should not recognize as valid any formal agreement executed according to law whereby one spouse would be divested of his or her interest in such estate and the other be invested with the unqualified fee-simple title.

Hunt v. Covington, 200 So. 76 (Fla. 1941).

Plaintiff now argues that the subsequent transfers to Janet Simpson, then to her children, and ultimately to the Mills Family Preservation Trust were fraudulent, as those grantees were effectively nominees of Wilford Simpson, and that it is entitled to foreclose its liens against the property (doc. 31, memorandum at 8-14). However, a large component of this argument becomes moot when considered in light of the safeguards afforded property held by tenants by the entireties. If, *arguendo*, the transfer to Janet Simpson was not fraudulent, then clearly she holds the property in fee simple and is free to dispose of it as she wishes. On the other hand, if that conveyance was fraudulent, Janet Simpson would not have fee simple title to the property, but rather the property would still be held by Wilford and Janet Simpson as tenants by the entireties. In either case, the subsequent transfers to the children and trust become irrelevant, as they too are either entirely valid or entirely void depending on the validity of the initial transfer to Janet.

Furthermore, it is also unnecessary to address whether the conveyance from Wilford and Janet Simpson to only Janet was fraudulent. As discussed immediately above, if the conveyance to Janet was fraudulent, the property remained a tenancy by the entireties and was unreachable by creditors of only Wilford Simpson. If the conveyance was valid, then Janet Simpson held the property in fee simple and Wilford had no interest at all. While there is a

possibility that by divorce or some other reason the tenancy by the entireties could be destroyed, thus creating a tenancy in common and making the validity of subsequent conveyances of utmost importance, that day has not yet arrived. As such, the Court declines to make those determinations today.

The facts of this case mandate an unusual result. Frequently, a debtor will attempt to convey his own property to a third party or into a tenancy by the entireties as an attempt to hinder or obstruct his creditors. Without discerning the motives behind their decision, the Court notes that Defendants did exactly the opposite, destroying the tenancy by the entireties in favor of a fee simple held by Janet Simpson alone. While this conveyance, if valid, would have placed the property beyond the reach of Wilford's individual creditors, the tenancy by the entireties already afforded that protection. Nonetheless, because it is undisputed that Wilford and Janet Simpson acquired the 27.77 acre parcel as tenants by the entireties without intention to defraud or avoid creditors, the Plaintiff is simply unable to enforce a lien against Mr. Simpson's interests in the property as it is held today, regardless of subsequent conveyances. Therefore, summary judgment in favor of Defendants is warranted.

3. **Florida Interpretation of Will.** PLR 9834027 gives effect to a Florida probate court's interpretation of a Will. The Will left an amount equal to the unified credit to a trust for the surviving spouse and the remaining assets to the spouse outright. Upon petition, the court interpreted the bequest to mean:

... a bequest of a sum equal to "the largest amount permitted to pass at Decedent's death that will not result in the imposition of a Federal Estate Tax with respect to his estate, after allowing for transfers made during his lifetime and any credits and deductions permitted to enable his estate to take full advantage of the maximum value of assets sheltered by the unified credit provision of the Internal Revenue Code."

The ruling suggests that the IRS may be "lenient" in determinations relating to the change from unified credit to applicable credit amount.

4. **Reversal of Tax Court, Equitable Recoupment.** The Sixth Circuit has reversed the Tax Court in Estate of Mueller v. Commissioner, 82 A.F.T.R.2d 98-5169, and held:

This is a case in which a taxpayer and the Internal Revenue Service ("IRS") disagree over the effect of an audit adjustment to the taxpayer's estate tax return. Specifically at issue are 8,924 shares of stock that the taxpayer undervalued when it filled the estate tax return, as a result of which the taxpayer underreported the taxable value of the shares and, consequently, underpaid its estate taxes. In addition, the government's determination that the stock was worth more than taxpayer claimed also had the effect of creating an overpayment in capital gains tax paid by the taxpayer in a previous year on the stock's sale. Just as the higher stock valuation resulted in a higher taxable amount, it also resulted in a higher basis in the stock and, therefore, a smaller amount of capital gains upon the sale of the stock. The problem for taxpayer is that the statute of limitations now bars any claim for a refund of the overpaid capital gains tax.

The question on appeal is whether the taxpayer is entitled to assert the defense of equitable recoupment in order to use the time-barred overpayment of capital gains taxes as a set-off against the timely charged deficiency in estate taxes. Before we can reach this question, however, we must first decide whether the Tax Court had the jurisdiction to apply the doctrine of equitable recoupment. Because we find that the Tax court lacked jurisdiction to consider a claim for equitable recoupment, we affirm the dismissal of the taxpayer's suit without reaching the merits of the equitable recoupment claim.

5. **Attachment of Federal Tax Lien to Disclaimed Property.** May a beneficiary who owes federal taxes avoid the attachment of a federal tax lien to inherited property by disclaiming? The answer appears to depend on the character of the right to inherited property under applicable state law.

The Eighth Circuit construed Arkansas law in Drye Family 1995 Trust v. United States, 82 A.F.T.R.2d 98-5190 (8th. Cir. 1998):

By extension, we hold that the state law consequences of Drye's right to his mother's estate, namely, the legal fiction that is created through Drye's disclaimer under Ark. Stat. Ann. section 28-2-101 et seq., is "of no concern to the operation of the federal tax law." Cf. Bess, 357 U.S. at 57 ("Such state laws 'are not laws for the United States . . . unless they have been made such by Congress itself.'") (quoting Fink v. O'Neil, 106 U.S. 272, 276 (1882)(concerning bankruptcy liens)); Leggett, 120 F.3d at 596 ("The view that the disclaimer is a legal fiction . . . supports the holding that property right existed before the disclaimer."); Terwilliger's Catering Plus, 911 F.2d at 1171-72 ("Although it is true that the state has the right to decide what property interests it wishes to create, it cannot thwart the operation of the Tax Code by classifying the interests it has created as something other than property rights.") Under this view, we conclude that the preexisting federal tax liens attached to Drye's state law right to his intestate share which vested on or about the time of his mother's death. See, e.g., Keenan v. Peevy, 590 S.W.2d 259, 269-70 (Ark. 1979)(holding that the title to real property vests immediately upon death of owner if heirs take through intestate succession, subject to appropriate provisions for administration under the probate code and subject to widow's dower and homestead rights, if any); Dean v. Brown, 227 S.W.2d 623, 628 (1950)(deciding under prior law that the personalty of an intestate became vested in the personal representative when appointed and remained so vested until distribution upon proper order of the probate court); see also Ark. Stat. Ann. section 28-9-203(c) ("Real estate passes immediately to the heirs upon the death of the intestate However, personalty will pass to the personal representative, if any, for distribution to the heirs").

The opinion discusses cases construing the law of other states:

The Second, Ninth, and Fifth Circuits addressed similar arguments in determining the effect of a state law disclaimer on preexisting federal tax liens and reached differing results. In Leggett, the most recent case, the Fifth Circuit determined that a disclaimer under Texas law nullifies any interest that the disclaimant has in the property, thereby defeating the attachment of federal tax liens. 120 F.3d at 596. As in the instant case, the IRS had made assessments against a taxpayer and

acquired a lien against all of her property and rights to property pursuant to section 6321 when her aunt died testate, leaving the taxpayer a one-twentieth interest in her estate. *Id.* at 593. The taxpayer subsequently disclaimed her entire interest in the estate pursuant to Texas's disclaimer statute and sought a declaration that the IRS had no lien against the estate's property in view of the disclaimer. *Id.* The district court ruled in favor of the IRS on the ground that Texas law creates only a right to accept or reject inheritance; that is, the taxpayer merely had a right of decision which does not constitute a property right under state law. *Id.* at 596. The Fifth Circuit reversed, applying Texas law to determine whether the state-law right constituted "property or rights to property" under section 6321. *Id.* at 594 ("[S]tate law determines whether a taxpayer has a property interest to which a federal lien may attach. . . . Therefore, we must decide whether, under Texas law, [the taxpayer] ever had a property interest in [the subject] estate.") (citations omitted). Reading the Texas Probate Code's vesting and disclaimer provisions together, the Fifth Circuit concluded that "a bequest or gift is nothing more than an offer which can be accepted [by taking possession, exercising dominion, or taking no action within the set time] or rejected [by timely filing a disclaimer]." *Id.* at 595-96 (citing Texas authority). Furthermore, the Fifth Circuit distinguished its holding from a contrary holding in United States v. Comparato, 22 F.3d 455 (2d Cir. 1994)(Comparato), on the ground that New York law is substantially different from Texas law and from Arizona law, which was applied in Mapes v. United States, 15 F.3d 138, 140 (9th Cir. 1994)(Mapes). Leggett, 120 F.3d at 596-97.

In Mapes, the taxpayer's mother died, leaving him half of her estate. 15 F.3d at 139. In order to prevent preexisting federal tax liens from attaching to his interest in the estate, the taxpayer renounced his interest in favor of his children pursuant to Arizona's Probate Code. *Id.* at 140. The district court's [sic] ruled in favor of the government and against the taxpayer's children in their wrongful levy action. *Id.* at 141. The Ninth Circuit reversed, holding that "state law, not federal law" determined "whether [the taxpayer] had any interest in property, lienable or not." *Id.* at 140. From this premise, the court concluded that the taxpayer did not have an interest under state law because the effect of the taxpayer's proper and timely renunciation was to prevent him from acquiring any interest to which a federal tax lien could have attached. *Id.* at 140-41. The court further held that the taxpayer's renunciation was not compromised by his temporary use of part of the estate (a vehicle, constituting one percent of the value of the estate) in order to prevent its loss or theft. *Id.* at 141.

As noted above, the Second Circuit reached a contrary result in Comparato. Comparato involved the estate of a quadriplegic who died intestate in 1984, leaving his parents, the Comparatos, as his statutory distributees. 22 F.3d at 456. In 1989 Anthony Comparato, the decedent's father, petitioned the Surrogate's Court to approve the settlement of a malpractice action that decedent had commenced before his death and a derivative wrongful death claim, and to distribute the proceeds equally between himself and his wife as the decedent's heirs. *Id.* In August 1989, before the Surrogate Court disposed of the petition, the IRS served notice of levy on the decedent's estate in the amount of the Comparatos' tax liability. *Id.* The Comparatos executed separate, untimely renunciations of their respective interests in their son's estate on April 10, 1991, which the Surrogate Court permitted them to file on September 23, 1991. *Id.* In 1992 the government commenced an action in the district court to reduce to judgment the assessments against the Comparatos. *Id.* The district court held that the Comparatos acquired property interests in the

proceeds of the malpractice claims on the date of their son's death and that the preexisting federal tax liens attached to the interests prior to the Comparatos' renunciation. Id. at 458. The Second Circuit affirmed, holding that, under New York law, the Comparatos' interests vested upon their son's death, thereby obviating any analysis of the retroactive effect of the renunciation. Id. at 457-58. "[O]nce state law provided [the Comparatos] with a vested interest in the proceeds of the malpractice actions, federal law controlled whether their interests were exempt from levy by the United States." Id. at 458 (citing United States v. Rodgers, 461 U.S. 677, 683 (1983)). Applying federal law, the court further determined that the express terms of the Code precluded any determination that the Comparatos' interests were exempt from levy by operation of a state law. Id. (citing 26 U.S.C. section 6334).

6. **Liability of Heirs for Unpaid Income and Self-Employment Taxes.** PLR 9851036 considered the situation in which a decedent owned property jointly with three of his children and owned the life insurance policy that was payable to a fourth child, all of which passed to the children outside of the decedent's probate estate. The decedent had not filed federal income tax returns or paid federal income tax or self-employment tax for approximately 40 years and no tax assessments were made against the decedent prior to his death and the decedent's probate estate lacked assets to pay the tax. The IRS determined that the heirs were not subject to transferee liability. The IRS did not explain how the taxpayer successfully avoided income tax for 40 years!

7. **Section 7491 -- Burden of Proof.** The Internal Revenue Service Restructuring and Reform of 1998 added a new section to the Internal Revenue Code, section 7491. The new section provides that with respect to a factual issue, the burden of proof will shift to the IRS from the taxpayer if the taxpayer introduces a "credible evidence." The Conference Report to the Act states that "credible evidence" is the "quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue of no contrary evidence were submitted." Thus, an expert opinion on which a court would rely should be credible evidence. The new provision applies with respect to transfers after July 22, 1998, subject to certain net worth limitations. Neither individuals nor estates are subject to the limitations.

T. **KENTUCKY DEVELOPMENTS**

1. **On the Brink of a New Millennium: Kentucky Supreme Court holds no cause of action for breach of promise to marry.** Never let it be said that Kentucky is not on the leading edge. In Gilbert v. Barkes, Ky., 97 S.W.2d 772 (1999) the Kentucky Supreme Court determined that there was no longer any common law cause of action for a breach of promise to marry. The court did state, however, that in certain circumstances a fiancée could

recover under other theories, such as breach of contract or intentional infliction of emotional distress, however, under the particular facts of the case, neither would be allowed. There was no proof of any direct economic loss and no wedding date was ever actually set. The decision was a close one with three Justices dissenting, stating "having successfully purged the common law of the tort of alienation of affection in Hoye v. Hoye, Ky., 824 S.W.2d 422 (1992), the majority of this Court now consigns to oblivion yet another ancient tort, the breach of promise to marry."

2. **Undue Influence and Lack of Testamentary Capacity.** The Kentucky Supreme Court dealt with the challenge of the validity of the Will on grounds of undue influence and lack of testamentary capacity in Bye v. Mattingly, Ky., 975 S.W.2d 451 (1998). On March 23, 1989, Mrs. McQuady died leaving all of her assets to Mr. McQuady. In May 1989, Mr. McQuady hired Ms. Bye as his housekeeper. He was unable to see at this time. On July 17, 1989, Mr. McQuady, accompanied by Ms. Bye, executed a new Will revoking bequests to family members, and leaving \$100 to his church, and the remainder to Ms. Bye.

On May 18, 1990, the family members who had been the beneficiaries of the earlier Will petitioned and were appointed limited conservators and limited guardian. On September 21, 1990, Mr. McQuady was diagnosed as suffering from Alzheimer's disease. Subsequently, a petition was filed seeking to allow Mr. McQuady to marry Ms. Bye and on May 17, 1991, a hearing was held on that matter. In the hearing, Mr. McQuady testified that he had signed the petition in error, that he did not want to marry Ms. Bye, and that he was afraid of Ms. Bye. The court denied the petition to marry and Ms. Bye's services as housekeeper were terminated.

On October 29, 1991, a new Will was executed by Mr. McQuady which reenacted the 1988 Will. One of the beneficiaries drove Mr. McQuady to and from the law office but did not participate in any discussion or activities regarding the Will and Mr. McQuady had private discussions with his lawyer. When the Will was executed, only the lawyer, Mr. McQuady, and a witness were present. On August 7, 1992, Mr. McQuady died and Ms. Bye sued challenging the validity of the 1991 Will on the grounds of undue influence and lack of testamentary capacity.

The court noted that there is strong presumption in favor of a testator possessing adequate testamentary capacity and held that although "a ruling of total or partial disability certainly is evidence of a lack of testamentary capacity, it is certainly not dispositive of the issue." The court cited cases in which deaf, blind, paralyzed, and epileptic testators were determined to have capacity, as well as those who believed in witchcraft, spiritualism, and atheism. The court

found, therefore, that Mr. McQuady would be presumed to have been experiencing a "lucid interval" during the execution of the Will.

With respect to undue influence, the court listed as badges of undue influence: "a physically weak and mentally impaired testator, a will which is unnatural in its provisions, a recently developed and comparatively short period of close relationship between the testator and principal beneficiary, participation by the principal beneficiary in the preparation of the will, possession of the will by the principal beneficiary after it was reduced to writing, efforts by the principal beneficiary to restrict contacts between the testator and the natural objects of his bounty, and absolute control of testator's business affairs." The court found that on these facts the only existing badges of undue influence were that the testator was physically and mentally weak and that one of the beneficiaries had complete control over the testator's business affairs as guardian.

The court specifically distinguished between contracts between a guardian and a ward which do create a presumption against the transaction which must be rebutted by the guardian with clear and convincing evidence, and a bequest in a will.

The court also noted that merely driving the testator to and from the lawyer's office was not "active participation" in the execution of a Will and, thus, did not give rise to a presumption of undue influence.

3. **Conflict of Interest By Trustee of Multiple Trusts.** The Kentucky Court of Appeals has rendered an interesting opinion in Wiggins v. PNC Bank, Kentucky, Inc., Ky., 988 S.W.2d 498 (1999). PNC Bank was trustee of two trusts having as the lifetime beneficiary Verna Schlegel Moesser. One trust was an inter vivos trust which was for her sole benefit with the remainder being distributed to her estate at her death. Another trust had been created by Ms. Moesser's mother and, under the facts, was passed to Ms. Moesser's mother's descendants after her death. PNC Bank made encroachments from both trusts for Ms. Moesser's benefit while she was incompetent and in a nursing home.

After Ms. Moesser died, the beneficiaries of Ms. Moesser's mother's trust (the Schlegel trust) contended that PNC Bank had a conflict of interest and should have obtained prior court approval before distributing assets from the Schlegel trust pursuant to KRS 386.820(2). That statute provides:

If the duty of the trustee and his individual interest or his interest as trustee of another trust, conflict in the exercise of a trust power, the power may be exercised only by court authorization (except as provided in KRS 386.810, subsections (3)(a), (d), (f), (r), and (x)) upon petition of the trustee. Under this section,

personal profit or advantage to an affiliated or subsidiary company or association is personal profit to any corporate trustee.

The Kentucky Court of Appeals agreed that a conflict existed and that KRS 386.820(2) applied. Thus, the statute limited PNC's discretion and it should have obtained prior court approval. The court remanded the case for a determination of damages.

The dissent makes the point that the "majority seems to say that merely because PNC had two trusts from which it could invade principal to support Verna, a 'conflict of interest' was automatically created when PNC exercised its discretion as to which funds would be used for her support." The majority opinion does not say why there was a conflict of interest, only that PNC was faced with the choice of whether to disadvantage the remainder beneficiaries of the Schlegel trust or the remainder beneficiaries of the Moesser trust.

Presumably if PNC Bank had acted in accordance with the authority of an attorney-in-fact or the revocable trust had been an agency account the issue would not have arisen. The result seems anomalous in that respect. Regardless, corporate fiduciaries, in particular, can be expected to face this issue on an on-going basis.

4. **Prenuptial Planning.** The settled law in Kentucky is that gifts before marriage are ineffective to defeat an intended spouse's dower interest. In Martin v. Martin, Ky., 138 S.W.2d 509 (1940), the court stated a general rule that pre-marital gifts of real estate were ineffective to defeat dower but that gifts of personalty were effective and then determined that there should be no difference between kinds of property. The court held that pre-marital gifts of all types were ineffective.

The result is the same for post-marital transfers. See Anderson v. Anderson, Ky. App., 5835 S.W.2d 504 (1979), and Harris v. Rock, Ky., 799 S.W.2d 10 (1990).

The cases are consistent with a public policy that protects spouses from disinheritance. It is not entirely clear whether such policy is appropriate.

U. **MISCELLANEOUS**

1. **Tax Apportionment.** Apportionment of estate tax presents on-going issues. One of those was addressed in Estate of Miller v. Commissioner, T.C. Memo. 1998-416: apportionment inside the residue. The decedent's Will provided for all taxes to be paid from the residue. The residue was to be divided, one-half for the

decedent's surviving spouse and the other half to a trust that did not qualify for the marital deduction. The applicable apportionment statute, Texas, was summarized by the court:

Generally, in the absence of specific directions in the will regarding the apportionment of estate tax, the State's apportionment statute mandates that estate tax be apportioned among estate beneficiaries according to the taxable value of their respective interests in the estate. Tex. Prob. Code Ann. sec. 322A(b)(1). Apportionment, pursuant to the statute, takes into consideration bequests qualifying for the marital deduction, and no estate tax is apportioned to the surviving spouse with respect to such bequests. Tex. Prob. Code Ann. sec. 322A(c) and (d). The Texas statute, however, allows the decedent to opt out of the general scheme by specifically providing for an alternative plan of apportionment. Tex. Prob. Code Ann. sec. 322A(b)(2).

The court relied on Estate of Fine v. Commissioner, 90 T.C. 1068 (1988), aff'd without published opinion, 885 F.2d 879 (11th Cir. 1989), and Estate of Brunetti v. Commissioner, T.C. Memo. 1988-517, and held that the Will "opted out" of the statute.

A contrary result was reached in Edward McKeon v. United States, 82 A.F.T.R.2d 98-5114 (9th Cir.), construing the California apportionment statute.

In Estate of Fagan v. Commissioner, T.C. Memo. 1999-46, the decedent's will provided in pertinent part as follows:

1.01 CLAIMS AGAINST MY ESTATE. I direct my Executor, hereinafter named, to pay out of the general funds of my estate the cost of the administration of my estate, all my legal debts, expenses of last illness, and funeral expenses.

1.02 PAYMENT OF TAXES. I direct my Executor to pay out of my residuary estate, otherwise passing under Article III hereof, and as soon as practical, all inheritance, estate, transfer, and succession taxes payable by reason of my death (including interest and penalties thereon in the discretion of my Executor) assessed on my property or interest included in my gross estate for tax purposes. I direct that my Executor shall not require that any part of such taxes by [sic] recovered from, paid by, or apportioned among the recipients of, or those interested in, such property.

* * * * *

ARTICLE III

DISPOSITION OF RESIDUARY ESTATE

All the rest, residue and remainder of my property, real and personal, tangible and intangible, wheresoever situate and howsoever held, including any property over which I may have a power of appointment, herein referred to as my residuary estate, I give, devise, and bequeath to First-Citizens Bank & Trust Company, as

Trustee under that certain Trust Agreement dated the 17th day of June, 1988, wherein I am the Grantor and First-Citizens Bank & Trust Company is Trustee, to be held and administered as a part of the trust hereby [sic] created.

The trust provided that the trust assets would be divided into three shares, the last of which was equal to three-fifths of the estate and was to be distributed among various charitable organizations. The trust agreement provided that that share should "not be reduced by any taxes chargeable against the Grantor's gross estate."

At issue before the court was whether the charitable share was calculated as a percentage of the entire estate, unreduced by federal estate taxes, or after the payment of federal estate taxes. The court determined that the language of the Will waived any general apportionment statutes under applicable state law (North Carolina) as well as section 2206 (apportionment to life insurance). The court found that the clause in the trust was insufficient to overcome the waiver of apportionment in the Will stating that the "apportionment clause in the trust agreement deals with an allocation of the tax burden on property that the beneficiaries of the trust are entitled to receive from the trust, not what the trust is entitled to receive from the grantor-decedent's estate."

In TAM 199915001 the decedent had a Will that provided for the payment of all estate taxes from the residue of the estate without apportionment. The decedent's estate plan also included a revocable trust and an irrevocable life insurance trust, the insurance proceeds payable to which were included in the decedent's gross estate. The TAM concludes that the general tax clause waived apportionment under section 2206 and thus the insurance trust would not be required to reimburse the probate estate but that reimbursement under section 2207B was not waived and thus taxes would be apportioned against the revocable trust because it was included in the decedent's estate under section 2036.

An issue not addressed was whether the revocable trust is also included under section 2038 or instead under section 2038. Section 2207B applies only to section 2036.

2. **Resulting Trust Argument Rejected.** In Estate of Horstmeier v. Commissioner, T.C. Memo. 1999-145, the court held that 100% of the residence titled in the name of the decedent would be included in the decedent's estate and rejected the estate's contention that a resulting trust in favor of the decedent's life partner was valid. The estate claimed that the decedent's life partner had beneficial interest in half of the property based on an understanding and agreement with the decedent that the decedent purchase the residence and would, in effect, transfer the residence over time to the life partner in exchange for services. The tax court found insufficient evidence of a resulting trust.

A somewhat different conclusion was reached in the Kentucky case of Rakhman v. Zusstone, Ky., 957 S.W.2d 241 (1997), in which Zusstone bought the residence and Rakhman contended that the residence was a gift to her on the occasion of the birth of their second child. The parties began living together, unmarried, in 1979, their second child was born in 1985, and the home was used as their residence until their separation in 1992. Any evidence that the residence was a gift was in testimony of Rakhman, although the court did find other instances in which Zusstone bought property and had it "held" in someone else's name.

The Kentucky Supreme Court found first that Rakhman was the natural object of Zusstone's affection stating "one with whom the donor has shared a home for nearly twelve years, who has been represented to the public as the donor's spouse, who has adopted the use of the donor's surname, and who has borne the donor two children and has shared the demands and joys of parenting with the donor, would come within a practical definition of the phrase." In 1985 when the property was purchased, Zusstone transferred funds into a bank account over which Rakhman had sole control, she wrote and signed the check in payment for the house, and the deed was placed in her name alone. Thus, there was presumption that the gift was made to her.

3. **Effectiveness of Off-Shore Trusts.** Of interest to those doing off-shore trusts for creditor protection planning is Federal Trade Comm'n v. Affordable Media, LLC, ___ F.3d ___, 99 Cal. Daily Op. Serv. 4689, (9th Cir. 1999), in which the Ninth Circuit upheld the U. S. District Court's findings of contempt against the Andersons for failing to return the list of proceeds from an off-shore trust. The Andersons claimed that they were unable to comply with the judicial order -- an impossibility defense -- but the Ninth Circuit rejected that contention noting that the District Court found that in fact the Andersons were indirectly in control of the trust. That finding was buttressed, apparently, by the fact that the Andersons acted, or could act, as the "trust protector."

The court did not squarely address the issue of whether an impossibility defense would have been sufficient had the Andersons not acted as trust protector. The court seemed sympathetic to the notion that an impossibility defense is not appropriate where the parties asserting the defense have in fact created the impossibility. To state it differently, where the parties themselves created a trust which was designed not to honor court orders, was a self-created impossibility. In that regard, the court stated:

Given that these offshore trusts operate by means of frustrating domestic courts' jurisdiction, we are unsure that we would find that the Andersons' inability to

comply with the district court's order is a defense to a civil contempt charge. We leave for another day the resolution of this more difficult question because we find that the Andersons have not satisfied their burden of proving that compliance with the district court's repatriation order was impossible. It is well established that a party petitioning for an adjudication that another party is in civil contempt does not have the burden of showing that the other party has the capacity to comply with the court's order. See NLRB v. Trans Ocean Export Packing, Inc., 473 F.2d 612, 616 (9th Cir. 1973). Instead, the party asserting the impossibility defense must show "categorically and in detail" why he is unable to comply. *Id.*; See also Rylander, 460 U.S. at 757 ("It is settled, however, that in raising this defense, the defendant has a burden of production.").

In the asset protection trust context, moreover, the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply. Foreign trusts are often designed to assist the settlor in avoiding being held in contempt of a domestic court while only feigning compliance with the court's orders:

Finally, the settlor should be aware that, although his trust will probably prove unassailable by domestic creditors, he may face minor hassles while defending his trust in court. In particular, if a creditor attacks an offshore trust in United States court, the settlor may face contempt of court orders during the proceedings. . . . [T]here is a possibility that the court will . . . order the settlor to collect his assets from the trust and turn them over to the court. If the settlor does not comply with these orders, a court may hold him in contempt. However, there are ways around such a conflict. . . . [T]he settlor could comply with the court order and 'order' his trustee to turn over the funds, knowing full well that the trustee will not comply with his request. Thereby, the settlor would technically comply with the court's orders, escape contempt of court charges, and still rest assured that his assets will remain protected.

James T. Lorenzetti, *The Offshore Trust: A Contemporary Asset Protection Scheme*, 102 Com. L. J. 138, 158 (1997). With foreign laws designed to frustrate the operation of domestic courts and foreign trustees acting in concert with domestic persons to thwart the United States courts, the domestic courts will have to be especially chary of accepting a defendant's assertions that repatriation or other compliance with a court's order concerning a foreign trust is impossible. Consequently, the burden on the defendant of proving impossibility as a defense to a contempt charge will be especially high.

LEGAL ETHICS MATERIALS

APPENDIX A (1): **PROFESSIONAL RESPONSIBILITY ISSUES
FOR TRUST AND ESTATE LAWYERS -
A Review of Issues Addressed by Kentucky Bar
Association Formal Ethics Opinion E-401,
Sheldon G. Gilman..... A - 77**

APPENDIX A (2): **KENTUCKY BAR ASSOCIATION ETHICS
HOTLINE OPINION REGARDING THE DUTY
TO ADVISE A SURVIVING SPOUSE OF HIS
OR HER RIGHT TO ELECT AGAINST A
DECEDENT'S WILL (*including reference to
Florida Bar Ethics Opinion 76-16, April 4, 1977*),
Sheldon G. Gilman..... A - 87**

PROFESSIONAL RESPONSIBILITY ISSUES FOR TRUST AND ESTATE LAWYERS

(A Review of Issues Addressed by Kentucky Bar Association Formal Ethics Opinion E-401)

Sheldon G. Gilman

I. Introduction to Issues**A. Review of Fundamental Issue: "Who does the lawyer represent?"**

1. Does the lawyer represent the fiduciary? If the lawyer represents the fiduciary, then does the lawyer represent the fiduciary in a fiduciary capacity or an individual (corporate) capacity?
2. Does the lawyer represent the beneficiaries?
3. Does the lawyer represent the estate/trust as an entity?
4. Does the lawyer represent the beneficiaries and the fiduciary?

B. Confidentiality and Privilege. If the fiduciary reveals to the lawyer or the lawyer discovers in the course of the representation that the fiduciary has made a mistake, or acted in a dishonest, fraudulent, or criminal manner, may or must the lawyer reveal this information to the beneficiaries, or the other fiduciaries, or a court that supervises estate administration, or does the duty of confidentiality or the concept of privilege preclude such revelation or discovery?

C. Conflicts of Interest. To whom must the lawyer be loyal if multiple co-fiduciaries or a predecessor and a successor fiduciary disagree, or the fiduciaries and the beneficiaries disagree, or a fiduciary is a creditor of the entity or one of several beneficiaries whose interests conflict with other fiduciaries or beneficiaries, and does the lawyer have a conflict of interest in the context of such representations? What is the potential for conflict among several constituents: the spouse as against the children (the income beneficiary as against the remainder beneficiaries and one co-fiduciary against another co-fiduciary), and the children as against the one child who is active in the business.

D. Competence and Loyalty to the Beneficiaries. Must the lawyer protect the beneficiaries' interests as individuals or only indirectly as beneficiaries of the fiduciary entity that the lawyer serves, and must the lawyer seek protective measures if, for example, a beneficiary is being overreached by a third party or by a fiduciary, or appears to require the appointment of a guardian or conservator to protect the beneficiary?

E. Review of Questions Presented By KBA E-401.

1. **Question 1:** Does a lawyer's representation of a fiduciary of a decedent's estate or trust expand or limit the lawyer's obligation to the fiduciary under the Rules of Professional Conduct?

2. Question 2: Does a lawyer's representation of a fiduciary of a decedent's trust or estate impose on the lawyer obligations to the beneficiaries of the decedent's trust or estate that the lawyer would not have toward third parties?

3. Question 3: Is the lawyer's obligation to preserve client confidences under Rule 1.6 altered by the fact that the client is a fiduciary?

4. Question 4: May the lawyer for the fiduciary also represent the beneficiaries of the decedent's trust or estate?

II. Review of Professional Rules

A. Rule 1.7: Conflict of Interest: General Rule.

1. A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(a) The lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

(b) Each client consents after consultation.

2. A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(a) The lawyer reasonably believes the representation will not be adversely affected; and

(b) The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

B. Comments To Rule 1.7. *Other Conflict Situations*

[10] Conflicts of interest in contexts other than litigation sometimes may be difficult to assess. Relevant factors in determining whether there is potential for adverse effect include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that actual conflict will arise and the likely prejudice to the client from the conflict if it does arise. The question is often one of proximity and degree.

[11] For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but

common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.

[12] Conflict questions may also arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may arise. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. The lawyer should make clear the relationship to the parties involved.

C. Requirement of "Consent and Consultation." The Rules of Professional Conduct define "consult" or "consultation" as denoting "communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question." A lawyer is obligated to disclose to the client the existence of the conflict, that multiple representation is sought, then disclose the implications thereof, including its risks and advantages. In this regard pages 114 through 118 of the American Bar Association's text, Annotated Model Rules of Professional Conduct, Third Edition, (1996) contains numerous citations and commentary on this issue of client "consultation," and is recommended reading for a further understanding of the requirements for and the meaning of "consultation." All communications between a lawyer and multiple clients regarding questions of conflict should be in writing, and the client's consent should be evidenced in writing.

D. Rule 1.2: Scope of Representation.

1. A lawyer shall abide by a client's decision concerning the objectives of representation, subject to paragraphs (c), (d) and (e), and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

2. A lawyer's representation of a client, including representation appointment, does not constitute an endorsement of the client's political, economic, social, or moral views or activities.

3. A lawyer may limit the objectives of the representation if the client consents after consultation.

4. A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning, or application of the law.

5. When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer

shall inform the client regarding the relevant limitations on the lawyer's conduct.

E. Comment to Rule 1.2.

[8] Where the client is a fiduciary, the lawyer may be charged with special obligations in dealings with a beneficiary.

F. Rule 1.6: Confidentiality of Information.

1. A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b).

2. A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

(a) To prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm; or

(b) To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(c) To comply with other law or a court order.

G. Comments to Rule 1.6.

[1] The lawyer is part of a judicial system charged with upholding the law. One of the lawyer's functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights.

[2] The observance of the ethical obligation of a lawyer to hold inviolate confidential information of the client not only facilitates the full development of facts essential to proper representation of the client but also encourages people to seek early legal assistance.

[3] Almost without exception, clients come to lawyers in order to determine what their rights are and what is, in the maze of laws and regulations, deemed to be legal and correct. The common law recognizes that the client's confidences must be protected from disclosure. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[4] A fundamental principle in the client-lawyer relationship is that the lawyer maintain confidentiality of information relating to the representation. The

client is thereby encouraged to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter.

[5] The principle of confidentiality is given effect in two related bodies of law, the attorney-client privilege (which includes the work product doctrine) in the law of evidence and the rule of confidentiality established in professional ethics. The attorney-client privilege applies in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule applies not merely to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

Disclosure Adverse to Client

[9] The confidentiality rule is subject to limited exceptions. In becoming privy to information about a client, a lawyer may foresee that the client intends serious harm to another person. However, to the extent a lawyer is required or permitted to disclose a client's purposes, the client will be inhibited from revealing facts which would enable the lawyer to counsel against a wrongful course of action. The public is better protected if full and open communication by the client is encouraged than if it is inhibited.

[10] Several situations must be distinguished.

[11] First, the lawyer may not counsel or assist a client in conduct that is criminal or fraudulent. See Rule 1.2(d). Similarly, a lawyer has a duty under Rule 3.3(a)(4) not to use false evidence. This duty is essentially a special instance of the duty prescribed in Rule 1.2(d) to avoid assisting a client in criminal or fraudulent conduct.

[12] Second, the lawyer may have been innocently involved in past conduct by the client that was criminal or fraudulent. In such a situation the lawyer has not violated Rule 1.2(d), because to "counsel or assist" criminal or fraudulent conduct requires knowing that the conduct is of that character.

[14] The lawyer's exercise of discretion requires consideration of such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. Where practical, the lawyer should seek to persuade the client to take suitable action. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes is necessary to the purpose. A lawyer's decision not to take preventive action permitted by paragraph (b)(1) does not violate this Rule.

Withdrawal

[15] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1).

[16] After withdrawal the lawyer is required to refrain from making disclosure of the clients' confidences, except as otherwise provided in Rule 1.6. Neither this rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and upon withdrawal the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like.

III. Review of State Choices

A. Representation of Fiduciary. Florida Law.

[C]ounsel for the personal representative of an estate owes *fiduciary duties* not only to the personal representative but also *to the beneficiaries* of the estate.... This does not mean, however, that counsel and the beneficiaries occupy an attorney-client relationship. They do not. "In Florida, the personal representative is the client rather than the estate or the beneficiaries." Rule 4-1.7, Rules Regulating the Florida Bar (comment). It follows that counsel does not generate a conflict of interest in representing the personal representative in a matter simply because one or more of the beneficiaries takes a position adverse to that of the personal representative. A contrary position would raise havoc with the orderly administration of decedents' estates, not to mention the additional attorney's fees that would be generated.¹

B. Representation of Estate or Trust. In Delaware, North Carolina, New York and Washington it appears that the lawyer for the fiduciary represents the fiduciary entity and *not just* the fiduciary.²

C. Recommendation for Action. In "Representations Involving Fiduciary Entities: Who is the Client?," 62 Fordham Law Review 1319 (1994), Jeffrey N. Pennell reviews the complexity of the problem, and makes the following comments:

Following the approach in Florida, other states should be encouraged to establish, by express amendment to their Rules or by a Comment explaining them, who the attorney represents in the absence of a representation agreement to the contrary. In establishing this rule it is necessary and appropriate to distinguish between an attorney's duties to non-clients (such as beneficiaries under most of the alternative visions

¹ In re Estate of Gory, 570 So.2d 1381, 1383 (Fla. Dist. Ct. App. 1990) (emphasis added) (order disqualifying personal representative's lawyers in dispute over personal representative's compensation reversed).

² Riggs National Bank v. Zimmer, 355 A.2d 709 (Del. Ch. 1976); N.Y. State Bar Ass'n, Ethics Op. 512 (1979), Jenkins v. Wheeler, 69 N.C. App. 140, review denied, 311 N.C. 758 (1984); In re Vetter, 711 P.2d 284, 289 (Wash. 1985);

of the entity representation situation) and to restrict the impetus to expand the concept of "derivative" duties by adopting a rule that provides protection to beneficiaries without creating untenable or undefinable obligations of the attorney. Among the available options, regarding the beneficiaries as the attorney's client should be rejected because the beneficiaries do not engage the attorney, the beneficiaries almost always have conflicting interests (because some are current and others are future interest holders), and in some cases the attorney may not know the wishes or even the identity of the various beneficiaries. Casting the attorney in the role of a watchdog over the fiduciary to protect the interests of beneficiaries also is untenable and subverts the attorney-client relation, regardless of who the client is deemed to be. Any rule that creates an obligation on an attorney to police a fiduciary should be rejected. (At page 1344).

IV. Duties to Beneficiaries

A. Review Rule 1.2.

B. Communications with Beneficiary. The lawyer should be careful not to allow the beneficiary to believe that the lawyer represents the beneficiary's interests. It is not uncommon for the beneficiary of an estate or trust to believe that the fiduciary's lawyer represents the estate or trust as an entity and thus, to some extent, the beneficiary's interests. If the lawyer representing the fiduciary believes that this has occurred, the lawyer should quickly correct the beneficiary's misperceptions and clearly advise the beneficiary that the lawyer only represents the fiduciary. The lawyer should avoid making comments, written or oral, which give the beneficiary a false sense of security. The lawyer should not suggest that the allowance of the fiduciary account is merely "routine," lest the beneficiary fail to scrutinize the account carefully on the basis of this representation.

V. ABA Formal Opinion 94-380 & KBA E-401

A. Review of Majority Rule - Lawyer Represents Fiduciary.

B. Review of KBA Opinion Citing ABA Opinion.

VI. Conclusion of KBA Opinion

A. Review of Five Points.

1. In representing a fiduciary the lawyer's client relationship is with the fiduciary and not with the trust or estate, nor with the beneficiaries of a trust or estate.

2. The fact that a fiduciary has obligations to the beneficiaries of the trust or estate does not in itself either expand or limit the lawyer's obligations to the fiduciary under the Rules of Professional Conduct, nor impose on the lawyer

obligations toward the beneficiaries that the lawyer would not have toward other third parties.

3. The lawyer's obligation to preserve client's confidences under Rule 1.6 is not altered by the circumstance that the client is a fiduciary.

4. A lawyer has a duty to advise multiple parties who are involved with a decedent's estate or trust regarding the identity of the lawyer's client, and the lawyer's obligations to that client. A lawyer should not imply that the lawyer represents the estate or trust or the beneficiaries of the estate or trust because of the probability of confusion. Further, in order to avoid such confusion, a lawyer should not use the term "lawyer for the estate" or the term "lawyer for the trust" on documents or correspondence or in other dealings with the fiduciary or the beneficiaries.

5. A lawyer may represent the fiduciary of a decedent's estate or a trust and the beneficiaries of an estate or trust if the lawyer obtains the consent of the multiple clients, and explains the limitations on the lawyer's actions in the event a conflict arises, and the consequences to the clients if a conflict occurs. Further, a lawyer may obtain the consent of multiple clients only after appropriate consultation with the multiple clients at the time of the commencement of the representation.

B. Recommendations

1. Get It In Writing
2. You Do Not Represent Trusts - Estates
3. Use The Hot Line

VII. Process of Opinion

A. Recognition of Problem - Review By Committee - Through Committee - Board of Governors.

B. Decision for Kentucky: Lawyers Representing Fiduciaries or Beneficiaries or Both.

VIII. Miscellaneous Ethical Issues for the Estate Planner

- A. Joint Representation of Spouses
- B. Gifts to Lawyers
- C. Will Provision Requiring Appointment as Fiduciary's Lawyer
- D. Lawyer Representation of Fiduciary & Beneficiaries
- E. Lawyer Selling Life Insurance
- F. Lawyer Serving as Fiduciary
- G. Lawyer Disclosure of Information After Client's Death

IX. Questions for Review

Partially disinherited (disgruntled) adult child wants to know the details of preparation of his mother's trust/will. His mother (my client) died recently. I suspect that he plans to file a will contest or action to rescind the trust. I am not representing anyone/any estate at this time, so there is no apparent conflict of interest. I drafted mother's will/trust 18 months ago.

- #1 Is there any ethical reason why I should or should not share with him the events surrounding preparation of mother's documents, as well as letters, drafts and notes in my file?
- #2 Do I owe the mother a continuing duty of confidentiality after her death?
- #3 Should I tell the disgruntled child that I will share information with him if he gives me written consent from all other legatees?
- #4 If the child attempts to obtain a court order to have me disclose the information do I have an affirmative obligation to oppose the child's efforts?

KENTUCKY BAR ASSOCIATION ETHICS HOTLINE OPINION
REGARDING THE DUTY TO ADVISE A SURVIVING SPOUSE
OF HIS OR HER RIGHT TO ELECT AGAINST A DECEDENT'S WILL

(including reference to Florida Bar Ethics Opinion 76-16, April 4, 1977)

This is in response to your request for advice from the Kentucky Bar Association's Ethics "Hotline" Committee regarding the following two ethics questions.

Ethics Question No. 1

Your letter contains a two page statement of facts, however, for purposes of providing you with advice I will summarize your detailed statement of facts as follows:

- You represent Mr. James Smith³ in his capacity as executor of the Estate of Mrs. Mary Jones. Mr. Smith is a nephew of the decedent and is one of two remainder beneficiaries. Mrs. Jones' estate exceeds \$700,000.
- The decedent was married to Mr. Jones, and Mr. Jones survived the decedent. The Will contains a small bequest to Mr. Jones with the bulk of the Estate passing to Mr. Smith and another nephew.
- You advised the executor/nephew that Mr. Jones, as surviving spouse, could elect to take his marital share of decedent's estate, and the executor "instructed me not to relay that information to Mr. Jones."
- Mr. Jones is living in a nursing home because of his inability to care for himself. At the executor's request you accompanied the executor to visit Mr. Jones in the nursing home and at the executor's request you prepared a power of attorney, and a living will for Mr. Jones. You state you advised Mr. Jones you represented the executor and you were preparing the documents as an accommodation.

You then stated you heard my ethics' presentation regarding KBA E-401 at this summer's University of Kentucky's Estate Planning Seminar, and at the end of my presentation someone posed a hypothetical question to me about the duty of the executor's attorney to advise the surviving spouse of their right to elect against the will. At that time, I made a comment that providing such advice may be necessary. Therefore, based upon my comment at the Seminar you have asked me the following two questions:

- 1) Do you have a responsibility to advise a surviving spouse of his right to elect against the decedent's Will; and,
- 2) If you do have a duty to disclose such information to the spouse, how should you make the disclosure; that is, in person or by letter to his attorney in fact.

The Kentucky Bar Association's Ethics Committee has not opined on the specific issue you have raised; however, the Florida Bar Association's Ethics Committee has considered the specific questions you have raised. Please find enclosed a copy of Florida Bar Ethics Opinion

³ Your letter advises that the names of the parties have been changed in order to protect client confidentiality.

76-16. April 4, 1977. In response to the question of whether a lawyer is obligated to inform the surviving spouse of the spouse's right to elect against the decedent's Will, and take an elective share, the Florida Ethics Committee provided the following advice.

"The lawyer is not necessarily required to inform the surviving spouse of such rights, but the Committee believes that it would be advisable to do so in most instances. When the personal representative is someone other than the surviving spouse, the surviving spouse may be looking to the lawyer or the personal representative for information even though there is no attorney-client relationship between them. If the lawyer knows this, we believe he may have a duty to inform the surviving spouse of these statutory rights. If the surviving spouse has retained a lawyer, there is probably no need to. When the surviving spouse is the personal representative, we believe the lawyer should advise the surviving spouse of these rights."

When the personal representative is someone other than the surviving spouse, and if the personal representative objects to the lawyer's informing the surviving spouse of the surviving spouse's rights, what are the lawyer's responsibilities?

"The right to claim an elective share, or family allowance or exempt property are, as stated above, rights provided by statute. The personal representative has the duty to administer the estate according to law, including Sections 732.201, 732.402, and 732.403. He has no duty to try to prevent the exercise of those rights."

Finally, the last question presented and responded to raises the fundamental question raised in your correspondence. The last question and answer is as follows.

5. Assuming that the personal representative is someone other than the surviving spouse, would the answer ... be different if the personal representative's opposition to the spouse claiming an elective share or statutory entitlements is based upon the personal representative's desire to increase his own distributive share? No. A personal representative is a fiduciary, and his private desires *vis-a-vis* the estate are immaterial.

I find the analysis of the Florida Bar Opinion well considered and consistent with a lawyer's duties under the Rules of Professional Conduct. Therefore, it is my opinion that you have a duty to advise the surviving spouse of his rights to elect against the decedent's Will. Your client's position as a primary residuary beneficiary of the estate may conflict with his fiduciary duties, and you may not allow yourself to participate, either directly or indirectly in the possible giving of a false impression.⁴

It is my opinion that your advice should be given by letter, and may be provided to the surviving spouse's attorney in fact.

⁴ See Rule 4.1, "Truthfulness in Statements to Others" - "In the course of representing a client a lawyer shall not knowingly make a false statement of material fact or law to a third person."

Ethics Question No. 2

Your second question presents an issue that was discussed in Kentucky Bar Association Ethics Opinion KBA E-376, regarding lawyer participation in the sale of life insurance products. In your correspondence you stated the following:

I have been approached by various life insurance people, financial planners, and others in the financial services business for referrals, and they have offered various fee-sharing incentives, all of which I have not accepted. Another insurance brokerage company has contacted me and suggested that I recommend to my clients to consider "no-commission" insurance. Their representatives suggested to me that it is "ethical" in Kentucky to charge a higher additional separate legal fee for advising the client on the insurance issues and the benefits of no-commission insurance. They did, however, recommend that I deliver to the client a letter which provides full disclosure of my relationship as a lawyer with the insurance brokerage. The client would supposedly pay a legal fee for my advice and the referral to the no-commission insurance agency. The insurance company the policy is finally placed with would pay the insurance brokerage company a fee for closing any sale which resulted. There would be no fee or commission sharing between me, and insurance brokerage or insurance company.

You made reference to a recent Kentucky ethics opinion, and you have asked what is the status of the ethics opinions in Kentucky on these matters. Also, you would like to know if this question has been previously presented to the Ethics Committee, and if you could have the benefit of my experience, etc.

It is my opinion that KBA E-376 provides significant advice on the questions you have raised; accordingly, I am enclosing a copy of this Opinion.⁵ Please note the following comments from this Opinion.

Further, to make our position as clear as possible, we emphasize that a lawyer has a duty of loyalty to the client, and that advising a client about the disposition of the client's estate after death, and the sale of life insurance raises inherent problems of conflicts of interest as the insurer pays the agent (lawyer) to maximize insurance sales, and the lawyer's responsibility to maintain independence may be compromised; accordingly, it is necessary for the lawyer to disclose all of these matters in writing to the client, and to obtain the client's consent. The disclosure should advise the client that it is appropriate to obtain independent advice, counsel, in these unique circumstances.

Since the issuance of the referred to opinion there have been no additional opinions on this subject. Further, I am not aware of any opinions of other Bar Associations on these issues. As to my advice on the question presented, I would seriously question any insurance advisor who makes the following statement.

⁵ As a member of the Kentucky Bar Association's Ethics Committee I served as the principal author of the subject opinion, and the comments made in this correspondence reflect the special insights I learned in preparing KBA E-376.

Their representatives suggested to me that it is "ethical" in Kentucky to charge a higher additional separate legal fee for advising the client on the insurance issues and the benefits of no-commission insurance.

In conclusion, it is my opinion that the arrangement proposed by the insurance agent raises serious issues of fraud, false impression, and conflicts of interest. I would not recommend participating in such an arrangement.

I trust this advice has been of assistance to you and if you have any further questions you will contact me. This advice is limited to the scope granted the writer as a representative of the "Hot Line," pursuant to SCR 3.530, the purpose of which is clearly stated that "*no attorney shall be disciplined for any professional act on his part performed in compliance with an opinion furnished to him on his petition, provided his petition clearly, fairly, accurately, and completely states his contemplated professional act.*" This Opinion is not an expression of law nor does it bind any court.

Very truly yours,

Sheldon G. Gilman

FLORIDA BAR ETHICS OPINION

OPINION 76-16

April 4, 1977

A surviving spouse who claims an elective share or statutory entitlements does not, without more, have a conflict of interest with the personal representative of an estate or other beneficiaries under a will. The attorney for the personal representative has the right and in some circumstances a duty, to inform the surviving spouse of the existence of those statutory rights.

Statutes: F.S. §§§§732.201, 732.402, 732.403, 733.504(9)

Chairman Sullivan stated the opinion of the committee:

A member of The Florida Bar submits a number of questions about the rights and duties of the lawyer for the personal representative of an estate administered under the Florida Probate Code. The questions and the Committee's answers to them are as follows:

1. Does the lawyer for the personal representative have the right to inform the surviving spouse of his or her entitlement to family allowance (Sec. 732.403), exempt property (Sec. 732.402), or right to claim an elective share (Sec. 732.201)?

Yes. The purpose of the Florida Probate Code is to provide a procedure to pay a decedent's debts and taxes and transfer and distribute the remaining assets as efficiently and inexpensively as possible to those entitled to them under the will or by intestacy. It is normal in most instances that the persons entitled to those assets will look to the personal representative or the lawyer for the estate to find out what they may expect to receive from the estate. A beneficiary or heir always has the right, of course, to retain independent counsel.

We believe that the lawyer for the personal representative has the right to provide those persons with that information and to provide the surviving spouse with information about his or her rights under the Probate Code. This is to be distinguished from counseling or giving legal advice.

The surviving spouse frequently is the personal representative. In claiming an elective share, a family allowance or exempt property we believe the surviving spouse is exercising a right provided by statute and is not acting in conflict with his or her duties as personal representative of the estate. Section 733.504(9), dealing with causes of removal of a personal representative because of a conflict of interest, specifically exempts as reasons for removal the surviving spouse's claiming an elective share or statutory entitlements. We believe that in most instances the lawyer for the personal representative prepares the papers by which the surviving spouse elects against the will or claims statutory entitlements. We see no ethical problem with this, provided there is no legal objection to claiming an elective share or entitlements.

If the surviving spouse claims one or more of the rights provided by statute, the result may be less for other beneficiaries. But the fact that claiming an elective share or statutory entitlements may alter the manner in which the estate is distributed does not, in the Committee's opinion, create a conflict of interest that requires the personal representative or his lawyer to refuse to

provide any information about the existence of those rights and, in effect, to treat the surviving spouse as an adverse party.

Such a result could force the surviving spouse to seek independent legal advice. We do not believe that the Probate Code intended to create a proliferation of lawyers; its purpose was just the opposite.

The Committee recognizes that there may be situations where it is apparent from the outset that there will be a dispute between a personal representative and a surviving spouse--a will contest, for example. In such situations, the lawyer for the personal representative should advise the surviving spouse that an actual or potential conflict of interest exists and suggest that he or she obtain independent legal advice.

Even where there is an actual or potential conflict of interest between personal representative and surviving spouse, we do not think the lawyer for the personal representative should refuse to furnish information about the surviving spouse's legal rights under the Florida Probate Code.

2. Is the lawyer obligated to inform the surviving spouse of such rights?

The lawyer is not necessarily required to inform the surviving spouse of such rights, but the Committee believes that it would be advisable to do so in most instances.

When the personal representative is someone other than the surviving spouse, the surviving spouse may be looking to the lawyer for the personal representative for information even though there is no attorney-client relationship between them. If the lawyer knows this, we believe he may have a duty to inform the surviving spouse of these statutory rights. If the surviving spouse has retained a lawyer, there is probably no need to. When the surviving spouse is the personal representative, we believe the lawyer should advise the surviving spouse of these rights.

3. Assuming that the personal representative is someone other than the surviving spouse, are the rights or obligations of the lawyer in 1. and 2., above, different if the personal representative objects to the lawyer's informing the surviving spouse of her entitlement?

No. The right to claim an elective share, or family allowance or exempt property are, as stated above, rights provided by statute. The personal representative has the duty to administer the estate according to law, including Sections 732.201, 732.402 and 732.403. He has no duty to try to prevent the exercise of those rights.

4. Assuming that the personal representative is someone other than the surviving spouse, would the answer to 3., above, be different if the lawyer had represented the decedent and spouse for a number of years?

No. The fact that the lawyer previously represented the decedent and spouse does not automatically create a duty to inform the surviving spouse of his or her statutory rights. But, as stated in part of our answer to 2., above, the lawyer for the personal representative may have a duty, as distinguished from a right, to inform a surviving spouse of certain statutory rights if the lawyer has represented the decedent and spouse previously and knows the surviving spouse is looking to him for information.

5. Assuming that the personal representative is someone other than the surviving spouse, would the answer to 3., above, be different if the personal representative's opposition to the spouse claiming an elective share or statutory entitlements is based upon the personal representative's desire to increase his own distributive share?

No. A personal representative is a fiduciary, and his private desires *vis-a-vis* the estate are immaterial.

ESTATE TAX FREEZES:
GRATs, Sales to Grantor Trusts, and
Appreciation Transfer Trusts

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**Annual Midwest Estate, Tax & Business Planning Institute
June, 1999**

**ESTATE FREEZES: GRATS, SALES TO GRANTOR TRUSTS,
AND APPRECIATION TRANSFER TRUSTS**

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ESTATE FREEZES: GRATS, SALES TO GRANTOR TRUSTS, AND APPRECIATION TRANSFER TRUSTS

This paper examines the uses of grantor retained annuity trusts, sales to grantor trusts, and appreciation transfer trusts as estate freezing techniques. The author refers the reader to the following resources for more information on these topics: Practical Drafting (U.S.Trust Company; Richard B. Covey, editor; especially the April, 1999 issue); Manning and Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," Tax Management Estates, Gifts, and Trusts Journal (Vol. 24, No. 1, January 14, 1999) (cited herein as Manning and Hesch); Ellen K. Harrison, "A Comparison of Retained Annuities and Sales to Grantor Trusts," ALI-ABA Estate Planning for the Family Business Owner (July, 1998); and, Mulligan, Defective Grantor Trusts Offer Many Tax Advantages, 19 Est. Plan. 131 (May/June 1992).

A. The Big Picture: Estate Freezes After Chapter 14

1. How We Got Here.

The purpose of an estate freeze is to limit the value of certain of the client's assets so that estate tax will not be paid on any appreciation of the "frozen" assets between the date of the freeze and the date of death. Perhaps the simplest freeze is accomplished by making a gift: the value of the gifted assets is forever frozen, as far as the transfer tax system is concerned, at the gift tax value. If the value of the assets increases between the date of the gift and the date of death then estate tax is not paid on the increase.

The maximum amount that may be frozen through simple gifting is the amount that may be sheltered by the unified credit (in 1999, \$650,000) and annual exclusion gifts unless the client is willing to pay gift tax. Paying gift tax is valuable not only for the freeze potential but also because the gift tax is removed from the transferor's estate if the transferor lives for at least three years, thus saving estate tax on the gift tax. See Pennell and Williamson, "The Economics of Prepaying Wealth Transfer Tax," Trusts and Estates (June, July and August, 1997) for an extended, and excellent, discussion of the economics of gifting.

Many clients do not want to pay significant amounts of gift tax, often because they lack liquidity, or are hesitant to sell assets and incur a capital gains tax, although they would like the benefits of an estate freeze. Prior to Chapter 14, enacted in 1990, several techniques were in common use. Those techniques are worth discussing briefly, in oversimplified form, as background to the issues addressed in this paper. In addition, certain of the concepts remain an integral part of freeze transactions today.

One technique was the preferred stock recapitalization. Suppose a client owned all the common stock of a corporation, worth \$1,000,000, which the client expected to increase in value. The corporation would have issued preferred stock worth, say, \$900,000 to the client. In order to justify a value of \$900,000 for the preferred stock it often would have had a dividend preference (set at a high rate to justify the lack of marketability of the stock) and certain kinds of voting rights. Often the intent was never to pay the dividend, although if it were not paid the IRS could attempt to argue that such nonpayment was a gift if the owner of the preferred stock was in control of the corporation. The IRS consistently lost such cases. See, e.g., Joseph M. Daniels, 68 TCM 1310 (1994); Snyder v. Commissioner, 93 T.C. 529 (1989); and Lewis G. Hutchens Non-Marital Trust, 66 TCM 1599 (1993).

In any event, if the preferred stock were worth \$900,000 then the common stock must be worth \$100,000. The common stock would be given to the client's donees and any increase in the value of the corporation would accrue to the common stock. The value of the corporation to the holder of the preferred stock was completely frozen if no dividends were paid on the stock, or partially frozen if a dividend were paid (or if the dividend was cumulative and was owed by the corporation at some future time). An S corporation could not be recapitalized because S corporations may have only one class of stock. Section 1361(c)(4).

For clients with other assets, a partnership was used with limited partnership units taking the place of preferred stock and general units, being

the equivalent of common stock. The frozen units were retained and the other units were given away. As with the corporate recapitalization, voting control of the partnership could be split up as was desired within the family.

Grantor retained income trusts (GRITs) were also popular. In 1984 new actuarial tables were issued by the IRS using a 10% earnings assumption, and replacing the old 6% tables. This made income interests more valuable and, consequently, remainder interests less valuable. Suppose a donor owned \$1,000,000 of bonds and gave those bonds to a trust in which the donor retained the income interest for a term of years. The value of the income interest was subtracted from the total value of the transfer and the value of the gift for gift tax purposes was what remained. If the donor died within the 10 year term the total value of the trust, including any appreciation, was included in the donor's estate by section 2036. For this reason the idea was modified to also give the client-donor a reversion in the trust assets during the 10 year term. The reversion - the ability to have the assets either paid to the donor's estate or subject to the donor's general power of appointment -- had value but did not "cost" the donor anything. Through this technique donors were able to give substantial assets at a reduced gift tax value. The benefits were increased if the assets yielded less than a 10% income return. At the extreme, if the trust were funded with non-income producing assets then the client would receive nothing and the freeze would be complete. The IRS attempted to prevent the use of non-income producing assets, but was not successful in preventing the use of the assets that had some income yield even if it was substantially less than 10%. See Froh v. Comm'r, 100 T.C. 1 (1993)(mineral interests under lease); cf. O'Reilly v. Comm'r, 95 T.C. 646 (1990), rev'd and remanded, 973 F.2d 1403 (8th Cir. 1992)(closely-held stock producing about 0.2% of annual income which the trustee indicated would not be sold).

Another technique was the buy-sell or stock restriction agreement. For instance, suppose a client with a \$1,000,000 corporation agreed that the client's children could purchase the stock in the corporation for \$500,000 at the client's death. The value of the corporation to the estate was not

\$1,000,000 but rather \$500,000. Buy-sell agreements were subject to more challenges than the recapitalization or the GRIT but would often withstand challenge if those who could purchase the assets at death also had a right of first refusal during the client's lifetime at the same price. In addition, if a formula price were agreed to, rather than a fixed price, the agreements were more likely to be upheld. See Saint Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982); Estate of Joseph H. Lauder, 60 TCM 977 (1990).

Finally, in certain instances a client would be given rights in stock or partnership units that disappeared at death. For instance, the client would have voting stock but the voting rights would disappear at death. That kind of planning was vindicated in Estate of Daniel J. Harrison, Jr., 52 TCM 1306 (1987).

2. Effect of Chapter 14.

Chapter 14 was intended to limit the effectiveness of these freeze techniques. It followed a failed attempt, section 2036(c), enacted in 1997 and repealed retroactively in 1990. Chapter 14 contains four sections.

Section 2701 attempts to limit the efficiency of recapitalizations by requiring dividends to be paid and by restricting the use of certain other preferences that had been used to increase the value of the frozen stock or partnership units. Section 2702 generally eliminates GRITs between parents and children, substituting instead trusts that pay annuity or unitrust interests. An exception to the last statement is that GRITs are allowed for residences; those are qualified personal residence trusts (QPRTS). Section 2703 adds requirements for buy-sell and stock restriction agreements which, in most instances, are difficult or impossible to meet in intra-family transfer situations. Section 2704 contains provisions intended to eliminate the benefits of disappearing rights. Sections 2704 and 2703 have become embroiled in issues surrounding the effectiveness of family limited partnerships but that is a collateral effect that has come about subsequent to enactment.

3. Effect of Section 7520.

Effective May 1, 1989, section 7520 was added to the Internal Revenue Code which established a floating interest rate to be used to value income and remainder interests (the applicable federal rate, or AFR). The rate (rounded to the nearest 0.2%) equals 120% of the federal mid-term rate under section 1274(d)(1). That rate is generally higher than income yields on most investments, but is generally lower, and often much lower, than the actual yield of investments when capital appreciation is included. Since 1989 the highest the AFR has been is 11.6% and the lowest is 5.4%. In general on the 20th of a month the AFR for the next month is issued, and the rate typically lags "economic reality" by 60 to 90 days.

The IRS was also directed to issue new actuarial tables not less often than every 10 years. T.D. 8819, Reg. 103851-99, sets forth the most recent tables. As expected, life expectancies have increased. However, for the very old life expectancies have actually decreased according to the 1990 Tables. See Appendix A.

These actuarial changes have substantially altered the valuation of income, annuity, and remainder factors.

4. What Do We Do Now?

We still recommend that clients make gifts. That point is worth emphasizing because it is so often-overlooked in the rush to do other, more "sophisticated," planning. A particular kind of gift is that made through an appreciation transfer trust.

We also use grantor retained annuity trusts (GRATs) and sales to defective grantor trusts. In each we are trying in large part to use the section 7520 rate assumption against the IRS. Stated differently, the techniques work if the yield on the assets - both income and appreciation - exceeds the assumed rate under section 7520. Each technique has benefits and risks as discussed below. In general, the consequences of the GRAT are better understood than are certain aspects of the sale to the grantor trust, however the sale technique is often more valuable.

B. Grantor Retained Annuity Trusts.

1. Overview.

Section 2702 provides that if a grantor makes a gift to a trust for the benefit of the grantor's family and retains an annuity interest that is described in Treas. Reg. § 25.2702-3 then the value of the annuity interest, as calculated using the section 7520 rate, will be subtracted from the fair market value of the property when calculating the taxable gift. If the requirements are not met then the value of the gift will be the full fair market value of the property.

The benefits of a GRAT may be simply illustrated. Suppose a grantor transfers \$1,000,000 to a trust with instructions to the trustee to pay to the grantor for a set number of years an annuity, say \$100,000 per year. If the AFR is 6.2% then the IRS assumes that at the end of one year the trust will be worth \$1,062,000. After the trust pays the grantor \$100,000 it is worth \$962,000. In year two the same pattern is repeated: at the end of the year the trust is worth \$1,022,000 and then \$100,000 is paid and the trust is worth \$922,000. According to the AFR assumption the trust will eventually be exhausted and we can calculate how long that will take. If the trustee is directed to pay all remaining trust assets to the grantor's children when the trust is assumed to be exhausted, the grantor will not have made a gift.

Suppose, however, that the trust assets have earned, all along, \$100,000 per year. In reality the \$1,000,000 of assets will still be in the trust and can be distributed to the children without gift tax. (An important caveat is that the IRS position is that a GRAT may not have a zero remainder, as discussed below.) The earnings may be in the form of income or appreciation; if the assets appreciate, a smaller portion will need to be distributed to the grantor each year to satisfy the annuity payments.

If the earnings of the trust assets are insufficient to make the annuity payments then the trust assets will gradually be exhausted. If creating the GRAT did not cause a taxable gift then there would be no negative to creating a GRAT at all. However, the IRS position that a GRAT will

always cause some gift means that there is a downside although normally the downside is minimal compared to the potential benefits.

For transfer tax purposes, the ideal GRAT would have a daily term. At the end of the day a prorated annuity would be paid. Either some assets would remain in the trust if the assets outperformed the AFR that day, and, if not, all assets would be returned to the grantor to be transferred into another GRAT the next day. Daily GRATs have not been approved by the IRS. The minimum term approved is two years.

2. Requirements.

a. Qualified annuity. A qualified annuity interest must be a fixed amount. That amount may be a stated dollar amount or a fixed fraction (e.g. a percentage) of the initial value of the trust assets as finally determined for federal tax purposes. The amount may increase but not to more than 120% of the amount for the previous year (i.e. any increase beyond that is not a qualified interest that may be subtracted in calculating the gift). Treas. Reg. §25.2702-3.

The trust must require payment; a right of withdrawal is not a qualified annuity interest. Treas. Reg. §25.2702-3(b)(1)(i).

The IRS ruling position is that notes may not be used as payment. PLR 9604005 (trust funded with nondividend paying stock and notes were intended to be used from the inception of the trust); see also PLR 9718008 (trust authorized payment in notes); and, contra, PLR 9515039. The IRS rationale for disallowing the use of notes is that the annuity must be payable in each taxable year of the trust and a note is not payment, but rather is a promise to pay.

If a grantor loans money to a trust that then uses the loan proceeds to make an annuity payment, the transaction may be construed similarly. On the other hand, if the trust borrows from a third party lender the analysis could be different. If the third party lender were the children of the grantor they would report the interest as income.

In the facts of PLR 9604005, the annuity payments were to be made entirely with notes and that was the plan from the inception of the trust. Arguably if notes were partially used when the trust assets did not perform as expected, that would be a different situation and would be less subject to the IRS substance over form analysis.

b. Term. The annuity must be stated in the trust and may be for the life of the annuitant, for a set term of years, or for the shorter of the two periods. The life of a person other than the annuitant may not be used to calculate the trust term. Treas. Reg. §25.2702-3(d)(3). The minimum term for a GRAT that has been approved by the IRS is two years. PLR 9239015.

Although a set term of years is allowable, the regulations provide that payments after the grantor's death are not qualified interests because they are to the grantor's estate not to the grantor. Treas. Reg. §25.2702-3(e), Examples 1 and 5.

Treas. Reg. §25.2702-2(a)(5) provides that a qualified interest is the retention of a power to revoke a qualified annuity interest of the grantor's spouse. The use of the provision would be to reduce the amount of the gift to the trust by not only the amount of the annuity payable to the grantor but also to the grantor's spouse. Example 7 of Treas. Reg. §25.2702-2(d)(1) illustrates the point. However, the Example is ambiguous as to the result if the grantor dies within the set term. The IRS has taken the position in PLR 9848004 that a spouse's revocable annuity interest is not a qualified interest if it only commences upon the grantor's death during the annuity term. See also TAM 9707001. The issue is before the Tax Court in Audrey J. Walton v. Commissioner, Tax Court Docket No. 3824-99. A Revenue Ruling is much easier to overturn than is a regulation.

c. The trust must prohibit payments to persons other than those with qualified interests while those interests exist. Treas. Reg. §25.2702-3(d)(2).

d. The trust must prohibit commutations of qualified interests. Treas. Reg. §25.2702-3(d)(4).

e. The trust must correct underpayments and overpayments occasioned by valuation errors, in a manner similar to that of charitable remainder trusts. If payments are made in-kind, and the assets distributed appreciate in value before they are repaid to the trust, the annuitant need not repay the appreciation; if the assets decrease in value after distribution, the annuitant's repayment obligation does not diminish. Interest may be owed on under or over payments in accordance with applicable state law. Treas. Reg. §25.2702-3(b)(2).

f. Excess income may be paid to the annuitant but does not reduce the amount of the grantor's initial gift. Treas. Reg. §25.2702-3(b)(1)(iii).

g. The annuity must be payable for each taxable year of the trust. The trust must provide that annuity payments be prorated for short taxable years, per the regulations, but the regulations also permit the payment of the annuity on the anniversary date of the trust. Treas. Reg. §25.2702-3(b)(3); the explanation of a change made on May 5, 1994 (T.D. 8536, 1994-1 C.B. 261); and PLR 9519029. The reasonable conclusion is that annuity payments may be made once annually, on the anniversary date of the trust.

In addition, payment of the annuity amount may be deferred no later than the date by which the trustee is required to file the income tax return for the trust, without regard to extensions. Treas. Reg. §25.2702-3(b)(1)(i). That would be the calendar year.

h. The trust must prohibit additional contributions. Treas. Reg. §25.2702-3(b)(4).

3. Income tax consequences of a GRAT.

a. Benefits of Grantor Trust Status. It is desirable for a GRAT to be a grantor trust for income tax purposes so that appreciated assets may be distributed to satisfy the annuity payments without triggering recognition of gain which is the normal result when appreciated assets are used to satisfy a fixed obligation, like an

annuity payment. Rev. Rul. 85-13, 1985-1 C.B. 184 so holds. However, a Second Circuit case, Rothstein v. United States, 735 F.2d 704 (1984) holds to the contrary. Despite Rothstein, the IRS has applied Rev. Rul 85-13 to a number of grantor trust situations: PLR 9535026, sale to grantor trust for a note is a nonrecognition event; Rev. Rul. 74-613, 1974-2 C.B. 153, transfer of an installment note to a grantor trust will not be a disposition and will not end installment sale treatment; and, PLR 9535026, interest paid by a grantor trust to a grantor is not income to the grantor nor deductible by the trust.

If the IRS did change its position what would be the effect on existing trusts? Prior distributions would be protected based on Section 7.01(5) of Rev. Proc. 89-14, 1989-1 C.B. 814, which allows taxpayers to rely on Revenue Rulings in determining the taxation of transactions. However, distributions after the change would not necessarily be protected.

A collateral benefit of a GRAT having grantor trust status is that a grantor trust is a permitted owner of S corporation stock.

b. Creation of Grantor Trust Status. Grantor trust status is often automatic due to the application of section 673(a) which treats the grantor as the owner of a trust if the grantor has a reversionary interest of over 5% at the creation of the trust. However, the test must be applied to income and principal separately. Because the annuity payments will normally be greater than the income of the trust, and even excess income may be accumulated to make future annuity payments, the income test will be satisfied. However, whether the test is satisfied with respect to principal depends on the value of the grantor's contingent reversion (i.e. what reverts to the grantor's estate if the grantor dies during the term), which in turns depends on the term of the trust, the annuity payment, and the age of the grantor. PLR 9152034 demonstrates the method of calculating the value of the reversion.

Generally some power should be given to the grantor to cause the GRAT to have grantor trust status. The most commonly used power is the administrative power of section 675(4)(C)

which is the power to reacquire trust assets by substituting assets of equivalent value in a nonfiduciary capacity. PLR 9713017 sets forth the IRS position that whether the power is held in a nonfiduciary capacity is a facts and circumstances test to be decided by the district director where the grantor's income tax return is filed. Treas. Reg. §1.675-1(b)(4) is the authority for the position, although how there could be facts and circumstances that create a fiduciary capacity and override the specific language of the instrument is difficult to imagine.

Maintaining grantor trust status after the annuity payments end is also desirable in many instances. That may be because S corporation stock is held in the trust or because the grantor desires to pay the income taxes on trust income (see discussion below, under Gift tax consequences of a GRAT). Continuing the section 675(4)(C) power after the annuity payments end creates the risk that the power will cause the assets of the trust to be included in the grantor's estate. The case of Jordhal v. Commissioner, 65 T.C. 92 (1975), is often cited for the proposition that such a power will not cause estate inclusion; however, the case itself involved a power held in a fiduciary capacity. PLR 9227013 determined that the assets in such a trust would not be included in the grantor's estate.

Giving someone other than the grantor the power of substitution would minimize the risk of inclusion in the grantor's estate. Is a section 675(4)(C) power held by a nongrantor effective to create grantor trust status? The regulations under section 675 state that the power held by any nonadverse party will create grantor trust status, but section 675 itself uses the term "reacquire" which should mean the grantor, or perhaps someone else who previously owned the property. PLR 9037011 construes the application of the powerholder broadly to include any other person, despite the language of the Code and regulations.

If the grantor has a section 675(4)(C) power and has the power to release the power, is the ability to change tax status of the trust a retained interest under section 2036? There is no authority on the issue.

Another common approach to creating grantor trust status, especially after the annuity payments end, is through section 675(2). If a trustee does not have the general authority to make loans to any person without adequate interest or security, but can do so to the grantor or the grantor's spouse, such power will cause the trust to be treated as a grantor trust. Arguably borrowing without adequate interest is a section 2036 power, thus the power should be restricted to loaning funds without adequate security. See PLRs 9525032 and 9645013.

Section 675(3) creates grantor trust status through actual borrowing with inadequate interest or security if the trustee is the grantor, the grantor's spouse, or a related or subordinate party. The loan need not be for more than a day, per Rev. Rul. 86-82, 1986-1 C.B. 253, but whether a loan confers grantor trust status with respect to principal is uncertain. See Benson v. Commissioner, 76 T.C. 1040 (1981), and Bennett v. Commissioner, 79 T.C. 470 (1982), for discussions that are close, but not exactly, on point.

4. Gift tax consequences of a GRAT.

a. Zeroing out. The amount of the gift that occurs when a GRAT is created is determined by subtracting the value of the annuity interest from the fair market value of the trust property contributed. May the annuity value be equal to the value of the contributed property? If so then a GRAT could be created with no gift - a so-called "zeroed out GRAT."

Treas. Reg. §20.2055-2(f)(2), Example 1, allows a charitable lead trust to be zeroed out. However, as noted above, the IRS has taken the contrary position with GRATs. In essence, the IRS position is that if the annuity is for a set term only, the portion of the annuity that would be paid to the grantor's estate if the grantor died during the term is not a qualified annuity. Stated differently, the chance that the grantor might die during the term reduces the value of the annuity. On the other hand, if the annuity is increased to take into consideration that the grantor might die during the term, then Rev. Rul. 77-454 and Treas. Reg.

§25.7520-3(b)(2) require that the value of the annuity be reduced by the probability that the trust will be exhausted during the term and will be unable to pay the annuity. In short, a GRAT may not be zeroed out. (However, see Estate of Benjamin Shapiro, 66 TCM 1067 (1993), which rejected the rationale of Rev. Rul. 77-454.)

The older the annuitant and the longer the annuity term, the greater will be the chance that the annuitant will die during the term and the greater will be the gift.

As the charts in Appendix B illustrate, a term certain produces a lower payout and a greater gift than does a contingent term. Generally a lower payout produces more efficient transfer tax results.

b. Effect of increasing payments. If the annuity payments increase during the term the amount of the gift will be increased because the chances of the annuitant dying are greater in the later years when the larger payments are to be made. On the other hand, if the trust assets increase in value substantially during the GRAT term, then the benefits of increasing payments may outweigh the added gift.

c. Effect of incorrect valuation of contributed assets. A GRAT may be created with the annuity described as a percentage of the initial fair market value of the trust assets. If the IRS increases that value on audit then the annuity also increases. The gift is increased as well but because the increase is a small percentage of the trust assets much less than it would have been had the annuity been stated as a stated dollar amount. The formula nature of a GRAT is specifically allowed by Treas. Reg. §25.2702-3(b)(1)(ii)(B) and thus should not be subject to Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. den. 323 U.S. 756 (1944).

d. Effect of multiple trusts. Generally a GRAT should contain only one asset, so that the appreciation of one asset will not be canceled out by the depreciation of another. Suppose a grantor creates multiple identical GRATs; may those be collapsed by the IRS? The issue may be avoided by using different terms or

trustees, or by having different remaindermen for each trust.

e. Grantor's payment of income taxes as an additional gift. If a GRAT is a grantor trust the grantor is taxed on all the income and capital gains of the trust. If the grantor is not reimbursed by the GRAT has the grantor made a gift to the GRAT? The answer depends on whether under the trust instrument or applicable state law the grantor has a right of reimbursement.

Both the original Uniform Principal and Income Act, and the Revised Uniform Principal and Income Act, provide that any tax on the trust upon profit or gain allocated to principal shall be paid out of principal. If the trust is a grantor trust is there any tax on the trust? There is little law on the subject other than two cases from Pennsylvania, which seem to hold that the language of the Acts does create a reimbursement right. Doughty Trust, 6 Fid. Rep. 2d 260 (1986); French Estate, 61 D&C 2d 654 (1963).

If the trust instrument negates whatever right of reimbursement may be given by applicable state law, does that create an additional gift to the trust? Stated differently, does a grantor make a larger gift when giving assets and agreeing to pay the income taxes than when giving assets subject to a right of reimbursement? Normally income tax consequences are not considered when determining gift tax - e.g. a gift of \$10,000 in cash has the same value as a gift of \$10,000 of zero basis stock. If the trustee is given the authority to reimburse but not the direction, is that sufficient to negate any added gift on funding, yet allow the grantor to pay the taxes without reimbursement?

The IRS ruling position is that a GRAT must state that income tax payments will be reimbursed. PLR 9444033 states that without a reimbursement provision "an additional gift to a remainderperson would occur when the grantor paid tax on any income that would otherwise be payable from the corpus of the trust." The ruling is circular because the issue is whether income tax would be payable on gain to the corpus. Subsequent rulings have omitted this discussion. See, e.g., PLR 9543049; 9838017.

GRATs must prohibit additional contributions. The IRS could take the position that the payment of income tax without reimbursement is not only a gift but also an additional contribution. If the grantor intended to pay the income taxes from the inception of the trust, that arrangement could invalidate the GRAT, although that result seems harsh.

5. Estate tax consequences of a GRAT.

Rev. Rul 82-105, 1982-1 C.B. 133, discusses the amount of a charitable remainder annuity trust that is included in the grantor annuitant's estate under section 2036(a)(1). The Ruling provides that a calculation be made to determine the portion of the trust that would be required to produce the annuity using the then in effect interest rate (6%). Today, that would be the AFR. Presumably the same calculation would be used for a GRAT.

Section 2033 would include any payments that were required to be made to the grantor's estate by the GRAT and 2038 would include those same payments if they were instead subject to a power of appointment. In limited instances this inclusion would be greater than that of section 2036. Generally the grantor will have a reversion upon death during the fixed term so that the payments will stop.

Trust assets included by reason of section 2036 will be reduced by the value of the gift, per section 2001(b). If the entire trust is included in the grantor annuitant's estate then the entire gift will be washed out. However, if the grantor and the grantor's spouse split gifts during the year in which the GRAT was funded then the half of the gifts deemed to be made by the spouse will not be washed out at the grantor's death. Thus, it is extremely important not to split gifts in the year in which a GRAT is created.

6. Generation skipping tax consequences of a GRAT.

a. Allocation of GST exemption. A GRAT is usually not a useful vehicle for transferring assets to grandchildren.

Section 2642(f) and Treas. Reg. §26.2632-1(c)(30)(ii) provide that GST exemption will not be allocated to the GRAT until the trust assets are not be included in the grantor's estate (the termination of the ETIP). Thus the GST exemption cannot be leveraged by applying it to the trust at creation.

Generally the remainder interest in a GRAT should be vested in the grantor's children. If a child dies during the GRAT term the predeceased child exception does not apply, unless the grantor dies and the trust assets are included in the grantor's estate. Even this result is not entirely certain because the transfer was first subject to gift tax and there is no direct authority for the position that subsequent inclusion in an estate is sufficient to override the earlier gift for purposes of the exception. Nevertheless, the better policy would seem to be to allow the predeceased child exception to apply where the grantor dies during the term.

One approach to avoiding an unwanted generation skipping tax would be for the remainder to pass to the then living children of the grantor; if a child dies prior to the GRAT term ending the child's family may be made whole by an equalization clause in the grantor's Will or by other gifts. Particular attention must be paid to the allocation of estate taxes and the tax-basis of assets if the equalization is to occur by Will.

Another approach would be to have the interest of a deceased child pass to the deceased child's estate. An advantage would be that no equalization provision would be needed. However, the remainder interest would be included in the deceased child's estate and could have substantial value, especially towards the end of the GRAT term. The interest could pass outright to the deceased child's spouse, or to an estate trust, and qualify for the marital deduction. Because a remainder does not generate any income it is uncertain whether the marital deduction would be available under sections 2056(b)(5) or (7). If the grantor were to die after the child but during the trust term then the trust assets would be included in the grantor's estate, after having been included in the child's estate. Section 2013 was not designed to cover such transactions and its application to mitigate a double tax is uncertain.

b. Assignment of remainder interest. Upon creation of a GRAT the remainder interest is worth the gift tax value, which is normally small. Suppose the interest is vested in the grantor's living children and those children assign their interests to their children, the grantor's grandchildren, immediately upon the creation of the GRAT. Is this effective for generation skipping tax purposes? Stated differently, will the transferor of the interest to the grandchildren be the grantor or the grantor's children? The IRS may be expected to attack such a plan using a step-transaction theory. The longer the time that passes between the creation and the assignment the more easily may a step-transaction theory be avoided but the larger the gift

May the assignor allocate GST exemption to the assignment to create a zero inclusion ratio? There is no authority on the point. Treas. Reg. §26.2652-1(a)(5), Example 4, provides that the assignment of a present interest in a trust has no effect on the transferor, but that is not on point with the transaction contemplated here which is the assignment of a future interest.

Assignment of a remainder interest to a trust in which one or more persons in the same generation as the child have an interest, along with the child's descendants, would postpone any generation skipping tax if the assignment were ineffective to change the transferor. For example, if the assignment were to a trust for the benefit of the child's spouse and descendants, and the assignment turned out to be ineffective for GST purposes, the trust assets could be distributed to the child's spouse. The death of the spouse prior to a determination of the generation skipping tax consequences would eliminate the postponement.

The assignment must be effective under applicable state law. The interest must be vested in the child and the trust must not contain a spendthrift clause that prohibits assignments.

7. Gift tax reporting.

Section 6501(a) provides for a three year statute of limitations on gifts, subject to exceptions. Section 6501(c)(9) provides that the gift tax statute never runs on gifts that are not

disclosed on a gift tax return "in a manner adequate to apprise the Secretary of the nature of such item." Treas. Reg. §301.6501(c)-1(e)(2) sets forth what must be shown in order for a gift to be adequately disclosed:

(i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;

(ii) The identity of, and relationship between, the transferor, transferee, all persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and

(iii) A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

If a gift tax return fully discloses the amount of the property transferred to the GRAT and shows the amount excluded by reason of the grantor's retained annuity interest the three year statute should apply. If the grantor is taking the position that the gift is zero, contrary to the regulations, the gift must be disclosed because it is of a future interest, according to the Form 709 Instructions.

8. Planning situations with GRATs.

a. Funding with S corporation stock. Most S corporations produce a high pre-income tax rate of return, often as much as 20% and sometimes more. The effective rate of return may be increased by creating voting and nonvoting stock. If the nonvoting stock is discounted by 40% then the effective rate of return increases by 67%. To illustrate, suppose an S corporation is worth \$1,000,000 and produces a pre-income tax return of \$180,000. If the S corporation undergoes a recapitalization that creates 100 voting shares and 9900 nonvoting shares the return attributable to the nonvoting shares is 99% of \$180,000, which is \$178,200. If the 9900 shares are worth \$990,000 less a 40% discount they are worth \$594,000. The effective rate of return is \$178,200/\$594,000 which is 30%. (And, $18\% \times 1.67 = 30\%$).

b. Funding with rental real estate. Rental real estate transferred to a partnership or limited liability company may have its pre-income tax rate of return boosted by discounted limited units or membership interests.

c. Funding with partnership units and paying out assets distributed from the partnership. Suppose discounted partnership interests are used to fund a GRAT. If the interests themselves are used to fund the annuity payments then they must be discounted. If partnership distributions are made so that the annuity payments may be made with undiscounted assets then substantial savings will result. The IRS cannot be expected to accept this result and will undoubtedly argue that the gift of the partnership units going in should be on an undiscounted basis. However, if the gift is sufficiently small this may be a risk the grantor is willing to take.

d. Funding with pre-IPO assets. Start-up ventures make ideal assets to use in a GRAT. Generally the start-up has a low value and will either fail or become very valuable. If the start-up fails the loss for transfer tax purposes will be the gift caused by the GRAT. Because the gift is tied directly to the grantor's chances of dying during the term, a short term will create a small

gift. To illustrate, the grantor of a three year trust must be over 80 for the gift to be as high as 10% and even at 90 the gift is only a little over 20%. If the start-up is successful the annuity payments may be easily satisfied with much higher valued stock or other interests. The start-up interests which are paid out in early years may be given to new GRATs.

e. Horses. If one "knows" that a horse that has a value of less than \$65,000 is likely to win the Kentucky Derby and Preakness, the horse would be an excellent candidate for a GRAT.

f. Paired GRATs. Suppose a derivative were created that was guaranteed to double in value by a certain date, perhaps two or three years into the future. Because there are no guarantees of assets that double in value something would need to be given up. Suppose what was given up was the creation of another derivative that was guaranteed to go to zero by the same time. For illustration purposes the doubling derivative is Green and the zero derivative is Black.

Suppose on the same day grantor creates two GRATs; one is funded with Green and the other with Black. What are the results? For simplicity suppose that two year GRATs are used. The annuity payout for a two year GRAT is approximately 55.5%; thus, 111% of the initial value must be paid out over two years. If \$1,000,000 is used - \$500,000 in each GRAT - then (1) all of the Black GRAT will be returned to the grantor, but will have zero value, and (2) from the Green GRAT will be returned 111% of \$500,000 which is \$555,000. The Green GRAT had in it, at the end of the two year term, \$1,000,000; thus \$445,000 worth of assets remained in the trust. The actual results would be less because some payment would be required at the end of year one. Nevertheless, significant savings are readily apparent. The gift on such a transaction would be approximately 1.8% or \$18,000 on a total transfer of \$1,000,000.

Is the IRS likely to collapse the transaction? If so, can collapse be prevented by having different trustees? What if one spouse

creates one trust and the other spouse creates the second trust?

C. **Sales to Grantor Trusts.**

1. **Overview.**

The "sales to a grantor trust" technique is simple. The grantor establishes a trust that is a grantor trust for income tax purposes but that will not be included in the grantor's estate for estate tax purposes, and sells assets to the trust taking back a note as payment. The note bears interest at the rate appropriate under section 1274. Generally the assets do not produce sufficient cash to pay both the interest and principal of the note, thus, at a future point the note is satisfied with the assets in the trust, which it is hoped will have appreciated so that assets remain in the trust after the note is satisfied. Normally the note is structured as an interest only note with a balloon payment and no prepayment penalty. Often even the interest is paid using trust assets. For a variety of reasons, satisfaction of the note prior the grantor's death is desirable.

A sale of assets to a grantor trust overcomes several drawbacks of a GRAT: (a) although a GRAT produces an initial gift, (unless the IRS regulatory position is overturned), a sale does not; (b) a GRAT can benefit only children (absent the remainder assignment technique and its attendant risks) whereas GST exemption may be allocated to the grantor trust that is the buyer; (c) a GRAT is unsuccessful if the grantor dies during the term whereas the sale is effective immediately with respect to all appreciation after the sale; (d) a GRAT cannot be commuted but the note may be prepaid; and (e) GRAT calculations involve the AFR which is higher than the section 1274 interest rate that may be used with sales to grantor trusts.

There are two principal issues that must be resolved before the sale technique is guaranteed to be successful: (a) when will the sold assets be excluded from the grantor's estate; and (b) what are the income tax consequences of the grantor dying before the note is paid off.

2. **Requirements.**

There are no established requirements for a sale to a grantor trust. That is, the sale is not something subject to a specific Internal Revenue Code section. However, the key elements are: (a) a valid sale and note under applicable state law; (b) a trust that is a grantor trust for income tax purposes but which is not included in the grantor's estate for estate tax purposes; and (c) use of a proper interest rate on the note.

The interest rate on the note taken back in the sale must bear interest as calculated by section 1274 in order for the note to be valued at its face value. Prop. Treas. Reg. §1.1012-2(b)(1) provides that the value of a note issued by a buyer which has adequate stated interest under section 1274 will be valued at face. See also Estate of Frazee v. Commissioner, 98 T.C. 554 (1992). For a note of more than three but fewer than 10 years the federal midterm rate applies; for a note of more than 9 years the federal long term rate applies.

The AFR, used for GRATs, is 120% of the federal midterm rate, rounded to the nearest two-tenths of one percent. Thus, under normal interest rate conditions the section 1274 rate will be less than the AFR. Because the IRS assumes is that the assets involved will increase in value at a slower rate, less must be given back to the grantor when compared with a GRAT.

3. **Income tax consequences of a sale to a grantor trust.**

A sale to a grantor trust is not recognized for income tax purposes (see the discussion above). Thus, the trust takes the income tax basis of the grantor in the sold assets. If the note is satisfied with assets, rather than cash, those assets will be included in the grantor's estate and will receive a new income tax basis under section 1014. The assets remaining in the trust, representing the appreciation beyond the interest payments, will have a zero income tax basis.

What are the consequences if the note is not paid off by the time the grantor dies? Manning and Hesch cite at least 12 articles in support of their statement that "[t]here is disagreement among

the commentators as to the resulting income tax consequences if the deferred payment note remains outstanding at the time of death."

All discussions begin with the same three authorities: Treas. Reg. §1.1001-2(c), Example 5; Madorin v. Commissioner, 84 T.C. 667 (1985); and Rev. Rul. 77-402, 1977-2 C.B. 222. Each of those involved the acquisition by a grantor trust of an interest in a tax shelter partnership. The tax shelter produced phantom losses claimed by the grantor because the partnership was held in a grantor trust. When the tax shelter was about to cease producing losses and convert to producing phantom income the grantor gave up the power that had created the grantor trust status. The grantor hoped that the trust or the beneficiaries would be taxed on the income, at the lower rates then in effect. The authorities hold that when the trust ceased to be a grantor trust a taxable transaction occurred (the transfer of a partnership in which the basis was lower than the liabilities with the difference being gain to the grantor) the consequences of which were reportable by the grantor on the current year's income tax return.

Presumably a similar result would occur if in a sale to a grantor trust the trust ceased to be a grantor trust while the grantor was living and before the note was satisfied. The grantor would recognize gain based on the unpaid balance of the note and the trust would acquire a fair market value basis equal to the amounts remaining due on the note.

The referenced authorities do not deal with a grantor trust that loses its status by reason of the grantor's death. This issue is of substantial importance. For example, if death causes gain to be recognized on the assets subject to the sale, then provision will need to be made for payment of the income taxes. Depending on the amount of appreciation in the assets that were sold, the transaction may be favorable or unfavorable. In addition, the note could continue as an asset of the grantor's estate thus creating estate tax.

The most likely result may be that death is not a recognition event. The assets in the trust would have a basis equal to its obligation on the note. The note would have a fair market value

basis under section 1014. The gain on the property originally sold would be avoided, however gain on any appreciation would remain and would be taxed whenever such property were sold. This theory is supported by analogizing to the transfer of property from a decedent to the decedent's estate, which is a nonrecognition event and by the fact that death does not cause income tax recapture of negative basis assets held in a revocable trust (which is obviously a grantor trust). Stated another way, escaping gain on the sold assets is the equivalent of escaping gain on the assets held in an estate.

On the other hand, the analogies are not necessarily on point. A revocable trust is different from a trust that is not included in the grantor's estate. In addition, a sale to a grantor trust involves, at all times, two legal entities. The negative basis asset analogy involves only one legal entity, the taxpayer.

If death is a recognition event then does recognition occur before death or after death? If before death then there is no basis step-up and the trust receives a basis equal to the sales price and gain would be triggered to the grantor for reporting on the grantor's final income tax return. The income tax would be deductible under section 2053. If after death, then the trust receives a purchase price basis and the basis of the note is stepped-up to fair market value. The value of the note would depend on its interest rate compared with the then current section 1274 rate, and whether or not installment sale treatment would be available would depend on the normal installment sale rules.

Virtually all commentators reject the sale after death approach because there is nothing for the estate to have sold. That is, the assets are not included in the estate only the note is. The sale before death approach cannot be ruled out because there is no authority on point.

Regardless of the treatment of the transaction at death, the note must be paid off. Once grantor trust status terminates gain will be recognized by the trust if appreciated assets are used or sold to satisfy the note.

4. **Gift tax consequences of a sale to a grantor trust.**

a. Value of the note. If the note for which the assets are sold has the same value as the assets there will be no gift. As discussed above, the note must bear appropriate interest under section 1274 to be valued at face. If the note has less than fair market value interest, section 7872 may create a gift. See Katzenstein "Some time Value of Money Issues in Estate Planning," ALI-ABA Planning Techniques for Large Estates (Nov. 1998), for a discussion of sections 483, 1274 and 7872.

Section 2702 provides that certain retained interests of a grantor are to be valued at zero. For a sale to a grantor trust to be effective the interest retained by the grantor must be valued at the value of the sold assets. Apparently, the IRS has considered the issue as turning on whether the transaction should be treated as a sale for debt or an exchange for equity.

PLR 9436006 considered a trust, funded with \$1,200,000 of marketable securities, that purchased other assets from the grantor for a 25 year note. The note provided for quarterly interest payments with a balloon principal payment at the end. The transaction was respected as a sale.

PLR 9535026 considered a trust that bought assets for a 20 year interest only note with a balloon principal payment. The IRS determined that neither section 2701 nor section 2702 would apply unless the notes were subsequently determined to be equity and not debt, a question of fact on which the IRS did not rule.

The ruling also discussed the value of the note and concluded that the value would be equal to its face only if there were no facts presented that indicated the note would not be paid and if it appeared that the trust had sufficient assets to pay the note. The latter issue is important in the application of section 2036 to these transactions and will be discussed below.

b. Value of the assets. If marketable securities are the object of the sale then there will be no valuation issue on the asset side.

Such is rarely the case. With any closely-held asset – a business, real estate, a partnership, an LLC, or marketable securities held in an entity – the issue of the proper value of the assets sold is significant. If the IRS successfully increases the value of the assets above the value of the note then the seller will have made a gift of the excess.

With a GRAT the issue of an excess gift is mitigated by stating the annuity payable as a fraction of the assets initially contributed to the GRAT. If the value of the assets is increased so will be the annuity owed. Can a sale to a grantor trust be structured similarly? The ideal clause would provide that assets of a certain amount were intended to have been sold and that any excess assets were to be returned to the seller. Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), is the bedrock case holding that such adjustment clauses may be ignored because they violate public policy: the IRS has no incentive to audit such transfers because no tax may be collected.

Three approaches have been suggested to get around this problem. The first is to attack Procter head on with a clause that would provide that the first \$X of assets sold will remain in the trust but all assets in excess of \$X will be returned to the seller. Suppose that the sale is intended to be of \$1,000,000 of assets. The trust might provide that the first \$1,200,000 transferred to the trust by sale would remain in the trust but that any excess would be returned to the seller. Arguably, Procter is inapplicable because the IRS does have an incentive to audit such transfers to collect some additional tax.

A second approach would be to sell assets described as a fraction. For example, assume that a partnership has 100 general partnership units and 9900 limited partnership units. The partnership owns \$1,000,000 of marketable securities. The sale is intended to be of \$600,000 worth of limited partnership units. The assets sold would be described as a fraction of the limited partnership units, the numerator of which is \$600,000 and the denominator of which is the fair market value of the limited partnership interests on the date of the sale. The actual number of units sold would remain uncertain until the valuation is fixed,

presumably at the time the gift tax statute of limitation expires.

A third approach would be to have an independent determination of value. To illustrate, the trust could provide that assets added to the trust by reason of gift would be allocated to charity. The sale would occur and the trustee would be required to determine whether any assets that were added to the trust were added by gift; that is, was the note equal to the value of the assets sold. If yes, then the excess assets would be transferred to charity. If the trustee incorrectly determined the value of assets at the time of transfer but was later "educated" by the IRS an allocation at that time would be effective to eliminate any gift tax because the trust had an obligation to charity from the beginning. Are any of these approaches effective? There is no authority. See Appendix C for a discussion of the relevant authorities.

c. Payment of income taxes by the grantor. If the grantor pays the income taxes for the trust the grantor may be making an additional gift as with the GRAT.

5. Estate tax consequences of a sale to a grantor trust.

a. Trust Creation. Creation of a trust that is a grantor trust for income tax purposes but which is not included in the grantor's estate is generally easy. The simplest example would be a trust which has the grantor's spouse as a discretionary beneficiary of income and principal (along with the grantor's descendants). Grantor trust status may be prolonged after the spouse's death in a number of ways, including those discussed above.

It is more difficult to have the grantor as a beneficiary because of the concern that the creditors of the grantor may reach the trust property thus causing inclusion under section 2036 or 2041. See Restatement (Second) of Trusts, § 156(2). Under Delaware and Alaska law this problem may be avoided, however the IRS has not ruled favorably on the issue of estate tax inclusion as of yet. PLR 9837007 specifically states that it is not ruling on the question, although the Service

did rule that a gift to such a trust is complete for gift tax purposes.

b. Section 2036 inclusion.

Section 2036(a)(1) includes in a grantor's estate property over which the grantor has a retained interest. Is a note a retained interest in the assets sold?

Generally assets that are sold are not subject to section 2036. In Rev. Rul. 77-193, 1977-1 C.B. 273, a decedent had sold timber rights prior to death in exchange for notes, one of which had not matured at death. The Ruling deals with the sale to an individual, not a trust, and holds that the obligation to pay was personal to the buyer and was independent of whether or not the sold assets produced income.

On the other hand, where \$5,000,000 in assets were transferred in a part sale and part gift transaction for a note with a face value of \$1,500,000, the assets produced \$360,000 of annual dividends and the interest owed was only \$165,000 per year, the Service determined that the trust assets were included in the transferor's estate. PLR 9251004 states that "[f]or purposes of section 2036 it is immaterial that a retained right is stated in terms of a contractual right or limited to a specific dollar amount so long as the retained right is a preferential right to a significant portion of the income."

The risk of section 2036 inclusion is reduced if the trust contains assets beyond those which it has bought in the sale transaction. Although there is no safe-harbor, lore has it that if the trust has at least 10% more assets than the assets sold to the trust that will be sufficient. That lore has been supported by a reported informal statement of the IRS to that effect. See Abbin, [S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through A Three Dimensional Analysis of Constructions To Be Applied In Selecting from the Cafeteria of Techniques, 31 U. Miami Est. Plan. Inst. P1300.1(O)(1997).

The Ninth Circuit has issued a number of opinions dealing with transfers to trusts in exchange for an annuity which are instructive. In

Lazarus v. Commissioner, 513 F.2d 824 (9th Cir. 1975), the court held that an annuity was a retained interest when the only initial funding of the trust was \$1000, the principal of the trust could not be invaded, and the asset transferred for the annuity was a nonnegotiable note. On the other hand, in Estate of LaFargue v. Commissioner, 689 F.2d 845 (9th Cir. 1982) principal could be invaded to pay the annuity, as well as trust income, and the annuitant did not control the trustee who could have sold the trust assets if necessary. Stern v. Commissioner, 747 F.2d 555 (9th Cir. 1984) is a similar case.

In Ray v. United States, 762 F.2d 1361 (9th Cir. 1985), a decedent and his former wife created a trust from which both the decedent and the former wife were to receive an annuity. Principal could be used as well as trust income to pay the annuity and principal could be invaded for other ascertainable standards. After both had died the trust assets were to be distributed to the couple's children. The court held that half the trust was included in the decedent's estate because the interest was not really an annuity interest but rather was a retained income interest. Among the decisive factors for the court was that the annuity payments closely approximated the trust income; the opinion states: "[t]his tie between the amount of payments and the trust income is the most important characteristic which distinguishes this transaction from an annuity purchase."

Where the grantor in a sale transaction has recourse to the personal assets of another, such as the trustee, section 2036 is very likely avoided because the transaction can be analogized to the sale described in Rev. Rul. 77-193 above. See, e.g., Estate of Becklenberg v. Commissioner, 273 F.2d 197 (7th Cir. 1959). A personal guarantee is often thought of as a way to accomplish the desired result. PLR 9515039 found that section 2036 would not apply if guarantors had sufficient assets to pay, if called upon, and the amount of the payments did not relate to the earnings of the assets transferred.

The collateral effects of a guarantee are uncertain. If the guarantor is not compensated for the guarantee then the guarantor is making a gift at the time the guarantee is given, rather than later

when the guarantee is called upon. See PLR 9113009. To what or whom is the gift made? If to the trust then does the guarantor become a partial grantor for income tax purposes and, if so, what is the effect on the sale? If the guarantor is a beneficiary of the trust, a child for instance, are the trust assets included in the child's estate because the child is both a grantor and beneficiary for section 2026 purposes? Matters are simplified if the guarantor is treated as making a gift to the grantor of the trust (the seller) directly; the argument would be that the only reason the guarantor was called on to make payments was because the trust could not, and if the trust could not then the guarantor would not be a real beneficiary of the trust because it would have no assets. The latter interpretation is without authority however much it may be a logical understanding of the "real world" consequences.

If section 2036 applies and the note is satisfied within three years of death, does section 2035 apply? By its terms section 2035 applies if there is a transfer of an interest within three years of death that would have caused section 2036 to apply. Arguably, payment of a note is not a "transfer."

In order to ensure that section 2036 does not apply, and that the note is not treated as equity and thus a retained interest under section 2702, and that the note is valued at face, the trust should be given assets beyond those it obtains in a sale. That gift must be weighed against the gift that is caused by the chance that the grantor might die when creating a GRAT.

6. **Generation skipping tax consequences of a sale to a grantor trust.**

The generation skipping tax consequences of a sale to a grantor trust are dependent on whether the trust assets are included in the grantor's estate. Section 2642(f) prevents the assignment of generation skipping tax exemption during any time trust assets will be included in the transferor's estate. If the assets are not included in the grantor's estate the ability to assign GST exemption immediately after the sale is a significant advantage over a GRAT.

As discussed above with the GRAT, the payment of income taxes may be an additional gift which will need to be considered for generation skipping tax purposes.

7. Gift tax reporting.

If the sale to a grantor trust is not a gift then it does not need to be reported on a gift tax return. On the other hand, failure to disclose the transaction means that the gift tax statute of limitations will never run. Selling for slightly less than the fair market value of the note so that a gift may be disclosed as part of the transaction would appear to start the statute of limitations and would seem desirable.

8. Planning situations

a. Gift, followed by Sale, followed by Payment with Frozen Assets. Does the following transaction meet the challenges posed by the discussion above? Grantor makes a gift of \$1,200,000 to a grantor trust which is not included in grantor's estate. Grantor sells \$12,000,000 to the trust for a note, interest only for 20 years, then a balloon payment; the note has a value of \$11,900,000. The assets to be sold are C corporation common stock and the trust owns all of the stock.

The grantor files a gift tax return reporting two gifts: a \$1,200,000 gift and a \$100,000 gift both of which are split with the grantor's spouse. Grantor and spouse apply \$1,300,000 of generation skipping tax exemption to the trust.

The trustee, worried about what happens if the grantor dies before the note is paid off, arranges for a recapitalization of the stock to create \$100,000 worth of common stock and \$12,900,000 of preferred stock. The preferred stock's value is supported by a preferred dividend, although it is noncumulative, and other "bells and whistles." The note is satisfied with the preferred stock immediately.

At death the grantor's estate includes preferred stock only, with a fixed value.

b. Loan to a grantor trust. The consequences of a loan to a grantor trust are the same as that of a sale for all purposes except for the issue of what occurs when the grantor dies. There is no sale transaction to be accelerated. If the grantor loans cash to a grantor trust, which invests in a business, a frozen transaction will result without any of the income tax risks. In addition, if the business is a start-up that generates losses, those will flow through the grantor trust to be used by the grantor, depending on the grantor's status within the passive loss rules.

D. Appreciation Transfer Trusts.

Much simpler than the GRAT or sale to a grantor trust is the appreciation transfer trust. A grantor transfers assets to a trust retaining the income for life. The trust provides that all appreciation in excess of the initial amount transferred will be paid, quarterly, to the grantor's children. At death, all of the trust assets will be paid to the grantor's children. The benefit of the trust is that the gift tax is removed from the grantor's estate if the grantor dies more than three years after the gift, with the appreciation transfer being an additional benefit.

The trust is a grantor trust for income tax purposes; the gift tax paid should increase the basis in the trust assets even though the trust is a grantor trust, thus enabling the assets to be sold prior to death at less tax cost than would otherwise have been the case.

The grantor has made a gift of the entire interest in the trust because the grantor's retained income right has a value of zero under section 2702.

At the grantor's death the entire value of the trust will be included in the grantor's estate and will receive a new income tax basis equal to its then fair market value. Section 2001(b) provides that if a gift is included in the grantor's estate the gift is "washed out" and the gift tax paid is a credit against the grantor's estate tax. There is no authority on the issue of whether the payment of

the appreciation of the trust to the grantor's children reduces the amount of the gift that is washed out; however, in no event is the grantor worse off than before.

The appreciation will pass to the grantor's children without gift tax because the grantor has made a complete gift of the trust property.

APPENDIX A

Life Expectancy Charts

Mortality: 90CM

Age	Life Expectancy
50	29.0
51	28.2
52	27.3
53	26.5
54	25.6
55	24.8
56	24.0
57	23.2
58	22.4
59	21.7
60	20.9
61	20.1
62	19.4
63	18.7
64	18.0
65	17.3
66	16.6
67	15.9
68	15.2
69	14.6
70	14.0
71	13.3
72	12.7
73	12.1
74	11.6
75	11.0
76	10.5
77	9.9
78	9.4
79	8.9
80	8.4
81	7.9
82	7.5
83	7.0
84	6.6
85	6.2
86	5.8
87	5.5
88	5.1
89	4.8
90	4.5
91	4.2
92	3.9
93	3.7
94	3.5
95	3.3
96	3.1
97	2.9
98	2.8
99	2.6
100	2.4

Produced on Factors 4.05 6-6-99

Mortality: 80CNSMT

Age	Life Expectancy
50	27.9
51	27.1
52	26.3
53	25.5
54	24.6
55	23.8
56	23.1
57	22.3
58	21.5
59	20.8
60	20.0
61	19.3
62	18.6
63	17.9
64	17.2
65	16.5
66	15.8
67	15.2
68	14.6
69	13.9
70	13.3
71	12.7
72	12.1
73	11.6
74	11.0
75	10.5
76	10.0
77	9.4
78	8.9
79	8.4
80	8.0
81	7.5
82	7.1
83	6.7
84	6.3
85	6.0
86	5.6
87	5.3
88	5.0
89	4.7
90	4.4
91	4.2
92	3.9
93	3.7
94	3.5
95	3.3
96	3.2
97	3.0
98	2.9
99	2.8
100	2.6

Produced on Factors 4.05 6-6-99

APPENDIX B

Annuity Analysis Charts

- B-1: 2 year single life GRAT
- B-2: 5 year single life GRAT
- B-3: 7 year single life GRAT
- B-4: 10 year single life GRAT
- B-5: GRAT for a 55 year old
- B-6: GRAT for a 65 year old
- B-7: GRAT for a 75 year old
- B-8: GRAT for an 85 year old
- B-9: GRAT for two 50 year olds
- B-10: GRAT for two 60 year olds
- B-11: GRAT for two 70 year olds
- B-12: GRAT for two 80 year olds
- B-13: GRAT for a 60 and 50 year old
- B-14: GRAT for a 70 and 60 year old
- B-15: GRAT for an 80 and 70 year old

2 Year Single Life GRAT

Zero Out Annuity Analysis

Term: 2
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Age	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
50	0.54849	0.55121	0.00493	0.00491	0.00002
51	0.54849	0.55148	0.00541	0.00539	0.00002
52	0.54849	0.55177	0.00594	0.00591	0.00002
53	0.54849	0.55209	0.00651	0.00648	0.00003
54	0.54849	0.55242	0.00711	0.00708	0.00003
55	0.54849	0.55279	0.00777	0.00773	0.00004
56	0.54849	0.55319	0.00849	0.00845	0.00004
57	0.54849	0.55366	0.00932	0.00927	0.00005
58	0.54849	0.55418	0.01026	0.01020	0.00006
59	0.54849	0.55473	0.01125	0.01118	0.00007
60	0.54849	0.55531	0.01227	0.01218	0.00008
61	0.54849	0.55589	0.01330	0.01320	0.00010
62	0.54849	0.55651	0.01440	0.01429	0.00011
63	0.54849	0.55720	0.01562	0.01548	0.00013
64	0.54849	0.55793	0.01691	0.01675	0.00016
65	0.54849	0.55869	0.01824	0.01806	0.00018
66	0.54849	0.55948	0.01964	0.01943	0.00021
67	0.54849	0.56038	0.02120	0.02095	0.00025
68	0.54849	0.56139	0.02297	0.02268	0.00029
69	0.54849	0.56255	0.02499	0.02465	0.00034
70	0.54849	0.56387	0.02726	0.02685	0.00041
71	0.54849	0.56531	0.02975	0.02926	0.00049
72	0.54849	0.56687	0.03242	0.03184	0.00058
73	0.54849	0.56848	0.03516	0.03448	0.00068
74	0.54849	0.57016	0.03799	0.03720	0.00080
75	0.54849	0.57193	0.04097	0.04005	0.00093
76	0.54849	0.57388	0.04423	0.04314	0.00108
77	0.54849	0.57606	0.04786	0.04659	0.00127
78	0.54849	0.57860	0.05203	0.05052	0.00151
79	0.54849	0.58154	0.05683	0.05502	0.00181
80	0.54849	0.58488	0.06222	0.06004	0.00218
81	0.54849	0.58858	0.06810	0.06548	0.00262
82	0.54849	0.59254	0.07433	0.07119	0.00313
83	0.54849	0.59666	0.08072	0.07701	0.00371
84	0.54849	0.60110	0.08752	0.08313	0.00439
85	0.54849	0.60626	0.09528	0.09004	0.00524

Produced on Factors 4.05 6-7-99

5 Year Single Life GRAT

Zero Out Annuity Analysis

Term: 5
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Age	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
50	0.23999	0.24313	0.01294	0.01277	0.00017
51	0.23999	0.24344	0.01419	0.01398	0.00020
52	0.23999	0.24377	0.01553	0.01529	0.00024
53	0.23999	0.24413	0.01699	0.01670	0.00029
54	0.23999	0.24453	0.01857	0.01822	0.00035
55	0.23999	0.24496	0.02031	0.01988	0.00042
56	0.23999	0.24544	0.02224	0.02173	0.00051
57	0.23999	0.24598	0.02437	0.02377	0.00061
58	0.23999	0.24656	0.02667	0.02595	0.00072
59	0.23999	0.24717	0.02907	0.02822	0.00085
60	0.23999	0.24781	0.03156	0.03056	0.00100
61	0.23999	0.24848	0.03417	0.03299	0.00118
62	0.23999	0.24919	0.03695	0.03558	0.00138
63	0.23999	0.24997	0.03993	0.03833	0.00160
64	0.23999	0.25079	0.04308	0.04121	0.00187
65	0.23999	0.25167	0.04643	0.04425	0.00218
66	0.23999	0.25263	0.05007	0.04752	0.00255
67	0.23999	0.25373	0.05415	0.05115	0.00300
68	0.23999	0.25496	0.05874	0.05519	0.00355
69	0.23999	0.25635	0.06386	0.05965	0.00420
70	0.23999	0.25789	0.06943	0.06446	0.00497
71	0.23999	0.25954	0.07536	0.06951	0.00585
72	0.23999	0.26130	0.08158	0.07474	0.00684
73	0.23999	0.26314	0.08801	0.08004	0.00797
74	0.23999	0.26511	0.09477	0.08549	0.00928
75	0.23999	0.26727	0.10207	0.09123	0.01084
76	0.23999	0.26969	0.11015	0.09741	0.01274
77	0.23999	0.27247	0.11921	0.10415	0.01506
78	0.23999	0.27566	0.12940	0.11152	0.01788
79	0.23999	0.27928	0.14071	0.11946	0.02125
80	0.23999	0.28331	0.15292	0.12776	0.02516
81	0.23999	0.28769	0.16582	0.13617	0.02965
82	0.23999	0.29243	0.17934	0.14476	0.03458
83	0.23999	0.29758	0.19355	0.15427	0.03928
84	0.23999	0.30334	0.20886	0.16412	0.04474
85	0.23999	0.30992	0.22564	0.17456	0.05108

Produced on Factors 4.05 6-7-99

7 Year Single Life GRAT

Zero Out Annuity Analysis

Term: 7
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Age	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
50	0.18169	0.18516	0.01876	0.01834	0.00042
51	0.18169	0.18550	0.02054	0.02003	0.00051
52	0.18169	0.18587	0.02247	0.02186	0.00061
53	0.18169	0.18627	0.02458	0.02385	0.00073
54	0.18169	0.18671	0.02687	0.02600	0.00087
55	0.18169	0.18719	0.02938	0.02833	0.00104
56	0.18169	0.18772	0.03212	0.03087	0.00124
57	0.18169	0.18830	0.03510	0.03362	0.00148
58	0.18169	0.18892	0.03829	0.03654	0.00175
59	0.18169	0.18958	0.04163	0.03956	0.00206
60	0.18169	0.19027	0.04511	0.04269	0.00242
61	0.18169	0.19100	0.04874	0.04592	0.00282
62	0.18169	0.19178	0.05262	0.04934	0.00329
63	0.18169	0.19263	0.05679	0.05295	0.00383
64	0.18169	0.19354	0.06124	0.05676	0.00447
65	0.18169	0.19453	0.06602	0.06079	0.00524
66	0.18169	0.19563	0.07126	0.06511	0.00615
67	0.18169	0.19687	0.07709	0.06985	0.00723
68	0.18169	0.19825	0.08353	0.07501	0.00852
69	0.18169	0.19978	0.09057	0.08056	0.01001
70	0.18169	0.20146	0.09812	0.08640	0.01173
71	0.18169	0.20326	0.10611	0.09242	0.01369
72	0.18169	0.20518	0.11450	0.09854	0.01595
73	0.18169	0.20724	0.12327	0.10497	0.01830
74	0.18169	0.20947	0.13261	0.11173	0.02088
75	0.18169	0.21195	0.14275	0.11883	0.02392
76	0.18169	0.21475	0.15394	0.12641	0.02753
77	0.18169	0.21793	0.16630	0.13452	0.03178
78	0.18169	0.22155	0.17990	0.14318	0.03672
79	0.18169	0.22561	0.19466	0.15222	0.04244
80	0.18169	0.23010	0.21039	0.16136	0.04903
81	0.18169	0.23504	0.22697	0.17033	0.05664
82	0.18169	0.24043	0.24432	0.17904	0.06528
83	0.18169	0.24635	0.26247	0.18902	0.07345
84	0.18169	0.25296	0.28175	0.19898	0.08277
85	0.18169	0.26049	0.30250	0.20901	0.09349

Produced on Factors 4.05 6-7-99

10 Year Single Life GRAT

Zero Out Annuity Analysis

Term: 10
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Age	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
50	0.13845	0.14248	0.02823	0.02705	0.00118
51	0.13845	0.14287	0.03088	0.02947	0.00141
52	0.13845	0.14329	0.03376	0.03208	0.00169
53	0.13845	0.14376	0.03689	0.03488	0.00201
54	0.13845	0.14426	0.04026	0.03787	0.00238
55	0.13845	0.14481	0.04390	0.04107	0.00283
56	0.13845	0.14541	0.04784	0.04450	0.00334
57	0.13845	0.14606	0.05208	0.04814	0.00394
58	0.13845	0.14676	0.05658	0.05196	0.00462
59	0.13845	0.14750	0.06130	0.05589	0.00540
60	0.13845	0.14828	0.06624	0.05993	0.00630
61	0.13845	0.14911	0.07145	0.06410	0.00735
62	0.13845	0.15001	0.07705	0.06854	0.00851
63	0.13845	0.15100	0.08308	0.07330	0.00978
64	0.13845	0.15208	0.08958	0.07831	0.01126
65	0.13845	0.15325	0.09657	0.08359	0.01297
66	0.13845	0.15455	0.10414	0.08919	0.01494
67	0.13845	0.15599	0.11240	0.09518	0.01722
68	0.13845	0.15758	0.12136	0.10151	0.01985
69	0.13845	0.15933	0.13101	0.10814	0.02287
70	0.13845	0.16124	0.14131	0.11495	0.02636
71	0.13845	0.16331	0.15221	0.12181	0.03040
72	0.13845	0.16556	0.16374	0.12915	0.03458
73	0.13845	0.16801	0.17590	0.13658	0.03932
74	0.13845	0.17069	0.18887	0.14408	0.04480
75	0.13845	0.17368	0.20282	0.15171	0.05111
76	0.13845	0.17703	0.21790	0.15952	0.05838
77	0.13845	0.18080	0.23420	0.16744	0.06676
78	0.13845	0.18504	0.25177	0.17644	0.07533
79	0.13845	0.18980	0.27052	0.18573	0.08479
80	0.13845	0.19507	0.29024	0.19473	0.09551
81	0.13845	0.20088	0.31075	0.20313	0.10763
82	0.13845	0.20725	0.33196	0.21111	0.12084
83	0.13845	0.21428	0.35385	0.22011	0.13374
84	0.13845	0.22211	0.37664	0.22846	0.14818
85	0.13845	0.23093	0.40045	0.23615	0.16430

Produced on Factors 4.05 6-7-99

GRAT for a 55 Year Old

Zero Out Annuity Analysis

Age: 55
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Term	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
2	0.54849	0.55279	0.00777	0.00773	0.00004
3	0.37688	0.38138	0.01180	0.01170	0.00011
4	0.29124	0.29597	0.01598	0.01575	0.00023
5	0.23999	0.24496	0.02031	0.01988	0.00042
6	0.20593	0.21116	0.02477	0.02409	0.00069
7	0.18169	0.18719	0.02938	0.02833	0.00104
8	0.16359	0.16937	0.03411	0.03260	0.00151
9	0.14959	0.15565	0.03895	0.03685	0.00210
10	0.13845	0.14481	0.04390	0.04107	0.00283
11	0.12940	0.13606	0.04895	0.04524	0.00372
12	0.12191	0.12888	0.05410	0.04931	0.00479
13	0.11561	0.12291	0.05933	0.05342	0.00592
14	0.11027	0.11789	0.06465	0.05745	0.00720
15	0.10567	0.11363	0.07003	0.06131	0.00873
16	0.10169	0.10999	0.07550	0.06497	0.01053
17	0.09821	0.10687	0.08103	0.06863	0.01241
18	0.09515	0.10418	0.08664	0.07208	0.01456
19	0.09244	0.10185	0.09232	0.07528	0.01704
20	0.09004	0.09982	0.09805	0.07846	0.01958

Produced on Factors 4.05 6-7-99

GRAT for a 65 Year Old

Zero Out Annuity Analysis

Age: 65
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Term	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
2	0.54849	0.55869	0.01824	0.01806	0.00018
3	0.37688	0.38753	0.02749	0.02691	0.00058
4	0.29124	0.30239	0.03688	0.03565	0.00123
5	0.23999	0.25167	0.04643	0.04425	0.00218
6	0.20593	0.21817	0.05614	0.05265	0.00349
7	0.18169	0.19453	0.06602	0.06079	0.00524
8	0.16359	0.17706	0.07607	0.06859	0.00748
9	0.14959	0.16371	0.08626	0.07600	0.01026
10	0.13845	0.15325	0.09657	0.08359	0.01297
11	0.12940	0.14490	0.10696	0.09060	0.01636
12	0.12191	0.13812	0.11741	0.09695	0.02046
13	0.11561	0.13257	0.12789	0.10332	0.02457
14	0.11027	0.12797	0.13838	0.10895	0.02943
15	0.10567	0.12415	0.14886	0.11428	0.03458
16	0.10169	0.12096	0.15932	0.11899	0.04033
17	0.09821	0.11829	0.16975	0.12344	0.04631
18	0.09515	0.11605	0.18012	0.12716	0.05296
19	0.09244	0.11419	0.19041	0.13069	0.05972
20	0.09004	0.11263	0.20058	0.13375	0.06683

Produced on Factors 4.05 6-7-99

GRAT for a 75 Year Old

Zero Out Annuity Analysis

Age: 75
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Term	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
2	0.54849	0.57193	0.04097	0.04005	0.00093
3	0.37688	0.40151	0.06133	0.05841	0.00292
4	0.29124	0.31715	0.08170	0.07554	0.00616
5	0.23999	0.26727	0.10207	0.09123	0.01084
6	0.20593	0.23465	0.12243	0.10526	0.01717
7	0.18169	0.21195	0.14275	0.11883	0.02392
8	0.16359	0.19545	0.16298	0.13122	0.03177
9	0.14959	0.18311	0.18303	0.14157	0.04147
10	0.13845	0.17368	0.20282	0.15171	0.05111
11	0.12940	0.16638	0.22225	0.15987	0.06238
12	0.12191	0.16067	0.24127	0.16717	0.07410
13	0.11561	0.15620	0.25981	0.17358	0.08623
14	0.11027	0.15268	0.27781	0.17861	0.09920
15	0.10567	0.14993	0.29521	0.18255	0.11267
16	0.10169	0.14779	0.31195	0.18623	0.12572
17	0.09821	0.14614	0.32798	0.18916	0.13882
18	0.09515	0.14488	0.34326	0.19140	0.15186
19	0.09244	0.14394	0.35774	0.19308	0.16466
20	0.09004	0.14323	0.37140	0.19433	0.17707

Produced on Factors 4.05 6-7-99

GRAT for a 85 Year Old

Zero Out Annuity Analysis

Age: 85
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Term	Term Zero Out Rate	Contingent Zero Out Rate	Example 5 Gift	Rev. Rul. 77-454 Gift	Difference In Gifts
2	0.54849	0.60626	0.09528	0.09004	0.00524
3	0.37688	0.43851	0.14053	0.12428	0.01625
4	0.29124	0.35693	0.18406	0.15067	0.03339
5	0.23999	0.30992	0.22564	0.17456	0.05108
6	0.20593	0.28023	0.26516	0.19299	0.07217
7	0.18169	0.26049	0.30250	0.20901	0.09349
8	0.16359	0.24696	0.33756	0.21999	0.11758
9	0.14959	0.23754	0.37024	0.22848	0.14175
10	0.13845	0.23093	0.40045	0.23615	0.16430
11	0.12940	0.22629	0.42818	0.24153	0.18665
12	0.12191	0.22306	0.45349	0.24528	0.20822
13	0.11561	0.22084	0.47647	0.24786	0.22861
14	0.11027	0.21932	0.49723	0.24962	0.24761
15	0.10567	0.21830	0.51594	0.25080	0.26514
16	0.10169	0.21763	0.53275	0.25158	0.28117
17	0.09821	0.21720	0.54784	0.25208	0.29576
18	0.09515	0.21693	0.56138	0.25239	0.30899
19	0.09244	0.21676	0.57353	0.25258	0.32095
20	0.09004	0.21667	0.58444	0.25270	0.33175

Produced on Factors 4.05 6-7-99

GRAT for Two 50 Year Olds

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 50 Age 2: 50

Current Interest: 6.40% Mortality: 90CM

Annuity Payments Per Year: 1 First Payment Delay: 12

Annuity Adjustment Factor: 1.0000

Term	Rev. Rul. 77-454 Gifts					
	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.55121	0.55121	0.54852	0.00491	0.00491	0.00004
3	0.37973	0.37973	0.37691	0.00746	0.00746	0.00008
4	0.29423	0.29423	0.29128	0.01008	0.01008	0.00015
5	0.24313	0.24313	0.24005	0.01277	0.01277	0.00024
6	0.20923	0.20923	0.20600	0.01553	0.01553	0.00037
7	0.18516	0.18516	0.18179	0.01834	0.01834	0.00052
8	0.16724	0.16724	0.16371	0.02120	0.02120	0.00071
9	0.15342	0.15342	0.14974	0.02411	0.02411	0.00095
10	0.14248	0.14248	0.13863	0.02705	0.02705	0.00123
11	0.13362	0.13362	0.12960	0.03002	0.03002	0.00156
12	0.12634	0.12634	0.12215	0.03300	0.03300	0.00195
13	0.12026	0.12026	0.11590	0.03598	0.03598	0.00240
14	0.11513	0.11513	0.11059	0.03894	0.03894	0.00292
15	0.11076	0.11076	0.10605	0.04191	0.04191	0.00350
16	0.10702	0.10702	0.10212	0.04488	0.04488	0.00416
17	0.10378	0.10378	0.09870	0.04779	0.04779	0.00490
18	0.10097	0.10097	0.09571	0.05059	0.05059	0.00571
19	0.09851	0.09851	0.09308	0.05333	0.05333	0.00659
20	0.09637	0.09637	0.09075	0.05604	0.05604	0.00756

Produced on Factors 4.05 6-6-99

GRAT for Two 60 Year Olds

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 60 Age 2: 60

Current Interest: 6.40% Mortality: 90CM

Annuity Payments Per Year: 1 First Payment Delay: 12

Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.55531	0.55531	0.54862	0.01218	0.01218	0.00023
3	0.38401	0.38401	0.37707	0.01829	0.01829	0.00050
4	0.29870	0.29870	0.29150	0.02443	0.02443	0.00090
5	0.24781	0.24781	0.24033	0.03056	0.03056	0.00143
6	0.21412	0.21412	0.20637	0.03666	0.03666	0.00212
7	0.19027	0.19027	0.18223	0.04269	0.04269	0.00296
8	0.17258	0.17258	0.16425	0.04860	0.04860	0.00396
9	0.15899	0.15899	0.15038	0.05436	0.05436	0.00514
10	0.14828	0.14828	0.13938	0.05993	0.05993	0.00651
11	0.13966	0.13966	0.13048	0.06546	0.06546	0.00806
12	0.13263	0.13263	0.12315	0.07090	0.07090	0.00980
13	0.12682	0.12682	0.11705	0.07602	0.07602	0.01174
14	0.12196	0.12196	0.11190	0.08080	0.08080	0.01387
15	0.11787	0.11787	0.10753	0.08564	0.08564	0.01618
16	0.11441	0.11441	0.10378	0.09002	0.09002	0.01864
17	0.11147	0.11147	0.10056	0.09417	0.09417	0.02122
18	0.10896	0.10896	0.09778	0.09805	0.09805	0.02388
19	0.10681	0.10681	0.09537	0.10162	0.10162	0.02664
20	0.10497	0.10497	0.09328	0.10487	0.10487	0.02952

Produced on Factors 4.05 6-6-99

GRAT for Two 70 Year Olds

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 70 Age 2: 70
Current Interest: 6.40% Mortality: 90CM
Annuity Payments Per Year: 1 First Payment Delay: 12
Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.56387	0.56387	0.54912	0.02685	0.02685	0.00114
3	0.39305	0.39305	0.37781	0.03982	0.03982	0.00245
4	0.30826	0.30826	0.29252	0.05240	0.05240	0.00434
5	0.25789	0.25789	0.24166	0.06446	0.06446	0.00683
6	0.22475	0.22475	0.20803	0.07583	0.07583	0.00989
7	0.20146	0.20146	0.18426	0.08640	0.08640	0.01352
8	0.18434	0.18434	0.16667	0.09655	0.09655	0.01768
9	0.17134	0.17134	0.15321	0.10636	0.10636	0.02230
10	0.16124	0.16124	0.14267	0.11495	0.11495	0.02731
11	0.15326	0.15326	0.13425	0.12315	0.12315	0.03261
12	0.14687	0.14687	0.12745	0.13044	0.13044	0.03806
13	0.14172	0.14172	0.12190	0.13709	0.13709	0.04350
14	0.13755	0.13755	0.11734	0.14274	0.14274	0.04932
15	0.13415	0.13415	0.11358	0.14813	0.14813	0.05484
16	0.13138	0.13138	0.11047	0.15253	0.15253	0.05991
17	0.12913	0.12913	0.10791	0.15618	0.15618	0.06504
18	0.12731	0.12731	0.10581	0.15966	0.15966	0.06931
19	0.12585	0.12585	0.10410	0.16245	0.16245	0.07350
20	0.12467	0.12467	0.10271	0.16470	0.16470	0.07697

Produced on Factors 4.05 6-6-99

GRAT for Two 80 Year Olds

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 80 Age 2: 80

Current Interest: 6.40% Mortality: 90CM

Annuity Payments Per Year: 1 First Payment Delay: 12

Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.58489	0.58489	0.55175	0.06004	0.06004	0.00587
3	0.41546	0.41546	0.38162	0.08597	0.08597	0.01224
4	0.33215	0.33215	0.29763	0.10869	0.10869	0.02079
5	0.28331	0.28331	0.24815	0.12776	0.12776	0.03109
6	0.25175	0.25175	0.21599	0.14609	0.14609	0.04254
7	0.23010	0.23010	0.19376	0.16136	0.16136	0.05447
8	0.21468	0.21468	0.17779	0.17454	0.17454	0.06607
9	0.20342	0.20342	0.16601	0.18495	0.18495	0.07748
10	0.19507	0.19507	0.15719	0.19473	0.19473	0.08855
11	0.18884	0.18884	0.15054	0.20202	0.20202	0.09760
12	0.18419	0.18419	0.14551	0.20747	0.20747	0.10634
13	0.18072	0.18072	0.14172	0.21187	0.21187	0.11325
14	0.17817	0.17817	0.13889	0.21576	0.21576	0.11841
15	0.17629	0.17629	0.13680	0.21862	0.21862	0.12307
16	0.17494	0.17494	0.13527	0.22068	0.22068	0.12666
17	0.17398	0.17398	0.13418	0.22214	0.22214	0.12921
18	0.17330	0.17330	0.13340	0.22317	0.22317	0.13104
19	0.17284	0.17284	0.13287	0.22387	0.22387	0.13228
20	0.17252	0.17252	0.13251	0.22436	0.22436	0.13312

Produced on Factors 4.05 6-6-99

GRAT for a 60 and 50 Year Old

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 60 Age 2: 50
Current Interest: 6.40% Mortality: 90CM
Annuity Payments Per Year: 1 First Payment Delay: 12
Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.55531	0.55121	0.54855	0.01218	0.00491	0.00009
3	0.38401	0.37973	0.37696	0.01829	0.00746	0.00020
4	0.29870	0.29423	0.29135	0.02443	0.01008	0.00037
5	0.24781	0.24313	0.24013	0.03056	0.01277	0.00059
6	0.21412	0.20923	0.20611	0.03666	0.01553	0.00088
7	0.19027	0.18516	0.18192	0.04269	0.01834	0.00124
8	0.17258	0.16724	0.16387	0.04860	0.02120	0.00169
9	0.15899	0.15342	0.14993	0.05436	0.02411	0.00221
10	0.14828	0.14248	0.13885	0.05993	0.02705	0.00284
11	0.13966	0.13362	0.12987	0.06546	0.03002	0.00356
12	0.13263	0.12634	0.12245	0.07090	0.03300	0.00439
13	0.12682	0.12026	0.11625	0.07602	0.03598	0.00534
14	0.12196	0.11513	0.11099	0.08080	0.03894	0.00641
15	0.11787	0.11076	0.10650	0.08564	0.04191	0.00759
16	0.11441	0.10702	0.10264	0.09002	0.04488	0.00890
17	0.11147	0.10378	0.09928	0.09417	0.04779	0.01033
18	0.10896	0.10097	0.09636	0.09805	0.05059	0.01186
19	0.10681	0.09851	0.09380	0.10162	0.05333	0.01350
20	0.10497	0.09637	0.09155	0.10487	0.05604	0.01522

Produced on Factors 4.05 6-6-99

GRAT for a 70 and 60 Year Old

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 70 Age 2: 60

Current Interest: 6.40% Mortality: 90CM

Annuity Payments Per Year: 1 First Payment Delay: 12

Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.56387	0.55531	0.54878	0.02685	0.01218	0.00051
3	0.39305	0.38401	0.37730	0.03982	0.01829	0.00111
4	0.30826	0.29870	0.29182	0.05240	0.02443	0.00198
5	0.25789	0.24781	0.24074	0.06446	0.03056	0.00313
6	0.22475	0.21412	0.20688	0.07583	0.03666	0.00459
7	0.20146	0.19027	0.18287	0.08640	0.04269	0.00635
8	0.18434	0.17258	0.16501	0.09655	0.04860	0.00842
9	0.17134	0.15899	0.15127	0.10636	0.05436	0.01080
10	0.16124	0.14828	0.14042	0.11495	0.05993	0.01348
11	0.15326	0.13966	0.13167	0.12315	0.06546	0.01644
12	0.14687	0.13263	0.12452	0.13044	0.07090	0.01967
13	0.14172	0.12682	0.11859	0.13709	0.07602	0.02313
14	0.13755	0.12196	0.11363	0.14274	0.08080	0.02677
15	0.13415	0.11787	0.10946	0.14813	0.08564	0.03051
16	0.13138	0.11441	0.10593	0.15253	0.09002	0.03434
17	0.12913	0.11147	0.10292	0.15618	0.09417	0.03834
18	0.12731	0.10896	0.10037	0.15966	0.09805	0.04221
19	0.12585	0.10681	0.09819	0.16245	0.10162	0.04585
20	0.12467	0.10497	0.09633	0.16470	0.10487	0.04960

Produced on Factors 4.05 6-6-99

GRAT for a 80 and 70 Year Old

Two Life Zero Out Annuity Analysis - Contingent Rate Basis (Last-to-Die)

Age 1: 80 Age 2: 70
 Current Interest: 6.40% Mortality: 90CM
 Annuity Payments Per Year: 1 First Payment Delay: 12
 Annuity Adjustment Factor: 1.0000

Term	Age 1 Zero Out Rate	Age 2 Zero Out Rate	Two Life Zero Out Rate	Rev. Rul. 77-454 Gifts		
				Age 1 (Only) Gift	Age 2 (Only) Gift	Two Life Gift
2	0.58489	0.56387	0.54992	0.06004	0.02685	0.00258
3	0.41546	0.39305	0.37898	0.08597	0.03982	0.00549
4	0.33215	0.30826	0.29409	0.10869	0.05240	0.00955
5	0.28331	0.25789	0.24366	0.12776	0.06446	0.01469
6	0.25175	0.22475	0.21049	0.14609	0.07583	0.02079
7	0.23010	0.20146	0.18720	0.16136	0.08640	0.02768
8	0.21468	0.18434	0.17012	0.17454	0.09655	0.03514
9	0.20342	0.17134	0.15719	0.18495	0.10636	0.04290
10	0.19507	0.16124	0.14718	0.19473	0.11495	0.05069
11	0.18884	0.15326	0.13931	0.20202	0.12315	0.05843
12	0.18419	0.14687	0.13306	0.20747	0.13044	0.06634
13	0.18072	0.14172	0.12806	0.21187	0.13709	0.07340
14	0.17817	0.13755	0.12404	0.21576	0.14274	0.08020
15	0.17629	0.13415	0.12081	0.21862	0.14813	0.08613
16	0.17494	0.13138	0.11820	0.22068	0.15253	0.09167
17	0.17398	0.12913	0.11612	0.22214	0.15618	0.09608
18	0.17330	0.12731	0.11445	0.22317	0.15966	0.10017
19	0.17284	0.12585	0.11312	0.22387	0.16245	0.10363
20	0.17252	0.12467	0.11208	0.22436	0.16470	0.10632

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APPENDIX C

Charitable Allocation Clauses

Charitable Allocation Clauses: Can Something That Limits Value Have Unlimited Value?

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A charitable allocation clause is an attempt to minimize the negative effects that can result from the audit adjustment by the Internal Revenue Service of the value of noncharitable gifts or bequests. A donor or decedent would transfer assets to a trust containing a charitable allocation clause; the clause would direct the trustee to allocate contributed assets having a certain value to a fund for the benefit of taxable beneficiaries, and to allocate all excess assets to charity.

To illustrate, parents could contribute \$2,100,000 in marketable securities to a partnership that has 100 general partnership units and 9900 limited partnership units. Parents could give the 9900 limited units to a trust at an appraised value of \$1,260,000 (a 40% discount). The trust could provide that the first \$1,250,000 of contributed assets be allocated to a fund for the benefit of parents' children, grandchildren and other descendants (a family fund), with the remaining contributed assets being allocated to the parent's donor advised fund at the local community foundation (or to other designated charitable organizations). The Trustee would review the appraisal of the limited units and would provide a copy to the local community foundation. Assuming the appraisal were in good order, the community foundation would agree that it should receive \$10,000 worth of units from the transfer but no more.

1. Benefits.

An effective charitable allocation clause in a trust might have two benefits. The IRS may be reluctant to audit transfers made to a trust containing such a clause because no gift or estate tax could be collected. In addition, even if the IRS did audit a transfer, and increased the value of the transferred assets, the result would not be payment of gift or estate tax but rather the reallocation of assets from the

noncharitable fund to the designated charity. If that charity were a donor advised fund at a community foundation, the funds would remain available for the family's charitable purposes.

2. Drafting the Clause.

A charitable allocation clause could be drafted as a formula, similar to a traditional formula marital deduction funding clause: the amount passing to the family fund would be the maximum amount that could pass free of estate or gift tax by reason of the applicable credit amount (with any appropriate adjustments). However, a simpler clause might specify a sum that would pass to the family fund with the remaining assets passing to the charitable fund. This approach would work equally well for lifetime and testamentary transfers.

Charitable allocation clauses in testamentary situations may be in common use already. For instance, a bequest of an amount equal to \$1,000,000 to each of a testator's living children with the residue passing to the testator's foundation is, in effect, a charitable allocation clause. The testator's personal representative will allocate assets to fill the children's \$1,000,000 bequests based on the personal representative's valuation of the estate's assets but such an allocation will not alter the amount of estate tax paid by the estate. If the personal representative undervalues the estate's assets the effect is that the children will receive "too much" and the foundation "too little". However, the IRS has little incentive to challenge valuations in the estate because no tax will be generated.

A sample clause suitable for an inter vivos or testamentary transfer might read as follows:

Trustee will allocate to the trust administered under Article ____

for the benefit of my spouse and my descendants a fraction of the assets added to the trust, the numerator of which is \$ _____ and the denominator of which is the fair market value of the assets added to the trust on the date of addition. The remaining assets will be allocated to the charitable organizations identified in Article __ as provided therein. Trustee may estimate the value of the assets to be allocated hereunder and make a preliminary allocation if Trustee notifies all beneficiaries that the allocation may be later adjusted. Trustee will exercise reasonable discretion in allocating the assets and may, but need not, take into consideration appraisals of such assets (whether or not obtained by Trustee) and any determination made by a federal or state taxing authority as to the value of such assets.

The purpose of a fractional allocation is to avoid an IRS question about appreciation and depreciation between the time the assets are added and the time they are allocated. If there is no such concern then the amount to be allocated to the family fund may be described as "an amount equal to" the desired dollar amount.

3. Role of the Charitable Organization.

The charitable organization should receive a copy of the appraisal from the trustee and should be asked to consent to the proposed allocation. In general, assuring that the charitable organization receives something under the likely appraised values would seem to be desirable. Not only would the charitable organization receive assets for its time and trouble and the trust appears to work because assets actually went to charity.

May the donor's private foundation be the beneficiary? In principle the answer is yes. However, the purpose of the clause is to reduce IRS challenges. If the donor's private foundation is the potential recipient then not only may the IRS claim that no independent party valued the gift, but also that the private foundation improperly surrendered its legal right to collect from the trust thereby making a gift to a disqualified person, (Treas. Reg. §53.4946-1(a)(vii)). Such a gift would be an act of self-dealing. Treas. Reg. §53.4941(f).

A charitable organization should not be lackadaisical about its duty as the donee under a charitable allocation clause. A charitable organization that did not collect all that it were due could be subject to sanction both by the Internal Revenue Service, for facilitating private inurement, and by the attorney general or other state authority regulating charities.

4. Contrast with Marital Allocation Clause.

A marital deduction clause is an alternative to the charitable allocation clause in order to avoid assets leaving the family unit. Such a clause allows the IRS to claim that the surviving spouse made a gift if the marital share is funded with assets having "too little" value. In Rev. Rul. 84-105, 1984-2 C.B. 197, the IRS determined that the surviving spouse made a gift by acquiescing to the underfunding of a pecuniary marital bequest.

If the trust were a QTIP trust a QTIP election will need to be made on the donor's next gift tax return, which must be timely filed, in order to avoid a tax. The filing may be avoided by using a general power of appointment marital trust.

5. Use after 1997 Change in the Gift Tax Statute of Limitations.

Charitable allocation clauses were less attractive before the change in the gift tax statute of limitations. For instance, in TAM 8611004 the National Office redetermined the number of units of a partnership that had been

given away by the decedent during lifetime in order to determine the number that should be included in the decedent's estate. The gift had been described as such interest in the partnership as had a stated dollar value. The TAM determined that even though the decedent and other partners thought the decedent had assigned a particular percentage of the partnership in fact less had been assigned; the decedent had not made a gift because the decedent retained the right to repossess the excess partnership units that had been assigned in error.

More generally, if the IRS may examine all gifts at the time of the estate tax audit, the auditing agent would retain significant leverage by advocating the reallocation of assets to a charitable organization rather than allowing them to stay in the family fund. The family would be somewhat happier having assets go to charity rather than to the government but at the same time the donor had not known of the readjustment and had not planned for it.

If gifts to the trust are properly disclosed the gift tax statute of limitations will expire three years after the return is filed. Suppose a gift tax examination results in the increase of gift values and assets are allocated to charity; the donor knows of that result (unless the donor has died before the audit is complete which is unlikely in most instances) and can plan accordingly. In the example which began this discussion, suppose the partnership were valued without a discount. The allocation clause would create an \$800,000 charitable fund at a community foundation which could be used to benefit the donors' charitable causes. If the donors intended to bequeath assets to charity those bequests could be eliminated and charitable fund assets used instead.

6. Income Tax Deduction.

If assets are allocated to a charitable organization by the Trustee does the donor receive an income tax deduction? An income tax deduction should be allowed to a donor with respect to whose gift Trustee allocates a part to a charitable organization within the same calendar year. The Trustee's actions were mandated by the trust agreement and thus the

contribution should be treated as being made by the donor.

What if the Trustee allocates assets to a charitable organization pursuant to a charitable allocation clause but does so after the year in which the donor makes the contribution to the trust? Section 170 provides that a deduction is allowed for contributions paid within the taxable year. Even if the Trustee's subsequent allocation of assets is retroactive, for purposes of the trust, section 170 would seem to prohibit any deduction from being taken as of the date of the initial contribution. May the donor take an income tax deduction in the year in which the Trustee's subsequent allocation is made? The answer ought to be yes. The donor's income tax position in that instance is helped if the trust is a grantor trust for income tax purposes.

7. Is the Clause Effective?

The IRS has consistently opposed certain arrangements designed to limit its ability to collect tax by increasing the value of assets transferred during life or at death. For instance, a donor may not give assets to a donee with the proviso that assets having a value in excess of \$X will be returned to the donor. On the other hand, marital deduction - exemption equivalent clauses have been used for decades, as have testamentary formula clauses of various types (e.g. a formula that zeros out charitable lead trust gifts). Which analysis is more appropriate for charitable allocation clauses?

The bedrock case is Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied 323 U.S. 756 (1944). The applicable provision that was struck down in that case read as follows:

Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax it is agreed by

all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.

Stated simply, in Procter a gift was made with an agreement that if more than a certain amount were determined to have been given the excess would be returned to the donor. The court invalidated the clause on three public policy grounds: (1) public officials would be discouraged from attempting to collect the tax since the only effect would be to defeat the gift; (2) the adjustment provision would tend to obstruct the administration of justice by requiring the court to address a moot case; and (3) the provisions should not be permitted to defeat a judgment rendered by the court.

In King v. United States, 545 F.2d 700 (10th Cir. 1976) aff'g 424 F. Supp. 117 (D. Colo. 1975), the clause examined provided that in an intra-family sales transaction if the value of closely-held stock were determined to be higher by the Internal Revenue Service the higher price would be paid. The District Court and Tenth Circuit concluded that the purpose of the clause was not to limit the ability of the IRS to examine the transaction but rather was part of a sale conducted on arms-length terms. The seller did not make a gift because there was no donative intent under Treasury Regulation Section 25.2512-8. Because the opinion rests on the arms-length nature of the transaction it is of limited guidance in other situations.

In Ward v. Commissioner, 87 T.C. 78 (1986), parents gave a certain number of shares to their sons subject to an adjustment clause that provided that if the value of the shares for gift tax purposes was increased the sons would return some shares to the parents but if the value were decreased the parents would give more shares to the sons. The Tax Court invalidated the adjustment clause.

More recently the Tax Court has considered a savings clause in a private annuity situation in Estate of McClendon v. C.I.R., T.C. Memo. 1993-459. There the private annuity agreement included an adjustment provision which increased the annuity if the value of the property transferred by the annuitant were increased upon gift tax audit. he court held:

Based upon our review of Procter and Ward, the adjustment clause at issue in the instant case does not merit consideration for purposes of determining petitioner's gift tax liability, and we so hold. In our view, it makes little sense to expend precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot. Equally important, our determination that the private annuity agreement resulted in a taxable gift is not directly binding on Bart or the McLendon Family Trust who are not parties to this case. See Ward v. Commissioner, supra at 114. Consequently, there being no assurance that the terms of the adjustment clause will be respected, it shall have no impact on this case.

A different kind of adjustment clause was at issue in Harwood v. Commissioner, 82 T.C. 239 (1984). There the trust provided that notes would be issued to the grantors if the value of gifts exceeded \$400,000. However, the determination of whether to issue the notes was left to the trustee:

In the event that the value of the partnership interest listed in Schedule "A" shall be finally determined to exceed \$400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower

value is not reasonably defensible, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and \$400,000. The note shall carry interest and be effective as of the day of the gift. [Italics added.]

The court found that the discretion of the trustee did make a difference:

We do not believe that the savings clause here under consideration falls within the ambit of Procter ... Procter is apposite only if we read the words "finally determined" to refer to a final judgment by a court of competent jurisdiction. Such an interpretation, however, would render a nullity the succeeding phrase "and in the opinion of the Attorney for the trustee a lower value is not reasonably defensible," since it would be absurd for the trustee to defend a lower value after a final judgment had been rendered. We believe the more reasonable interpretation of the clause at issue is to read "finally determined" to mean either eventually determined by appraisers or "determined by the IRS."

On this reading of the savings clause, the trustee has no power to issue notes to the grantors upon a determination by a court that the value of property transferred to the trustee exceeded \$400,000.

The IRS has contested a formula clause in Evelyn East v. Commissioner, Tax Court Docket No. 12019-98. The clause there allocated units having a certain value to grandchildren's trusts with excess units being allocated to trusts for children only. The IRS appears to be taking a position based on Procter. Taxpayer's counsel has indicated the case will likely be settled.

This analysis suggests that the kind of charitable allocation clause under consideration here is distinguishable in two ways from those struck down using a Procter analysis. One distinguishing factor would be that the grantors would not receive back any excess gifts, rather any excess would be distributed to charity. A second distinguishing factor is that the clause is similar to that in Harwood in that it gives discretion to the Trustee regarding the amount of the allocation rather than making it automatic.

Is the effectiveness of the clause enhanced if the IRS is allowed to collect some tax? For example, suppose the clause were drafted such that amounts above \$1,100,000 were transferred to a charitable fund, and then assets appraised at \$1,000,000 were transferred to the trust. The IRS could adjust the value on audit upwards by \$100,000 and collect gift tax on that additional gift. However, the amount of the gift tax that might be owed would be capped at a level acceptable to the client (in the illustration, the tax on \$100,000).

8. Effect of Special Attacks on Limited Partnerships.

What is the effect of attacks on family limited partnerships on the clause. For instance, if the law turned out to be that no discounts were allowed for gifts of limited partnership interests holding marketable securities to family members, but discounts remained in place for gifts to others - charities, for instance - what is the effect on the trust discussed at the beginning of this section? Presumably the IRS would take the position that the units had an undiscounted value for purposes of allocation to the fund for the descendants. Does that automatically mean that more is allocated to charity? The answer could be no if the valuation

of the units under normal state law valuation principles is unchanged. Stated differently, if values increase because appraisals are wrong or state law rights are misunderstood the clause may work, but if values increase simply because the IRS disregards the partnership (under a Murphy theory for instance) or because section 2703 or section 2704 alter the valuation in a limited context – family transfers – the clause may not work.

May the clause be drafted so that it “ties in” to value as finally determined for federal gift tax purposes including Chapter 14 and Murphy type arguments? Arguably yes but that would seem to increase the ability of the IRS to argue that in fact the clause was nothing more than a mechanism to avoid gift tax.

May the clause be drafted in reverse? To illustrate, assume \$2,100,000 of marketable securities in a limited partnership with 9900 limited units, representing 99% of the partnership units, given to a trust. The trust provides that the first \$10,000 worth of units will be allocated to charity and the next \$1,250,000 to a fund for descendants, and amounts beyond that to charity again. Is it possible for the IRS to claim that units have one value on the front and back ends and a different value in the middle?

9. Conclusion. A charitable allocation clause seems to be an effective mechanism to limit gift tax expense.

Charity From Nothing: Protection From Environmental and Premises Liability Under Check-the-Box

Turney P. Berry, Timothy J. Eifler, and Lauren D. Anderson, all of Ogden, Newell & Welch, Louisville, Ky., have written this special report, which looks at the factors charities need to consider when contributors want to donate real property.

Tax Analysts Document Number: Doc 1999-22114

Citations: (July 1, 1999)

———— **SUMMARY** ————

Turney P. Berry, Timothy J. Eifler, and Lauren D. Anderson, all of Ogden, Newell & Welch, Louisville, Ky., have written this special report, which looks at the factors charities need to consider when contributors want to donate real property.

The authors are attorneys at the firm of Ogden, Newell & Welch, Louisville, Ky. Timothy Eifler practices federal, state, and local tax. Turney Berry works on estate planning issues, and Lauren Anderson focuses on environmental law.

———— **FULL TEXT** ————

[1] A frequently recurring issue for charities involves whether to accept contributions of real property. Ownership of real property subjects the owner to potential environmental liability for prior and future releases of hazardous materials on the real property as well as premises liability for injuries to persons or property occurring on the real property. This potential risk can far outweigh any current financial advantage to the charity from accepting such a donation. This article outlines a potential method whereby charities can accept contributions of real property and simultaneously avoid incurring environmental or premises liability under the new "check-the-box" regulations. This article does not address issues raised by charities engaging in substantial real property activities which go beyond the mere ownership or passive rental of real property.

I. ENVIRONMENTAL LIABILITY

[2] At one time, the greatest risk for a charity as a result of receiving a donation of real property was that the real property could not be used directly by the charity, could not be rented, and was unsaleable. Today, the imposition of liability to remedy environmental problems on real property may surpass these traditional concerns.

[3] The Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. section 9601 et seq. (CERCLA) creates the possibility of significant liabilities being imposed on owners and operators of real property on which hazardous materials are located. There are two primary bases for liability under CERCLA -- operator liability and owner liability.

[4] The statute imposes liability on the "operator" of a parcel of real property. 42 U.S.C. section 9607(a)(4). /1/ There seem to be two competing tests used to determine whether one is an operator.

[5] The "actual control" test imposes liability if there is substantial control exercised over the property. In certain cases, this test can reach parent corporations -- as well as individual officers, directors and shareholders -- who actively participate in the management of a facility. See *United States v. Northeastern Pharmaceutical & Chemical Co. Inc.*, 810 F.2d 726 (8th Cir. 1986). In other cases, however, the actual control test has resulted in parent corporations being protected from liability arising out of real property owned by wholly-owned subsidiaries. See generally, *Lansford-Coaldale Water Authority v. Tonolli Corp.*, 4 F.2d 1209 (3d Cir. 1993), *United States v. Kayser-Roth Corp.*, 910 F.2d 24 (1st Cir. 1990), cert. denied, 498 U.S. 1084 (1991).

[6] The competing standard, the "authority-to-control" test, is met if there is capability to control, even if that capability is not utilized. See generally, *Nurad Inc. v. William E. Hooper & Sons Co.*, 966 F.2d 837 (4th Cir. 1991), cert. denied, 506 U.S. 940, 113 S.Ct. 377 (1992). This test poses several problems for subsidiaries.

[7] The U.S. Supreme Court recently clarified the application of operator liability to parent corporations. In *United States v. Bestfoods*, 118 S.Ct. 1876 (1998), the court clarified that a parent corporation cannot be held liable as an operator of a polluting facility indirectly through its ownership of a subsidiary. To hold a parent corporation liable for a polluting

facility owned by a subsidiary, the parent itself "must manage, direct, or conduct operations specifically related to . . . the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." *Id.* at 1887. Control of a subsidiary, if extensive enough, may give rise to indirect owner liability by piercing the corporate veil, but not to direct operator liability.

[8] The "actual control" test, while easier to satisfy, may not be of much assistance to a planner. The test of whether actual control exists will be made after an examination of the manner in which the affairs of the subsidiary were actually conducted. However, for real property passively owned by a subsidiary which does not conduct active operations on the property, it is now clear that operator liability cannot obtain.

[9] Although Bestfoods held that a parent corporation (or an individual corporate principal) may be directly liable as an operator, owner liability under CERCLA is still essentially a traditional "piercing the corporate veil" exercise. See Bestfoods, 118 S.Ct. 1876, 1184-85; *Joslyn Manufacturing Co. v. T.J. James & Co.*, 893 F.2d 80 (5th Cir. 1990). Cases holding otherwise are overruled by the decision in Bestfoods. See, e.g., *Riverside Market Dev. Corp. v. International Bldg. Prods. Inc.*, 931 F.2d 327 (5th Cir.), cert. denied, 502 U.S. 1004 (1991); *United States v. Kayser-Roth Corp.*, 910 F.2d 24 (1st Cir. 1990), cert. denied, 498 U.S. 1084 (1991); *Schiavone v. Pearce*, 79 F.3d 248 (2nd Cir. 1996). Piercing the veil is a function of the state law of the jurisdiction in which the entity is formed; different states look at different factors and give those factors different respective weights. Factors that are commonly reviewed include: (1) under capitalization; (2) failure to observe corporate formalities; (3) nonpayment or overpayment of dividends; (4) dominant shareholders siphoning off corporate funds; and (5) personal guarantees by shareholders of corporate obligations. *White v. Winchester Land Development Corp.*, 584 S.W.2d 56, 26 (Ky. App. 1979). Generally speaking, the veil is pierced where necessary to prevent the use of the corporation, and the benefit of limited liability, to perpetrate a fraud and to prevent unjust enrichment.

[10] Courts generally will pierce the corporation veil if (1) the shareholders have disregarded corporate formalities (failed to have appropriate meetings of directors and shareholders or failed to keep proper records of corporate actions) or (2) the corporation is undercapitalized. If an LLC is operated with sufficient attention to proper procedures and with sufficient capital, there should be no owner liability imposed on members.

II. TRADITIONAL METHODS TO PROTECT CHARITABLE ASSETS

[11] To avoid owner liability under federal environmental liability statutes, charities have traditionally sought to place title to real property into a liability remote entity. The use of a subsidiary corporation to hold real property has the advantage of protecting the charity's assets by providing a layer of limited liability between the real property ownership and related activities and the organization. This structure provides adequate protection if the appropriate corporate formalities are observed and the subsidiary is not merely an alter ego for the charity. The entity of choice for charities is generally a wholly-owned title-holding company exempt from federal income taxation under section 501(c)(2).

[12] A title-holding company must be a corporation (not a trust or association) which is "organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under [section 501]." /2/ Section 501(c)(2). A section 501(c)(2) corporation will not qualify for exemption if it carries on any activity other than holding title to property, collecting income therefrom, and paying it to the parent. Reg. section 1.501(c)(2)-1(a). The corporation cannot distribute income to more than one tax-exempt organization unless the organizations are related. /3/ While the exemption provision appears straightforward, the use of exempt title-holding companies is not without a number of limitations and pitfalls.

[13] Title-holding companies generally cannot receive UBTI, although up to 10 percent UBTI can be incidentally derived from real property holdings. Sections 501(c)(2) and (25)(G); see also Committee Reports on P.L. 103-66 (Omnibus Reconciliation Act of 1993). Therefore, the assets held by such a company must be closely supervised to avoid excessive UBTI and a possible revocation of the entity's exemption.

[14] Additionally, title-holding companies are described in section 501(c)(2) and are therefore not described in section 170(e)(2). Contributions of real property to a title-holding company are not tax deductible by a donor for either income or gift tax purposes. See sections 170 or 2522. To ensure the charitable deduction of the donor, title to such property must first be contributed to the charity and thereafter contributed by the charity to the capital of the subsidiary title-holding company. Transferring real property already owned by a charity to a subsidiary corporation is not as beneficial as initially acquiring real property in the name of the subsidiary; the subsidiary will not necessarily protect a previous owner, who is by that time in the chain of title, against environmental liabilities.

[15] A public charity would traditionally establish a supporting organization under section 509(a)(3) as an alternative title-holding vehicle where the charity wants to avoid being in the chain of title to donated real property or where a title-holding company would fail to qualify as exempt from federal income tax due to excessive UBTI. This alternative allows deductible contributions to be made directly to the liability remote entity. While direct contributions of real property to a title-holding company or a supporting organization avoids the charity being in the chain of title to the property, the care

and maintenance of the subsidiary adds an additional administrative burden on the charity. The charitable parent must obtain recognition of the subsidiary's tax- exemption and annually file returns on its behalf. Additionally, a separate set of books must be maintained for the subsidiary.

III. THE "CHECK-THE-BOX" REGULATIONS

[16] Prior to January 1, 1997, the entity classification regulations, typically referred to as the Kintner regulations, applied a four-factor test for determining whether an entity was classified as a corporation or a partnership for federal tax purposes. A business entity was classified as a corporation if it had more than two of the following corporate characteristics: (1) limited liability; (2) centralization of management; (3) free transferability of interests and (4) continuity of life. In response to a deluge of requests for classification rulings by taxpayers forming limited liability companies, the Internal Revenue Service promulgated the "check-the-box" entity classification regulations. The regulations classify state-law corporations as corporations for "federal tax purposes." Reg. section 301.7701-3(a). Generally, pass-through entity (partnership) status is provided as a default classification for most domestic unincorporated entities such as LLCs. Such entities have the option under the regulations to elect corporate classification. The election to be taxed as a corporation is (and a protective election to be taxed as a pass-through can be) made by "checking a box" on IRS Form 8832 and filing the form within 75 days of formation of an unincorporated entity.

[17] One new twist in the check-the-box regulations is the creation of a new classification -- the tax nothing. Single-member unincorporated entities such as single-member LLCs (SMLLCs) are, for tax purposes, disregarded unless such entities elect to be taxed as corporations. A SMLLC owned by an individual is treated for federal tax purposes as a sole proprietorship. A corporate owned SMLLC is treated as a branch or division of its corporate member. Despite being disregarded for Federal tax purposes, under state law, a SMLLC insulates its member from the SMLLC's liabilities.

[18] Tax nothings are currently being tested in a variety of federal income tax arenas. The most notable and widely publicized use of a tax nothing is to achieve foreign tax savings. Surprisingly, the IRS is seeking to end this use of the tax nothing. /4/ Similar techniques can be used to lower state income tax liabilities. Surprisingly, no rulings have been issued in the tax-exempt, gift tax or estate tax areas.

IV. IRS VIEWS OF SMLLCs

[19] The IRS has issued a number of private letter rulings addressing the use of SMLLCs in section 1031 tax-deferred exchanges and by S corporation shareholders. These rulings provide a guide to the Service's application of the new "check-the-box" regulations to transfers of assets and to tax rules requiring specific characteristics of transferors, transferees, or both.

[20] Under section 1031, a taxpayer who exchanges real property held for investment or for use in a trade or business for real property of a "like kind" which is similarly held for investment or for use in a trade or business may defer recognizing gain on the transfer of his or her property. A number of cases and rulings have clarified that the taxpayer who transfers the relinquished property must be the same taxpayer who acquires the replacement property in order to obtain the tax-deferral. See, e.g., TAM 9818003.

[21] In PLRs 9807013 and 9751012, the IRS ruled that a taxpayer's transfer of replacement property from the seller in the second leg of a section 1031 exchange directly to the taxpayer's wholly owned SMLLC would not disqualify the taxpayer from receiving nonrecognition treatment. The IRS concluded that because the SMLLC is disregarded as an entity separate from the taxpayer, the transfer of title to the replacement property directly to the SMLLC would be treated as if the taxpayer had directly received the replacement property. Accordingly, the exchange qualified because the taxpayer who transferred the relinquished property was the same taxpayer who received the replacement property.

[22] In PLRs 9739014 and 9745017, the IRS addressed the use of SMLLCs by S corporation shareholders. Shareholders which otherwise qualified as S corporation shareholders under section 1361(b)(1) each transferred their shares of stock to SMLLCs. Although limited liability companies are not listed as qualifying shareholders of an S corporation in section 1361(b), the IRS ruled that an otherwise qualifying shareholder of an S corporation could hold stock through a SMLLC without disqualifying the corporation's election. The owner of a SMLLC is treated as owning the LLC's assets directly. As a result, any shares held by a SMLLC are treated as being owned directly by the LLC's owner in determining whether a corporation is eligible to elect S status or continue its eligibility as an S corporation.

[23] In these rulings, the IRS looked through the SMLLCs to deem the single members as recipients of property actually transferred to the SMLLCs. Further, the IRS treated the single members as if they owned outright all property owned in the name of the SMLLCs. This logic should apply equally to property transferred to a SMLLC wholly-owned by a charity.

V. STATE REVENUE AUTHORITIES' VIEWS OF SMLLCs

[24] State income taxes are generally based on either federal taxable income or federal adjusted gross income. Further, most states specifically adopt the federal income tax law and the administrative and judicial interpretations of the federal income tax law except to the extent required by differences between the state tax law and federal tax law. As a result, most state revenue authorities have taken the position that the check-the-box regulations are incorporated by reference into the state tax provisions. /5/ Some revenue authorities have issued pronouncements that they interpret state income tax laws to be in conformity with the federal. /6/ Finally, a number of states have legislatively mandated conformity. /7/

[25] It would appear that, as a general rule, most states adopt the check-the-box rules. The most notable exception is Texas which imposes a corporate income tax on LLCs regardless of their federal income tax treatment. /8/ In all but one of the states adopting conformity, the check-the-box regulations apply for income tax purposes only. The notable exception is Alabama which applies the check-the-box regulations for "purposes of taxation." Ala. Code section 10-12-8 (b).

VI. USE OF TAX NOTHINGS TO ACHIEVE ASSET PROTECTION -- FEDERAL INCOME TAX ISSUES

[26] The check-the-box regulations present charities with two alternative methods to achieve liability protection in the context of contributions of real property. If a SMLLC is disregarded as an entity separate from its owner for all federal tax purposes, then a charity should be able to structure a contribution of real property either as a contribution of the single membership interest in a SMLLC which holds the real property or as a contribution of the property, not to the charity, but to a SMLLC wholly-owned by the charity.

[27] The first scenario would involve cooperation by the donor or, for testamentary devises, the executor/executrix of the donor's estate (the transferor). The charity would request that the Transferor create a SMLLC under state law with the transferor as the SMLLC member. The transferor would then contribute the SMLLC interest to the charity. Under the second scenario, the charity would itself create the SMLLC. The charity would direct the Transferor to transfer title to the contributed real property directly to the SMLLC.

[28] It is not economically feasible for a charity to create a separate title-holding company or a supporting organization for each parcel of contributed real property. However, the costs and burden of creating and maintaining a separate SMLLC for each such parcel would be minimal. The charity could at minimal cost create a SMLLC for every contribution whether the SMLLC is formed by the transferor or the charity. Further, the SMLLC is not constrained by the limitations of either section 501(c)(2) and regulations section 1.501(c)(2)-1 or section 501(c)(25). UBTI limitations would be analyzed not by looking at the operations of the SMLLC but of the entire charity. Thus, oversight of the SMLLC's operations would be minimal.

[29] Arguably, a SMLLC provides greater liability protection than a state law corporation. /9/ The corporate formalities required by LLCs are substantially less than those traditionally required for corporations under state law. Most states allow for informal governance procedures and do not require that the owners of LLCs hold regular meetings or record minutes of meetings. Further, many states' LLC statutes provide that the failure to hold meetings of members or managers or the failure to observe the formalities pertaining to the calling or conduct of meetings will not affect the determination of whether members have personal liability for the obligations of the LLC provided the articles of organization or the operating agreement of the LLC does not require the holding of meetings of members or managers. /10/ Charities can seek additional liability protection by organizing the SMLLC in a jurisdiction which is reluctant to pierce the veil.

[30] A number of issues with respect to these alternative methods of receiving contributions of real property remain open. In the first scenario, it is not clear whether the transferor would be treated as a contributing the property owned by the SMLLC or the SMLLC itself to the charity. This distinction may be critical for qualifying certain contributions. For example, a contribution of a remainder interest in a residence to a public charity qualifies for a charitable contribution deduction. Section 170(f)(3)(A). A contribution of a SMLLC which owns a remainder interest in a personal residence should qualify as a deductible contribution of either a SMLLC or the remainder interest. However, the tax planner should be sure that the property interest owned by the SMLLC qualifies and cannot base his or her analysis merely on the qualifying a contribution of the membership interest. This can be particularly important where the LLC is formed under the law of a state which mandates that an interest in a SMLLC is personal property. /11/ This distinction also has implications as to whether the property contributed is ordinary income or capital gain property under section 170(e). The Service has not issued a ruling as to whether a transfer of a SMLLC interest is treated as the transfer of the underlying assets for all federal tax purposes.

[31] The second scenario raises a number of issues under the exempt organizations provisions. While the check-the-box regulations specify that a SMLLC would be disregarded as separate from its owner for all Federal tax purposes, the operation of this rule in conjunction with section 508 is unclear. Section 508 requires that an organization file a notice (Form 1023) with the Service in order to be treated as exempt from federal income tax under section 501(c)(3). See reg. section 1.508-1(a)(2). Further, the regulations under section 508 require that the governing instrument contain certain

provisions. See reg. section 1.508-3. The SMLLC should not have to file an application for exemption if it is disregarded and treated as part of its exempt owner. Nevertheless, the potential application of section 508 jeopardizes the donee's charitable contribution deduction under sections 170 and 2522 and renders the use by a charity of the second scenario to be unclear at best.

[32] The Service and donors will likely have concerns as to how donors can be ensured that a SMLLC is a qualified donee. While a charity may provide donors with a copy of its determination letter, the letter is silent as to the exemption of any SMLLC owned by the charity. It is unclear how the Service will address this problem. Cautious donors will likely seek rulings on contributions of high value real property to SMLLCs wholly-owned by charities. At the very least, such donors will require that the charity provide the donor with a copy of the charity's determination letter and a Form 8832 filed by the charity with respect to the SMLLC and stamped by the Service, making a protective election for the SMLLC to be disregarded from its owner.

VII. USE OF TAX NOTHINGS TO ACHIEVE ASSET PROTECTION -- STATE AND LOCAL TAX ISSUES

[33] A SMLLC is a useful tool for a charity to shield itself from environmental and premises liability while avoiding federal tax problems. However, the effect of a SMLLC for purposes of state and local taxes is much less clear. A number of issues with respect to sales and use and property taxes remain unaddressed.

[34] States often provide constitutional or statutory sales and use tax exemptions for purchases by a charity of taxable property or services where such property or services are purchased for use in a charitable activity. Unless a state adopts the check-the-box regulations for all tax purposes, not just for income tax, a SMLLC should be considered an entity wholly separate from its charitable owner for non-income taxes. Accordingly, all purchases of construction materials or other property purchased for use with respect to the property held by a SMLLC will be subject to state sales and use taxes. The charitable member may be able to purchase these materials directly, thereafter contribute them to the SMLLC and thereby qualify for an exemption. /12/

[35] Many states also provide constitutional and/or statutory exemptions from property taxes for charitable institutions. These exemptions are often quite narrow, frequently requiring that the property be actively used for the purposes for which the institution was established. Rental property or unimproved land often will not qualify. Nevertheless, a number of states have broad charitable exemptions which would include such unrelated real property.

[36] As under state sales and use tax laws, SMLLCs are generally respected as separate entities for state property tax purposes. A charitably owned SMLLC will be subject to ad valorem tax on its property unless the state where the property is situated adopts the check-the-box regulations for all taxes. Nevertheless, strong policy arguments can be made that an intervening SMLLC should not effect a charitable property tax exemption. The fact that the charitable member wholly controls the SMLLC strongly suggest that the SMLLC should be disregarded for property tax purposes. Such arguments would be buttressed were the IRS to rule that SMLLCs are treated as subsumed under the 501(c)(3) status of their owners. Alternatively, the SMLLC could be considered a nominee or a mere title holding entity for property tax purposes. Making such arguments to a state revenue authority could, however, prove damaging in subsequent litigation over reimbursement for an environmental cleanup or premises liability.

VIII. RULING

[37] It is clear that charities may be able to obtain substantial benefits by using SMLLCs in conjunction with contributions of real property. A charity should establish a separate SMLLC for each parcel of real property it receives and should direct that the contribution be made directly to the SMLLC. The potential application of section 508, however, continues to cause concern as to the viability of this technique to reduce liability exposure.

[38] In early December 1998, the authors submitted a request to the Service for a ruling as to whether a SMLLC owned by an organization qualifying under section 501(c)(3) will be subsumed within its owner's exemption. Further, we requested that the IRS address whether contributions to such a SMLLC will be deductible by the donee.

[39] Subsequent to our request, the Service issued Rev. Proc. 99-4 (January 4, 1999). Section 8.11 now provides that the Service will not issue a letter ruling with respect to a disregarded entity described in regs. sections 301.7701-1(a)(4), -2, and -3 when the sole member of the entity is an exempt organization. We understand that the Service is still reviewing these issues and has not as yet determined its position.

[40] We have similarly requested a ruling from the relevant state revenue authority as to whether, after the donation to the SMLLC, the property will be exempt from state and local ad valorem taxation. The state revenue authority has informally stated that it is considering issuing a favorable ruling. Assuming the property tax and federal income tax hurdles can be overcome, SMLLCs offer a viable method to reduce a charity's exposure to potential environmental and

premises liabilities resulting from accepting donations of real property.

FOOTNOTES

/1/ 42 U.S.C. section 9607(a)(4) actually imposes liability on the operator of a "facility." A "facility" is defined as (A) any building, structure, installation, equipment, pipe or pipeline, well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft, or (B) any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located. 42 U.S.C. section 9601(9).

/2/ Note that any organization described in 501(c), not just charities described in 501(c)(3), can form a title-holding company.

/3/ GCM 37351 (1977). Title-holding companies (corporations and trusts) with up to 35 exempt shareholders (or beneficiaries), whether or not such shareholders (or beneficiaries) are related, may obtain an exemption under section 501(c)(25).

/4/ The IRS issued Notice 98-11, 1998-6 IRB 18, proposing to end this use of tax nothing and has issued proposed and temporary regulations implementing the Notice. Most recently, IRS issued Notice 98-35, 1998-27 IRB 1, which stated that the Service will withdraw the Notice 98-11 temporary and proposed regulations and re-propose them to be effective February 1, 2000.

/5/ La. Rev. Stat. sections 12:1368 and 47:287.701(A); Colo. Rev. Stat. section 39-22-103(2.5).

/6/ See Del. Reg. section 1.1900-1; Haw. Dept. of Rev., Tax Info. Release 97-4 (8/4/97); Mass. Dept. of Rev., Tech. Info Release 97-8 (6/16/97); Minn. Dept. of Revenue, Revenue Notice No. 97-03 (3/17/97); New York Dept. of Tax and Fin., TSB-A-96(19)C (7/24/96).

/7/ See Ky. Rev. Stat. 141.208; 1997 Ariz. S.B. 1298 (4/29/97); 1997 Cal.S.B. 1234; Fla. S.B. 704 (5/22/98).

/8/ Tex. Tax Code section 171.001(a)(2). Florida and Pennsylvania had similar rules which were recently repealed. Fla. S.B. 704 (5/22/98); 1997 Pa. H.B. 134 (5/6/97).

/9/ Certain LLC statutes expressly incorporate the law of piercing the corporate veil. See, e.g., Me. Rev. Stat. Ann. Title 31, section (2) and (3). N.D. Cent. Code section 10-32-29(3), Wash. Rev. Code section 25.15.060. In other states, courts are showing a willingness, even without such statutory direction, to apply this equitable doctrine to the still relatively novel LLC.

/10/ See, e.g., Cal. Corp. Code section 17101(b), Haw. Rev. Stat. section 428-303(b), Ill. Rev. Stat. section 180/10-10(c), S.C. Code Ann. section 33-44-303(b), Tenn. Code Ann. section 48-217-101(e) and Iowa Code section 490A.603.

/11/ See, e.g., N.J. Rev. Stat. section 42:2B-43. Query whether a contribution of an interest in a New Jersey SMLLC which holds a qualified conservation easement should be treated as real property or personal property for federal income tax purposes.

/12/ See, e.g., Private Letter Ruling P-1998-163, Kansas Dept. of Revenue (9/17/98).

END OF FOOTNOTES

Code Section: SECTION 7701 -- DEFINITIONS

Geographic Identifier: United States

Subject Area: Exempt organizations

**Index Terms: business organizations, classification
exempt organizations**

Magazine Citation: The Exempt Organization Tax Review, June 1999, p. 481; 24 The Exempt Organization Tax Review 481

Cross Reference:

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**DRAFTING DISPOSITIVE PROVISIONS
UNDER THE PRUDENT INVESTOR RULE**

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DRAFTING OF DISPOSITIVE PROVISIONS UNDER PRUDENT INVESTOR RULE

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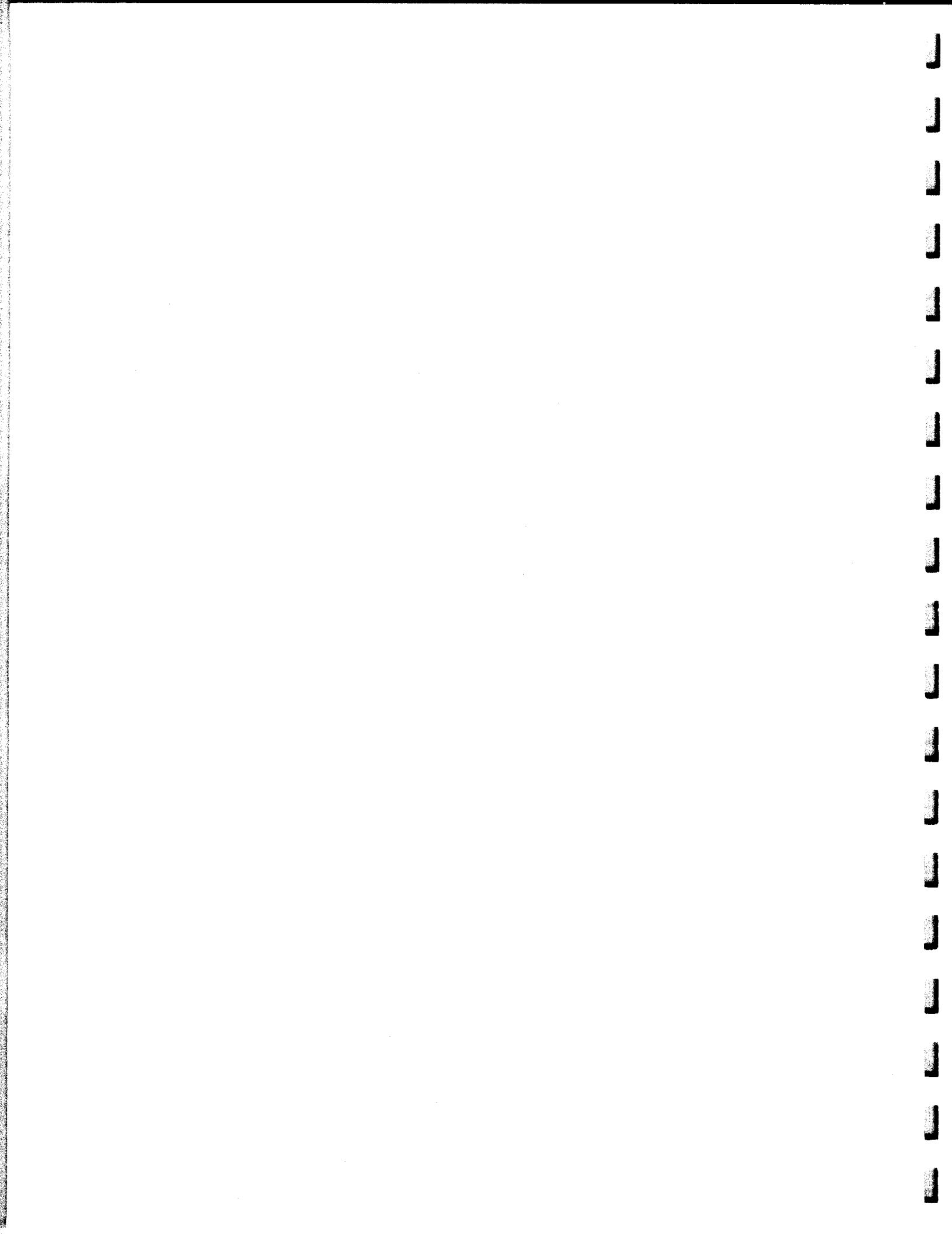
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DRAFTING OF DISPOSITIVE PROVISIONS UNDER
PRUDENT INVESTOR RULE

Jerold I. Horn
June 29, 1999

PART ONE

I. OBJECTIVES.

- A. Tax - Prevent attribution of the property, for tax purposes, to any person before the person becomes entitled to receive the property or to exercise a general power, given to the person as a beneficiary, to appoint it.
- B. Protection - Avoid claims of creditors and spouses, to extent consistent with other objectives.
- C. Approach outright ownership if one or more beneficially interested persons exclusively are to possess any nonfiduciary powers and:
 - 1. one or more independent trustees exclusively are to possess any fiduciary powers (see II, Col. A, below); or
 - 2. one or more beneficially interested persons exclusively are to possess any fiduciary powers (see II, Col. B, below); or
 - 3. one or more independent trustees exclusively are to possess any fiduciary powers that beneficially interested persons cannot possess, and either (i) one or more independent trustees and one or more beneficially interested persons are to share any fiduciary powers that beneficially interested persons can possess, or (ii) one or more beneficially interested persons exclusively are to possess any fiduciary powers that beneficially interested persons can possess (see II, Col. C, below).

**II. DRAFTING TO APPROACH BENEFITS
(BUT NOT BURDENS) OF OUTRIGHT OWNERSHIP.**

A	B	C
<u>Objectives are A, B and C.1 (independent entity is trustee)</u>	<u>Objectives are A, B and C.2 (beneficially interested person is trustee)</u>	<u>Objectives are A, B and C.3 (beneficially interested person and independent entity are trustees)</u>
1.a.i. Mandatory distribution of all income to one person (#1)	1.a.i. Same as A.1.a.i.	1.a.i. Same as A.1.a.i.
or	or	or
ii. Income per discretion of independent trustee, to one person or spray (#s 4 and 6)	ii. Income per ascertainable standard, to one person, no spray (#8)	ii. Combination of A.1.a.ii. (with one distributee) and B.1.a.ii. (#s 14 and 16)
b. Principal per discretion of independent trustee, to one person or spray (#s 5 and 7)	b. Principal per ascertainable standard, to one person, no spray (#9)	b. Combination of A.1.b. (with one distributee) and B.1.b. (#s 15 and 17)
c. Nonfiduciary 5 + 5 power (#18)	c. Same as A.1.c.	c. Same as A.1.c.
or	or	or
2.a. Nonfiduciary power to withdraw unitrust percentage (#43)	2.a. Same as A.2.a.	2.a. Same as A.2.a.
b. Additional payments to unitrust recipient per discretion of independent trustee (second paragraph of #40)	b. Additional payments to unitrust recipient per ascertainable standard (second paragraph of #41)	b. Combination of A.2.b. and B.2.b. (second paragraph of #42)
3. Nonfiduciary, inter vivos, nongeneral power of appointment (#19)	3. Same as A.3.	3. Same as A.3.
4. Nonfiduciary, testamentary, nongeneral power of appointment (#20)	4. Same as A.4.	4. Same as A.4.

PART TWO: BEFORE THE PRUDENT INVESTOR RULE

A. No one possesses any discretion.

1. Mandatory distribution of income.

The trustee must pay all ordinary income currently to (a) one person or (b) in fixed shares to more than one person.

a. Examples:

i. Single distributee (Form #1).

(1) Income. The Trustee shall pay the net income to my wife quarter-annually.

ii. Plural distributees (Form #2).

(1) Income. The Trustee shall pay the net income quarter-annually to my children, in equal shares.

b. Taxation of ordinary income.

All of the trust's ordinary income, to the extent of distributable net income, is includable in the gross income for income tax purposes of the (a) distributee or (b) distributees proportionately. Code §§651 and 652.

2. No distribution permitted of principal.

a. Example (Form #3):

(B) Principal. The Trustee shall not distribute principal.

b. Taxation of corpus income.

Generally, none of the trust's corpus income is deductible from the trust's gross income for income tax purposes. Code §§641, 643(a)(3), 651, 652, 661 and 662.

B. Discretionary distributions: independent trustee possesses discretion.

1. Examples:

a. Single permissible distributee.

i. Income (Form #4).

(1) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #5).

(2) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

b. Plural permissible distributees.

i. Income (Form #6).

(1) Income. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #7).

(2) Principal. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

2. Taxation of ordinary income.

a. A permissible distributee includes in his or her gross income for income tax purposes only such

ordinary income of the trust as he or she receives. Code §§661 and 662.

- b. The balance of the ordinary income is not deductible from the trust's gross income. Code §§661 and 662.

3. Taxation of corpus income.

Generally, none of the trust's corpus income is deductible from the trust's gross income for income tax purposes. Code §§641, 643(a)(3), 661 and 662.

4. Drafting.

- a. According to the forms, the trustee's discretion is unlimited.

- i. The trust does not contain any standard, ascertainable or otherwise.

- ii. The trust does not contain any specification of purpose.

- b. Any limiting standard or specification of purpose tends to impede flexibility.

- i. The trustee can make such distributions as it believes the grantor, if serving as trustee, would make, including distribution of the entire trust estate and termination of the trust.

- ii. The trustee can include (or not include) the trust estate in one or more beneficiaries' gross estates, to such extent as the trustee believes advisable, taking into account (i) the portion of the trust that is exempt from generation-skipping tax and (ii) the transfer tax bases of the permissible distributees.

- iii. The trustee might be able to avoid multiple incidence of the generation-skipping tax by means of taxable distributions before the occurrence of a taxable termination.

C. Discretionary distributions: nonindependent trustee possesses discretion.

1. Examples:

- a. Single permissible distributee.

i. Income (Form #8).

(1) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #9).

(2) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed.

b. Plural permissible distributees.

i. Income (Form #10).

(1) Income. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the net income as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #11).

(2) Principal. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the principal as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed.

2. Tax problems.

- a. Generally, a person is deemed, for income tax purposes and transfer tax purposes, to own all property that he or she can pay to himself or herself, even if the power holder does not exer-

cise the power. Code §§678(a)(1), 2041(a)(2) and 2514(b).

- b. Further, even a nongeneral power of appointment can cause the power holder to make a taxable gift. If the exercise of a nongeneral power has the effect of transferring the beneficial interest of the power holder, the exercise might produce a taxable transfer of any enjoyment that the power holder forgoes. Rev. Rul. 79-327, 1979-2 C.B. 342; Regester v. Commissioner, 83 T.C. 1 (1984); contra James C. Self, Jr. v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), 56-2 USTC ¶11,613; cf. reg. §25.2511-1(g)(2).
- c. A person who can pay property to another, in discharge of his or her legal obligation, is regarded to that extent as being able to pay the property to himself or herself and thus as having a general power of appointment.

3. Solutions.

- a. Preventing (i) ownership (for tax purposes) due to powers to pay to self and (ii) gifts due to powers to pay to others: ascertainable standards.

Use of an ascertainable standard to limit the power holder's power is a potential solution to the first and second problems.

- i. If the ascertainable standard is described in Code sections 2041(b)(1)(A) and 2514(c)(1), the power holder's power to pay to himself or herself is not a general power of appointment.
- ii. The power holder arguably will not be treated as owning the subject income for income tax purposes.
 - (a) A judicial gloss supplies the standard for purposes of Code section 678(a)(1).
 - (b) See Casner, 3A ESTATE PLANNING §12.9.2 (Little, Brown, Fifth Edition, 1986); Agnes R. May, 8 T.C. 860 (1947); Ruth W. Oppenheimer, 16 T.C. 515 (1951); Townsend v. Commissioner, 5 T.C. 1380 (1945); United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960), 60-1 USTC ¶9430 (involving a legal life estate but decided under Code §678(a)(1) and

involving a loosely-written standard including even the life tenant's "comfort"); United States v. Smither, 205 F.2d 518 (5th Cir. 1953), 53-2 USTC ¶9482 (also involving a standard including the beneficiaries' "comfort"); and Funk v. Commissioner, 195 F.2d 127 (3d Cir. 1950), 50-2 USTC ¶9507 (involving payment for the beneficiaries' "needs." "Thus, its use [i.e., the use of the word 'needs'] confined the trustee to limits objectively determinable, and any conduct on [the trustee's] part beyond those limits would be unreasonable and a breach of trust. . . ." 50-2 USTC ¶9507). But see Falk v. Commissioner, 189 F.2d 806 (3d Cir. 1951), 51-1 USTC ¶9337 cert. denied, 342 U.S. 861, 72 S. Ct. 89. Cf. Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945), 45-1 USTC ¶9134, cert. denied, 324 U.S. 871, 65 S. Ct. 1017.

iii. If the power is a trustee's fiduciary power that is limited by an ascertainable standard described in regulations section 25.2511-1(g)(2), the power holder's exercise of the power to pay to other than himself or herself property in which he or she has a beneficial interest but no general power of appointment is not a taxable gift.

(a) This ascertainable standard relates to one or more persons other than the power holder.

(b) According to regulations section 25.2511-1(g)(2),

"If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument . . ." [emphasis supplied].

iv. While some of the important drafting issues relate to how much discretion the power

holder may have consistently with the exception, others relate to the advisability, for nontax reasons, of using ascertainable standards in particular configurations.

- (a) First, the standard in the forms requires the trustee to consider the resources otherwise available to the distributee.
 - (i) Required consideration of other resources tends to limit the power holder's ability to distribute trust property.
 - (A) It tends to require the distributee to exhaust other resources, including any source of support from other than the trust.
 - (B) Therefore, it also tends to cause any distribution that is made from the trust not to discharge another person's obligation to the distributee.
 - (ii) Conversely, required nonconsideration of other resources tends to limit the power holder's ability not to distribute trust property. The concerns that this formulation presents are whether it limits sufficiently the power holder's access to the property and whether a payment can discharge a legal obligation of someone who is not named as a beneficiary.
 - (iii) The power holder has the greatest discretion if he or she may, but need not, consider the resources otherwise available to the distributee. This formulation broadens the realm within which the power holder may, but need not, distribute the property. The additional concern that it presents is whether it complies with those regulations sections (i.e., 20.2041-1(c)(2) and 25.2511-1(g)(2)) that require the

standard to limit both the exercise and the nonexercise of the power.

(iv) Consideration of the distributee's other resources should be optional for at least some tax purposes.

(A) Whether the power holder must take into account the distributee's other "income" is "immaterial" for purposes of determining whether the ascertainable standard exception of Code sections 2041(b)(1)(A) and 2514(c)(1) is applicable. Reg. §20.2041-1(c)(2).

(B) However, the regulation is unclear whether "income" is used advisedly or whether it crudely refers to "resources" generally.

(v) This writer recommends the conservative approach: do require the power holder to take into account resources otherwise available to the distributee.

(b) Second, the mandatory "shall" (rather than the permissive "may") requires the trustee to exercise the power if the ascertainable event occurs.

(i) The issue is whether an ascertainable standard is sufficient if it limits the extent to which the power is exercisable but does not control whether and when the power holder must exercise the power. See generally Estate of Carpenter v. United States, 80-1 USTC ¶13,339 at 84,323 (W.D. Wis. 1980).

(ii) Is the standard sufficient if it places a "ceiling" upon the exercise of the power but does not place a "floor" under it?

(iii) The answer might depend upon the nature of the power and upon the

particular tax risk that it presents.

- (A) Certain sections of the Internal Revenue Code appear to describe the amount of power that a person might possess to benefit himself or herself without owning the property for estate, gift or income tax purposes. They suggest that the standard need limit only the extent to which the power is exercisable. See Code §§ 2041(b)(1)(A), 2514(c)(1) and 678(a)(1); Cf. reg. §20.2041-1(c)(2).
 - (B) Other statutory and regulatory provisions seem concerned with control or discretion, per se. They suggest that the standard must limit the power's exercise and its nonexercise. See Code §§674(b)(5)(A) and 674(d); reg. §25.2511-1(g)(2); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), 47-1 USTC ¶10,551; Estate of Budlong, 7 T.C. 756 (1946); and Estate of Carpenter v. United States, 80-1 USTC ¶13,339 (W.D. Wis. 1980).
- (iv) Again, this writer recommends the conservative approach: draft the standard explicitly to limit both (i) the right to exercise the power and (ii) the right not to exercise it.
- (A) According to this approach, the right not to exercise the power is discretionary only to a limited extent and a person who the power can benefit can force its exercise. Cf. Security - Peoples Trust Co. v. United States, 238 F.Supp. 40 (W.D.Pa. 1965), 65-1 USTC ¶12,294.
 - (B) Further, this approach might serve the collateral function

of assuring the trust's creator and the beneficiaries that the trust will discharge desired purposes.

- (c) Third, an ascertainable standard does not exist according to regulations section 25.2511-1(g)(2) if the trustee's determination regarding exercise or nonexercise is "conclusive."
- (d) Fourth, if a power is exercisable in favor of more than one person, an ascertainable standard can make the power unwieldy.
 - (i) A mandate to use the power might force the power holder unsatisfactorily to reconcile the competing interests of the various beneficiaries.
 - (A) How should the power holder reconcile present and future needs?
 - (B) How should the power holder reconcile similar needs of persons in different generations?
 - (ii) The problem is particularly acute when the power is exercisable in favor of the power holder.
 - (A) The power holder has an inherent conflict.
 - (B) The conflict might prevent the power holder from using the trust for the purposes for which the grantor intended it.
- (e) Fifth, unless each permissible distributee has limited resources and is a person, for example an orphaned child or an unmarried adult, to whom no one owes any obligation of support, this writer generally does not recommend a trust that requires each distribution to comply with an ascertainable standard.

- (i) Required consideration of resources otherwise available tends to preclude distributions and, if each distribution is subject to the standard, impede the usefulness of the trust.
 - (ii) Rather, this writer generally suggests that a useful format is (1) a mandate to pay income (see Form #1) coupled with an ascertainable standard with respect to principal (see Form #9), or (2) a mandate to pay (see Form #37), or a right to withdraw (see Form #41), a unitrust percentage coupled with an ascertainable standard with respect to the balance of the trust.
- b. Preventing general powers of appointment due to power holder's powers to pay to other than self.

i. Examples:

(a) Removal of discretion (Form #12).

(1) No trustee shall possess, or participate in the exercise of, any power that, but for this paragraph (1), the trustee would have to make any determination with respect to any payment which would discharge any legal obligation of the trustee personally.

(b) Prohibition of payment (Form #13).

The Trustee shall not make (or have any power to make) any payment which would discharge any legal obligation of any person to whom the Trustee can not make payment directly.

ii. Purpose.

- (a) The ability of a trustee to use trust property to discharge his or her legal obligation seems very unlikely in the context in which it often is asserted to exist. Consider a trust in which (i) the power holder is not named or described as a permissible distributee and (ii) the governing instrument does not explicitly permit payments for the

support of any person who is named or described as a permissible distributee.

- (i) In this context, the power holder's distribution of trust property in discharge of a personal obligation of the power holder seems to be solely for the benefit of someone who is not named or described as a beneficiary.
 - (ii) Therefore, the distribution appears to violate the trust.
- (b) However, consider a configuration in which the problem might exist.
- (i) Assume that a testator creates a trust that requires the trustee currently to pay income to the grantor's child for life and permits the trustee to distribute principal to the child for the child's health, education and support, remainder to the child's descendants, per stirpes, who survive the child. Assume additionally that the grantor creates the trust upon the grantor's death, the grantor's spouse (the child's surviving parent) is the trustee and the child is a minor when the grantor dies.
 - (ii) The person serving as trustee is empowered only to make distributions to other than himself or herself.
 - (iii) The ascertainable standard relates to other than the power holder and permits distributions for the named or described distributee's support.
 - (iv) The issue is whether a person who has a legal obligation to support the named or described distributee can exercise the power to discharge his or her personal obligation.

- (v) This result seems impossible if the ascertainable standard includes a requirement that the trustee consider resources otherwise available to the named or described distributee.

iii. Drafting.

- (a) The draftsman should assume that an ascertainable standard can not remove a power from the category of a general power of appointment unless the standard relates to the health, education or support of the power holder.

- (i) The only ascertainable standards that, according to applicable statute, cause a power not to be a general power are those that relate to the health, education or support of the power holder. Code §§2041(b)(1)(A) and 2514(c)(1).

- (ii) The Internal Revenue Service seems to support this assumption. Rev. Rul. 79-154, 1979-1 C.B. 301; cf. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), 47-1 USTC ¶10,551; Estate of Budlong, 7 T.C. 756 (1946); and Sowell v. Commissioner, 708 F.2d 1564 (10th Cir. 1983), 83-1 USTC ¶13,526.

- (b) What strategy, then, is appropriate?

- (i) The draftsman absolutely can prohibit any distribution that would discharge any legal obligation owed by a person who is not named or described as a permissible distributee. See Form #13. Cf. Upjohn v. United States, 72-2 USTC ¶12,888 (W.D. Mich. 1972).

- (ii) However, if the drafting objective is only to prevent a general power of appointment, the appropriate focus appears to be upon the particular power relative to the power holder, rather than upon the power, per se.

(iii) Therefore, if the drafting objective is only to prevent a general power of appointment, an absolute prohibition of any distribution that purportedly can discharge a legal obligation of a person who is not named or described as a permissible distributee of the distribution seems unnecessary.

D. Discretionary distributions: combination of (i) nonindependent trustee possesses some discretion and (ii) independent trustee possesses other discretion.

1. Examples:

a. Single permissible distributee.

i. Income (Form #14).

(1) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to my wife so much or all, if any, of any balance of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #15).

(2) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to my wife so much or all, if any, of any balance of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason

whatsoever, including the termination of the trust.

b. Plural permissible distributees.

i. Income (Form #16).

(1) Income. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the net income as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of any balance of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

ii. Principal (Form #17).

(2) Principal. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the principal as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of any balance of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

2. Purpose.

This approach is a combination of the approach described at B, supra, and the approach described at C, supra. It can allow greater flexibility than either of the constituent approaches alone.

3. Drafting.

This hybrid is usable with (i) an independent trustee always serving, (ii) an independent trustee serving only at the instance of a nonindependent trustee or any person to whom the governing instrument empowers the independent trustee, if serving, to distribute trust property or (iii) an independent trustee serving only at the instance of any independent person.

This writer often uses "two tiers" of dispositive powers, with some but not all of the powers granted solely to an independent trustee. He particularly uses a variation in which an independent trustee is not required always to serve and is only a permissible or mandatory addition, or a required successor, to one or more beneficially interested trustees. See generally United States v. Byrum, 72-2 USTC ¶12,859 (Sup. Ct. 1972); United States v. Winchell, 61-1 USTC ¶12,015 (9th Cir. 1961); and Wall v. Commissioner, 101 T.C. 300 (1993).

If an interest holder can add an independent trustee and the addition shifts an interest so that the interest holder relinquishes beneficial enjoyment, arguably a gift lurks somewhere. Consider, for example, what happens if a holder of a mandatory income interest can appoint an independent trustee with the effect of transforming the mandatory income interest into a discretionary interest. Due to loss of dominion and control, a gift might occur upon a mere shift of the interest due to the appointment. If a gift does not occur upon the shift of the interest as a result of the appointment, a gift (or a transfer for estate tax purposes) probably does occur if and when, because of the holder's appointment of an independent trustee, the person who previously had the mandatory income interest receives less than all of the income.

Consider an embellishment to the system. The embellishment would permit a beneficially interested trustee to possess certain powers exclusively, notwithstanding the discretionary or mandatory addition of an independent trustee. Absent the embellishment, the addition of an independent trustee, discretionary or mandatory, would mean that the beneficially interested trustee would share all powers with the new, independent trustee, although, of course, the independent trustee could (but need not) delegate back to the beneficially interested trustee all powers except those that would be

sensitive in the hands of the beneficially interested trustee.

Set forth below are some configurations in which this writer grants one set of powers to a beneficially-interested trustee and another to an independent trustee, or grants dispositive powers only to an independent trustee, and contemplates that an independent trustee will, or will not, serve at all times.

a. Single distributee.

i. First configuration.

(a) Facts.

An independent trustee has wide-open discretion to pay income to one person, or to accumulate it, and to pay principal to the same person or not pay it.

(b) Examples:

(i) Irrevocable insurance trust where insured has only one descendant.

(ii) Wide-open discretionary trust for one distributee.

(iii) 2503(c) trust.

(iv) 2642(c) trust.

(v) Crummey trust for non-skip person.

(c) Observations.

(i) Only the independent trustee can make a distribution.

(ii) No independent trustee is required to serve.

(iii) According to one alternative, either member of the group that consists of a beneficially interested trustee and the person to whom the independent trustee, if serving, could make any distribution can direct the addition of an independent trustee.

(iv) According to another alternative, any independent person can direct the addition of an independent trustee.

(d) Comment.

A common denominator among the examples is that the trust might have little property, and, therefore, no need for distributions, for an extended period. Although this configuration does not involve the grant of any powers to any beneficially interested trustee, it presents some of the same issues.

ii. Second configuration.

(a) Facts.

The governing instrument mandates the trustee to pay income currently to one person, permits a beneficially interested trustee to distribute principal to the income beneficiary according to an ascertainable standard and accords an independent trustee wide-open discretion to distribute principal to the income beneficiary.

(b) Examples:

- (i) QTIP, right-to-withdraw and general-testamentary-power-of-appointment marital trusts.
- (ii) Trust for one person for life, including credit shelter trust for sole benefit of settlor's spouse.
- (iii) Trust for one person until the person attains stated age(s).

(c) Observations.

- (i) No independent trustee is required to serve.
- (ii) According to one alternative, either member of the group that consists of a beneficially interested trustee and the person to whom the independent trustee, if serving, could make any distribution can direct the addition of an independent trustee.
- (iii) According to another alternative, any independent person can direct the addition of an independent trustee.

iii. Third configuration.

(a) Facts.

Same as ii, except, instead of a mandate concerning income, a beneficially interested trustee either (i) can pay income to himself or herself, according to an ascertainable standard, or (ii) can pay income to one person other than himself or herself, according to an ascertainable standard, and in each case an independent trustee has wide-open discretion to pay income to the person who is the permissible recipient of income.

(b) Examples:

- (i) Trust for one person for life, including credit shelter trust for sole benefit of settlor's spouse.
- (ii) Trust for one person until the person attains stated age(s).

iv. Fourth configuration.

Also included in this classification is the ability of an independent trustee to grant a general testamentary power of appointment to the person described as the distributee in i, ii and iii, above, or described as the primary beneficiary in b.iii, below.

b. Multiple distributees.

i. Fifth configuration.

(a) Facts.

An independent trustee has wide-open discretion to pay income to any one or more of a number of persons, or to accumulate it, and to pay principal to any or more of the same persons or not to pay it.

(b) Examples:

- (i) Irrevocable insurance trust for multiple descendants of grantor.
- (ii) Wide-open discretionary trust for multiple distributees.

(c) Observations.

- (i) Only the independent trustee can make a distribution.
- (ii) No independent trustee is required to serve.
- (iii) According to one alternative, any member of the group that consists of a beneficially interested trustee and each person to whom the independent trustee, if serving, could make any distribution can direct the addition of an independent trustee.
- (iv) According to another alternative, any independent person can direct the addition of an independent trustee.

(d) Comment.

A common denominator among the examples is that the trust might have little property, and, therefore, no need for distributions, for an extended period. Although this configuration does not involve the grant of any powers to any beneficially interested trustee, it presents some of the same issues.

ii. Sixth configuration.

(a) Facts.

During the incapacity of the grantor of a revocable trust, a beneficially interested trustee can pay income and principal according to an ascertainable standard to the grantor and to any person dependent upon the grantor, and an independent trustee, acting as an attorney in fact, can make gifts and qualified transfers on behalf of the grantor.

(b) Observations.

- (i) No independent trustee is required to serve.
- (ii) According to one alternative, any member of the group that consists of a beneficially interested trustee and each person to whom the independent trustee, if serving, could make any distribution can direct the addition of an independent trustee.
- (iii) According to another alternative, any independent person can direct the addition of an independent trustee.

iii. Seventh configuration.

(a) Facts.

Same as i and ii, above, except when the trust must terminate within a relatively short period of time (for example, a trust that is created for the period of the Rule Against Perpetuities and must terminate within twenty-one years), the independent trustee has wide-open discretion to distribute principal to any one or more among the primary beneficiary and the descendants of the primary beneficiary.

(b) Observations.

- (i) Only the independent trustee can distribute principal to descendants of the primary beneficiary.

(ii) No independent trustee is required to serve.

(iii) According to one alternative, any member of the group that consists of a beneficially interested trustee and each person to whom the independent trustee, if serving, could make any distribution can direct the addition of an independent trustee. Nevertheless, if an independent trustee, if added, could distribute any of the trust estate to other than the primary beneficiary, with the effect of being able to reduce the amount that the primary beneficiary otherwise would have a right to receive, the primary beneficiary should not exercise the power to add an independent trustee. See "Eighth configuration" at c., below.

(iv) According to another alternative, any independent person can direct the addition of an independent trustee.

c. Configuration in which the system is not used.

Eighth configuration.

i. Facts.

The instrument mandates the trustee to pay income currently to one person but provides that, if an independent trustee is serving, the independent trustee, instead, has wide-open discretion to pay income and principal to one or more members of the group that consists of the person who previously was the mandatory beneficiary of income and that person's descendants.

ii. Observations.

(a) No independent trustee is required to serve.

(b) An independent trustee serves either as a successor to, or solely at the instance of, the mandatory beneficiary of income.

iii. Comment.

A problem inheres in the coupling of (i) a shift from a mandatory income interest to a

discretionary interest with (ii) the mechanics, described in the preceding sentence, for initiation of service of an independent trustee.

E. Discretionary distributions: nonindependent person who is not a fiduciary possesses discretion (powers of appointment).

1. During power holder's life.

a. Five-and-five power.

The "five-and-five" exception to the general rule concerning the existence of a general power of appointment permits a person to have extremely flexible access to property for his or her benefit without the normal tax cost.

i. Example:

Right to Withdraw Greater of \$5000 and 5% (Form #18).

Additionally,

- a [after the Marital Trust entirely has been distributed or expended,]
if my wife is living immediately before the end of a calendar year, the Trustee shall pay to my wife so much or all, if any, of the principal, not to exceed in value the greater of five thousand dollars and five percent of the value of the principal as of the end of the year, as my wife last directs in writing before the end of the year.

ii. Transfer Tax Implications and Planning.

The transfer tax implications are discussed in detail at Part Three, IV, H.4. Suffice it to say here that a lapse during any calendar year during the life of the power holder is treated as a transfer for estate tax purposes

"only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

"(A) \$5,000, or

"(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the

lapsed powers could have been satisfied." Code §2041(b)(2).

The gift tax rules are similar. See Code §2514(e).

iii. Income Tax Implications and Planning.

The most important of the income tax implications is that the right to withdraw causes the power holder to own both (i) all ordinary income that is subject to the power and (ii) all income, ordinary and other, that is attributable to the principal that is subject to the power. Code §678(a)(1); see generally Code §671 and reg. §1.671-3. The income tax implications are discussed in detail at Part Three, IV, H.5.

b. Nongeneral power of appointment.

i. Example (Form #19):

Additionally, the Trustee shall pay so much or all, if any, of the principal to such one or more

a [members of a group consisting exclusively of my descendants]

b [appointees, other than my wife and the estate, creditors and creditors of the estate of my wife,]

in such amounts and portions and subject to such trusts, terms and conditions as my wife directs in writing at any time or from time to time.

c [Section 4.06. Certain Powers of Appointment. Anything to the contrary notwithstanding, no power of appointment granted in this instrument with limitation of permissible appointees shall be exercisable, directly or indirectly, (a) to discharge any legal obligation of the person given the power or (b) in favor of (i) the person given the power or the creditors or the estate or the creditors of the estate of the person given the power or (ii) any deceased individual or terminated trust. The preceding sentence shall not apply to any power given a trustee or to any power to withdraw.]

ii. Effect of possession and exercise.

The exercise of the power by a power holder who has a beneficial interest in the subject property is deemed to be a gift to such extent as the exercise transfers the power holder's beneficial interest. Rev.

Rul. 79-327, 1979-2 C.B. 342; Regester v. Commissioner, 83 T.C. 1 (1984); contra James C. Self, Jr. v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), 56-2 USTC ¶11,613.

- (a) Since the power is not a trustee's fiduciary power, an ascertainable standard is not a solution. Reg. §25.2511-1(g)(2).
 - (b) The mere possession of this power does not include the property in the transfer tax base of the power holder.
- iii. Preventing general power of appointment due to power holder's powers to pay to other than self.

The ability of a person to exercise this power to discharge his or her legal obligation seems very unlikely. The power permits payments only to other than the power holder. Any payment that would discharge a legal obligation of the power holder would seem to be solely for the benefit of, and, therefore, a payment to, someone to whom the power does not permit distributions and, therefore, would appear to violate the trust. Assuming that the issue otherwise would exist, use of variable c in Form #19 should avoid it.

2. After power holder's death: nongeneral power of appointment exercisable by will.

a. Example (Form #20):

(B) Disposition on Death of Survivor.

Upon the death of my wife, if my wife survives me, the Trustee shall distribute the trust estate of the Remainder Trust to such one or more

- a [members of a group consisting exclusively of my descendants]
- b [appointees, other than the estate, creditors and creditors of the estate of my wife,] in such amounts and portions and subject to such trusts, terms and conditions as my wife may appoint by Will specifically referring to this power. Upon the death of the survivor of my wife and me, to such extent, if any, as the trust estate of the Remainder Trust is not effectively appointed, the Trustee shall distribute the trust estate of the Remainder Trust to the Trustee of the Family Trust under Section 3.04.

b. Estate and gift tax effect.

Neither the possession nor the exercise of the testamentary power generates any liability for gift tax or estate tax.

PART THREE: CHANGES DUE TO PRUDENT INVESTOR RULE

I. The Prudent Investor Rule.

The prudent investor rule (the "Rule"), Restatement (Third) of Trusts §§227 et seq. (1992), is superseding the prudent person rule, Restatement (Second) of Trusts §§227 et seq. (1959), as the law of investment of private trusts. Approximately twenty-seven states have adopted the version (or the substance of substantial portions of the version) of the prudent investor rule set forth in the Uniform Prudent Investor Act promulgated in 1994 by the National Conference of Commissioners on Uniform State laws. Nine other states and the District of Columbia have adopted other statutes that require a total portfolio approach to investment management.

A. Prudent Person Rule.

The prudent person rule served for more than 150 years as the foundation statement of the investment duties of trustees of private trusts.

1. The prudent person rule originally appeared in Harvard College v. Amory, 9 Pick. (26 Mass.) 446 (1830). According to Harvard College, trustees should

"observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. at 461.

2. The Restatement of the Law of Trusts, published by the American Law Institute in 1935, included the prudent person rule.
3. The Restatement Second of the Law of Trusts, published by the American Law Institute in 1959, included the following statement of the prudent person rule:

"§227. Investments Which a Trustee Can Properly Make

In making investments of trust funds the trustee is under a duty to the beneficiary

(a) in the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived;

(b) in the absence of provisions in the terms of the trust, to conform to the statutes, if any, governing investments by trustees;

(c) to conform to the terms of the trust, except as stated in §§165-168."

B. Prudent Investor Rule.

The American Law Institute replaced the prudent person rule with the prudent investor rule in May of 1990. The Institute in 1992 published a complete revision, entitled "Restatement of the Law Third (Trusts), Prudent Investor Rule," of the part of Restatement Second that addressed the same subject. Unless otherwise noted, all references in this outline to the prudent investor rule, and to the Rule, are to the version that appears in Restatement Third.

1. According to the Restatement Third,

"§227. General Standard of Prudent Investment

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a

duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

(1) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183);

(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and

(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).

(d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute."

2. Edward C. Halbach, Jr., of the University of California (Berkeley) Law School, was the reporter. Many of his Reporter's Notes, not reviewed by the Institute, appear with and elaborate the black letter and the official Comments.
3. Even before the promulgation of the Rule, a number of states, including California, Delaware, Georgia, Minnesota, Tennessee and Washington, had revised their legislation to adopt some of the principles that emerged in the Rule. Other states, led by Illinois (760 Ill. Comp. Stat. §§5/5 and 5/5.1) with legislation effective July 1, 1992, then Virginia (Va. Code §2645.1), then Florida (Fla. Stat. §§518.11 and 518.112) and then New York (N.Y. Est., Powers and Trusts Law §11-2.3), quickly adopted legislation that drew upon the precepts of the Rule.
4. The National Conference of Commissioners on Uniform State Laws approved its Uniform Prudent Investor Act ("UPIA") during the summer of 1994 and recommended UPIA for enactment in all of the states. UPIA draws upon the Illinois legislation in significant respects. John Langbein of Yale University Law School was the reporter. A copy of UPIA is included in the Appendix.

C. Scope of Outline.

This outline focuses solely upon the changes that the prudent investor rule might produce compared to the prudent person rule.

II. Reasons for the Rule.

The prudent investor rule is the product of a perception that the manner in which the prudent person rule had developed was preventing the law from accommodating modern portfolio theory and, therefore, was hindering investment that best served the purposes for which private trusts were created. Specific rules that were derived from specific results in specific cases, rather than broad principles, were driving the law. The promulgation of the prudent investor rule was more an attempt to restore flexibility than an attempt to change the foundation statement.

A. Deficiencies of Existing Law.

According to the critics, the law, as it had developed according to the prudent person rule, tended to:

- (i) Focus upon the propriety of each asset in isolation rather than as an integral part of a portfolio,
- (ii) Focus upon preservation of nominal value of principal rather than upon maintenance of purchasing power,
- (iii) Prohibit certain investments entirely,
- (iv) Provide a "safe harbor" for certain investments,
- (v) Deter the fiduciary from delegating management, and
- (vi) Deter the fiduciary from acquiring new types of investment products.

B. Evidence of Dissatisfaction.

The ferment that ultimately produced the prudent investor rule is reflected also in

- (i) The Uniform Management of Institutional Funds Act, which applies to funds held by charitable institutions,
- (ii) Section 4944 of the Internal Revenue Code ("Code"), which prohibits any investment that would prevent a private foundation from prosecuting its purposes,

(iii) Section 404(a)(1)(B) of ERISA, 29 U.S.C. §1104(a), and

(iv) Reform, usually relatively narrow in scope, in various states.

III. Accommodation of Modern Portfolio Theory.

The Rule is designed to accommodate modern portfolio theory. See generally Restatement (Third) of Trusts §227 Comments; Macey, An Introduction to Modern Financial Theory (American College of Trust and Estate Counsel Foundation, 2d ed. 1998); Longstreth, Modern Investment Management and the Prudent Man Rule (Oxford University Press, 1986); and Malkiel, A Random Walk Down Wall Street (Norton, 6th ed. 1996). This accommodation has vast implications, in turn, for the administration, planning and drafting of trusts.

A. First Principle of the Theory.

Prominent among the principles of modern portfolio theory is the concept that the value (price) of an asset is a function of two factors. The first is the rate of total return (i.e., ordinary income and capital appreciation) that the asset is anticipated to generate. The second is the risk that the actual return will fall short of the anticipated return.

1. An analysis of the risk of shortfall of return leads to a focus upon assets as integral parts of a whole portfolio rather than to a focus upon each asset in isolation. This focus in turn enhances the importance of the rate of total return.
 - a. The analysis leads to the conclusion that determination of whether a trustee has discharged its duties must focus upon the manner in which the trustee has made investment decisions. Restatement (Third) of Trusts §227, Comment b.
 - b. The analysis leads away from the labeling of any asset as inherently prudent or imprudent, per se.
 - c. The behavior of the trustee is judged in relation to circumstances, not in a vacuum. Id.
 - d. Since the Rule is a rule of trustee conduct rather than a rule of portfolio performance, the Rule purports to diminish the importance of hindsight. Id.
2. The risk of shortfall of return is divided into two categories.

- a. The first is market risk, sometimes known as systemic, systematic, nondiversifiable or compensated risk, i.e., the risk that the return in the market in which the asset is situated will fall short of the anticipated return.

"Certain . . . sorts of risks plague all firms more or less indiscriminately. This sort of risk is called market risk, or sometimes systematic or undiversifiable risk. The risk associated with a presidential assassination, or a change in the monetary policy of the Board of Governors of the Federal Reserve System, or a general economic downturn affect all firms, and are, therefore, examples of market risk." Macey, op. cit. 23.

- b. The second is nonmarket risk, sometimes known as diversifiable, specific, unique or uncompensated risk, i.e., the risk that something that may occur particularly with respect to the particular asset may increase or decrease its return.

"Firm-specific risk, also called unique risk, residual risk, unsystematic risk, and diversifiable risk, refers to those elements of risk that are unique to particular companies. The risk that the chief executive officer of a particular firm will have a fatal heart attack, or that an earthquake or flood will render a plant inoperable, or that a firm will suffer a labor strike all are examples of firm-specific risks because they are unique to a particular company. Some sorts of firm-specific risks, such as the risk that the government will cut the defense budget are unique to particular classes of firms (i.e., contractors), but these sorts of risks are also defined as firm-specific risks." Id. at 23.

3. According to modern portfolio theory, the market (for at least a certain class of assets, for example, stocks, relative to the market for other assets, for example, bonds) compensates the investor for market risk (i.e., the first type of risk).

- a. Any compensation for this risk is in the form of an adjustment of the return that inures to the particular asset (i.e., generally, a higher rate of return corresponds to a higher market risk of a shortfall). See generally Restatement (Third) of Trusts §227, Comment g.
- b. Since, other things being equal, investors seek to avoid volatility, investors attempt to "charge" as a price for their investment, and the market (for at least some assets relative to the market for other assets) provides, a return that varies directly with volatility. See generally Macey, op. cit. 15-17; and Restatement (Third) of Trusts §227, Comment e; see, however, Fama and French, "The Cross-Section of Expected Stock Returns," The Journal of Finance (June, 1992) 427.
 - i. A return that is more volatile because of the market will tend at certain times to exceed, and at other times to fall short of, the return that inures to assets for which the return is less volatile.
 - ii. However, additionally, the market (for at least some assets relative to the market for other assets) will tend to yield to an asset that has a volatile return a premium return that is directly attributable to volatility.
 - iii. Some investors are willing to suffer large losses over a long time in anticipation of ultimately receiving a higher return.
 - iv. Other investors are willing to forgo higher returns in exchange for greater stability.
 - v. Arguably, the substance of volatility rather than volatility, per se, is what investors seek to avoid. The substance of volatility is the likelihood that a failure to realize a certain return will prevent a beneficiary from having something that the trustee wants the beneficiary to have at the time that the trustee wants the beneficiary to have it. See Jeffrey, "A New Paradigm for Portfolio Risk," The Journal of Portfolio Management (Fall, 1984) 33.
 - vi. According to the Restatement Third, "Risk tolerance [i.e., tolerance of

volatility of return] largely depends on a combination of the regular distribution requirements of the trust and any irregular distributions that may in fact become necessary or appropriate. These obligations in turn are likely, depending on the terms of the trust, to be affected by the needs of one or more of the beneficiaries. Thus, these various distribution requirements facing the trustee effectively serve to define the consequences of the volatility risk with respect to a particular trust." Restatement (Third) of Trusts §227, Comment e.

4. Again according to modern portfolio theory, to the extent the risk of shortfall of return is nonmarket risk, i.e., the risk is unique to the particular asset, the market does not compensate for the risk. See generally Restatement (Third) of Trusts §227, Comment g. Thus, the market does not compensate for the risk that an unanticipated event, such as the departure of key personnel, might reduce the fortunes of a particular company.
5. An investor can regulate market risk by selecting a level of risk and (at least to some extent) reward and by selecting investments that are consistent with that level.
 - a. For example, the investor can select investments that are more, less or as risky as the market as a whole.
 - b. Stated differently, an investor might select investments that tend to rise and fall in value at a rate greater than, less than or the same as the market as a whole, and the investor can tend to obtain rewards that vary commensurately.
 - c. The trustee should attempt to assemble a portfolio that maximizes return at any level of risk. Conversely, the trustee should attempt to assemble a portfolio that minimizes risk at any level of return.
 - d. The Restatement Third makes clear that the trustee must regard inflation as a risk.
 - i. It implies that, absent special circumstances, selection of a level of reward that will cause inflation to erode the value of principal breaches the duty of the trustee to use caution to preserve safety of capital.

Restatement (Third) of Trusts §227,
Comments c and e.

- ii. A trustee usually has a duty to incur what risk is necessary to obtain a return that preserves real values.
 - e. The trustee should orient itself to the opportunities. It easily can accomplish a large part of the orientation by determining both a risk-free return (i.e., the return that inures to United States Treasury obligations) and an average-risk return (i.e., the return that prevails generally in the market).
6. An investor can protect against nonmarket risk (i.e., the second type of risk) by diversifying, i.e., acquiring assets that tend to offset the unique risk that attends each asset separately. See generally Restatement (Third) of Trusts §227, Comment g.
- a. Therefore, the Rule generally imposes a duty upon the trustee to eliminate the risk that is unique to each asset, i.e., a duty to diversify.
 - i. Diversification that is accomplished without pooling of assets can tend to increase transactional costs.
 - ii. However, pooling among trusts and with other investors, by means, for example, of mutual funds, can accomplish diversification without increasing transactional costs.
 - b. The duty to diversify for the purpose of eliminating nonmarket risk is a centerpiece of the Rule.
 - i. The duty to diversify induces the trustee to focus upon each asset as an integral part of a portfolio and not in isolation.
 - ii. No asset inherently is appropriate or inappropriate, per se.
7. The duty to diversify should solve the problem, and, therefore, reduce the importance, of nonmarket risk. Correlatively, it should elevate the importance of market risk and lead to the conclusion that the chief duties of the trustee are to determine and implement the mix of market risk and reward that is appropriate for the trust.

B. Second Principle of the Theory.

A second tenet of modern portfolio theory, expressed in varying degrees of conviction, is that an investor is not able to outperform the market at whatever mix of risk and reward the investor is seeking and, therefore, any attempt to do so is futile, counterproductive and wasteful. See generally, Macey, op cit. 37 et. seq.; and Restatement (Third) of Trusts ch. 7 (Introduction, pp. 6-7; Reporter's Notes, pp. 75-76).

1. According to the theory, capital markets are efficient, information is disseminated and reflected in prices immediately, and, therefore, no asset is relatively overpriced or underpriced.
2. This principle has important implications for the conduct of trustees.
 - a. It tends to reduce the value of certain types of advisors and advice.
 - b. It tends to increase the value of certain types of investments such as index funds that tend to mimic a market as a whole.
 - c. Generally, it tends to sanction the use of certain strategies of passive investment and to challenge the use of strategies of active investment that produce inferior returns.
3. The Rule specifically prohibits the trustee from incurring costs that are not reasonable in amount. Restatement (Third) of Trusts §227(c)(3). An implication is that a trustee that uses a strategy of active investment must justify the increased costs in terms of an increase in expected returns.

IV. Diminished Distinction Between Income and Principal.

A. General Principles.

The focus of the Rule upon the integration of each asset into a portfolio (as opposed to a focus on each asset separately and in isolation from each other asset) and the focus of the Rule generally on total return from both ordinary income and capital appreciation (as opposed to a focus solely on ordinary income, or a focus separately on ordinary income and capital appreciation) tend to diminish the focus of the law upon a distinction between income and principal.

1. The most significant implication of the Rule's diminishment of the distinction between income

and principal is that the diminishment might permit and encourage planners and drafters to prepare dispositive instruments that do what the Rule does, i.e., reduce or eliminate distinctions between income and principal and, therefore, reduce the significance of the difference between ordinary income and capital appreciation.

- a. This diminishment signals an impending revolution in drafting and administration of private trusts.
 - b. The revolution is the subject of the balance of this outline.
2. As a practical matter, at least unless and until principal and income law is changed to complement the changes that the Rule represents in investment law, the Rule's reduction of the significance of the distinction between income and principal probably will have little impact on the amount of ordinary income that a trustee must generate when administering a trust according to a governing instrument that includes a functional distinction between income and principal.
- a. A revised version of the Uniform Principal and Income Act, approved by the National Conference of Commissioners on Uniform State Laws and recommended by it for enactment in all the states, represents a step in this direction.
 - b. Except to any extent that principal and income law permits deviation from traditional rules, trustees that administer trusts which include a functional distinction between income and principal will have to continue to observe the functional distinction.
 - c. The Rule at least seems to permit trustees of some of these trusts to focus upon the production of ordinary income by the portfolio rather than asset-by-asset.
 - d. However, trustees of other of these trusts, such as trusts that are designed to qualify for the marital deduction because of a requirement to pay all income to the spouse, apparently must continue to invest, with respect to productivity of ordinary income, asset-by-asset. Reg. §20.2056(b)-5(f)(5).
3. A trust that provides that a particular beneficiary shall receive ordinary income and that principal shall pass solely to one or more

others requires the trustee to distinguish carefully between income and principal and to make all investment decisions on the basis of impartiality between income and principal.

Example (Form #21):

(A) Income. The Trustee shall pay the net income to my wife quarter-annually.

(B) Principal. The Trustee shall not distribute principal.

(C) Termination. Upon the death of my wife, the trust shall terminate, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

4. A trust that permits the trustee to pay principal to the person to whom the trustee is required to pay income tends to reduce, but not eliminate, the distinction between income and principal.

Example (Form #22):

(A) Income. The Trustee shall pay the net income to my wife quarter-annually.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

5. A trust that, according to an ascertainable standard (see Form #23) or without any standard (see Form #24), permits the trustee to pay income to a person, or to any one or more persons in a group of persons, or to accumulate it, and to pay principal to the same person or persons, tends to eliminate the significance of the distinction between income and principal and to free the trustee to concentrate upon total return.

a. Example (Form #23):

(A) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. The Trustee shall accumulate any net income that it does not pay.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

b. Example (Form #24):

(A) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

B. Facilitating the Change Generally.

Given the decreased importance that the Rule attaches to whether a particular asset is unproductive or underproductive of trust accounting income, the draftsman should consider (i) eliminating requirements that assets produce a requisite amount of ordinary income and (ii) waiving the application of statutory and other law concerning property that fails to produce a requisite amount of ordinary income.

Example (Form #25):

(1) To retain property in the form and character in which received and to invest in any kind of property (including common trust funds and securities of any trustee), whether or not income-productive or located in the United States or authorized for trust investments.

1. However, since, contrary to the Rule, the marital deduction rules seem to focus upon each asset in isolation from each other asset, the draftsman should not eliminate the ability of a spouse to insist that the trustee eliminate from a marital trust any asset that is not productive. See reg. §20.2056(b)-5(f)(5).

Example (Form #26):

Unproductive property shall not be held for more than a reasonable time in the trust estate of the Marital Trust without the consent of my wife.

2. Similarly, when dealing with a trustee that has a beneficial interest in the decision about retention or acquisition of unproductive or underproductive property and a trust that mandates the distribution of trust accounting income, so that the investment decision will affect how much the trustee personally will receive, the draftsman should not exonerate the trustee for deviating from any productivity requirements that, absent the exoneration, the law of the state imposes. See generally Code §§2041 and 2514.

C. Annuity Trusts and Unitrusts Generally.

The ability of the trustee, as a matter of law, to concentrate upon total return seems to enhance the importance of annuity trusts and unitrusts.

1. A traditional annuity trust pays a fixed amount of dollars per period of time, without regard to whether the annuity amount is derived from income or from principal.

2. A conventional unitrust pays a dollar amount per period of time equal to a fixed percentage of the total value of the trust estate redetermined each period, also without regard to whether the unitrust amount is derived from income or from principal.
3. The traditional type of annuity trust produces a fixed, rigid and unvarying amount to the annuitant.
 - a. Attorney William L. Hoisington, commenting to this writer, suggested the consideration of an "indexed" annuity that fluctuates with changes in price levels and purchasing power.
 - b. According to Hoisington, by being able to focus, simply, upon the number of dollars necessary to accomplish an objective (for example, the support of the annuitant) and knowing the amount required for this purpose at the time of the creation of the trust and that the purchasing power will remain constant, a client might understand an indexed annuity trust better than a unitrust.
4. Whereas a traditional annuity does not change at all and an indexed annuity changes according to changes in values outside the trust, a unitrust amount is linked to changes in value of the trust property itself. Therefore, a unitrust amount precisely reflects changes in the trust but only roughly reflects changes in price levels and purchasing power.
 - a. Since the unitrust amount varies directly with changes in value of the trust property, the number and the timing of valuation dates affect the fluctuation of the amount.
 - b. A greater number of dates and a greater time over which they occur tends to produce a "smoother" flow than a fewer number of dates over a shorter time.
5. An annuity trust periodically generates an obligation, or debt, in an amount that is fixed upon the creation of the trust, subject, however, in the case of a trust that provides an annuity which is indexed to changes in cost of living, only to fluctuation because of changes in price levels.
6. By comparison, a conventional unitrust periodically generates an obligation in an amount that is fixed only on the date on which

the trust value that determines the unitrust amount is determined.

7. Both an annuity trust and a unitrust seem to permit the trustee to focus upon total return.
 - a. An annuity trust seems to require the trustee to seek the total return that best will generate the annuity and, consistent with payment of the annuity, enhance the assets that can inure to others upon termination of the annuity.
 - b. Similarly, a unitrust impels the trustee to seek the total return that best will enhance both the unitrust interest and the property that will inure to others upon termination of the unitrust interest.
 - c. Since the level of payout that is required from an annuity trust or a unitrust is the principal factor that determines the value of the property that can continue to produce the annuity or unitrust amount and remain when the annuity or unitrust interest terminates, determination of the investment objectives for the trust involves a complex analysis of the extent to which payments should decrease the value, and the extent to which ordinary income and capital appreciation should increase the value.
 - d. By contrast, a trust that pays only income might imply, relatively directly, that the investment objectives of the trustee are to produce a reasonable stream of income and yet maintain, in real terms, a constant value of principal.
8. The payout requirement of the conventional unitrust seems to place less pressure upon the trustee than the payout requirement of a traditional annuity trust, regardless of whether the distributions are in cash or in kind.
 - a. The reason is that in a declining market the payout required from a traditional annuity trust represents an increasing percentage of a decreasing value, whereas the payout required from a unitrust is an unvarying percentage of a changing value.
 - b. Since satisfaction of the required distribution in kind seems to produce the same economic effect as satisfaction of the required distribution in cash, the trustee seems unable to relieve the pressure by satisfying the annuity interest or the unitrust interest in kind.

9. Special problems confront any attempt to draft a trust that both (i) is to qualify for the marital deduction and also (ii) is to permit the trustee to invest for total return.
- a. An annuity trust that is created by gift, or by a decedent who dies, after October 24, 1992, might not qualify for the marital deduction. Code §§2056(b)(7)(B)(ii), 2056(b)(10), 2523(e) and 2523(f)(3); reg. §§20.2056(b)-7(e) and 25.2523(f)-1(c)(3).
 - b. Similarly, a trust that is solely a unitrust might pay less than its income and, therefore, cannot meet the income requirement of the marital deduction. Code §§2056(b)(5) and (b)(7).
 - c. A trust that pays the greater of (i) trust accounting income and (ii) a unitrust amount must pay at least its income and, therefore, can meet the income requirement.
 - i. However, the important issue is whether this "greater-of" arrangement permits the trustee to focus upon total return.
 - ii. The concern is that the possibility that income can exceed the unitrust amount might force the trustee to continue to concentrate on producing a yield in the form of income for trust accounting purposes.
 - iii. Attorney William L. Hoisington, commenting to this writer, suggested, and this writer agrees, that if the unitrust percentage that is specified is clearly as high as the yield of ordinary income that an income beneficiary could demand a trustee to generate according to state law, the "greater-of" arrangement would protect the income beneficiary and, therefore, should free the trustee to invest for total return. Cf. reg. §20.2056(b)-5(f)(5).
 - (a) However, the grantor usually has no way to know with certainty what this amount is.
 - (b) Selection of a lesser amount can undermine the elimination of the focus upon ordinary income.
 - (c) While selection of a greater amount can eliminate the focus on ordinary income, it also can eliminate a portion of the trust.

D. Annuity Trust Examples.

1. No trustee possesses any discretion: mandatory distribution of annuity, no additional distribution (Form #27).
-

a (1) Annuity Interest. Each year, the Trustee shall pay to the descendant [X] dollars [, adjusted to reflect any increase in the consumer price index between the date of this instrument and the date of the first payment for the year]

. The Trustee shall pay the annuity amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the annuity amount for any short year.

(2) Additional. The Trustee shall not distribute to the descendant any principal or income other than according to (1).

2. Independent trustee possesses discretion: mandatory distribution of annuity, independent trustee can make additional distributions (Form #28).
-

a (1) Annuity Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant [X] dollars [, adjusted to reflect any increase in the consumer price index between the date of this instrument and the date of the first payment for the year]

. The Trustee shall pay the annuity amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the annuity amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3. Nonindependent trustee possesses discretion: mandatory distribution of annuity, nonindependent trustee can make additional distributions (Form #29).
-

(1) Annuity Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant [X] dollars

a [, adjusted to reflect any increase in the consumer price index between the date of this instrument and the date of the first payment for the year]

. The Trustee shall pay the annuity amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the annuity amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed.

4. Combination of (i) nonindependent trustee possesses some discretion and (ii) independent trustee possesses other discretion: mandatory distribution of annuity, independent and nonindependent trustees can make additional distributions (Form #30).

a (1) Annuity Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant [X] dollars [, adjusted to reflect any increase in the consumer price index between the date of this instrument and the date of the first payment for the year]

. The Trustee shall pay the annuity amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the annuity amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to the descendant so much or all, if any, of any balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

E. Conventional Unitrust Examples.

1. No trustee possesses any discretion: mandatory distribution of unitrust amount, no additional distribution (Form #31).

- (1) Unitrust Interest. Each year, the Trustee shall pay to the descendant a unitrust amount equal to [X] percent of the
- a [net fair market value of the assets of the trust valued as of the first business day of the year]
- b [average of the net fair market values of the assets of the trust valued as of the first business day of the year and of each year of the preceding four]
- . The Trustee shall pay the unitrust amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the unitrust amount for any short year.

(2) Additional. The Trustee shall not distribute to the descendant any principal or income other than according to (1).

2. Independent trustee possesses discretion: mandatory distribution of unitrust amount, independent trustee can make additional distributions (Form #32).

- (1) Unitrust Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant a unitrust amount equal to [X] percent of the
- a [net fair market value of the assets of the trust valued as of the first business day of the year]
- b [average of the net fair market values of the assets of the trust valued as of the first business day of the year and of each year of the preceding four]
- . The Trustee shall pay the unitrust amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the unitrust amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3. Nonindependent trustee possesses discretion: mandatory distribution of unitrust amount, nonindependent trustee can make additional distributions (Form #33).

- (1) Unitrust Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant a unitrust amount equal to [X] percent of the
- a [net fair market value of the assets of the trust valued as of the first business day of the year]
- b [average of the net fair market values of the assets of the trust valued as of the first business day of the year and of each year of the preceding four]
- . The Trustee shall pay the unitrust amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the unitrust amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed.

4. Combination of (i) nonindependent trustee possesses some discretion and (ii) independent trustee possesses other discretion: mandatory distribution of unitrust amount, independent and nonindependent trustees can make additional distributions (Form #34).

- (1) Unitrust Interest. Each year, after the descendant has attained thirty years of age, the Trustee shall pay to the descendant a unitrust amount equal to [X] percent of the
- a [net fair market value of the assets of the trust valued as of the first business day of the year]
- b [average of the net fair market values of the assets of the trust valued as of the first business day of the year and of each year of the preceding four]
- . The Trustee shall pay the unitrust amount in equal quarter-annual installments from income and, to the extent that income is not sufficient, from principal. The Trustee shall prorate the unitrust amount for any short year.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to the descendant so much or all, if any, of any balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

F. Mandated-Percentage Unitrusts.

Consider expressing as a percentage of the trust estate, rather than as a dollar amount, the unitrust interest that the trustee is required to distribute.

1. Compared to a conventional unitrust in which the unitrust interest is expressed as a dollar amount, this arrangement enhances flexibility in (i) timing of recognition of gain and (ii) determining the identity of the taxpayer that recognizes the gain.
 - a. Unless the trustee elects to the contrary according to subsection 643(e) of the Code, satisfaction of the percentage in kind should not produce a deemed sale. See generally Code §663(a)(1); reg. §§1.661(a)-2(f)(1), 1.1014-4(a)(3) and 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286; Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); and Suisman v. Eaton, 15 F. Supp. 113 (D.Conn. 1935), affirmed 83 F.2d 1019 (2d Cir. 1935), cert. denied 299 U.S. 573 (1936).
 - b. However, if the satisfaction in kind does not produce a deemed sale, the distributee takes for income tax purposes the same basis that the trustee had. Code §643(e).
 - c. By making or not making the election according to subsection 643(e) of the Code, the trustee can defer or accelerate recognition of gain and can determine which, the trustee or the unitrust recipient, shall pay the tax on any gain.

2. The ability of the trustee to satisfy the percentage in kind (rather than in dollars) should permit the trustee (but not the unitrust recipient) to avoid the need for cash.
 - a. Any distribution of an asset in kind will carry distributable net income from the trust to the distributee and include it in the gross income of the distributee to the extent of the income tax basis of the trustee in the distributed asset. Code §§643(e), 661 and 662.
 - b. Therefore, the distribution in kind will tend to require the distributee to obtain cash in order to pay tax.
3. Use of the concept of a percentage gives the trustee considerable flexibility about how to satisfy the unitrust interest. If the governing instrument authorizes the trustee to make distributions in nonprorata shares, the trustee should have flexibility that ranges from satisfying the unitrust interest with one asset to satisfying it with a fractional share of each and every asset including both income and principal.

G. Mandated-Percentage Unitrust Examples.

1. No trustee possesses any discretion: mandated distribution of unitrust percentage, no additional distribution
(Form #35).

(1) Unitrust Interest. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant a [X] fractional share of the trust estate.

(2) Additional. The Trustee shall not distribute to the descendant any of the trust estate other than according to (1).

2. Independent trustee possesses discretion: mandated distribution of unitrust percentage, independent trustee can make additional distributions (Form #36).

(1) Unitrust Interest. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year,

the Trustee shall pay to the descendant a [X] fractional share of the trust estate.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3. Nonindependent trustee possesses discretion: mandated distribution of unitrust percentage, nonindependent trustee can make additional distributions (Form #37).

(1) Unitrust Interest. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant a [X] fractional share of the trust estate.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed.

4. Combination of (i) nonindependent trustee possesses some discretion and (ii) independent trustee possesses other discretion: mandated distribution of unitrust percentage, independent and nonindependent trustees can make additional distributions (Form #38).

(1) Unitrust Interest. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant a [X] fractional share of the trust estate.

(2) Additional. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay

to the descendant so much or all, if any, of any balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

5. Alternative version of subparagraph (1).

(1) Unitrust Interest. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant so much of the trust estate as is equal in value to [X] percent of the value of the trust estate as of the end of the year.

H. Withdrawable-Percentage ("GIVE-ME-FIVE") Unitrusts.

Next, instead of requiring the trustee to distribute a unitrust percentage or a unitrust amount, consider specifying a percentage of the trust estate, not in excess of five percent (or specifying, alternatively, so much of the trust estate as has a value equal to the value of a percentage of the trust estate, not in excess of five percent) and providing that the unitrust recipient may, but need not, withdraw all or any of it until a particular time each year. The withdrawable-percentage ("GIVE-ME-FIVE") unitrust is an attractive alternative to (i) a trust that mandates the current payment of income, (ii) a conventional unitrust in which the unitrust interest is expressed as a dollar amount and the current payment of the unitrust amount is mandated and (iii) a unitrust in which the unitrust interest is expressed as a percentage of the trust estate and the current distribution of the unitrust percentage is mandated.

The withdrawable-percentage unitrust is particularly attractive when (as in a credit shelter or generation-skipping configuration) the trust is exempt from the generation-skipping tax and the primary beneficiary is a nonskip person (e.g., the grantor's spouse or child), or is a skip person (e.g., the grantor's grandchild) who is assigned to a generation higher than that of another skip person, who might not need, but wants the security of, the beneficial enjoyment that the trust can provide. The withdrawable-percentage unitrust allows the primary beneficiary to consume the resources of the beneficiary that, if not consumed,

will generate liability for gift tax, estate tax or generation-skipping tax (or more than one of them), and thus to conserve the trust's resources that are sheltered from the transfer taxes.

As an example, instead of forcing the grantor's spouse to receive all income from a marital deduction trust and all income from a credit shelter trust, a withdrawable-percentage unitrust can permit the grantor's spouse to receive all income from the marital deduction trust, to consume the spouse's property (or principal of the marital deduction trust) in an amount that approximates the income of the credit shelter trust, and thus to conserve the trust estate of the credit shelter trust. Similarly, instead of forcing the grantor's child to receive all income from a trust that has an inclusion ratio of zero for generation-skipping tax purposes, a withdrawable-percentage unitrust can permit the grantor's child to consume the child's property in an amount that approximates the income of the generation-skipping trust, or can permit the trustee to distribute property from a trust that is not exempt from the generation-skipping tax in an amount that approximates the income of the trust that is exempt from the generation-skipping tax, and thus to conserve the trust estate of the generation-skipping trust.

1. Alternative Versions.

One version of the withdrawable-percentage unitrust permits the beneficiary to withdraw a percentage or fractional share of the trust estate. An alternative version permits the beneficiary to withdraw so much of the trust estate as has a value equal to the value of a specified fraction of the trust estate as of the time of lapse of the right to withdraw. Technically, this aspect of the latter version seems identical to that which appears in a conventional unitrust. The only economic difference between the versions is that the former version seems to describe something that can change in value until the trustee satisfies it, while the latter version seems to impose a ceiling of a fixed number of dollars. Each version should produce the same income tax results. See generally reg. §1.671-3.

The version that permits the beneficiary to withdraw "so much . . . of the trust estate" might offer greater flexibility than the version that permits the beneficiary to withdraw a

"fractional share." If the governing instrument authorizes the trustee to distribute nonprorata shares of assets in satisfaction of any withdrawal, the version that permits the beneficiary to withdraw a "fractional share" should vest in the trustee, and arguably solely in the trustee, the ability to satisfy a withdrawal with other than a fractional share of each and every asset. The version that permits the beneficiary to withdraw "so much . . . of the trust estate," on the other hand, might allow the beneficiary, himself or herself, to select the assets that are to satisfy any exercise of the right to withdraw.

2. Advantages.

- a. Use of a lapsing right to withdraw, instead of a mandated payment, permits the unitrust recipient to exclude the trust estate from the gross estate of the recipient for estate tax purposes and from the gifts of the recipient for gift tax purposes. See, however, the text at IV.H.6, infra.
- b. The right to withdraw also permits the unitrust recipient to regulate the efficiency of the trust for generation-skipping tax purposes by determining whether a nonskip person (or a skip person who is in a generation that is higher than that of another skip person) shall receive distributions.
- c. Additionally, the lapsing right to withdraw permits the power holder to avoid dissipation of GST exemption. Id.
- d. The unitrust concept eliminates any functional distinction between income and principal. Therefore, it permits the trustee to take full advantage of the prudent investor rule and modern portfolio theory by investing for total return.
- e. Expression of the unitrust interest as a percentage (or as so much of the trust estate as has a value equal to the value of a percentage), rather than as a dollar amount, permits satisfaction of the interest in kind without recognition of gain.
- f. The unitrust percentage of five percent assures that the unitrust recipient can receive approximately the same enjoyment

that he or she would receive if he or she were to receive all income of a trust that owned a balanced portfolio of investments.

- g. The primary beneficiary can serve as the sole trustee of a withdrawable-percentage unitrust at least as well as he or she can serve as the sole trustee of a mandated-payment-of-income trust. The primary beneficiary can serve as the sole trustee of a withdrawable-percentage unitrust just as well as he or she can serve as the sole trustee of a conventional unitrust and a mandated-percentage unitrust.
- h. Since, within limits, the unitrust recipient, himself or herself, can determine the transfer tax results, a withdrawable-percentage unitrust seems more flexible for transfer tax purposes than (i) a grant of discretion to an independent trustee to make distributions (see Form #24), (ii) a mandate to a trustee to make distributions (see, for example, Form #21 and Form #31) and (iii) a grant of discretion, limited by an ascertainable standard, to a person to make distributions to himself or herself (see Form #23).

3. A Problem.

Although the withdrawable-percentage unitrust offers superior results for transfer tax purposes, it poses a problem, fortunately solvable, for income tax purposes.

- a. The right to withdraw includes in the gross income of the power holder all gross income that is attributable to the subject property. Code §678(a)(1). If (i) the inclusion is inadvertent and not desired and (ii) the power causes inclusion of more than the income that is attributable to the property to which the power applies during the taxable year, the inclusion can present the power holder with an unexpected and unwanted obligation that the power holder can lack the resources to discharge.
- b. Nevertheless, although the withdrawable-percentage unitrust seems less flexible for income tax purposes than a power granted to an independent trustee and, arguably, a power to withdraw limited by an

ascertainable standard, the more appropriate comparison is probably between (i) the withdrawable-percentage unitrust and (ii) a mandate to a trustee to distribute all income (see, for example, Form #21).

4. Transfer Tax Implications and Planning.

- a. Generally, the lapse of a general power of appointment is treated as a transfer for gift and estate tax purposes. Code §§2041(a)(2) and 2514(b).
- b. However, a lapse during any calendar year during the life of the power holder is treated as a transfer for estate tax purposes

"only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

"(A) \$5,000, or

"(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied." Code §2041(b)(2).

The gift tax rules are similar. See Code §2514(e).

- i. A lapse that is within the limits of Code sections 2041(b)(2) and 2514(e) is not a gift for gift tax purposes. Reg. §§20.2041-3(d)(3) and 25.2514-3(c).
- ii. Similarly, the lapse is not a transfer with retained enjoyment for estate tax purposes. Reg. §20.2041-3(d) and (4).
- iii. Possession of the right to withdraw at the death of the power holder does include in the gross estate of the power holder any property that the power holder could have withdrawn immediately before death. Code §2041(b)(1) and reg. §20.2041-3(d)(3).

- (a) However, confining the possession of the power to immediately before the end of the year should prevent the power from including any of the trust estate in the gross estate of the power holder.
 - (b) Similarly, conditioning the power upon the exhaustion of another trust (for example, a marital deduction trust, such as a QTIP or testamentary-power-of-appointment trust) that the power holder does not have discretion to exhaust prevents the power from including property in the gross estate of the power holder unless the power holder dies after the other trust is exhausted. Reg. §20.2041-3(b); cf. Estate of Kurz v. Commissioner, 101 T.C. 44 (1993), affirmed 95-2 USTC ¶60, 215 (7th Cir. 1995).
- iv. Except to any extent that the power subjects property to gift tax or estate tax or the power holder exercises the power, the power does not cause the power holder to become the transferor for generation-skipping tax purposes. Therefore, the power does not dissipate the effect of allocation of GST exemption of the original transferor. Code §2652(a).
- c. Where a power of appointment is necessary to qualify property for the marital deduction, a right to withdraw is sufficient only if the grantor's spouse can exercise the right in all events. Cf. Ltr. Rul. 8202023 with Estate of Hollingshead v. Commissioner, 70 T.C. 578 (1978).

5. Income Tax Implications and Planning.

- a. The most important of the income tax implications is that the right to withdraw causes the power holder to own both (i) all ordinary income that is subject to the power and (ii) all income, ordinary and other, that is attributable to the principal that is subject to the power. Code §678(a)(1); see generally Code §671 and reg. §1.671-3.

- i. For example, a right to withdraw a fractional portion of a trust estate causes the power holder to own, for income tax purposes, all of the ordinary and other income of the fractional portion.
 - (a) Even if the right to withdraw is exercised, the rules that apportion income, for income tax purposes, between a trust and its beneficiaries based upon the amount of distributable net income ("dni") that is, or is not, carried from the trust to the beneficiaries should not apply to the portion of the trust that is subject to the right to withdraw. Rev. Rul. 67-241, 1967-2 C.B. 225.
 - (b) Rather, the system should treat the holder of the power as receiving that which he or she already owns.
 - (c) The holder of a right to withdraw a fractional portion is regarded, for income tax purposes, as owning the fractional portion.
 - (d) Even though Revenue Ruling 67-241, 1967-2 C.B. 225, seems to support the proposition that the power holder owns, for income tax purposes, that which he or she can withdraw and, therefore, the dni rules do not apply to any exercise of the power, the regulations promulgated according to Code section 665 (regulations section 1.665(b)-1A(d), Example 4) clearly assert that the throwback rules do apply to any exercise of the power. The partial abolition of the throwback rules might change results but should not change any reasoning. See Code §665(c). Although the two sets of rules seem inconsistent and arguably the throwback rules should not oust the grantor trust system where the two systems overlap, the planner should appreciate the possibility

that the throwback rules might apply to an exercise.

ii. The Internal Revenue Service asserts that even after the right to withdraw lapses because the power holder fails to exercise it, except to any extent that the power holder ceases to be the "grantor" according to the principles of Code sections 671 through 677, the power holder owns, for income tax purposes, all of the income that the exercise of the power would have permitted the power holder to possess. Code §678(a)(2); and Ltr. Ruls. 9034004 and 8701007.

(a) This result depends upon (i) the theory that a "lapse" is a "release" for purposes of Code section 678(a)(2) or (ii) the theory that a lapse of a right to withdraw has the same economic effect, and should have the same tax effect, as a withdrawal of property from a trust and a recontribution of the property to the trust. See Early, "Income taxation of lapsed powers of withdrawal: Analyzing their current status," Journal of Taxation (April, 1985) 198.

(b) Neither of the theories mentioned in the preceding paragraph clearly controls.

(i) Code sections 2041(b)(2) and 2514(e), on the one hand, state that a lapse is treated as a release except to any extent that a lapse within the limits of the five-and-five rules is not treated as a release.

(ii) Code section 678(a)(2), on the other hand, does not state that a lapse ever is treated as a release. Therefore, according to the argument, a release is something other than a lapse, for purposes of Code section 678(a)(2).

(iii) Nevertheless, for purposes of planning, this writer assumes that a lapse is equivalent to a release for purposes of Code section 678(a)(2).

iii. Assume that a person has a right to withdraw five percent of a trust that has \$1,000 of principal and that generates \$50 of ordinary income and \$100 of corpus income ratably during its first year.

(a) As a first example of the application of the Service's position, assume that the power applies during the entire year and lapses at the end of the year.

(i) The power holder is regarded as owning five percent of the trust estate and, therefore, as owning five percent of the \$50 of ordinary income and five percent of the \$100 of corpus income.

(ii) Even if the power holder never possesses any other power to withdraw, except to any extent that the power holder ceases to be the "grantor" according to the principles of Code sections 671-677, the power holder owns, for income tax purposes, all of the income of the fractional portion, both during the year in which the power exists and at all times after the power lapses.

(b) As a second example, assume that the facts are the same as in the first example except that the power holder exercises the power. The results are the same as in the first example for the first year and for as long as the power holder owns the withdrawn property and the withdrawn property continues to be a fractional share of the aggregate of what is withdrawn and what remains in the trust.

- (c) As a third example, assume that the facts are the same as in the first example except that the power exists only on the first day of the first year. The results are the same as in the first example.
- (d) As a fourth example, assume that the facts are the same as in the first example except that (as in the forms) the power exists only immediately before the end of the year. The results are the same as in the first example except that in the first year the power holder arguably does not own, for income tax purposes, any of the trust estate.
- (e) As a fifth example, assume that the facts are the same as in the first example except that the power recurs each year. The Internal Revenue Service might assert that the power holder becomes the owner, for income tax purposes, of an additional portion of the trust estate each year. See Code §678(a)(2) and Ltr. Rul. 9034004.
- (i) The theory of the Service in Letter Ruling 9034004 is that a power to withdraw five percent each year applies to all of the trust estate (i.e., the same property) each year and, therefore, the power holder has the right each year to withdraw five percent of both (i) the portion of the trust estate that the power holder previously did not own for income tax purposes and (ii) the portion of the trust estate that the power holder previously did own for income tax purposes.
- (ii) The effect of the theory is that each year the power holder additionally becomes the owner for income tax

purposes of five percent of the portion of the trust estate that previously the power holder did not own.

- (iii) The theory of Letter Ruling 9034004 is not binding.
 - (f) According to another theory applied to the fifth example, the power applies each year to all of the trust estate (i.e., the same as according to the theory of Letter Ruling 9034004) but the power applies, for income tax purposes, each subsequent year the same as it applies the first year, so that the portion that the power holder owns does not increase each year.
 - (g) According to yet another theory, previously discussed, a lapse is not a release. Therefore, Code section 678(a)(2) is not operative and the taxpayer owns only any portion that the taxpayer presently can withdraw.
 - (i) An implication of this theory is that the amount of income that the taxpayer owns is a function of the time that the power exists.
 - (ii) Arguably, a power that is exercisable only immediately before the end of the year does not cause the taxpayer to own any income.
 - (h) Perhaps a taxpayer can choose any of the theories, if he or she follows the chosen theory consistently.
- iv. If the gross income of the power holder would include all ordinary income of the trust even if the power were not to exist, the power additionally would include only a portion of corpus income in the gross income of the power holder.

- v. If, on the other hand, the gross income of the power holder would not include all ordinary income of the trust if the power were not to exist, the power additionally would include a portion of ordinary income and a portion of corpus income in the gross income of the power holder.
- vi. The extent to which the addition of the power would alter the tax burden of the power holder would depend upon whether the power would cause the power holder to own the same, or an additional, portion of the trust estate each year.
- vii. The grantor, in any event, should consider including sufficient flexibility to permit the power holder to receive from the trust sufficient property to discharge any income tax liability of the power holder that is attributable to the trust.

b. An additional implication for income tax purposes is that even if satisfaction in kind of a right to withdraw a dollar amount would produce a deemed sale of the property that is distributed, expression of the unitrust interest as a right to withdraw a fractional (or percentage) portion of the trust estate (or, alternatively, if the exercise of the right is not framed as a withdrawal of a dollar amount, expression of the unitrust interest as a right to withdraw as much of the trust estate as has a value equal to the value of a fractional portion) should cause satisfaction of the right in kind not to produce a deemed sale. Code §663(a)(1); reg. §§1.661(a)-2(f)(1), 1.1014-4(a)(3) and 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286; Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); and Suisman v. Eaton, 15 F. Supp. 113 (D.Conn. 1935), affirmed 83 F.2d 1019 (2d Cir. 1935), cert. denied 299 U.S. 573 (1936); cf. Rev. Rul 67-241, 1967-2 C.B. 225.

- i. Some would argue that according to the theory of Revenue Ruling 67-241, 1967-2 C.B. 225, the power holder already possesses the portion of the trust that he or she can withdraw and, therefore,

satisfaction in kind of a right to withdraw even a number of dollars might not produce a deemed sale and, accordingly, avoidance of a deemed sale does not require avoidance of a right to withdraw a dollar amount.

- ii. However, the argument seems to ignore that satisfaction in kind of a right to withdraw dollars is not the same as payment in dollars.

6. Interface Between Income Tax and Transfer Tax Implications, and Planning for It.

By including income in the gross income of a unitrust recipient who does not receive the income but who nevertheless pays the income tax upon it and thus preserves it intact for others, the right to withdraw might enhance the property that a given amount of transfer (for gift or estate tax purposes) can make available for members of the family of the power holder.

- a. However, with uncertain effect, the Internal Revenue Service might attempt to treat the power holder's payment of income tax as a contribution to the trust to any extent that the payment exceeds the amount that the power holder receives from the trust. Cf. Ltr. Rul. 9441031.
- b. This treatment would include the deemed contribution in the gross estate or transfers for gift tax purposes, or (depending upon the configuration of the trust) both the gross estate and the transfers for gift tax purposes, of the power holder. Code §2511.
- c. The power holder can avoid these results by receiving from the trust, each year, property that has a value at least equal to the marginal amount of income tax that the right to withdraw causes the power holder to pay.
- d. Consider arming the power holder, himself or herself, with the solution to this problem by giving the power holder a nongeneral power to appoint the trust estate and a continuing right to withdraw any of the trust estate that, because the power holder contributed it or is deemed to

have contributed it, would be included in the gross estate of the power holder for estate tax purposes if the power holder were to die.

7. Conclusion.

Compared to a trust that mandates the current payment of all income, a withdrawable-percentage unitrust might increase the taxable income of the primary beneficiary and reduce the taxable income of the trustee. However, since the rate that applies to the taxable income of a trustee reaches the maximum at a lower level of taxable income than the rate that applies to the taxable income of an individual, the withdrawable-percentage unitrust usually will not increase (and often will decrease) the aggregate of the income tax. Although the withdrawable-percentage unitrust will tend to increase the difficulty of determining the income tax, it will tend not to increase the tax itself. A withdrawable-percentage unitrust that is designed for flexibility can cope with the additional complexity.

Transfer tax advantages and investment advantages are what make the withdrawable-percentage unitrust an attractive alternative to a trust that mandates the current payment of income. Free of transfer tax, the primary beneficiary of the withdrawable-percentage unitrust can cause the trust to conserve at least all of the trust estate in excess of the aggregate of the income tax liabilities of the beneficiary, and of the trustee, with respect to taxable income that is attributable to the trust. By contrast, the most that the primary beneficiary can allow to pass free of transfer tax by means of the pay-all-income trust is the portion of the trust estate that exceeds the sum of the trust accounting income and the income tax liability of the trustee. Stated differently, this portion consists of the trust accounting principal that remains after the trustee pays all income tax upon corpus income.

Even assuming that the Internal Revenue Service is correct about a beneficiary making a contribution to a trust to the extent that the beneficiary's payment of income tax upon taxable income that is attributable to the trust exceeds what the beneficiary receives from the trust, (i) all of the trust estate (i.e., trust

accounting income plus trust accounting principal) net of the income tax upon the taxable income that is attributable to the trust exceeds (ii) the trust accounting principal net of income tax upon corpus income. The difference is significant. It consists of the amount by which trust accounting income exceeds the income tax that is attributable to the trust accounting income. Stated differently, this amount is the after-tax income of the trust.

I. Withdrawable-Percentage ("GIVE-ME-FIVE")
Unitrust Examples.

1. No trustee possesses any discretion: permissive withdrawal of unitrust percentage, no additional distribution (Form #39).

(1) Right to Withdraw. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant such fractional share (not to exceed one-twentieth), if any, of the trust estate as the descendant last directs in writing before the end of the year. As used in the preceding sentence, "trust estate" shall not include the Included Portion (defined in subsection (2) of this subsection (C)).

(2) Additional. The Trustee shall pay to the descendant so much or all, if any, of the Included Portion as the descendant directs in writing at any time or from time to time. The Included Portion at any particular time is any of the trust estate that, because of the descendant's actual or deemed contribution, would be included in the gross estate of the descendant (for purposes of determining the United States estate tax payable because of the death of the descendant) if the descendant died at such time. The Trustee shall not distribute to the descendant any of the trust estate other than according to (1) and the first sentence of this (2).

2. Independent trustee possesses discretion: permissive withdrawal of unitrust percentage, independent trustee can make additional distributions (Form #40).

(1) Right to Withdraw. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant such fractional share (not to exceed one-twentieth), if any, of the trust estate as the descendant last directs in

writing before the end of the year. As used in the preceding sentence, "trust estate" shall not include the Included Portion (defined in subsection (2) of this subsection (C)).

(2) Additional. The Trustee shall pay to the descendant so much or all, if any, of the Included Portion as the descendant directs in writing at any time or from time to time. The Included Portion at any particular time is any of the trust estate that, because of the descendant's actual or deemed contribution, would be included in the gross estate of the descendant (for purposes of determining the United States estate tax payable because of the death of the descendant) if the descendant died at such time. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3. Nonindependent trustee possesses discretion: permissive withdrawal of unitrust percentage, nonindependent trustee can make additional distributions (Form #41).

(1) Right to Withdraw. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant such fractional share (not to exceed one-twentieth), if any, of the trust estate as the descendant last directs in writing before the end of the year. As used in the preceding sentence, "trust estate" shall not include the Included Portion (defined in subsection (2) of this subsection (C)).

(2) Additional. The Trustee shall pay to the descendant so much or all, if any, of the Included Portion as the descendant directs in writing at any time or from time to time. The Included Portion at any particular time is any of the trust estate that, because of the descendant's actual or deemed contribution, would be included in the gross estate of the descendant (for purposes of determining the United States estate tax payable because of the death of the descendant) if the descendant died at such time. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise

available, to provide for the descendant's health, education and support in the manner of living to which accustomed.

4. Combination of (i) nonindependent trustee possesses some discretion and (ii) independent trustee possesses other discretion: permissive withdrawal of unitrust percentage, independent and nonindependent trustees can make additional distributions (Form #42).
-

(1) Right to Withdraw. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant such fractional share (not to exceed one-twentieth), if any, of the trust estate as the descendant last directs in writing before the end of the year. As used in the preceding sentence, "trust estate" shall not include the Included Portion (defined in subsection (2) of this subsection (C)).

(2) Additional. The Trustee shall pay to the descendant so much or all, if any, of the Included Portion as the descendant directs in writing at any time or from time to time. The Included Portion at any particular time is any of the trust estate that, because of the descendant's actual or deemed contribution, would be included in the gross estate of the descendant (for purposes of determining the United States estate tax payable because of the death of the descendant) if the descendant died at such time. Additionally, the Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to the descendant so much or all, if any, of any balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

5. Alternative version of subparagraph (1) (Form #43).

(1) Right to Withdraw. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant so much, if any, of the trust estate, not to exceed in value five percent of the value of the trust estate as of the end of the year, as the descendant last directs in writing before the end of the year. As used in the preceding sentence, "trust estate" shall not include the Included Portion (defined in subsection (2) of this subsection (C)).

APPENDIX

UNIFORM PRUDENT INVESTOR ACT

SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

SECTION 2. STANDARD OF CARE, PORTFOLIO STRATEGY, RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;
- (3) the expected tax consequences of investment decisions or strategies;
- (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation of appreciation of capital; and

(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

SECTION 3. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

SECTION 4. DUTIES AT INCEPTION OF TRUSTEESHIP. Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

SECTION 7. INVESTMENT COSTS. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

SECTION 8. REVIEWING COMPLIANCE. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

- (1) selecting an agent;
- (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
- (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

SECTION 10. LANGUAGE INVOKING STANDARD OF [ACT]. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own

affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

SECTION 11. APPLICATION TO EXISTING TRUSTS. This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

SECTION 12. UNIFORMITY OF APPLICATION AND CONSTRUCTION. This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

SECTION 13. SHORT TITLE. This [Act] may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

SECTION 14. SEVERABILITY. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 15. EFFECTIVE DATE. This [Act] takes effect .
.....

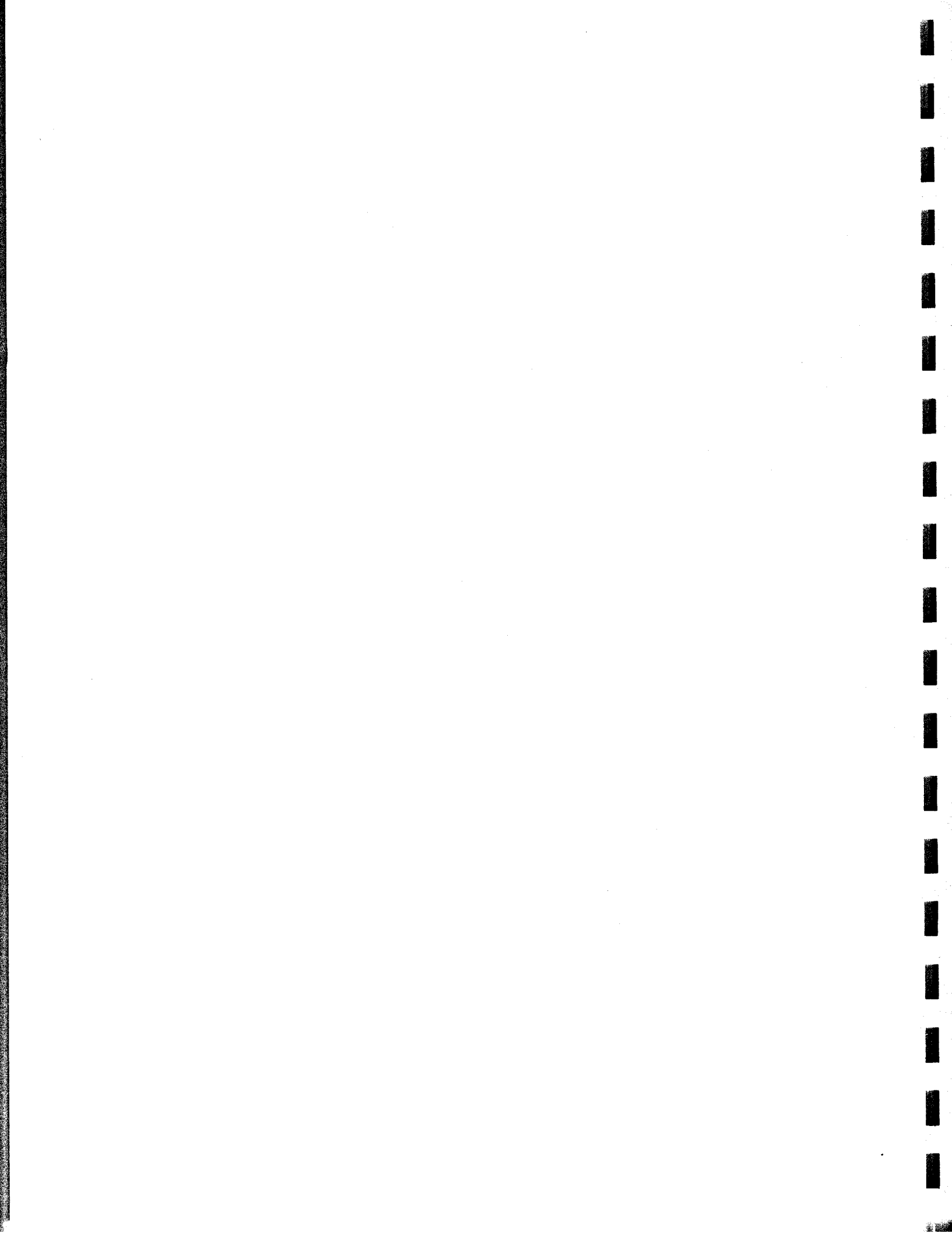
SECTION 16. REPEALS. The following acts and parts of acts are repealed:

- (1)
- (2)
- (3)

MISSED OPPORTUNITIES:

INNOVATIVE USES OF ESOPs
IN ESTATE PLANNING FOR BUSINESS OWNERS

David Ackerman
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Chicago, Illinois



**MISSED OPPORTUNITIES:
Innovative Uses of ESOPs in Estate Planning for Business Owners**

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MISSED OPPORTUNITIES -- INNOVATIVE USE OF ESOPS IN ESTATE PLANNING FOR BUSINESS OWNERS

**By David Ackerman
McBride Baker & Coles
Chicago, Illinois**

I. INTRODUCTION

A. ESOPs are an Important but often Overlooked Estate Planning Technique for Business Owners

1. Special tax incentives for ESOPs make them attractive, not only as employee benefit plans, but also as an estate planning tool
2. Estate planners still think of ESOPs merely as employee benefit plans
3. Employee benefits lawyers often fail to see how ESOPs can be used in estate planning because of their unfamiliarity with the estate tax rules

B. Why Estate Planners Should be Interested in ESOPs

1. ESOPs can be used effectively to accomplish important estate planning objectives of business owners
 - a. source of liquidity with which to pay estate taxes
 - b. deferring or completely avoiding recognition of income
 - c. converting ordinary income into capital gain
 - d. facilitation of private business ownership succession

- e. reducing the after-tax cost of borrowing
- f. reducing the effective rate of transfer taxes
- 2. Implementation of an ESOP generally triggers a need for reconsideration of a business owner's estate plan
 - a. nature of owner's wealth substantially changed
 - b. implementation of ESOP often creates opportunities for use of other estate planning techniques
 - (1) immediately after a leveraged ESOP transaction, value of plan sponsor's stock is depressed - - and this creates opportunities for tax-effective gifts
 - (2) charitable remainder trusts can be used effectively to hold low-basis replacement properties purchased with proceeds of a tax-deferred sale to an ESOP
 - c. family limited partnerships can be combined effectively with ESOP transactions

C. Scope of Presentation

- 1. Special estate planning needs of business owners which can be addressed by ESOPs
- 2. General overview of how ESOPs work
- 3. Description of special tax incentives for ESOPs which make them attractive as an estate planning technique
- 4. How ESOPs can be used in estate planning
- 5. Combining ESOPs with other estate planning techniques

II. SPECIAL ESTATE PLANNING NEEDS OF THE BUSINESS OWNER

A. Typical Objectives of Family Business Owner

- 1. Maintain business in family
- 2. Retire with adequate and assured income
- 3. Security for spouse

4. Treat children equally

5. Minimize taxes

B. The Odds against Keeping the Business in the Family

1. Less than one out of three family businesses will make it through a second generation

2. Only about one out of five family businesses will make it through a third generation

C. Reasons So Few Family Businesses are Perpetuated

1. "Forced" sale of business

a. failure to groom successors

b. failure to plan for payment of estate taxes

2. Disagreements among successor family members

a. children and cousins not active in business may desire or need dividend income from the business

b. children and cousins active in the business likely will prefer not to pay large dividends

(1) desire to fund future expansion out of accumulated earnings

(2) draw salaries and, therefore, have no need to obtain additional dividend income

D. Role of Estate Planner

1. Encourage business owner to consider what will happen to the business after he or she dies or retires

2. Present planning ideas to address the business owner's needs

3. Implement plan

4. Monitor plan to assure that it remains appropriate, taking into account - -

a. changes in client's circumstances, and

b. changes in tax and other laws

III. HOW AN ESOP WORKS

A. Definition: employee benefit plan designed to invest primarily in stock of the sponsoring employer

B. Basic Tax Attributes

1. Contributions to the plan are deductible by the sponsoring employer (within applicable limits, which are described in Section III D below)
2. Income earned by the ESOP trust is exempt from tax
3. Participants in the ESOP do not recognize income until their benefits are withdrawn

C. Requirements for Tax-Qualification

1. Participation in the plan must be available to a broad cross-section of employees
 - a. cannot limit participation to a select group of key executives
 - b. union employees may be excluded
2. Benefits must be allocated in a nondiscriminatory manner
 - a. benefits may not be allocated in a way that unduly favors officers, shareholders, or highly-compensated employees
 - b. safe harbor: benefits may be allocated in proportion to relative compensation of participating employees
 - (1) however, any compensation in excess of \$160,000 must be disregarded
 - (2) \$160,000 cap subject to adjustment to reflect changes in the cost of living
3. Written plan
4. Vesting standards
 - a. seven-year graded
 - b. five-year "cliff"

5. A trust must be established to hold the employer securities and other assets of the plan
 - a. trust must be administered for the exclusive benefit of the participants in the plan and their beneficiaries
 - b. trustee subject to "prudent person" and other fiduciary rules of ERISA

D. Limitations on Contributions and Allocations

1. Limits on tax-deductible contributions
 - a. general rule: maximum annual deduction limited to 15 percent of compensation of participants in plan ("covered compensation")
 - b. maximum deductible amount may be increased to 25 percent of covered compensation if a money purchase pension plan is included as part of the ESOP
 - c. increased limits for amounts allocated to repay an ESOP loan (for C corporations only)
 - (1) contributions used to pay interest are fully deductible
 - (2) contributions used to pay principal are deductible up to 25 percent of covered compensation
2. Individual allocation limitation
 - a. general rule: lesser of 25 percent of compensation or \$30,000
 - b. this limitation does not apply to contributions used to repay interest on an ESOP loan or forfeitures if no more than one-third of the employer contributions applied to repayment of principal is allocated to "highly compensated employees"

E. Special ESOP Tax-Qualification Rules

1. Voting Rights
 - a. voting rights on publicly-traded securities must be passed through to participants

b. pass-through of voting rights with respect to other securities may be limited to extraordinary transactions (such as a merger, sale of substantially all assets, recapitalization, or liquidation)

(1) if participants' voting rights are limited, the trustee will vote the stock

(2) trustee may be subject to direction by other designated persons (e.g., ESOP Committee)

2. Distribution Rules

a. timing: unless a participant elects a later date, distributions must commence no later than one year after the close of the plan year —

(1) in which he or she terminates employment due to reaching normal retirement age, disability, or death; or

(2) which is the fifth plan year following the plan year in which he or she otherwise separates from service

b. distributions of securities acquired with the proceeds of a loan may be delayed until the loan is repaid

c. benefits may be distributed in installments over five years (over a longer term where the benefits exceed \$725,000)

d. right to demand employer securities: a participant may demand that his or her benefits be distributed in the form of stock of the employer, unless either - -

(1) articles of incorporation or by-laws restrict ownership of employer securities to employees

(2) plan sponsor is an S corporation

3. Put Option

a. unless the employer's stock is publicly traded, a participant may require the employer to repurchase any employer stock distributed to him or her at a price determined under a "fair valuation formula"

b. if benefits are distributed in a lump sum, the employer may elect to pay the purchase price upon exercise of the put option in installments over a period not to exceed five years

4. Diversification Requirements

- a. at least three investment options must be offered to participants who have attained age 55 and who have completed ten years of participation in the plan
- b. alternative: distribute cash equal to the amount with respect to which an investment option otherwise must have been provided
- c. amount subject to direction by participant
 - (1) twenty-five percent of the balance credited to his or her account during the first five years after diversification right accrues
 - (2) fifty percent thereafter

IV. TAX-FREE ROLLOVER ON SALE OF STOCK TO AN ESOP

- A. Section 1042 of the Internal Revenue Code (the "Code") provides an opportunity for a tax-free rollover of the proceeds of a sale of stock to an ESOP if the proceeds are reinvested in securities of other corporations
 1. Available only with respect to sales of common stock of private C corporations
 2. The stock must have been owned by the seller for at least three years
- B. Conditions for Tax-Free Treatment
 1. Sale of "qualified securities" to an ESOP
 2. Immediately after the sale, the ESOP owns at least 30 percent of the sponsoring employer's stock
 3. Sale proceeds are reinvested in "qualified replacement property" (stocks or bonds of domestic operating corporations)
 4. Election to defer tax
- C. Definition Of "Qualified Securities"
 1. Must be "employer securities"

- a. common stock issued by the employer (or by a corporation which is a member of the same controlled group as the employer) having a combination of voting power and dividend rights equal to or in excess of:
 - (1) that class of common stock of the employer (or of any other member of the controlled group) having the greatest voting power, and
 - (2) that class of common stock of the employer (or of any other member of the controlled group) having the greatest dividend rights
 - b. certain noncallable preferred stock also may qualify
2. The employer securities must have been issued by a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market
 3. The employer securities must not have been received by the taxpayer in --
 - a. a distribution from a tax-qualified employee benefit plan, or
 - b. a transfer pursuant to an option or other right to acquire stock to which the provisions of Sections 83, 422, or 423 of the Code apply

D. The 30-Percent ESOP Ownership Test

1. Immediately after the sale, the ESOP must own either --
 - a. 30 percent of each class of outstanding stock or the plan sponsor, or
 - b. 30 percent of the total value of all outstanding stock of the plan sponsor
2. For this purpose, the term "stock" does not include nonvoting preferred stock which is not convertible into another class of stock
3. Note: 30-percent test is applied immediately after the transaction
 - a. this means that it is not necessary for a corporation to have previously adopted an ESOP in order to set up a tax-deferred sale
 - b. rather, an ESOP can be set up for the purpose of arranging a tax-deferred sale

E. "Qualified Replacement Property"

1. Definition: any security issued by a domestic operating corporation (other than the plan sponsor or any member of a controlled group which includes the plan sponsor)
2. Definition of "security"
 - a. a share of stock in a corporation
 - b. a right to subscribe for or to receive a share of stock in a corporation
 - c. a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation with interest coupons or in registered form
3. Definition of "operating corporation": a corporation more than 50 percent of the assets of which were, at the time that the security was purchased or before the close of the replacement period, used in the active conduct of a trade or business
 - a. financial institutions and insurance companies are treated as "operating corporations"
 - b. controlling and controlled corporations are treated as a single corporation
4. Passive investment income test
 - a. a security issued by a domestic operating corporation will not be "qualified replacement property" if, for the taxable year preceding the taxable year in which the security was purchased, the corporation had passive investment income in excess of 25 percent of the corporation's gross receipts
 - b. "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of securities
5. Replacement Period: the qualified replacement properties must be purchased within the "replacement period" in order for the sale to the ESOP to qualify for nonrecognition treatment
 - a. the replacement period begins three months before the date on which the sale of the qualified securities to the ESOP occurs, and
 - b. the replacement period ends twelve months after the date of the sale

6. Basis and holding period for qualified replacement properties
 - a. taxpayer's basis in qualified replacement properties is reduced by gain deferred in connection with sale to ESOP
 - (1) in effect, carryover basis
 - (2) if more than one item of qualified replacement property is purchased, the carryover basis is prorated among all of the qualified replacement properties on the basis of their relative values
 - b. tacking of holding period: the taxpayer's holding period for the qualified replacement properties includes the period during which the taxpayer held the qualified securities sold to the ESOP

F. Election to Defer Tax

1. Election to defer tax pursuant to Section 1042 of the Code must be made in a "statement of election" attached to the taxpayer's income tax return for the taxable year in which the ESOP sale occurs
 - a. once made, the election is irrevocable
 - b. the temporary regulations provide that if the election is not made in a timely manner, the taxpayer may not later make an election on an amended return [Temp. Regs. §1.1042-1T (Q&A-3)]
 - c. temporary regulations set forth information to be included in statement of election [Temp. Regs. §1.1042-1T (Q&A-3)(b)]
2. Qualified replacement properties must be described in "statements of purchase" which must be filed with the taxpayer's tax returns
 - a. statements of purchase must describe the qualified replacement property and state the date of the purchase and the cost of the property
 - b. statements of purchase must be notarized not later than 30 days after the purchase
3. Partial elections
 - a. a taxpayer may elect to defer part, but not all, of the gain realized in connection with a sale of qualified securities to an ESOP

- b. e.g., if a taxpayer sells to an ESOP qualified securities in which his or her basis is \$1 million for a price of \$11 million and purchases \$9 million of qualified replacement properties, then \$1 million of gain would be recognized

G. Recapture of Gain upon Disposition of Qualified Replacement Property

1. General Rule: upon disposition of qualified replacement property, gain recognized to extent of the gain previously deferred under Section 1042 of the Code by reason of the taxpayer's acquisition of the qualified replacement property
2. Exceptions: no recognition of gain in connection with transfers of qualified replacement properties by reason of any of the following - -
 - a. death of the taxpayer
 - b. a gift by the taxpayer
 - c. a corporate reorganization to which Section 368 of the Code applies (unless the taxpayer controls the acquiring or acquired corporation and the qualified replacement property is substituted-basis property in the hands of the transferee)
 - d. a transaction to which Section 1042 of the Code applies

H. Additional Rules

1. If the ESOP disposes of the employer securities with respect to which the Section 1042 election has been made within three years, the plan sponsor is subject to a ten-percent excise tax
2. Seller's shares must not be allocated back to the seller or to related parties or to 25-percent shareholders

V. THE ESOP AS A TAX-FAVORED FINANCING TECHNIQUE

A. Deduction of Principal

1. The fiduciary rules applicable to tax-qualified plans generally prohibit sponsoring employers from lending money to a qualified plan, guaranteeing a loan to a plan, or providing collateral for a loan
2. However, a special exemption is provided for loans to ESOPs, where the loan proceeds are used to acquire common stock of the sponsoring employer

B. Example of a Simple Leveraged ESOP Transaction:

1. The ESOP uses the loan proceeds to purchase shares of the sponsoring corporation, either from the corporation or from stockholders;
2. The corporation makes annual cash contributions to the ESOP in amounts sufficient to amortize the loan; and
3. The corporation takes deductions for the amounts so contributed (for both the amounts used to pay principal as well as the amounts used to pay interest)

VI. THE DIVIDENDS-PAID DEDUCTION

A. Section 404(k) of the Code allows a tax deduction for cash dividends paid on employer stock held by an ESOP if the dividends either are - -

1. used to make payments on an ESOP loan, the proceeds of which were used to acquire the employer securities with respect to which the dividends are paid, or
2. paid in cash to the plan participants or paid to the plan and then distributed to the participants within 90 days after the close of the plan year in which the dividends are paid

B. No Deduction if Plan Sponsor is an S Corporation

VII. POTENTIAL PROBLEMS

A. Dilution of Equity

1. After an ESOP is put in place, participants share in all future growth of the business on a pro rata basis
2. "Cost" of sharing equity with employees may be offset, in part or in full, by:
 - a. increases in employee productivity,
 - b. reductions in other employee benefits, and
 - c. tax savings

B. Repurchase Liability

1. If the stock of an employer that sponsors an ESOP is not publicly traded, the participants have the right to require the sponsoring employer (not the ESOP) to repurchase any shares distributed to them
2. Before establishing an ESOP, a company should consider whether this put option requirement might impose an undue financial burden upon the company at any time in the future
 - a. although the repurchase liability initially may be modest, it will grow, perhaps rapidly, as the ESOP matures and as more shares of stock are allocated to accounts of employees
 - b. moreover, if the company is successful, the value of the shares themselves should increase
3. Methods for managing the repurchase liability
 - a. pay-as-you-go
 - b. establish cash reserves, either within the ESOP or in a "sinking fund" controlled by the company
 - c. insurance
 - d. repurchase through ESOP, thereby making cost of shares tax-deductible

C. Valuation of the Stock

1. Valuations are required at least once a year and whenever stock is sold or contributed to an ESOP
2. All valuations of employer stock held by an ESOP that is not publicly traded must be made by an independent appraiser

VIII. USES OF ESOPS IN ESTATE PLANNING FOR BUSINESS OWNERS

A. Business Perpetuation

1. ESOPS present an attractive alternative to sale of business if younger executives have been adequately trained to manage the business

2. ESOP sale provides source of liquid assets which can be used for the following purposes:
 - a. payment of estate taxes, and
 - b. providing properties other than stock of the family business for inheritance by family members who will not be employed by the business
3. Control over the business can be retained by the family
 - a. a minority interest in the business can be sold to the ESOP
 - b. even if ESOP holds a majority interest, control in fact not likely to change
 - (1) seller, members of seller's family, or other officers or directors can be selected as trustee, with right to vote stock
 - (2) even if trustee is independent, change in control unlikely
 - (a) trustee can be subject to direction from a committee selected by the Board of Directors
 - (b) independent trustee not likely to change management in the absence of extraordinary circumstances, even if it has power to do so
4. Tax-advantaged financing

B. Diversification of Wealth

1. ESOP sale is an attractive alternative a sale to a third party
2. Disadvantages of sales to third parties
 - a. hard to find third parties who will purchase a minority interest in a private company
 - b. if a buyer can be found, he or she will demand substantial discounts for lack of control and lack of marketability
 - c. sale to third party will be taxable
3. Sale to ESOP
 - a. seller can retain control

- b. if a minority interest is sold, a minority-interest discount must be taken in determining sales price, but little or no discount for lack of marketability is required because ESOP participants will have a put option
 - c. tax can be deferred
 - 4. Comparison to stock redemption
 - a. stock redemption taxable, most likely at ordinary income rates
 - b. the owner's stock is repurchased with "after-tax dollars" (as compared to the use of "pre-tax dollars" in a leveraged ESOP transaction)
- C. Post-Mortem Planning
 - 1. Financing for purchase of stock from estate can be arranged on a tax-advantaged basis
 - 2. No need for income tax deferral since stock basis will be stepped up to fair market value in estate
 - 3. Avoid "forced" sale to outside parties

IX. COMBINING ESOPS WITH OTHER ESTATE PLANNING TECHNIQUES

- A. Deferring or Avoiding Recapture of Gain on Disposition of Qualified Replacement Properties
 - 1. If a taxpayer elects to defer recognition of gain in connection with a sale to a stock to an ESOP, the taxpayer takes a carryover basis in the qualified replacement properties
 - 2. Investing the ESOP sale proceeds
 - a. investment considerations (beyond scope of this presentation)
 - b. tax considerations
 - (1) long-term planning horizon: the longer the replacement properties are held, the longer the tax on the gain realized in the ESOP transaction is deferred

- (2) capital gains tax can be completely avoided if replacement properties are held until the death of the taxpayer, under the normal rules allowing for a step-up in basis at death
3. Diversified Portfolio
 - a. easiest strategy
 - b. deferred gain recognized proportionately when qualified replacement properties are sold
4. Floating Rate Notes
 - a. long-term U.S. corporate bonds
 - (1) interest rate: "floating," based on an index (such as LIBOR or commercial paper rate)
 - (2) term: typically 40-60 years
 - (3) call protection for 20 years or more
 - b. "Monetization": borrow against the notes and buy and sell securities in a margin account
 - c. benefits of investing in floating-rate notes
 - (1) can trade securities in margin account on a tax-free basis
 - (2) flexibility: in margin account, alternative investments are available (e.g. partnerships, real estate, life insurance)
 - (3) assets purchased with loans secured by floating-rate notes may be used to fund a family limited partnership (see discussion at Section IX-C below)
5. Gifts
 - a. outright gifts

- b. gifts in trust
- c. GRATs for children

B. Use of Charitable Remainder Trusts

1. Transfer of qualified replacement properties to a charitable remainder trust does not trigger recognition of income
2. Benefits of transfer to charitable trust
 - a. tax on gain from sale to ESOP permanently avoided
 - (1) charitable trust can sell replacement properties and reinvest without incurring tax liability
 - (2) allows for active trading and continued diversification of ESOP sale-proceeds portfolio
 - b. income tax deduction for taxpayer
 - c. trust pays an annual income from earnings on the trust fund for the remaining life of the taxpayer or for the remaining lives of the taxpayer and his or her spouse
 - d. substantial deferred benefit for charitable beneficiary
3. Alternative structure: gift of company stock to charitable trust, followed by sale to ESOP
 - a. tax consequences
 - (1) tax deduction for taxpayer
 - (2) no tax to charitable trust upon sale of stock to ESOP
 - (3) taxpayer avoids estate taxation on transferred stock, while retaining annuity interest

- b. comparison to gift of qualified replacement properties
 - (1) can sell less than a 30-percent interest to the ESOP
 - (2) seller and member of seller's family can participate in the ESOP

C. Combining ESOPs and Family Limited Partnerships

- 1. Set up family limited partnership prior to ESOP transaction and transfer minority interest in family corporation to partnership
 - a. should qualify for minority-interest discount
 - b. additional valuation discount attributable to holding of stock in family limited partnership
 - c. family limited partnership can sell stock to ESOP on a tax-deferred basis and reinvest in a diversified portfolio of qualified replacement properties
 - (1) if the stock is sold in an integrated transaction with a sufficient amount of other stock to provide the ESOP with a controlling interest, stock can be sold to ESOP at a control price (far in excess of the value used for gift tax purposes)
 - (2) stock can be sold to ESOP on an installment basis, taking advantage of current low interest rates
 - (3) some of the family partnership units can be transferred to a generation-skipping trust
 - d. Disadvantages
 - (1) family limited partnership cannot make in-kind distributions of qualified replacement properties without triggering recognition of gain
 - (2) carryover basis for qualified replacement properties

2. Post-ESOP family limited partnership
 - a. proceeds from ESOP sale cannot be transferred directly to a family limited partnership and qualify for the tax deferral because an interest in a partnership does not constitute qualified replacement property
 - b. a transfer of qualified replacement properties to a family limited partnership will trigger recognition of gain
 - c. gain recognition can be avoided if cash from a loan secured by floating-rate notes is used to fund the family limited partnership (or assets purchased with the proceeds from a loan against floating-rate notes may be used)

X. DEALING WITH RETAINED BUSINESS INTEREST

A. Alternatives

1. Hold
2. Sell business or go public in the future
3. Sell more shares to ESOP in future
4. Gifts to children and grandchildren
 - a. outright
 - b. use of trusts

B. Retention of Remaining Business Interests

1. Preserve options
2. Wait and see how designated successors are working out
 - a. if they are able to manage the business, a second-stage ESOP transaction can be implemented in the future
 - b. if successor management does not perform well, company can be sold or another alternative can be pursued

C. Sale of Business or Public Offering

1. Existence of ESOP will not preclude a future sale of the business or public stock offering
2. Proceeds from sale or public offering will have to be shared with ESOP (but in the meantime owner has diversified wealth on a tax-deferred basis)

D. Gifts

1. The period immediately following a leveraged ESOP transaction is an ideal time to make a gift of stock of the plan sponsor
 - a. value of stock depressed by ESOP indebtedness
 - b. value of stock likely to appreciate rapidly as debt is paid down and company grows
2. If owner gives away enough shares to reduce his or her ownership interest below 50 percent, the estate then will be entitled to minority-interest discount for estate tax purposes
3. Example: owner sells 30 percent of stock of family company to ESOP and then makes a gift of 21 percent of the outstanding shares to his or her children
 - a. value of stock depressed by reason of ESOP indebtedness
 - b. in addition, a minority-interest discount can be taken
 - c. retained interest in owner's estate also qualifies for minority-interest discount
4. Use of trusts
 - a. generation-skipping trusts
 - b. GRATs
 - (1) use of a GRAT can be facilitated by causing the company to make an S election
 - (2) annuity interest then can be funded with distributions that would be made by corporation anyway to cover shareholders' tax liabilities

- (3) no tax on share of corporate income allocable to ESOP
- (4) S election cannot be made until year after year in which tax-deferred sale takes place

E. Other Planning Techniques

1. Preferred stock recapitalization
2. Installment sale

SUCCESSION PLANNING EXAMPLE**I. Facts**

- A. Frank owns all of the stock of a corporation
- B. Frank is 70 years old and is ready to retire
- C. Frank's son, Sam, is 40 years old and desires to take over management of the business
- D. Most of Frank's wealth consists of his stock of the corporation
- E. The value of the corporation is approximately \$10 million
- F. The corporation has 100 employees

II. Objectives**A. Frank's Objectives:**

- 1. Develop a plan to enable him to retire with an adequate and assured income
- 2. Diversify his personal wealth
- 3. Transfer control of the business to Sam

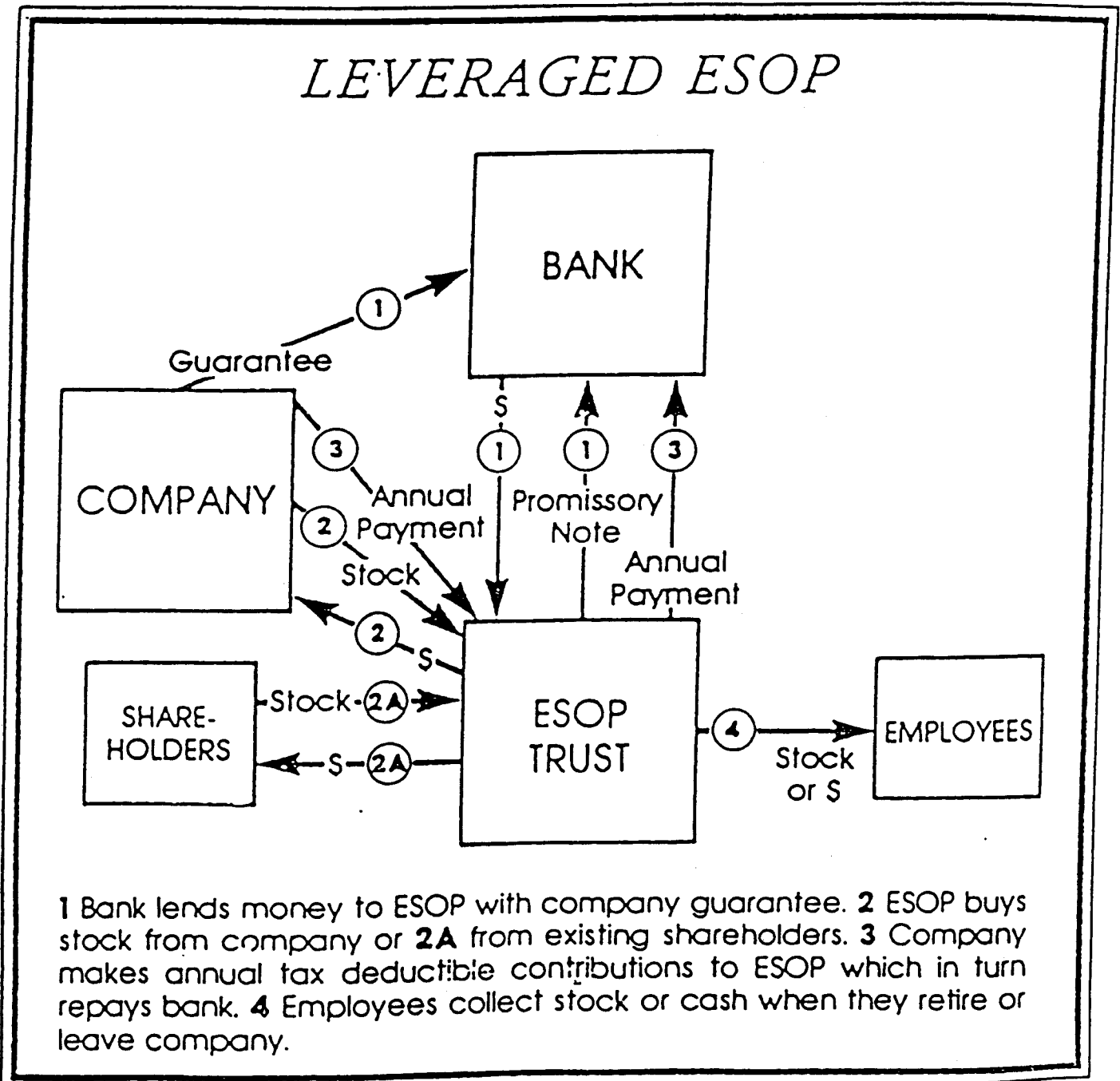
B. Sam's Objectives:

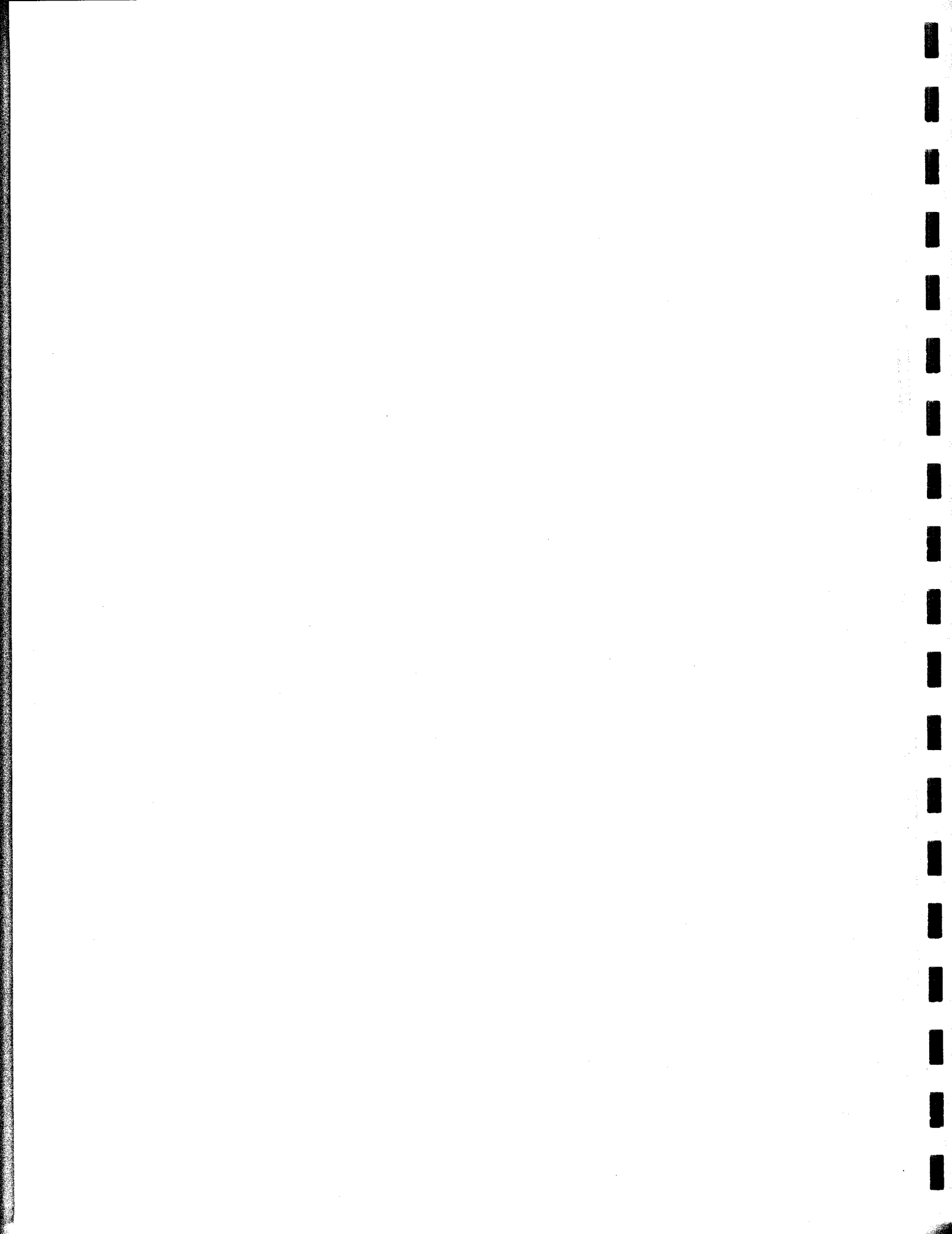
- 1. Take over management of the business
- 2. Assure retirement security for Frank
- 3. Minimize long-term debt burden imposed upon company
- 4. Provide incentive for key employees to help Sam to expand the business

III. Alternatives

- A. Sell the Business
- B. Installment Purchase by Sam
- C. Redeem part or all of Frank's stock
- D. Use an ESOP to Purchase Some or All of Frank's Stock

ILLUSTRATION OF A LEVERAGED ESOP





**FIDUCIARY MANAGEMENT
OF THE CLOSELY HELD BUSINESS**

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FIDUCIARY MANAGEMENT OF THE CLOSELY HELD BUSINESS

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Fiduciary Management of the Closely Held Business

by

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1. INTRODUCTION

1.1 Focus of Materials.

1.1(a) These materials review the rules which establish the basis for fiduciary conduct in the management of closely held businesses. Also, these materials review some of the cases which have interpreted the rules establishing fiduciary conduct. An analysis of specific rules and cases are for purposes of illustration and for determining proper conduct. These materials do not constitute a review of the law of all 50 states.

1.1(b) These materials review defensive planning strategies that may be available to the fiduciary to minimize the risks of fiduciary administration involving the management, control and sale of a closely held business.

1.1(c) Definitions.

1.1(c)(1) A closely held business encompasses a corporation, limited liability company, partnership or a sole proprietorship where the ownership is concentrated in a small group of individuals, typically a family unit.

1.1(c)(2) Fiduciary is the person charged with the responsibility for estate and trust administration, and is sometimes referred to as personal representative, executor and trustee.

1.2 Reasons for Fiduciary Management. There are many reasons for a client to prefer that the business be continued and/or managed by a fiduciary, and it is imperative that the fiduciary understand and document the client's reasons for preferring fiduciary management.

1.2(a) Difficulty in Developing Alternative Plans. The decedent may not have had time to develop alternate arrangements for the profitable disposal of the business. Experience indicates that the bargaining position of a retiring owner is weak, and in many situations it is better to continue the income stream generated by the business compared to a sale of the business at a reduced value and then take the risk a collecting the purchase price. Further, the problems in business valuation, market share limitations and unknown collection ability are real. In this situation the client recognizes the problem, but prefers that someone else deal with it. The client's lack of action and the reasons therefore should be documented.

1.2(b) Quality of Business Opportunity. The decedent may believe that it is desirable to retain the business for the benefit of his/her family, especially if the business is relatively secure, yields a high rate of return, and has competent management. Many businesses today are operated by absentee owners with effective and properly compensated executive employees.

1.3 Reasons for Higher Level of Fiduciary Concern.

1.3(a) Litigation to surcharge a fiduciary has become more common as we Americans become more accustomed to blaming others when a bad result occurs. The reasons for an increase in litigation are stated below.

1.3(a)(1) As estate administration becomes more complex, especially as tax laws constantly change and numerous tax elections become available, the opportunity for error increases.

1.3(a)(2) Beneficiaries expect and demand more from fiduciaries, and the beneficiaries expectations are not always realistic.

1.3(a)(3) There is greater conflict today among a client's beneficiaries who do not share the same family environment - second spouses; his children; her children; our children; the children in the business; the children or in-laws not in the business, etc.

1.3(a)(4) Fiduciary advertising creates a higher level of expectation by the beneficiaries.

1.3(a)(5) Fiduciaries face increasing competition for business, forcing them to be more accommodating to beneficiaries leading to a situation of inability to meet expectations.

1.3(a)(6) Absent local participation by responsible fiduciary management, and or direction by fiduciary executive officer group; either the real managers don't know, don't understand and/or have not created realistic expectations.

1.4 Protections of Fiduciary. A fiduciary is best protected by performing due diligence, as reviewed in this presentation¹ and then documenting in a clear and unequivocal manner the steps taken to protect the various competing interests - beneficiaries and business (creditors and minority shareholders). *The fiduciary must assume that it will be sued for breach of fiduciary responsibilities - start to build your defense before day one!*

1.4(a) Develop Guidelines. The importance of developing guidelines and policies for the fiduciary management of a closely held business is imperative. The more thorough the guidelines the more likely the fiduciary will be protected when the disgruntled beneficiary commences an action against the fiduciary. *A fiduciary should disclose its guidelines to customers and beneficiaries.* In the development of fiduciary guidelines consider the following.

1.4(a)(1) Acceptance of Trust Appointment. The time to determine whether you will serve is before you are appointed. Your guidelines will protect you from a faulty start, and once you are appointed keep in mind that it is very difficult to resign without substantial exposure and great risk. If you are not aware of your appointment before the date of decedent's death, that may be a clue that you may not want to serve as the fiduciary.

¹ See Article 9 of this outline - Fiduciary Business Examination Issues.

1.4(a)(2) Preparation for Operating a Closely Held Business. Is there anyone in the business who has the capacity to assume the responsibility for business management before the business owner's death? Does the fiduciary have the capacity to manage a business or does the instrument and/or law permit delegation? What arrangements may be made for payment of business debts, especially any owed to the fiduciary.

1.4(a)(3) Establish "Control" Guidelines. Determine the level of *control* that the fiduciary will exercise when you take over the business. What will be your level of participation?

1.4(a)(4) Establish Confidentiality Guidelines. As you will be required to disclose all conflicts of interests, what are your fiduciary guidelines for maintaining confidentiality of such things as bank customer records, conflicting trust relationships? *The law in this area is not clear!*

1.4(a)(5) Establish Method of Disclosing Conflicts of Interest. Develop a user friendly letter that explains possible conflicts; for example, that you are a bank, you have a depository relationship, and a trust relationship with various beneficiaries, employees of the company and you have concluded that such relationships are normal and customary and do not, in your careful review, constitute an improper relationship. Further, that if and when a situation occurs which gives rise to a conflict of interest you will then inform all parties. The point is: *take the lead - get out front of the issue!*²

1.4(a)(6) Determine Level of Beneficiary Competence. Do any of the beneficiaries have the ability to manage the business? Are the beneficiaries hostile or is beneficiary's counsel hostile? Do you understand the reasons and the sources for the hostility - is it a *ploy* to establish a basis for removal of the fiduciary?

1.4(b) Document Performance of Due Diligence. The failure to document the extent of the due diligence process and the extent of informing the beneficiary will only serve to confirm the disgruntled beneficiary's claims of mismanagement, breach of fiduciary duty and lead to an ultimate finding of fiduciary misconduct.

1.5 Develop Education Program for Staff & Board Members.

1.5(a) Positives & Negatives of Commercial Department. A professional fiduciary is usually thankful for the commercial side of their business for leads and development of positive bank relationships. However, there is a "curse" that comes with the relationship - the professional fiduciary has a responsibility to teach the commercial side the problems of fiduciary responsibility and conflicts of interest. [Charging the highest rate of interest to your fiduciary controlled business may be a breach of a fiduciary obligation - the potential for losses exceeds the gains.]

1.5(b) Positives & Negatives of Board Members. The members of the fiduciary's Board of Directors and Community Advisory Boards usually get to their position by bringing business to the

² See Exhibit 1 - Letter to Advisory Committee - Fiduciary Stock.

commercial side of the bank's fiduciary's business. These Board members must be taught the fiduciary's rules for playing golf and lunching safely!

2. REVIEW OF FIDUCIARY RESPONSIBILITY RULES - IN GENERAL.

2.1 Develop an Understanding Conflict of Interest Rules.

2.1(a) Conflict of Interest Rules in the Business Setting. In *Meinhard v. Salmon*, 249 N.Y. 458 (1928) Benjamin Cardozo clarified the application of fiduciary conflict rules to business transactions. Salmon had taken a lease on a hotel for 20 years, with an obligation to convert the property to stores and offices. Meinhard agreed to put up half the money, they were to share the profits, and Salmon was to be the sole managing partner. Near the end of the 20 year term, a new owner of the property, who also owned adjoining land, wanted to tear down the existing buildings and construct a larger building. In order to accomplish the project, he negotiated with a company controlled by Salmon. A new \$3 million building was to be erected, and the new rent would be from \$350,000 to \$475,000, as compared with the original \$55,000 rent. Meinhard was not informed of the project until after the new lease had been signed, and he brought suit claiming that he was deprived of the chance to participate in the new opportunity that arose out of the original venture and asserting his right to a share of the new lease. Cardozo's opinion treated the case as presenting a major issue of fiduciary conduct.

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. *Meinhard v. Salmon*, 249 N.Y. 458 at 464, 164 N.E. 545 at 546 (1928).

2.1(b) Conflict of Interest Rules and Lawyer Ethics. For lawyers serving as a fiduciary the lawyer must be mindful of the lawyer conflict rules which prohibit direct conflicts and situations where the lawyer's role would be "materially" limited. See Rules 1.7 and 1.8, and the *Comments* to the Rules of Professional Conduct.³

2.1(c) Conflict of Interest Rules and Fiduciaries. There are various types of potential conflict of interest situations, and different conclusions result from each type of conflict relationship. Defining the nature of the conflict and commenting on such conflicts is an appropriate place to begin this analysis. While it is easy to quote fiduciary responsibilities in the abstract, like "duty of loyalty," "good faith," "duty to deal impartially" and avoidance of "self-dealing" it is often difficult, in the abstract to *see* the potential conflict.

2.1(c)(1) Trustee - Beneficiary Direct Conflict. The typical example is where the trustee's own personal interests conflict with the beneficiary's personal interests. For

³See Exhibit 2 - Conflict Rules for Lawyers

example, a corporate fiduciary wants to purchase property to build a new bank building and the trust estate owns the real property - the bank wants the cheapest price and the trust estate wants the highest price. The trustee's business interests and the beneficiary's interests create a conflict of interest.

2.1(c)(2) *Trustee Beneficiary to Beneficiary Conflict.* The typical example is a multiple trust situation; for example, a marital deduction trust and the by-pass trust. It is not unusual for the marital deduction trust to provide for encroachments on principal for the spouse's benefit with one set of remaindermen. The by-pass trust may also provide for the surviving spouse with a different set of remaindermen. In this situation the trustee has no personal interest in either trust, but the trustee's exercise of the power to encroach upon principal of one trust or the other will adversely impact the amount of the economic benefit for the remainder beneficiaries; hence, the creation of a conflict of interest.

2.1(c)(3) *Trustee Trust to Trust Conflict.* The typical example is where the economic interests of one trust conflict with the economic interests of another trust. For example, trustee while administering trust A enters into a contract with energy company to exploit mineral interests on property owned by trustee of trust A. Now, the energy company wants to exploit mineral interests on adjoining property which is owned by the same trustee of trust B. The contract for trust B is better than the contract for trust A, and the contract for trust B will adversely affect the economic interests of trust A.

2.1(c)(4) Possible Safe Resolutions.

2.1(c)(4)(A) Disclose All Information. As the trustee has a duty to fully disclose to the beneficiary all facts and circumstances which have come to the fiduciary's knowledge, a prudent fiduciary would disclose more rather than less, and solicit advice from the beneficiaries and request their direction.

2.1(c)(4)(B) Recommend that Independent Advice be Obtained. The trustee should recommend that the beneficiaries obtain independent advice, free of the advice or recommendation of the trustee.

2.1(c)(4)(C) Apply to Court for Instructions. Where a question exists as to the fairness of a fiduciary's actions, applying to the court for instructions is the only safe response. See 125 ALR656.

2.2 General Fiduciary Duties. A fiduciary is under a duty to act for the benefit of the estate, and the fiduciary's duties include the following.

2.2(a) *Read the Will and Trust.* The first and most important duty of the trustee is to study and become thoroughly familiar with the provisions of the will or trust instrument, and thereafter follow such provisions.⁴

⁴ See *Loring - A Trustee's Handbook*, Aspen Publishers, Inc. 1998.

2.2(b) The Duty to Administer the Trust. A fiduciary who has accepted the administration of a trust/estate cannot resign without court approval, and/or the consent of all beneficiaries. Further, the fiduciary is responsible to carry out the wishes of its client; not necessarily the wishes of the beneficiaries.

2.2(c) The Duty of Loyalty. A fiduciary must act solely in the interests of the beneficiaries; however, when questions of disclosure of conflicts of interest arise, there are significant problems for the fiduciary.

2.2(c)(1) How do you deal with correspondent bank relationships?

2.2(c)(2) How do you deal with customer account records - are bank customer account records confidential?

2.2(c)(3) How do you deal with the multiple trusts, multiple set of beneficiary issues, and should these relationships disclosed?

2.2(c)(4) Are there inter-locking directorships or bank lending relationships? Consider the following Example:

An examination of the financial statements for The Lincoln Company discloses cash deposits of \$4 million in the bank fiduciary's commercial department, and Company loans from the bank fiduciary of \$5 million. Ask:

Is there a interest rate differential?

Is all the borrowing necessary?

Should the fiduciary make arrangements to terminate the lending relationship?

2.2(c)(5) Are there interlocking ownership of stock? Have you checked other trust relationships?

2.2(c)(6) Are there creditors of the business that affect your fiduciary management of the business? What about competing business relationships - who does the fiduciary do business with?

2.2(c)(7) If a lawyer serves as the fiduciary then the lawyer fiduciary must also learn to deal with lawyer ethics' conflict rules.

2.2(d) The Duty Not to Delegate. Generally, discretionary acts may not be delegated, only pure ministerial acts may be delegated. For obvious reasons, a fiduciary may not wish to take an active part in the conduct of the business; however, as the decedent placed great faith in the fiduciary's talents and capabilities by charging the fiduciary with the care of the property, it is generally held that the trustee must personally perform those acts and duties which require the exercise of discretion.

2.2(d)(1) Should the fiduciary personally undertake the day-to-day transactions of the business or may the fiduciary employ a manager, and in this event, what degree of control must the fiduciary place over the manager?

2.2(d)(2) Some of the circumstances that have been considered by the courts to determine the "reasonableness" of the delegation of authority include the following.

2.2(d)(2)(A) The provisions of the instrument - broad or narrow?

2.2(d)(2)(B) Distance of the fiduciary to the situs of the business?

2.2(d)(2)(C) Decedent's former practices in the management of the business?

2.2(d)(2)(D) Methods currently employed by competitors in operating similar businesses?

2.2(d)(2)(E) The fiduciary's possession of the requisite skill for managing the type of business?

2.2(d)(3) Some states have enacted statutes that permit the delegation of certain powers and duties to another trustee.

2.2(e) The Duty to Keep and Render Accounts. The fiduciary must maintain clear records of receipts, disbursements, gains and losses. The fiduciary must make reports to the beneficiaries.

2.2(f) The Duty to Exercise Reasonable Care and Skill. A fiduciary must exercise the care and skill of a prudent person in administering an estate/trust. The fiduciary's primary goal is to preserve the assets entrusted to the fiduciary.

2.2(g) The Duty to Take and Keep *Control* of Trust Assets.

2.2(g)(1) A fiduciary must take possession of and maintain control of each trust asset. How is that to be accomplished in a closely held business? Court and commentaries advise that the fiduciary should take "*control*," however, there is very little guidance as to what is meant by this word - *control*. Does it mean being a part of management, being a board member, showing up at the place of business each day, receiving and reviewing business management reports?

2.2(g)(2) Some courts have indicated that they would attribute control to the estate when the fiduciary exercises control and votes the stock.

2.2(h) The Duty to Preserve Trust Property. A fiduciary has a duty to apply the skill of a person of ordinary prudence in preserving the entire trust estate, and this may compel the fiduciary to sell the closely held business interest. The attitude is based upon a belief that normal fluctuations of business fortune are so unpredictable that a fiduciary should not risk trust funds in such an

investment, that the knowledge and skill required to operate a business are beyond the expected capacity of the average fiduciary, and that continuing a decedent's business is fundamentally at odds with the other obligations and duties of the fiduciary.

2.2(i) The Duty to Enforce Claims. A fiduciary has a duty to take reasonable steps to collect claims of the trust.

2.2(j) The Duty to Keep Trust Property Separate. A fiduciary must keep estate property separate from its own property, and the fiduciary must designate estate property as property of the estate.

2.2(k) The Duty to Make Trust Property Productive. A fiduciary has a duty to invest trust funds so they will be productive of income. Also, note that property held in a marital deduction trust must permit the spouse to make the property productive of income or convert it within a reasonable time. See Treasury Regulation §20.2056(b)(7) and PLR 8931005. What do you do when the closely held business corporation does not pay dividends?

2.2(l) The Duty to Be Impartial With Beneficiaries. Any discretion that a fiduciary exercises in favor of one beneficiary over another must be based upon the provisions of the governing instrument. Consider the following problems.

2.2(l)(1) A spouse who elects to take against the Will and claims the marital share provided by statute. Is the spouse a beneficiary for purposes of fiduciary responsibility?

2.2(l)(2) Predeceased husband's trust gives surviving spouse a life estate with remainder to children of his first marriage. Trustee has broad discretionary powers to spray income and principal for use and benefit of spouse. Surviving spouse creates her own revocable living trust and puts the bulk of her assets into the trust, giving the trustee broad discretionary powers. At spouse's death the remaining trust assets pass to her children from her first marriage. During surviving spouse's life the trustee makes distributions from predeceased husband's trust for surviving spouse's benefit, and at her death the husband's children attack the fiduciary for making such distributions.

2.3 Prudent Investor Rule.

2.3(a) General Rule of Section 227 of the *Restatement (Third) of Trusts* provides:

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to

diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

- (1) conform to fundamental fiduciary duties of loyalty and impartiality;
- (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
- (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

(d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.

2.3(b) Duty with Respect to Original Investments. The prudent investor rule includes a separate section with respect to the handling of original investments.

2.3(b)(1) Section 229 of the *Restatement (Third) of Trusts* provides:

[t]he trustee is under a duty to the beneficiaries, within a reasonable time after the creation of the trust, to review the contents of the trust estate and to make and implement decisions concerning the retention and disposition of original investments in order to conform to the requirements of §§ 227 and 228.

2.3(b)(2) In a discussion of the Prudent Investor Rule on Section 229, the following comments were made.

“A general authorization to the trustee to retain original investments is not a safe harbor and does not absolve the trustee from undertaking the procedure described in section 229. Similarly, language in the governing instrument that authorizes the retention of a specific asset, such as a family business, does not excuse the trustee from discharging the duties described in section 229 and, by reference, sections 227 and 228, including duties of care, caution, diversification, and impartiality. However, subject to the trustee's duty of impartiality and consistent with the purposes of the trust, the trustee is permitted to consider any special relationship between particular property and an objective of the grantor.”⁵

2.3(c) Effect of “Sole Discretion.” A reference in an instrument to a fiduciary acting in its “sole discretion” means that in the absence of bad faith or gross negligence the fiduciary cannot be held liable for the exercise or non-exercise of fiduciary powers. The comments of the *Restatement of Trusts* provides, in part, the following:

The mere fact that the trustee is given discretion does not authorize him to act beyond the

⁵ Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the “Give-Me-Five” Unitrust*, 23 Real Property, Probate and Trust Journal 1, at page 20 (Spring 1998).

bounds of a reasonable judgment. The settlor may, however, manifest an intention that the trustee's judgment need not be exercised reasonably, even where there is standard by which the reasonableness of the trustee's conduct can be judged. . . . The mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court, so long as the trustee acts in a state of mind not contemplated by the settlor. Thus, the trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment.

2.4 Legislative Response to Prudent Rules. Numerous states have enacted various provisions to protect and guide the fiduciary in the application of the prudent investor rules, and many of these provisions will have applicability to protect the fiduciary in the management of the closely held business.

2.4(a) Avoidance of Liability Provisions. Some states permit a fiduciary to be relieved of responsibility for a breach of trust if an appropriate provision is in the instrument except in instances of actions constituting abuse.

2.4(b) Delegation of Management Functions. Some states have enacted provisions that permit a fiduciary to delegate investment and management functions.

2.4(c) Reliance On and Approval of Beneficiaries or Advisors. Some states have enacted provisions that will permit the fiduciary to protect themselves if they refer questions of fiduciary administration to the beneficiaries or an advisory committee.

2.4(d) California - CA Probate §16401 - Liability for acts of agents

(a) Except as provided in subdivision (b), the trustee is not liable to the beneficiary for the acts or omissions of an agent.

(b) Under any of the circumstances described in this subdivision, the trustee is liable to the beneficiary for an act or omission of an agent employed by the trustee in the administration of the trust that would be a breach of the trust if committed by the trustee:

(1) Where the trustee directs the act of the agent.

(2) Where the trustee delegates to the agent the authority to perform an act that the trustee is under a duty not to delegate.

(3) Where the trustee does not use reasonable prudence in the selection of the agent or the retention of the agent selected by the trustee.

(4) Where the trustee does not periodically review the agent's overall performance and compliance with the terms of the delegation.

(5) Where the trustee conceals the act of the agent.

(6) Where the trustee neglects to take reasonable steps to compel the agent to redress the wrong in a case where the trustee knows of the agent's acts or omissions.

(c) The liability of a trustee for acts or omissions of agents that occurred before July 1, 1987, is governed by prior law and not by this section.

2.4(e) Colorado - § 15-1-307

Whenever an instrument under which a fiduciary is acting reserves to the settler or vests in an advisory or investment committee or in any other person or persons including one or more other fiduciaries, to the exclusion of the fiduciary or to the exclusion of one or more of several fiduciaries, authority to direct the making or retention of any investment, the excluded fiduciary or fiduciaries shall not be liable, either individually or as a fiduciary, for any loss resulting from the making or retention of any investment pursuant to such direction.

2.4(f) Delaware - § 3313

(a) Where 1 or more persons are given authority by the terms of a governing instrument to direct, consent to, or disapprove a fiduciary's investment decisions, or proposed investment decisions, such persons shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise.

(b) If a governing instrument provides that a fiduciary is to make investment decisions upon the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful misconduct, the fiduciary shall not be liable for any loss resulting from any such act.

(c) If a governing instrument provides that a fiduciary is to make investment decisions with the consent of an adviser, then except in cases of wilful misconduct or gross negligence, the fiduciary shall not be liable for any loss resulting from any act taken or omitted as the result of such adviser's not providing such consent after being requested by the fiduciary to do so.

(d) For purposes of this section "investment decision" means with respect to any investment, the retention, purchases, sale, exchange, tender or other transactions affecting the ownership thereof.

2.4(g) Florida - § 518.112

(1) A fiduciary may delegate any part or all of the investment functions, with regard to acts constituting investment functions that a prudent investor of comparable skills might delegate under the circumstances, to an investment agent as provided in subsection (3), if the fiduciary exercises reasonable care, judgment, and caution in selecting the investment agent, in establishing the scope and specific terms of any delegation, and in reviewing periodically the agent's actions in order to monitor overall performance and compliance with the scope and specific terms of the delegation.

...

(3) A fiduciary, may delegate investment functions to an investment agent under subsection (1) or subsection (2), if:

...

(b) In the case of a trust or estate, the fiduciary has given written notice, of its intention to begin delegating investment functions under this section, to all beneficiaries, or their legal representative, eligible to receive distributions from the trust or estate within 30 days of the delegation unless such notice is waived by the eligible beneficiaries entitled to receive such notice. This notice shall thereafter, until or unless the beneficiaries eligible to receive income from the trust or distributions from the estate at the time are notified to the contrary, authorize the trustee or legal representative to delegate investment functions pursuant to this subsection. This discretion to revoke the delegation does not imply under subsection (2) any continuing obligation to review the agent's actions.

...

(4) If all requirements of subsection (3) are satisfied, the fiduciary shall not be responsible otherwise for the investment decisions nor actions or omissions of the investment agent to which the investment functions are delegated.

2.4(h) Illinois - 760 ILCS 5/4.09

To appoint attorneys, auditors, financial advisers and other agents and to pay reasonable compensation to such appointees. If the trustee uses reasonable care, skill, and caution in the selection of the agent, the trustee may rely upon the advice or recommendation of the agent without further investigation and, except as may otherwise be provided in subsection (b) Section 5.1 with respect to investment agents, shall have no responsibility for actions taken or omitted upon the advice or recommendation of the agent.

2.4(i) Kentucky - KRS 287.275

(1) When an instrument, under which a bank empowered to act as a fiduciary or trust company acts, reserves in the grantor, or vests in an advisory or investment committee or in one (1) or more other persons, any power, including, but not limited to, the authority to direct the acquisition, disposition, or retention of any investment or the power to authorize any act that the bank or trust company may propose, the fiduciary is not liable, either individually or as a fiduciary, for either of the following:

(a) Any loss that results from compliance with an authorized direction of the grantor, committee, person, or persons; or

(b) Any loss that results from a failure to take any action proposed by the bank or trust company that requires the prior authorization of the grantor, committee, person, or persons if the bank or trust company timely sought but failed to obtain that authorization.

(2) The bank or trust company referred to in subsection (1) of this section is relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the grantor, an advisory or investment committee, or one (1) or more other persons have authority to direct the acquisition, disposition, or retention of any investment.

(3) This section shall not apply to the extent that the instrument, under which the bank or trust company referred to in subsection (1) of this section acts, contains provisions that are inconsistent with this section.

2.4(j) Texas - § 114.003

If a trust instrument reserves or vests authority in any person to the exclusion of the trustee, including the settlor, an advisory or investment committee, or one or more cotrustees, to direct the making or retention of an investment or to perform any other act in the management or administration of the trust, the excluded trustee or cotrustees is not liable for a loss resulting from the exercise of the authority in regard to the investments, management, or administration of the trust.

3. PLANNING BEFORE BUSINESS OWNER'S DEATH.

3.1 Develop Understanding With Settlor - Client.

3.1(a) Document Settlor's Objectives. As the trustee is responsible to administer the trust pursuant to the settlor's desires, the designated fiduciary should carefully document, in writing, the settlor's plans and desires. The fiduciary should consider the following specific actions.

3.1(a)(1) Determine Settlor's Role in Business. What is the nature of the settlor's interest, and can the business continue without him/her. What is competency of various levels of management? Should advance action be taken to dispose of business or should efforts be made to continue to the business until the settlor's death, and then liquidated.

3.1(a)(2) Determine Basis for Sale of Business. If the business is to be sold, or should be sold, what recommendations for action does the client have; specifically, who should the fiduciary contact to sell the business; who would be probable buyers, who would be good advisors?

3.1(a)(3) Determine Sufficiency of Cash. A review of probable cash requirements is essential. Consider extension of time to pay estate taxes under Code §6166, and life insurance opportunities - especially second-to-die policies.

3.1(a)(4) Confirm Authority of Trustee. Confirm with the estate planning client the risks and costs of maintaining a business under a trust, and that estate planning documents grant sufficient authority and have settlor prepare private letters, memorandums that document settlor's intent.

3.1(a)(5) Confirm Level of Fiduciary Compensation. The time to obtain an approval and contract agreement for level of compensation is at the beginning, before actions have started - not later when no one is pleased with results obtained.

3.1(b) Coordinate Planning With Family Members. If at all possible, attempt to participate in a meeting with the adult family members to review the general nature of the client's estate plan and his objectives. Attempt to ensure that the beneficiaries hear, first hand, their parent's intent, desires, and objectives. Attempt to resolve conflicts now, with your client's effective participation.

3.2 Develop Mechanism for Fiduciary Oversight.⁶

3.2(a) Consider Use of Advisory Committee. The use of an advisory committee to participate in the review and supervision of the client's estate and business interests will properly protect the trustee's actions. If the fiduciary submits reports and recommendations to the advisory committee for direction, and when the fiduciary acts pursuant to the directions of the committee the fiduciary should receive "full acquittance." If state law does not provide for giving the fiduciary "full acquittance," then make sure it gets into the will or trust.

3.2(b) Consider Co-Fiduciary. In the event of two or more fiduciaries, then determine how differences of opinion will be resolved and who is to have primary responsibility for the business;

⁶ Lack of planning to properly cover the fiduciary's legal interests is a fatal mistake, as documented in numerous cases.

that is, retention, sale, etc. Some states specifically permit a delegation of a power to another trustee. For example, see Wash. Rev. Code §30.99.030(3).

3.2(c) Consider Appointment of Agents or Independent Fiduciary. Allowing the fiduciary to delegate complex responsibility issues or develop basis of joint review will usually only serve to protect the fiduciary. Acting alone may only create an opportunity for the fiduciary to serve as the “target” in a litigation gallery.

3.3 Legal Authority for Continuation of Business. Numerous states have specific provisions denying a fiduciary the right to carry on a decedent’s business. In these states it is possible to petition the court to continue the business. An examination of state law of the decedent’s domicile is imperative, especially in those situations where a change of domicile is contemplated.

3.4 Shareholder Restriction Agreements.

3.4(a) The law does not favor restrictive provisions of a shareholder or corporate stock restriction agreement.

3.4(a)(1) The Uniform Commercial Code, Section 8-204, generally provides that restrictions on the transfer of stock are invalid unless the restrictions are stated “conspicuously” on the face of the stock certificate.⁷ *Check the stock certificate!*

3.4(a)(2) Are the provisions of the agreement intended to restrict the testamentary transfer of the owner’s interest? The general rule of construction is that unless a restriction is specific, it will not be applied to a transfer of securities by operation of law - and that includes “transfers” resulting from death. In one case a restriction on “transfer or sale” was held inapplicable to a bequest of stock.⁸ The greater weight of authority is to the effect that if the restriction is reasonable and the stock has been accepted with knowledge of it, particularly a provision giving a close corporation or its stockholders an option or opportunity to purchase the stock, the agreement is valid. However, many states have strictly construed stock restriction agreements to deny the restrictive effect of such agreements.⁹

3.4(b) It is appropriate to consider various funding mechanisms, terms of payment, life

⁷ UCC §8-204. Effect of issuer’s restrictions on transfer.

A restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless:

- (1) The security is certificated and the restriction is noted conspicuously on the security certificate; or
- (2) The security is uncertificated and the registered owner has been notified of the restriction.

⁸ See *Taylor’s Adm’r v. Taylor*, 301 S.W.2d 579 (Ky. 1957).

⁹ See *Elson v. Security State Bank of Allerton*, 246 Iowa 601, 67 N.W.2d 525; *Guaranty Laundry Co. v. Pulliam*, 198 Okl. 667, 181 P.2d 1007; *Wentworth v. Russell State Bank*, 167 Kan. 246, 205 P.2d 972.

insurance, and the methodology for determining value.

3.4(c) Review affect of bargain sales under the contemplated stock restriction agreement because a "bargain sale" will not bind the IRS. You do not want to sell at a low price, and have the IRS determine a high price for imposing taxes - you wind up with no money to pay taxes.

3.4(d) In *Matter of Galewitz*, 5 N.Y. 2d 721, 152 N.E.2d 666 (N.Y. 1958), the decedent and his son entered into a contract providing an option in the survivor to have an option to purchase all the shares of the deceased at a price determined by a court appointed accountant, with the option price to be determined at date of death. The executors retained title until the purchase price for the shares were fully paid. The son was entitled to profits occurring after decedent's death where delay resulted from litigation over validity of contract.

3.4(e) In *Isaacson v. Beau Label Corp.*, 461 N.Y.S.2d 420, 93 A.D.2d 880 (N.Y. 1983) the surviving spouse claimed that the shareholders' agreement was illegal and unenforceable because the price under the agreement would, in the spouse's view, constitute inadequate consideration in exchange for her mandatory offer of sale of the decedent's stock to the corporation. The Court held that the fact that a buy-sell provision of a shareholders' agreement can be a testamentary substitute does not create a right to challenge the adequacy of consideration under such agreement. Absent allegations of fraud, duress or undue influence, shareholder agreement executed by deceased husband were valid and enforceable against the surviving spouse.

3.5 One Form of Suggested Language for Will & Trust.¹⁰

3.5(a) Continuation of Business.

My fiduciary (personal representative/trustee) may continue any business of mine for such period and upon such terms as my fiduciary determines, including the power to (a) invest additional sums in the business oven to the extent that the trust may be invested largely or entirely in the business without liability for loss resulting from lack of diversification, (b) to act as or to select other persons (including any beneficiary) to act as directors, officers or other employees of such business, to be compensated without regard to such person being a beneficiary and (c) to make such other arrangements as the trustee determines.

3.5(b) Authorization to Serve on Board.

My fiduciary may serve as a director of XYZ corporation or may designate another to serve as director, and to receive (or permit such other person to receive) director's fees that will be in addition to its compensation as fiduciary of my estate or trust, and to pay obtain and pay out of principal or income the cost of liability insurance for any such director.

¹⁰ The suggested form provisions are adopted from the *Trust & Will Provisions of Practical Drafting*, published by the U.S. Trust Company of New York (1998).

3.5(c) Retention of Experts.

My fiduciary may retain any pay from my estate investment bankers, appraisers, accountants, legal counsel and others when my fiduciary determines that such services are desirable in connection with the affairs of XYZ corporation.

3.5(d) Section 303 Redemption. [*Does this provision imply mandatory use of §303, which would adversely affect ability to extend payment of estate taxes under §6166?*]

If my estate includes the stock of any corporation which, together with other stock of the same or a different corporation includible in my estate that satisfies the requirements of Internal Revenue Code Section 303, I direct that any property received by my fiduciary from the corporation in connection with a redemption of the stock shall not be used to satisfy the provisions of any marital and charitable bequests.

3.5(e) Negating Duty to Test Market.

If my fiduciary determines to dispose of the securities of the XYZ corporation, it will be under no obligation to solicit offers from third parties and, based solely upon appraisal of a qualified appraiser, my fiduciary may sell the securities to another shareholder (including a trust beneficiary) or to the Corporation upon such terms as it in its sole discretion deems reasonable.

3.5(f) Approval of Conflicts of Interest.

In the exercise of their powers, one or more of my fiduciaries may have conflicting fiduciary and individual interests and I direct that such interests will not be a basis for any fiduciary not participating in the exercise of such fiduciary's powers as to my business interests.

3.6 An Alternate Form of Language.¹¹

To retain and continue the operation of any business, in any form, for such period, or to dispose of the business at such time and upon such terms, as shall seem advisable, to invest additional property in the business, even to the extent the property administrable under this instrument may be invested largely or entirely in the business, to act as, or to select any one or more persons (including any fiduciary, or officer of the business, and any beneficiary) to act as, directors, officers, and employees of the business, to pay compensation for so acting without regard to whether the payee is a fiduciary (or an officer of the business) or a beneficiary and to make such other arrangements with respect to the business as shall seem advisable.

¹¹ Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, 23 Real Property, Probate and Trust Journal 1, at page 22 (Spring 1998).

3.7 Gilman Trust Power Provisions.¹²

3.7(a) *Closely Held Business Powers.* To retain, and to purchase and retain, any business interest transferred to the Trustee, as shareholder, security holder, creditor, partner or otherwise, for any period of time whatsoever, even though the interest may constitute all or a large portion of the Trust principal; to comply with the provisions of any agreement restricting transfer of the interest; to participate in the conduct of the related business or rely upon others to do so, and to take or delegate to others discretionary power to take any action with respect to its management and affairs which an individual could take as outright owner of the business or the business interest, including the voting of stock (by separate trust or otherwise regardless of whether that separate trust will extend for a term within or beyond the term of the Trust) and the determination of all questions of policy; to execute and amend partnership agreements; to participate in any incorporation, reorganization, merger consolidation, sale of assets, recapitalization, liquidation or dissolution of the business, or any change in its nature, or in any buy-sell, stock restriction, or stock redemption agreements; to invest in additional stock or securities of, or make secured, unsecured, or subordinated loans to, the business with trust funds; to take all appropriate actions to prevent, identify, or respond to actual or threatened violations of any environmental law or regulation thereunder; to elect or employ with compensation, as directors, officers, employees, or agents of the business, any persons, including a Trustee of any trust held under this instrument, or any director, officer, employee, or agent of a Corporate Trustee of any trust held under this instrument, without adversely affecting the compensation to which that Trustee would otherwise be entitled; to rely upon reports of certified public accountants as to the operations and financial condition of the business, without independent investigation; to deal with and act for the business in any capacity (including in the case of a Corporate Trustee any banking or trust capacity and the loaning of money out of the Trustee's own funds) and to be compensated therefor; and to sell or liquidate the business or any interest in the business.

3.7(b) *"S" Corporation Stock.* To appoint the stock of a corporation which is taxed as an "S" corporation for Federal income tax purposes to such person or persons who are beneficiaries of any trust created under this instrument in such interests and proportions, including an appointment in trust for any such person or persons as long as such trust qualifies as an eligible shareholder of an "S" corporation so as to allow the corporation to maintain its income tax status as an "S" corporation. Any separate trust will have provisions identical to the trust in which such stock would otherwise be held, except that: (i) all of the income of such trust will be distributed to the beneficiary of such trust; (ii) no distributions of principal from such trust may be made to any individual other than the beneficiary during the beneficiary's lifetime; (iii) during the beneficiary's lifetime, no one will have the power to appoint any portion of the Trust Property to anyone other than the beneficiary; and (iv) in the event that any other requirements are imposed on a trust in order to make such trust eligible for treatment as a Qualified Subchapter S Trust, such separate trust will be modified to meet such other requirements. In addition, the Trustee is authorized to make any elections or give any consents which are required to achieve or maintain S corporation status for stock to be held in trust

¹² I do not remember the original sources of these provisions, however, to the best of my recollection they have been adopted from various forms, and have been revised over the last 25 years based upon some good and bad experiences.

pursuant to this instrument and may also enter into such stock purchase, voting or other agreements as the Trustee determines necessary or appropriate for the protection of the trust, the shareholders of the S corporation and/or the deemed shareholders of the S corporation.

3.7(c) Conflict of Interest. To engage in transactions with the Trustee in an individual capacity, or with any business entity in which the Trustee is employed or has an interest, including a sale, purchase, or loan of property. In no event will any such transaction be treated as a conflict of interest or similar prohibited act unless it is proved that the Trustee was clearly motivated by and acted in its own self-interest, knowing that such action was not in the interests of the Trust.

3.7(d) Restrictions on Sale of Business Interests. Notwithstanding any provision in this instrument to the contrary, the Trustee will not sell or dispose of any of my business interests in XXX, AAA, DDD, whether in the form of a shareholder interest in a corporation, partnership interest in a partnership, or a membership interest in a limited liability company or any successor, subsidiary, or any affiliated business organization therewith without the prior written consent of the Advisory Committee. Further, prior to the voting of any of my interests in any of such business organizations or of any successor, subsidiary, or affiliated company, the Trustee will consult with and be bound by the decision of the Advisory Committee in regard thereto. The Trustee will be relieved from all liability resulting from actions taken pursuant thereto. As the Trustee may be retaining such business interest as an asset of this Trust pursuant to the direction of the Advisory Committee, the Trustee will be relieved of any responsibility for following the direction of the Advisory Committee. It is expected that the Trustee's fees will be adjusted to reflect its "custodial" relationship with regards to such business organization.

3.8 Suggested Advisory Committee Provision. The advantages of using advisory committees to the fiduciary can be very helpful, and the following provisions and discussion may be helpful to a client and fiduciary's understanding of their relationships. Many states have adopted provisions that protect a fiduciary if the fiduciary's actions have been approved by the beneficiaries or advisory committee.

3.8(a) Powers. The Committee, acting through a majority of its members, has the powers that have been conferred upon it at various points throughout this instrument and has the following specific discretionary powers and authority:

3.8(a)(1) To consult with the Trustee with respect to general investment policy.

3.8(a)(2) To consult with the Trustee regarding discretionary encroachments upon principal.

3.8(a)(3) To direct the Trustee with regard to the specific selection of assets for purchase, sale, retention, and transfer if the Committee deems it necessary or appropriate to do so. The Advisory Committee may employ and designate other persons to recommend purchases and sales, in which event the Committee will notify the Trustee in writing of such appointment. Until notified in writing that such appointment has been revoked, the Trustee will have no power over such investments of the Trust other than that of a Custodian. In this event, the Trustee and Committee may consider a reduction in the amount of the Trustee's

fees.

3.8(b) To direct the Trustee with regard to the selection, retention and evaluation of policies of life insurance, and absent the specific direction of the Advisory Committee, the Trustee will have no authority or obligation to purchase, exchange or surrender any life insurance policy which is held as an asset of this Trust. The Trustee has no responsibility to undertake any review or to provide advice regarding any life insurance policy nor will the Trustee be responsible for the investment performance, or lack thereof, by any issuer of any life insurance policy held as an asset of this Trust.

3.8(c) To remove the Trustee at any time and appoint a successor independent Trustee. In case the Committee terminates or ceases to exist, then a majority of the beneficiaries may remove the Trustee and appoint a successor Trustee, such Trustee must be "independent" within the meaning of Internal Revenue Code Section 674(c).

3.8(d) To appoint an Investment Advisor to advise and direct the Trustee regarding the investment of trust assets. The Committee may remove the Investment Advisor at any time and appoint a successor. In the event that no successor is appointed, or the Investment Advisor fails to serve as such, then the Trustee will again become responsible for the investment of Trust assets. The Committee will determine the amount of the Investment Advisor's fee and inform the Trustee of the fee determination, and the fee will be payable from the Trust estate as an administration expense. The Trustee will be relieved from liability resulting from actions taken pursuant to the directions of the Investment Advisor. The appointment of an Investment Advisor will not in any way limit or otherwise affect the discretion or responsibility given to the Trustee with regard to the use and enjoyment of the Trust estate. During the period an Investment Advisor is acting hereunder, the Trustee will act as a Custodial Trustee concerning the Trust Property and will have no investment responsibility for the Trust assets. In this event, the Trustee and Committee may consider a reduction in the amount of the Trustee's fees.

3.8(e) The Trustee may reimburse members of the Committee for costs and expenses incurred in their role as advisors. Any expenses paid will be considered a cost of the administration of the Trust concerned. Further, members of the Committee may be compensated for their services as such.

3.8(f) No member of the Committee will at any time be held liable for any action taken or not taken (including any action taken or not taken in exercising a business judgment and/or in making payments to or for the benefit of any beneficiary), or for any loss or depreciation of value of any property in any trust created hereby, whether due to an error of judgment or otherwise, where such member of the Committee has not acted in bad faith. In the case of the delegation of any discretionary power hereunder, the member of the Committee so delegating will not be liable for the acts, omissions or defaults of the agents, servants or employees to whom the delegation is made. The member of the Committee will be entitled to recover from the Trust estate (but only to the extent of the assets therein at the time a request for such recovery is made) for any and all losses, damages, expenses (including attorney fees), claims, lawsuits or judgments incurred or suffered by such member of the Committee, whether individually or in a fiduciary capacity by virtue of, or in any way arising from, any action taken or not taken by, or allegedly taken or not taken by such member of the Committee; except that no member of the Committee will be entitled to recover any such amount if it is established to a certainty by a final judgment of a court of competent jurisdiction that such

person was acting in bad faith at such time.

3.8(g) Members of the Committee will at all times act as, and have the obligations of, fiduciaries. If the Committee fails to respond to requests for advice from the Trustee or if the Committee is divided and is unable to reach a decision, then the Trustee will act to protect the interests of the beneficiaries as the Trustee deems best in the exercise of its independent fiduciary discretion. Further, no party dealing with the Trustee has any duty to see if the Trustee is acting within the scope of the Trustee's authority. The Trustee will incur no liability when it acts at the direction of the Committee or the Committee's designee. Further, the Trustee will be held harmless from any actions taken as a direction from the Committee or the Committee's designee.

3.9 Relationship of Advisory Committee and Fiduciary. In order to resolve or remove any doubt as to the relationship of the fiduciary and the advisory committee the following provision is suggested for careful consideration.

It is my desire that the Trustee and the Advisory Committee work together to carry out the terms and provisions of the Trust(s) created under this instrument. I have given my Trustee full and complete powers for the administration of the Trust(s) that I created under this instrument; provided, however, such empowerment provisions are subject to the review and approval of the Advisory Committee as the Committee performs its oversight functions. It is my desire that my Trustee develop a plan for the administration of the Trust(s) created hereunder, and to submit such plan(s) to the Advisory Committee for its review and approval.

4. PLANNING AFTER DECEDENT'S DEATH.

4.1 General. The fiduciary should determine the nature of the decedent's interest in the business and the most immediate steps to protect the beneficiaries interests. General rules of fiduciary standards need to be reviewed and then observed. The fiduciary should have a meeting with all persons who will have responsibility for fiduciary administration, and the review of actions should be confirmed in writing.

4.1(a) Commence Examination of Business.¹³

4.1(b) Solicit Accountant's Recommendations.¹⁴

4.1(c) Acts of Prior Fiduciary. Was decedent's affairs managed by a guardian or other fiduciary and do the actions of the prior fiduciary need to be examined?

4.1(d) Fiduciary Authority to Operate Business. Absent express authority, a fiduciary may not continue a business beyond a reasonable period that is necessary to dispose of the business in a reasonable manner, and diversify an estate's investments. Authority may be derived from the governing instrument, statute, consent of all interested parties, court order, or may arise by

¹³See Article 8 of this outline - Fiduciary Business Examination Issues.

¹⁴See Exhibit 5 - Accountant's Review.

implication.

4.1(e) Legality of Business Operations. Are the major aspects of the decedent's business operations in conformity with law? Is the business qualified to do business in the states in which it conducts its business operations?

4.1(f) Confirm Level of Fiduciary Compensation. The understanding should be in writing, and noticed to adult beneficiaries and approved by probate court.

4.1(g) Prudent Investor Rule. A fiduciary charged with continuing a business must conduct itself as would a reasonably prudent businessman engaged in a similar operation. See the above discussion of the Prudent Investor Rule.

4.1(h) Delegation. A fiduciary may not delegate certain acts and duties to another except where permitted by law or the instrument, and it is questionable whether such provisions would be effective for protecting the fiduciary.

4.1(i) Control. The fiduciary should exercise and take control over the decedent's assets. The foremost duty of a fiduciary is the obligation to preserve the assets of the estate/trust. However, often it is questionable how *control* is achieved when the decedent owns less than all of the business' ownership interests.

4.1(i)(1) Can the business survive during the transition? Is there any one who can continue the business as it currently exists?

4.1(i)(2) The fiduciary should attempt to stabilize the business and appoint appropriate review mechanisms.

4.1(i)(3) How should or can the fiduciary take over control of the Board of Directors; should the fiduciary attempt to replace the entire Board of Directors? Should efforts be made to do away with the Board and have direct shareholder voting on all issues? Do the Articles of Incorporation or state law require cumulative voting for directors?

4.1(i)(4) The fiduciary should exercise financial control over the business.

4.1(j) Form of Business. If the decedent's business is in the form other than a corporation or limited liability company, then serious action needs to occur to exam the one issue of personal liability to the fiduciary and possible risk to the decedent's entire estate. It may be appropriate to organize the decedent's business in the form of a corporation or a limited liability company.

4.1(k) Tax Structure of Business. Is the business taxed as "C" or "S"? Should "S" be elected or terminated.

4.2 Control of Business Issues. The dual roles of the trustee creates conflict between the duties of the trustee to the beneficiary and to the corporation which can lead to self-dealing and other forms of abuse.

4.2(a) Control Positions.¹⁵ The position of control arises by the exercise of the rights attendant to the equity or voting interest of the company or in the selection of the trustee to a director or officer position with the company. It may also entail the use of power over the company's equity or voting interests to elect persons associated with the trustee.

4.2(b) Self-Dealing & Conflict of Interests. As expressed time and time again, a fiduciary must avoid self-dealing and conflict of interests; however, in many circumstances, such issues are ultimately resolved on an after the fact basis.

4.2(b)(1) The situation is created by the decedent (settlor) not by the trustee; if the decedent places the fiduciary in such position then some form of assumption must be made that the decedent knew the logical consequences which would result from such action.

4.2(b)(2) A conflict exists between the duty owed by the trustee in the management position to the company and its shareholders in general and that owed by the trustee to the trust and the beneficiaries thereof.

4.2(b)(3) In situations where the fiduciary is to sell the business, the courts have indicated that the fiduciary always has a conflict of interest. When the fiduciary is called upon to sell the business it needs to be in the position to obtain the highest price to benefit the trust, but, in many situations fiduciaries have negotiated a low price to benefit the company which is redeeming the stock. (See, for example, *Childs v. National Bank of Austin*, 658 F.2d 487 (7th Cir.1981.)

4.2(c) Alternatives for Resolving Conflicts of Interest. Most courts will be deferential to trustee - managers in the resolution of conflicts, but rarely do the courts give guidance as to how the fiduciary's duties are to be resolved. Alternative possibilities include the following, even though no one approach will best resolve the problems caused by various conflict of interest issues.

4.2(c)(1) The fiduciary manager in protecting the business for the beneficiaries benefit and also protect the beneficiaries, might refrain from acting in a way that might benefit one over the other. While this may give the appearance of being fair, it is not because it may be contrary to the decedent's presumed intent. Moreover, a failure to act is often tantamount to taking a position.

4.2(c)(2) The fiduciary must act to equally promote both interests as much as possible. This is almost impossible if irreconcilable conflict between the interests exist.

4.2(c)(3) The fiduciary may act in the interest of either the business or the beneficiaries, at the fiduciary's option. While this may give the fiduciary comfort, it is hardly fair to the trust beneficiaries.

¹⁵ This paper will not deal with compensation issues of the trustee who becomes an executor and is deserving of compensation for performance of services rendered in such capacity and who also becomes an executive or director who may become entitled to a salary, stock options or other forms of remuneration or incentive compensation.

4.2(c)(4) The fiduciary must always act in the best interests of the beneficiaries and this is consistent with the intent of fiduciary responsibility and, as a practical matter, the interests are one and the same. The appointment of a fiduciary is arguably *the* reason for the decedent's appointment of the fiduciary. A later circumstance that arises to cause the interests to conflict should not detract from that fundamental goal.

4.2(c)(5) The fiduciary must always act in the best interests of the business. This position might make sense because it may be argued that the decedent intended that the fiduciary would have a primary duty to the business; however, this position is inconsistent the nature of fiduciary responsibility as the courts understand it.

4.2(d) Determine Fiduciary's Authority to Assume Control.

4.2(d)(1) When the instrument (will or trust) authorizes the trustee to assume management control of a business then the terms of the instrument are operative to protect the fiduciary's action in taking control of the business. The fact that a conflict of interest is created is not an impediment to the trustee assuming a management position because the decedent created the potential conflict.

4.2(d)(2) When the instrument is silent or ambiguous the issues involve not only the propriety of taking a management position, but compensation, conflicts of interest and self-dealing. The general rule against self-dealing and conflicts of interest can not be ignored; hence permission and/or direction from the beneficiaries and/or a supervising court become imperative. In the absence of gaining proper authority, it is appropriate to consider resignation. Important facts and the surrounding circumstances that may be supportive of the fiduciary's action to take control include the following:

- Was the decedent active in the business for the period prior to his death, and what, exactly, was the decedent's role - active or passive?
- What actions had the intended fiduciary taken to secure or clarify his position prior to decedent's death?
- What was the fiduciary's relationship with the business and the decedent prior to decedent's death? Was the fiduciary or its representatives acting as a creditor, advisor, or a participating board member?
- What plans, if any, did decedent leave for the management of the business? For example, is there successor management already operating the business? Were other persons available for management positions?

4.3 Preserving Business. A fiduciary must act to preserve and protect the decedent's business and its assets. Therefore, careful attention to the following important items is imperative.

4.3(a) Determine & Monitor Cash Requirements. If the business does not have sufficient cash resources then determine appropriate course of action to keep from failing.

4.3(b) Determine Ability of Management. Attempt to ensure continuity of business opportunities and present management.

4.3(c) Determine Level of Fiduciary Participation. Will the fiduciary's best action be to take over management or to serve in an advisory position. Do not jump without knowing where you will land.

4.4 Determine Propriety of Business Actions. A review should be undertaken to determine the propriety of actions of officers and members of Board of Directors. For example, has the Board of Directors (managers) approved compensation arrangements for officers; loans from and to banks, and to insiders (officers and members of Board of Directors), and real estate transactions, etc.

4.5 Sale of Business Issues. As a general principal, a fiduciary is required to sell the decedent's business interests as soon as practicable after death.

4.5(a) Fiduciary Authority to Sell. It is important to determine the authority of the fiduciary to cause a sale of the decedent's business interests; that is, is the fiduciary authorized to sell pursuant to the governing instrument, statute or consent of all interested parties or by court decree.

4.5(a)(1) For those states following Model Business Corporation Act, a corporation may sell or lease "all, or substantially all" of its property in the "usual and regular course of business," or pledge or mortgage all assets whether or not within the usual course of business, without having to get shareholder approval of the transaction. Where a sale or lease of all or substantially all of a corporation's assets is not made in the usual and regular course of business, approval by a majority of shareholders is required. Although most states require only a bare majority of shareholders to approve a sale or lease, some states require a two thirds majority.

4.5(a)(2) What constitutes the "ordinary business" of a corporation depends on the business the corporation is in. Whether property represents "all or substantially all" of the assets of a corporation depends on whether the transfer of the property would substantially affect the existence and purpose of the corporation.

4.5(b) Pre-emptive Rights of Shareholders. State law may impose a limitation upon the ability of a controlling shareholder or a member of a control group to redeem stock without offering the same opportunity to shareholders who are not members of that group.

4.5(c) Notice to Beneficiaries of Certain Transactions. In some states a fiduciary may not enter into a "significant non-routine transaction" in the absence of a "compelling circumstance" without providing notice to the beneficiaries of the nature and terms of the intended transaction. In these states, the sale of a closely held business is included within the list of defined "non-routine transactions."

4.5(d) Employ Appraiser to Determine Value and Review Appraisal. It is necessary to have a preliminary determination of value, and, in many cases, multiple appraisals and reviews of

appraisals are not only appropriate but necessary. Careful consideration should be given to ERISA¹⁶ rules for determining valuations issues. Valuations for the Internal Revenue Service usually do not bear any relationship to the fiduciary concerns raised by disgruntled beneficiaries.

4.5(e) Revenue Ruling 59-60 provides the “age-old” guidance regarding the valuation for estate and gift tax purposes of stock in a closely held business. A fiduciary must personally devote significant time to an analysis of the factors so as to better prepare themselves for negotiations for the sale of the business and reasoned communication with the beneficiaries. The Ruling lists the following factors for determining value, and the fiduciary should know how to apply these factors to the decedent’s business.

4.5(e)(1) The nature of the business and its history from its inception.

4.5(e)(2) The economic outlook in general and the outlook of the specific industry in particular.

4.5(e)(3) The book value of the stock and the financial condition of the business.

4.5(e)(4) The earning capacity of the company. NOTE - §5 of the Ruling states: “Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, . . . primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.”¹⁷

4.5(e)(5) The dividend-paying capacity. NOTE - The Ruling states: “Where an actual or effective controlling interest in a corporation is to be valued, the dividend paying factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company.”

4.5(e)(6) Whether or not the enterprise has goodwill or other intangible value.

4.5(e)(7) Sales of the stock and the size of the block of stock to be valued.

4.5(e)(8) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

¹⁶ The reference to ERISA is to the Employee Retirement and Income Security Act of 1974, as amended.

¹⁷ The IRS Valuation Guide suggests that when investment assets and operating assets are being valued, the earnings from the operating assets should be capitalized and investment assets should be valued at their current values.

4.5(e)(9) §4.02(b) makes clear that the loss of a “one-man” business may have a depressing effect.¹⁸

4.5(f) Sale to Majority Shareholder. In *Brown v. Allied Corrugated Box Company*, 91 Cal. App. 3d 477 (1979), the court held that a discount for lack of control was not appropriate when the sale was to a majority shareholder.

4.5(g) Built In Gains' Taxes. The IRS recognizes the effect of the double tax on the sale of corporate assets.

4.5(h) Tax Effects of Estate Tax Value. Consider tax affect of low appraisal values to establish estate tax value and higher selling price at capital gains' rates. Determine the effect if the surviving spouse renounces the will and takes the statutory share. As a general principal, the surviving spouse would pay capital gains taxes but not pay estate taxes.

4.5(i) Restricted Stock. A decedent's closely held business which is represented by “restricted stock” must be considered in terms of determining value and the freedom of transfer.¹⁹

4.6 Supporting Documents - Sale of Business.

4.6(a) Solicitation of Bids.²⁰

4.6(b) Fiduciary Representation and Warranties.²¹

4.7 Effect of Spouse Electing Against the Will.

4.7(a) *Hall v. Elliott*, 236 Md 196, 202 A.2d 726 (MD 1964), decedent bequeathed the bulk of his shares of his closely held business to the employees with restrictions in order to ensure continued control of company by the employees. The decedent's spouse renounced the Will, and elected her marital share. The Court held the employees were entitled to compensation out of residuary estate when the shares of the closely held business were adeemed by spouse's election against the Will.

¹⁸ *Estate of Huntsman v. Comm'r.*, 66 T.C. 861 (1976), the value of decedent's business was discounted to reflect his death despite the fact that the company had competent officers to replace him. However, in *Estate of Stirton Oman*, 53 TCM 52 (1987), a key person discount was rejected because the decedent's son “had taken over the management of the company before his father's death and continued thereafter to manage the company.”

¹⁹ In *Estate of Gilford v. Comm'r.*, 88 T.C. 38 (1987), in a case where the decedent's closely held business' shares were actively traded in the over-the counter market, and decedent's “restricted stock” could not be sold free of such restrictions, a valuation discount of 35 percent was appropriate.

²⁰See Exhibit 3 - Letter Requesting Bids

²¹See Exhibit 4 - Seller's Special Representations and Warranties.

4.7(b) In *Winters National Bank & Trust Co. v. Riffe*, 2 Ohio St.2d 72, 206 N.E.2d 212 (OH 1965), the surviving spouse's share would exclude the decedent's interest in closely held business when the spouse's share could be satisfied entirely from assets other than corporate stock which had been specifically bequeathed in trust.

4.7(c) In *Burk Estate*, 37 D. & C. 2d 528 (Pa. 1965), the decedent had entered into a buy-sell agreement with son giving the son the right to purchase all common shares at a fixed price per share. The surviving spouse exercised her elective right; the Court held that spouse's right attached to one-third of each asset, including stock, rather than to the proceeds of sale of the stock pursuant to the buy-sell agreement. The value of the stock at death exceeded the agreement sales price.

4.7(d) In *Matter of Riefberg*, 58 N.Y.2d 134, 446 N.E.2d 424 (N.Y. 1983), the Court held that a buy-sell agreement was a testamentary substitute under the New York statute which required that decedent's property be available to the surviving spouse's elective share. The shareholders' agreement was amended one day before decedent's death to provide that corporation pay entire value of decedent's shares directly to his former wife, her four children and another individual. The court found that the agreement was a "testamentary substitute," and, therefore, the value of that interest was includible in computing estate against which decedent's surviving spouse could exercise her statutory right of election.

5. OBLIGATIONS TO MINORITY SHAREHOLDERS.²²

5.1 Duty to Disclose Information. The Board of Directors and a majority shareholder have a fiduciary duty to disclose material information when seeking shareholder action and when disseminating information to minority shareholders. In the absence of a request for shareholder action, corporation law generally does not require directors to provide shareholders with information concerning the finances or affairs of the corporation.

5.1(a) In *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) the Delaware Supreme Court, in a case alleging that the Board of Directors breached their fiduciary duties by permitting the Corporation to disseminate false financial information that ultimately led to the Corporation's loss of value of \$2 billion, the Court complimented Professor Hamermesh for an excellent article on the subject²³ and made the following key points.

- The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That tripartite fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.
- The directors' duty to disclose all available material information in connection with a request

²² The source of some these materials have been based upon commentary and analysis found in Fletcher Cyc Corp §8.

²³ Lawrence A. Hamermesh, Calling Off the Lynch Mob: A Corporate Director's Fiduciary Disclosure Duty, 49 *Vanderbilt L. Rev.* 1087 (1996).

for shareholder action must be balanced against its concomitant duty to protect the corporate enterprise, in particular, by keeping certain financial information confidential. Directors are required to provide shareholders with all information that is material to the action being requested and to provide a balanced, truthful account of all matters disclosed in the communications with shareholders. Accordingly, directors have definitive guidance in discharging their fiduciary duty by an analysis of the factual circumstances relating to the specific shareholder action being requested and an inquiry into the potential for deception or misinformation.

- Delaware law also protects shareholders who receive false communications from directors even in the absence of a request for shareholder action. When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty. That violation may result in a derivative claim on behalf of the corporation or a cause of action for damages. There may also be a basis for equitable relief to remedy the violation.

5.1(b) In *Shell Petroleum, Inc. v. Smith*, 606 A.2d 112 (Del. 1992), the Delaware Supreme Court responded to an action commenced by minority shareholders that Shell had provided material misstatements in connection with a merger. The Court stated: "It is only logical that a majority shareholder who directs a subsidiary to prepare certain disclosure materials and then distributes those materials to minority shareholders should be held accountable for any errors contained therein."

5.1(c) In *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1988), an unsuccessful bidder at corporate auction sued to preliminarily enjoin lockup agreement between corporate directors and "white knight." The Court held that asset lockup option granted to white knight by target corporation as part of merger agreement was invalid and unenforceable. The Court made the following key points:

- While corporate directors may rely in good faith upon information, opinions, reports or statements presented by corporate officers, employees and experts selected with reasonable care, they may not avoid their active and direct duty of oversight in a matter as significant as a sale of corporate control, particularly where corporate insiders are among bidders.
- Delaware law imposes an unremitting duty of candor not only on corporate officers and directors, but also on those who are privy to material information obtained in course of representing corporate interests.
- Fiduciaries, corporate or otherwise, may not use superior information or knowledge to mislead others in performance of their own fiduciary obligations.

5.2 Majority Shareholder's Fiduciary Obligation to Minority Shareholders. The owners of a controlling interest in a corporation are said to owe a fiduciary duty to the corporation and its shareholders; hence, the majority shareholder must act in good faith with respect to the rights of

minority shareholders, and with respect to the transfer of control.²⁴ The majority shareholders occupy a fiduciary relationship toward minority shareholders, similar to that of the corporation itself or its officers and directors.²⁵ Further, the same fiduciary duty is due from a dominant or controlling shareholder to the minority as is due from the director of a corporation to the shareholders.

5.2(a) Closely Held Corporation Issues. In closely held corporations the shareholders must bear toward each other the same relationship of trust and confidence which prevails in partnerships.²⁶ In the family held corporation, a special relationship may exist between shareholders because of the blood relationship; however, it has been determined that the mere relationship of brother and sister does not by itself create a fiduciary relationship.²⁷ See *Nixon v. Blackwell*, discussed below, to the contrary, where the court opined: "A stockholder who bargains for stock in a closely-held corporation and who pays for those shares can make a business judgment whether to buy into such a minority position, and if so on what terms."

5.2(b) Minority Shareholder as Employee. There is a distinction between a duty a corporation owes a minority shareholder, as a shareholder, from any duty it might owe a minority shareholder as an employee. However, when considering the employment relationship, courts will consider all forms of evidence, the parties situation, and other particulars of the case.²⁸

5.2(c) Effect of Shareholder Agreement. When a shareholders' agreement determines price, and the agreement is unambiguous, and the agreement has been entered into without fraud, misleading or overreaching, the agreement will prevail. The cases then apply the situation when fraud, misleading actions or overreaching has occurred.²⁹

5.3 Nature of Obligation to Minority Shareholders.

5.3(a) Explanation of Fiduciary Duty. The majority shareholders' actions must be free from fraud, and must not amount to a wanton destruction of the rights of the minority. Where a majority shareholder stands to benefit as a controlling shareholder, the majority's actions must be intrinsically

²⁴ See *Santa Fe Industries v. Green*, 430 US 462; *United States v. Byrum*, 408 US 125 (applying Ohio law); *Slattery v. Bower*, 924 F2d 6 (CA1 1991)(applying Maine law); *Grigsby v. CMI Corp.*, 590 F Supp 826 (ND Cal 1984); *Clagett v. Hutchinson*, 583 F2d 1259 (CA4 1978).

²⁵ See *Yanow v. Teal Industries, Inc.*, 178 Conn 263, 422 A2d 311.

²⁶ See *Pedro v. Pedro*, 463 NW2d 285 (Minn App 1990).

²⁷ See *In re T.J. Ronan Paint Corp.*, 98 AD2d 413, 469 NYS2d 931. However, this is *most* inconsistent with the fiduciary standards Benjamin Cardozo would have employed, especially in light of his special relationship with his sister. See *Cardozo*, Andrew L. Kaufman, Harvard University Press (1998).

²⁸ See *Pedro*, *infra*.

²⁹ See *Estate of Meller v. Adolf Meller Co.*, 554 A2d 648 (RI 1989).

fair to the minority interest.³⁰ The test applied when minority shareholders brought suit against the majority, alleging a breach of the strict faith duty owed to them by the majority, was whether the controlling group could demonstrate a legitimate business purpose for its actions.³¹

5.3(b) Rights of Employee vs. Non-Employee Shareholders. In *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), the minority shareholders brought suit alleging breach of fiduciary duty as result of allegedly discriminatory policy unfairly favoring employee shareholders by establishing ESOP, key man insurance plans, liquidity offered by ESOP, etc. The Delaware Supreme Court held that the fairness test, rather than business judgment rule applied to determine whether directors of closely held corporation treated non-employee minority shareholders unfairly, and that after substantial proof, it was determined that majority met its burden of proving the entire fairness of their dealing with non-employee shareholders. Further, the Court opined that it would not create judicially-created rules to protect minority shareholders of closely held businesses. "A stockholder who bargains for stock in a closely-held corporation and who pays for those shares can make a business judgment whether to buy into such a minority position, and if so on what terms."

5.4 Special Obligations Upon Sale of Company.

5.4(a) Majority Shareholder's General Rights of Sale.

5.4(a)(1) A majority shareholder may sell their controlling interest without liability for any profits so long as the majority does not dominate, mislead or interfere with other shareholders in the exercise of their rights or abuse their position or control. A majority shareholder who becomes a director or paid officer of the corporation is not precluded from selling, even at a premium, his shares of stock.³² A majority shareholder is generally under no duty to the minority shareholders to refrain from receiving a premium upon the sale of the controlling stock. Many of the cases on point explain why this theory of law is limited, will not be applied, and the circumstances upon which the majority shareholder will be held liable to the minority shareholders.

5.4(a)(2) A majority shareholder who is also a director or officer owes no fiduciary duty to other shareholders regarding the terms of sale of personal shares of stock, where such sales does not affect the general well being of the corporation.³³ The degree of fiduciary duty owed by the majority shareholder to the minority shareholder has been characterized as a

³⁰ See *Slattery v. Bower*, 924 F2d 6 (CA1 1991).

³¹ See *Leader v. Hycor, Inc.*, 395 Mass 215, 479 NE2d 173.

³² See *Treadway Co., Inc. v. Care Corp.*, 490 F. Supp 668 (SD NY 1980), affd 638 F2d 357 (CA2 1981). In *Harris v. Carter*, 582 A.2d 222 (Del Ch 1990) the Court stated: "Shareholder has right to sell his or her stock and in ordinary course owes no duty in that connection to other shareholders when acting in good faith.

³³ See *Eliassen v. Green Bay & Western R. Co.*, 569 F Supp 84 (ED Wis 1982).

relative standard, varying with the circumstances.³⁴ The sale of a majority interest may result in a breach of a fiduciary duty if the purchasers will loot or mismanage the corporation, or if the sale involves fraud, misuse of confidential information, wrongful appropriation of corporation assets, or personal use of a business advantage that rightfully belongs to the corporation.

5.4(a)(3) Majority shareholders may sell their stock to another corporation although it might be detrimental to minority shareholders to have another corporation control the majority of the stock. A majority shareholder, however, has no duty to sell its holdings in a corporation merely because the sale would profit the minority shareholders.³⁵

5.4(b) Duty to Examine Motives of Purchaser. The controlling shareholder occupies a fiduciary relationship to the corporation and its shareholders with respect to the transfer of control, and are under a duty not to transfer control to outsiders if the circumstances are such as to awaken suspicion and put a prudent person on guard, unless a reasonably adequate investigation discloses facts that would convince a reasonable person that not fraud is intended or likely to result. It has been held that a majority shareholder who is also a director, when contemplating sale of majority stock at a price not available to other shareholders and which sale may prejudice the minority shareholders, has a duty to act affirmatively and openly with full disclosure, and a violation of this fiduciary obligation is actionable by the minority shareholders.³⁶ However, some courts have required actual knowledge of the purchaser's fraudulent intent as a requisite to the finding of breach of fiduciary duty.³⁷

5.5 Recognition of Right to Premium For Control.

5.5(a) Control of Corporation is Personal. A majority shareholder's power to control the corporation is not a corporate asset; therefore, on a sale of the stock the value of this aspect of ownership need not be shared with the other, minority, shareholders. In the absence of fraud, a shareholder who desires to gain control of a corporation is free to pay other shareholders a premium in order to gain such control. The shareholder attempting to gain control need not pay all minority shareholders equally. However, it has been held that where a majority shareholder has sold at a premium controlling interest in a corporation to the corporation's customers at a time of unusually high profits, the majority shareholder may have to share the gain with minority shareholders whose

³⁴ Degree of duty is not as compelling in situation where offer is merely made to purchase stock, where presumably minority shareholder is free to decline to participate, as it is in case of merger, where minority shareholder's interest is transformed regardless of whether or not he consents to action. *Lynch v. Vickers Energy Corp.*, 402 A2d 5 (Del Ch 1979).

³⁵ See *Bershad v. Curtiss-Wright Corp.*, 535 A2d 840 (Del 1987).

³⁶ See *Brown v. Halbert*, 271 Cal App2d 252, 76 Cal Rptr 781.

³⁷ See *Essex Universal Corp. v. Yates*, 305 F2d 572.

interests would otherwise be injured.³⁸

5.5(b) Minority Shareholders Do Not Have Right To Premium. In *Mendel v. Carroll*, 651 A.2d 297 (Del. Ch. 1994), the Chancery Court responded to the minority's request to require the Board of Directors to issue option shares in order that offerors could dilute voting power of an existing control block of stock. The family that controlled the corporation's stock had made an offer to purchase the shares at \$25.75 per share while a competing third party had offered \$27.80 per share. The Court denied the minority's request holding that the difference in price reflected the third party's control premium, and that the controlling shareholders were entitled to that premium and did not have to offer it to the minority shareholders. "The law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium."

5.6 Burden of Persuasion. When a majority shareholder, deemed to be a fiduciary, is challenged for having engaged in self-dealing, the majority shareholder has the burden of coming forward with evidence and the burden of persuasion to show that the transaction was scrupulously fair.³⁹ Fiduciaries have the burden of proving both: (1) their good faith in dealing with the corporations they control; and, (2) the inherent fairness of those dealings to those corporations, their shareholders and their creditors.⁴⁰ In cases based on a violation of fiduciary duty, a plaintiff is not required to prove injury or economic loss as a condition of relief.

6. COURT RESPONSES TO PRUDENT RULES AND SALE OF BUSINESSES.

6.1 In *Estate of Doelger*, 4 N.Y.S.2d 334 (1938), the Court made some careful distinctions between the responsibilities of a fiduciary of an estate and the application of the fiduciary relationship when conducted in the form of a business corporation. The court made the following inciteful comments:

A clear distinction must be made between the powers and limitations of a corporation formed pursuant to directions in the will and the powers and limitations of a trustee appointed under the will. The testator designates his trustee and has power to give the trustee absolute and unlimited discretion in investments. As the testator has such power, if he does not use it and says nothing about the trustee's right to invest, the law limits the trustee to what are designated as legal investments. But the testator cannot either create, or confer powers on, a corporation. The sovereign alone has such power. And when on the executors

³⁸ See *Perlman v. Feldmann*, 219 F.2d 173, where the Court commented: "We do not mean to suggest that a majority shareholder cannot dispose of a controlling block of stock to outsiders without having to account to this corporation for profits or even never do this with impunity when the buyer is an interested customer for the corporation's product, although when the sale necessarily results in a sacrifice of this element of corporate goodwill and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains."

³⁹ See *Gottesman v. General Motors Corp.*, 279 F Supp 361; and *Farber v. Servan Land Co.*, 393 F Supp 633; *Brown v. Halbert*, 271 Cal App2d 252, 76 Cal Rptr 781.

⁴⁰ See *Garner v. Pearson*, 545 F Supp 549.

petition it creates a corporation, the state and not the testator gives the corporation all the powers it possesses, including the powers of investment that are usual, legal and customary in such corporation. As the testator can give no power to the corporation, his silence does not keep from it any the law confers. In the case of the trustee, since the testator has the power to give discretionary authority in investments, silence means limitation. In the case of the corporation, since the testator has no such power, silence means the absence of limitation. (At pages 339-340.)

6.2 In Taylor v. Nationsbank Corporation, 481 S.E.2d 358 (NC 1997), the Court sustained the beneficiaries efforts to obtain a copy of the trust instruments in order to determine the method used to pay them their cash bequests. The Court stated that §173 of the *Restatement (Second) of Trusts* makes it clear that the trustee must always provide beneficiaries complete and accurate information and documentation regarding the administration of the trust.

6.3 In Fletcher v. Fletcher, 253 Va. 30, 480 S.E.2d 488 (VA 1997), the Court required that the trustee disclose the entire trust agreement to the beneficiary. "The beneficiary is entitled to review the trust documents in their entirety in order to assure the trustees are discharging their duty to deal impartially with all the beneficiaries within the restrictions and conditions imposed by the Trust Agreement."

6.4 In Allard v. Pacific Nat'l Bank, 99 Wn.2d 394, 663 P.2d 104 (1983), the Washington Supreme Court held that the trustee had a duty to inform the beneficiaries of the contemplated sale of real property comprising the entire trust estate because such sale is a "significant non-routine transaction." Such a sale could not occur in the absence of a "compelling circumstance" without providing written notice to the beneficiaries of the nature and terms of the intended transaction.

6.5 In Matter of Mendleson, 46 Misc.2d 960, 261 N.Y.S.2d 525 (1965), the decedent made a "special request" that shares of a company be retained and not sold "unless a sale thereof is deemed for the best interests of my estate by my said executor or trustee." The court held the fiduciary liable for a loss caused by a devaluation of the business, and stated: "The duty of the trustee here was not so much to watch the market but the business itself which faltered."

6.6 In Arthur E. Kettle, 423 N.Y.S.2d 701 (3rd Dept. 1980), the decedent's Will provided that the stock of the corporation be retained "unless compelling reasons arise for [its] disposal." Within two months of acquiring the stock the fiduciary sold half the stock in order to diversify the trust estate, and the widow sued the fiduciary for its actions as she deemed it unnecessary to sell the stock. The court required that the stock be repurchased because the fiduciary demonstrated no compelling reason for selling the stock, and that the fiduciary pay all costs associated with the repurchase.

6.7 In El Boletin Popular Pub. Co. v. Springer, 33 N.M. 275, 265 Pac. 713 (1928), the fiduciary employed a full time manager to run the business and the fiduciary exercised supervisory control over the hired manager. The court indicated that the extent of delegation of managerial duties was to be decided with reference to reasonableness under the circumstances.

6.8 In First Ala. Bank of Huntsville v. Spragins, 515 So.2d 962 (Ala. 1987), the corporate trustee retained its own stock, which constituted inception assets, for more than eight years, and the value of the stock represented about 75 percent of the trust estate. The decedent had been president and

chairman of the board of directors of the corporate fiduciary. During the eight years the stock increased in value, and the Will specifically authorized investments to be made “regardless of lack of diversification,” and for the trustee to retain assets “originally received . . . without liability for depreciation or loss through error of judgment.” The beneficiaries contended that these provisions did not protect the fiduciary when a violation of the duty of loyalty existed and retention constituted self-dealing. The Court found that a breach of trust occurred. In determining the amount of damages the Court relied on expert testimony that showed the differences in the principal values of the prudently and imprudently managed estates and the income earned on each, taking into consideration trust distributions. The difference in appreciation of a diversified quality investment portfolio over the amount of the appreciation in the Bank stock was about \$1 million; hence, this was the amount of determined damages. *Plus punitive damages and court costs!*

6.9 In *Goddard v. Continental Nat. Bank & Trust*, 532 N.E.2d 435 (Ill.1988), the Court reviewed whether the trial court erred in finding, as a matter of law, that the settlor unambiguously authorized the trustees to continue to hold the stock “*come what may*.” The Court determined that this “phrase certainly is not the equivalent of an intent to retain the property indefinitely. Accordingly, we cannot agree with the trial court’s finding that the settlor’s intent is unambiguous. In other words, we believe the trust provisions are capable of more than one meaning. . . .” The case was sent back to the trial court who applied the “*come what may*” standard, and then found that the fiduciary committed a breach of trust.

6.10 In *Hoffman v. First Virginia Bank*, 263 S.E.2d 402 (1980), the court held that an authorization in the Will that made specific reference to the Virginia prudent person statute, and waived it, was sufficient to protect the fiduciary from its application.

6.11 In *Hatcher v. United States Nat. Bank of Oregon*, 643 P.2d 359 (Ore. App. 1982), the court reviewed a fiduciary’s actions in selling the decedent’s closely held stock. The court found that the fiduciary committed a breach of trust because the fiduciary did not make a thorough appraisal determining the value of the stock before selling it, and the fiduciary should have at least tested the market to determine the stock’s value. The fiduciary breached its trust by failing to: (1) obtain fair market value for the corporate stock; (2) failing to obtain beneficiary approval; (3) not getting any cash at closing; (4) only obtaining a pledge of the stock that was the subject of the sale and this stock was not to have voting rights; (5) not providing for any restrictions on salaries or dividends payable by corporation; (6) not providing for any restrictions on the corporation mortgaging its assets and/or incurring indebtedness, and, finally (7) providing for an interest rate substantially below an appropriate market rate based upon the provisions of the sales agreement. The Court construed the exoneration provision as nothing more than a statement of the prudent person rule, and that exoneration provisions would *not* be permitted to apply to provide additional protection.

6.12 In *Estate of Stern*, New York (1989) the court explained the problems that arise when the stock constituting control of the company is held in trust and the trustee, son of the founder, is both a family member beneficiary and chief executive officer of the company. The daughter commenced an action to cause her brother’s removal as trustee because of his failure to make the trust productive of income. The Court granted the requested relief because the court concluded that the interests of the corporation were more important to the son, and the son had not considered a sale of the stock to the public because it would jeopardize the son trustee’s control of the corporate business to the son’s personal detriment. The son’s personal interest is in direct conflict with the son’s duty of

undivided loyalty to the beneficiaries; hence, the court removed the son trustee.

6.13 In Johnson v. Witkowski, 573 N.E. 2d 513, (Mass. App. Ct. 1991), the Court, in setting aside a sale of the business made the following comments:

- We note initially that the difficulty arises here because of the defendants' multiple roles. They were trustees of the trust and were also stockholders, directors, and officers of a close corporation involved in transactions in which they stood on both sides and in which they had a self-interest. In each capacity, the defendants had fiduciary duties. Wearing more than one hat - here, at least three - requires a fiduciary to be very nimble as well as most prudent. While the fiduciary may purport to wear one hat at a particular moment, in truth, all hats are worn together at all times.
- Directors of corporation who also served as trustees of corporation's stock breached their fiduciary duties when they caused corporation to guaranty a loan to another corporation without authorization of the Board of Directors and later caused the corporation to guaranty loans used to finance an acquisition of another company, where the directors had a financial interest, and the result of all the transactions was to release them from their personal guaranties.

6.14 In Donahue vs. Rodd Electrotpe Co. of New England, Inc., 367 Mass. 578, 328 N.E.2d 505 (1975), the Court held that a closely held business may not purchase its shares from a stockholder who is a member of a control group without offering stockholders outside of the group an equal opportunity to sell a ratable number of their shares at the same price. Courts from Alaska, Florida, Illinois, and Ohio have followed this holding.

6.15 In InterFirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882 (Tex. App. 1987), the beneficiaries sued the trustee for an alleged imprudent sale of one-third interest in a closely held business. The trustee making the sale succeeded an original individual trustee whose final accounting indicated a value of \$185 per share. The shares were redeemed by the closely held business a few months later for \$512 per share. Few previous sales of stock had been made, and the previous highest sale had been for \$163. The book value of the shares was determined to be \$1,409. At trial the jury determined the stock's fair market value at \$1,549. Actual damages of \$1 million were awarded, including interest of \$265,000. The beneficiaries were awarded *\$10 million in punitive damages*. The decedent's Will provided: "The Trustee shall never be liable for any action or failure to act hereunder in the absence of proof of bad faith." The Appeals Court noted that this provision meant the trustee's liability had to be based upon self dealing, bad faith or intentionally adverse acts or reckless indifference towards the interests of the trust beneficiaries. The Court in holding the trustee liable, although reducing punitive damages to \$2.7 million, made the following important points:

- The fiduciary did not obtain an outside appraisal for the stock and did not inform the beneficiaries of the proposed sale.
- The fiduciary's trust officer testified that because the stock comprised more than one-third of the total trust the stock should be sold in order to diversify the trust estate and generate more income. The trust officer concluded that the Company was the only

likely purchaser, and he applied his own valuation methodology to determine the price per share. He was aware that the Company's earnings had dramatically increased, but he concluded that this a "short-lived phenomenon."

- A fiduciary is obligated to secure competitive bidding and make attempts to obtain offers from other sources.
- "If [the fiduciary] had made a diligent effort to get the best price possible for the stock by publicizing its sale, by notifying the beneficiaries, by getting an outside appraisal, and by then accepting the highest offer, its actions would not have been in bad faith. If [the fiduciary] had not been in the position of obtaining an advantage for itself as a lender to [the business], a self-serving motive could not be inferred from the situation. But the combination of these three factors presents circumstances *evinced bad faith and self-dealing to the detriment of the beneficiaries of the trusts*. . . . The price of one-third of the market value is a fact from which inferences of bad faith and self-dealing can be drawn."
- The fiduciary objected to the trial court's failure to instruct the jury that it had no duty to consult with the beneficiaries before selling the stock. The court determined that a fiduciary has a duty to inform beneficiaries of material facts relating to non-routine transactions which significantly affect the trust prior to the transaction taking place. "While Texas law does not require the consent of the beneficiaries before selling trust assets, the fact that the property is in a trust does not require that the beneficiaries are to be kept in ignorance of the administration of the trust."

6.16 In *Ripsey v. Denver United States National Bank*, 273 F. Supp. 718 (CO. 1967), the beneficiaries successfully sued the bank fiduciary for selling the trust's stock of the closely held company to the company's management when the fiduciary sold the company without contacting a potential competing buyer who *foreseeably* would have paid more for the business, especially when the fiduciary did not even give the company's competitor an opportunity to make an offer. The beneficiaries argued that the fiduciary deliberately sold the stock at a lower price to the company's management because the company's management representatives contacted the fiduciary's bank directors in attempts to influence the sale. The court stated:

Even though will authorized trustee to sell trust property in its sole judgment at private sale without advertisement or notice to anyone, without aid or necessity of any court order, without consulting beneficiaries and without regard to their opinions, desires or judgment and to sell at such price and upon such terms as trustee should determine trustee was not authorized to act unreasonably or operate beyond bounds of prudent judgment.

The fiduciary then attempted to rely upon an exculpatory provision in the decedent's Will, and the Court responded, stating:

It is doubtful whether this provision applies to a loss which resulted from a sale which was not conducted in accordance with orthodox trust principles. But even if it does apply it falls short of exculpating the Bank here. Such a provision is usually held to add nothing. It does not limit the trustee liability for even negligence.

6.17 In Giagnorio v. Emmett C. Torkelson Trust, 292 Ill. App.3d 318, 686 N.E.2d 42 (IL 1997), a contingent beneficiary brought action against decedent's surviving spouse who as trustee sold the business stock to another beneficiary. The contingent beneficiary alleged that the trustee sold stock for substantially less than appraised value, with no money down, and without adequate protection in event of purchaser's insolvency stated cause of action and fiduciary held liable.

6.18 In Huntington National Bank v. Wolfe & Huntington National Bank, 99 Ohio App.3d 585, 651 N.E.2d 458(1994), the fiduciary brought a declaratory action in probate court to seek determination of their authority to sell stock of family corporation and distribute cash. The fiduciary acknowledged that he had a conflict of interest in sale of stock, but that he had selected an independent appraiser to determine the value of the stock, obtained approval of independent bank fiduciary, and advised beneficiaries of his intended actions and sought probate court approval. The appellate court dismissed the beneficiaries appeal from a decision in favor of fiduciary.

6.19 In Murphy v. Central Bank and Trust Co., 699 P.2d 13 (CO., 1985), the court found the fiduciary liable for breach of trust by not securing competitive bidding, by not properly maintaining trust property in order to enhance its value for sale was sufficient evidence of fiduciary's breach of duty of loyalty.

6.20 In C. Green Charitable Trust & Jaffe v. Comerica Bank - Detroit, a bank fiduciary was liable to trust for a bad faith violation of fiduciary duties with regard to the sale of trust property by not disclosing name of purchaser to the trust's beneficiaries and to the co-trustee, and by failing to adequately establish the value of the property and failing to obtain highest price available for property.

6.21 In Wilmington Trust Company v. Coulter, 41 Del.Ch. 548, 200 A.2d 441 (DE., 1964), held bank fiduciary liable for breach of trust by failing to inform co-trustee when it received offer to purchase stock at a one-third higher price than that fixed by an as yet unbinding agreement for sale of stock and did not reconsider the sale prior to completing the sale.

6.22 In Thomas v. Turner, Ky. App. 736 S.W.2d 343 (1987), the court stated that a bank fiduciary's sale of trust property to a substantial customer of bank constituted a conflict of interest which should have prevented sale from occurring; bank as trustee gave special consideration to customer that it could not give to other potential purchasers if land had been offered at public auction, trustee made no efforts to market land through its real estate division or with any real estate broker, trustee never informed beneficiaries of the contemplated sale, and after customer communicate its first purchase offer to fiduciary, the fiduciary did not so much as make a counteroffer.

6.23 In In re Mendleson's Will, 261 N.Y.S.2d 525 (1965), the court held that fiduciary who failed to make reasonable effort to dispose of the shares of a close corporation within a year after a duty arose to dispose of such shares because of decline in value was liable for breach of duty.

6.24 In Ledbetter v. First State Bank & Trust Co., 85 F.3d 1537 (Georgia, 11th Cir.1996), a trustee bank's interests conflicted with those of beneficiary in violation of duty of undivided loyalty, by virtue of bank's holding of its parent company's stock in trust and overlapping and interlocking management of the two corporations. Attempts by trustee to resign was evidence of its bad faith.

6.25 In *In re Pulitzer's Estate*, 260 N. Y. Supp. 975 (1st Dep't, 1932), the decedent's estate contained the stock of a publishing corporation, and one of the corporation's assets was a newspaper. The court granted the fiduciary's request to cause the corporation to sell the newspaper, but refused to give guidance as to how to cause the corporation to make the sale. The court recognized that the newspaper is an asset of the corporation and not the estate, yet it proceeded to authorize its sale on the theory that this is necessary to protect the trust estate. The court asserted its power over corporate assets, but then refused to sanction the details of the sale, showing a regard for the corporate entity.

6.26 In *Howard v. Shay*, 100 F.3d 1484 (9th Cir. 1996). The former employees of a company who participated in the company's ESOP brought an action under ERISA for a breach of a fiduciary duty in connection with the sale by the ESOP of its sole asset, company stock. The ESOP originally purchased the stock for \$10.67 a share, and, upon the ESOP's termination, sold the shares at \$14.40 per share. The sales price was based on a report of an independent appraiser, Arthur Young & Company, and the appraiser's report was accepted by the fiduciaries without further review. Arthur Young determined that the per share asset value was \$83; however, the reduction in price to \$14.40 was based upon substantial reductions for lack of marketability and minority ownership. In finding the fiduciaries liable for a breach of its fiduciary duties the Court made the following statements.

- Although securing an independent assessment from a financial advisor or legal counsel is evidence of a thorough investigation, ... , it is not a complete defense to a charge of imprudence. As Judge Friendly has explained, independent expert advice is not a "whitewash." The fiduciary must (1) investigate the expert's qualifications, (2) provide the expert with complete and accurate information, and (3) make certain that reliance on the expert's advice is reasonably justified under the circumstances.
- We agree that the district court exhibited some confusion over the correct articulation of the prudent man standard. The business judgment rule is a creature of corporate, not trust, law. But we reverse on the grounds that even if the district court applied the prudent man standard, it did not apply it correctly. The fiduciaries failed to carry their burden of proving that they fulfilled their duties of care and loyalty and that the ESOP received adequate consideration. The focus is on the thoroughness of the investigation. The fiduciaries completed the transaction without negotiation. Rather than shop the stock to a third party buyer or appoint a non-conflicted fiduciary, the fiduciaries relied on the Arthur Young valuation, and they did not question the valuation or retain a second firm to review it.
- An independent appraisal "is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly." To justifiably rely on an independent appraisal, a conflicted fiduciary need not become an expert in the valuation of closely held corporations. But the fiduciary is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense. If after a careful review of the valuation and a discussion with the expert, there are still uncertainties, the fiduciary should have a second firm review the valuation.

The dissenting opinion provided the following comments:

- The crucial distinction between *Cunningham* and the case before us is that the *Cunningham* fiduciaries - the company's board of directors - knew that the company had not performed as well as the growth projections. In effect, they knew that the expert's appraisal was out of date. In this case, however, the majority faults the fiduciaries not for providing inaccurate data to the expert, but for failing to question the expert's methodology and valuation assumptions. The district court specifically found that the fiduciaries in this case used an appropriate selection process in choosing Arthur Young, and that they provided Arthur Young with all relevant, material information. Unless that finding is clearly erroneous, this court should hold that the fiduciaries acted prudently. The majority's unprecedented rule essentially requires the fiduciaries to be experts in subjects in which they admittedly have insufficient knowledge or experience. Fiduciaries use experts precisely because they are not qualified to do the appraisal themselves; once they have carefully selected and adequately informed the expert, they should be able to rely on the expert's conclusions.

7. BENEFICIARIES vs. BUSINESS & INCOME vs. REMAINDERMEN.

7.1 Multiple Fiduciary Duties. When a closely held business is a substantial asset of the trust, and the trust has various split interests; for example, different income and remainder beneficiaries, the fiduciary should expect that conflict problems will quickly rise to an open level of hostility. As a general rule, closely held corporations are under-capitalized and have needs for the accumulation of current income to finance business growth. Further, as a matter of financial and tax policy, the owners of closely held businesses do not want their businesses paying significant dividends, but instead would rather have such excess sources of income distributed in the form wages, employee fringe benefits, expensive business trips, and the like.

7.1(a) Rights of Income Beneficiaries.

7.1(a)(1) The most typical example is the marital deduction trust, where the instrument must give the spouse the right to demand that the fiduciary make trust income productive in order for the trust assets to qualify for the marital deduction. What does the fiduciary do when the spouse exercises that right?

7.1(a)(2) What happens when the closely held business is an asset of a charitable remainder trust; the charity wants income and the instrument requires the payment of an annuity or unitrust amount?

7.1(b) Duty of Loyalty. While a fiduciary has a duty of loyalty - the obligation to act solely in the best interests of the beneficiaries - the mere statement of the test offers no real guidance to the fiduciary who attempts to comply with the multiple problems of split beneficial interests on the one hand, and corporate responsibilities to creditors and minority shareholders on the other. The duty of loyalty of the corporate director is also clearly established and has been said to be analogous to that

of a trustee to a beneficiary.⁴¹

7.2 Fiduciary Control of Corporation & Payment of Dividends.

7.2(a) Board of Directors Control Corporation - Not the Fiduciary?

7.2(a)(1) The case of *In the Matter of Koretzky*, 8 N.J. 506, 86 A.2d 238 (1951) is helpful to an analysis of who controls an operating corporation; that is, the fiduciary shareholder or the corporation's board of directors. The testator left the controlling shares of the closely held business in trust for his family, and when the court found reasons to remove the fiduciary, the court provided the following advice. "The corporations were not made parties defendant. The business of a corporation is operated by its board of directors, and ownership by the estate of the controlling interest of the outstanding stock confers no power upon the fiduciaries of the estate (whether they be executors or trustees) to bind the corporation." According to the Court, the question is: Must the fiduciary who controls the corporation cause the corporation to follow rules of trust administration so as to ensure that income beneficiaries benefit from the trust estate?" Note the court's response:

- The trustee has a duty to exercise his control so as to favor the beneficiaries of the trust. "But the . . . principle does not embrace a duty to advance the interests of a beneficiary at the expense of the corporation and other outstanding stockholders' interest."
- The court stated: "*it is the duty of a board of directors to manage the corporate affairs solely in the interest of the corporation, quite regardless of the effect of its policies and management upon the fortunes of individual stockholders in the corporation.*"

7.2(a)(2) The case of *D'Arcangelo v. D'Arcangelo*, 137 N.J. Eq. 63, 43 A.2d 169 (1945), the court reviewed a situation where the testator attempted to impose requirements upon the heirs of his controlling shares of stock to cause the corporation to employ and pay defined sums to his other family members. The court opined that the heirs who received the stock were not required to comply with the testator's wishes because the corporation is controlled by its board of directors and *not* by the shareholders.

7.2(a)(3) In *Rosencrans v. Fry*, 91 A. 2d 162 (N.J. 1952), the court addressed the question of the power of the trustee to withhold dividends when he is acting as director of the corporation. The duty of the trustee to vote shares in such a way as to promote the interests of the beneficiaries was recognized, but the court stated that this obligation "does not embrace a duty to advance the interests of a beneficiary at the expense of the corporation and other outstanding stockholders' interests. That duty must be adjusted with the duty of a director as such."

7.2(b) Payment of Dividends.

⁴¹ See 3 Fletcher, Private Corporations §§ 838-988.

7.2(b)(1) Generally - No Right to Dividends.

7.2(b)(1)(A) "If the corporate entity is inviolate, the corporation's net income must be considered its own to spend or save as its directors see fit, the life beneficiary of a trust which has for its *res* the majority of the shares can look only to such dividends as may be declared from this net income. There are two Pennsylvania cases which unhesitatingly adopt this conclusion. The shares, it is pointed out, and the corporation, belong to the estate."⁴²

7.2(b)(1)(B) The position of most courts appears to be that where the fiduciary does not hold all of the shares of the corporation he will not be held in breach of trust merely because he has failed to prevent accumulations of surplus necessary to the continued vitality and growth of the business. The effect of these decisions is to liberate the trustee and the business from the application of trust rules as to principal and income and to focus the trustee's duty to make the assets productive of income, not on the corporate surplus, but on the continued retention of the business interest by the trust.

7.2(b)(2) On the Other Hand - Why not? A close examination of general corporation law discloses that unless the payment of dividends impair a corporation's capital or the corporation suffers insolvency, corporate law neither views excessively liberal dividend policies as unlawful nor renders the directors liable for such action.

7.2(c) Depreciation of Corporate Assets. Depreciation is an expense properly charged against corporate income and a failure to depreciate assets will overstate income. A refusal to take depreciation is a continuing impairment of capital, and will adversely affect the corporate entity. Noted trust authorities have stated that:

Unless it is otherwise provided by the terms of the trust, if property held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary is wasting property, the trustee under a duty to the beneficiary who is entitled to the principal, either (a) to make provision for amortization, or (b) to sell such property. [See Restatement (Second) Trusts §239.]

7.3 Responsibilities to Minority Shareholders. There are a significant number of cases that hold that majority stockholders are in a fiduciary relationship to the minority stockholders and the corporate creditors when the majority interest uses its voting power to exercise actual control over the operations of the corporation.⁴³ It is not the power to elect directors which imposes this duty, but rather the use of this power in such a way as to control directorial discretion by making the directors agents of the majority shareholders.

7.4 Observation. The law of trusts fails to provide workable rules on the question of retention and distribution of earnings of a business held in trust. The line drawn between principal and

⁴² Notes, *Corporations in Decedents' Estates*, 27 Virginia Law Review 497 at 501 (1941).

⁴³ See Rohrlich, *Law & Practice in Corporate Control*, 96-110.

income, based on distinctions between repairs and improvements, between "temporary" and "permanent" improvements, between "wasting assets" and not-so-wasting assets, between "amortization" and "depreciation," along with countless other confused ideas, impose singly and collectively a rigid stranglehold on the trustee - controlled business enterprise of the kind which often cannot be avoided.

8. SELECTED TAX ISSUES AFFECTING FIDUCIARY ADMINISTRATION.

8.1 Section 6166 - Deferral of Estate Tax on Business Assets.

8.1(a) Overview. §6166 permits an extension of time for payment of the estate tax when the estate consists largely of an interest in a closely held business. The estate tax can be deferred for as much as 14 years from the date the estate tax return was due to be filed if the benefits of §6166 are timely elected, and the IRS approves the election. In 1984, Congress amended §6166 to permit stock in holding companies to be treated as business stock in certain situations, and in 1997, Congress lowered the interest rate payable on the estate tax that has been deferred, and eliminated income and estate tax deductions for the interest paid.

8.1(b) General Rules of §6166.

8.1(b)(1) Qualification -- §6166(a)(1) and (2). An executor may elect to pay part or all of the estate tax in two or more equal installments, but not exceeding 10 installments, if the gross estate of a U.S. citizen or resident includes an interest in a closely held business worth more than 35% of the adjusted gross estate. Qualifying estates may defer that portion of the estate tax not payable in the proportion which the closely held business amount bears to the adjusted gross estate.

8.1(b)(2) Payment Dates -- §6166(a)(3). The first installment of estate tax must be paid not more than five years after the date prescribed for filing the estate tax return, determined without regard to any extensions of time for filing the return. Each succeeding installment must be paid on or before the next anniversary of such date. A fiduciary should elect the maximum benefit available because if an election is made for a period that is less than the maximum allowable, a longer period cannot be elected after the date for making the initial election.

8.1(b)(3) The Election -- §6166(d). The election must be made not later than the date prescribed for filing the estate tax return, including extensions. The district director is responsible for deciding if an election meets the conditions of §6166 and the fiduciary is to be notified if the election is not accepted.

8.1(b)(4) Declaratory Judgment to Determine §6166 Eligibility. The Taxpayer Relief Act of 1997, grants an estate access to the Tax Court to resolve disputes regarding the estate's eligibility for deferral without being required to pay the full amount of estate tax before seeking judicial review of the ineligibility determination. Exhaustion of administrative remedies within the IRS is required before an action.

8.1(c) Definitions and Special Rules.

8.1(c)(1) Interest in Closely Held Business-- §6166(b)(1). "Interest in a closely held business" means one or more of the following: (i) a trade or business carried on as a proprietorship; (ii) a partnership carrying on a trade or business if either the partnership has 15 or fewer partners, or 20% or more of the total capital interest in the partnership is included in the decedent's gross estate; (iii) a corporation carrying on a trade or business if either the corporation has 15 or fewer shareholders, or 20% or more in value of the corporation's voting stock is included in the decedent's gross estate.⁴⁴ If the business is conducted as a sole proprietorship, then only the assets actually used in the business are considered in making the determination as to an "interest in a closely held business."⁴⁵

8.1(c)(2) Qualification as a Trade or Business. Active business activity is required, and passive investments will not qualify as a business, although §6166 does not define "trade or business." The IRS takes the position that to qualify for estate tax deferral, the decedent must have owned an interest in a "corporation carrying on a trade or business," and this means that a business entity carrying on a "manufacturing, mercantile, or service enterprise" meets the necessary requirements while the "mere management of passive investment assets" does not.⁴⁶ While the legislative history of all three versions of §6166 is silent as to what constitutes a business, there is no indication that the word "business" should be construed differently under §6166 than under any other section using that term.

8.1(c)(2)(A) A large number of controversies surround the ownership by a decedent of real estate, either as a farm or improved by buildings. If the decedent (personally or through an agent) took part in the management of a farm, the business was an active one, and the estate qualified for deferral under §6166.⁴⁷ Similarly, if the decedent rented the land to sharecroppers, but took part in farm management decisions and received a portion of the produce, the business was active and the estate qualified for tax deferral.

8.1(c)(2)(B) In PLR 9801009, the IRS ruled that a decedent's real estate leasing and management business qualified as a business under §6166(b) even though decedent delegated management responsibilities during his last illness, because decedent's level of activity (being on 24-hour call for emergencies, personally operating and managing the properties) was more than a mere owner managing investments).

⁴⁴ §6166(b)(1).

⁴⁵ A timber business held by a trust of which the decedent was a beneficiary has also qualified. TAM 9635004 advised that land the decedent owned, which comprised two-thirds of the land used in the cattle ranching business the decedent engaged in as a partner in a partnership, was an interest in a closely held business under §6166(b)(1)(A). The National Office concluded that the asset qualifies for §6166 treatment even though it was owned by the decedent individually, and not by the partnership.

⁴⁶ See, e.g., TAM 8448006.

⁴⁷ See, e.g., TAM 8432007, as well as Rev. Rul. 75-366.

8.1(c)(2)(C) If the decedent merely owned the property and rented it, the business was one of mere management of passive assets, and the estate did not qualify for tax deferral.⁴⁸

8.1(c)(3) More Closely Held Business Rules -- §6166(b)(2).

8.1(c)(3)(A) Determinations called for by the definition "interest in a closely held business" are made immediately before the decedent's death.

8.1(c)(3)(B) An interest in a closely held business owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries, except that no person is treated as a beneficiary of a trust who does not have a present interest in the trust. A decedent is treated as owning all the stock and partnership interests held by the decedent or any member of his family as defined by §267(c)(4), which treats the decedent's spouse, lineal descendants, ancestors, and siblings as members of the decedent's family. According to the IRS, the §6166(b)(2) attribution rules apply for purposes of determining whether a partnership or corporation has 15 or fewer partners or shareholders within the meaning of §6166(b)(1), but do not apply for purposes of the 35% of adjusted gross estate test of §6166(a)(1), the 20% test in §§6166(b)(1)(B)(I) and 6166(b)(1)(C)(I), or the formula used in determining the maximum amount of tax that may be paid in installments set forth in §6166(a)(2).

8.1(c)(4) Farm Structures -- §6166(b)(3). Farm residences and related improvements receive special consideration for purposes of determining whether an estate meets the 35% test of §6166. The interest in a closely held business "which is in the business of farming" includes any interest in residential buildings and related improvements on the farm which are occupied on a regular basis by the owner or lessee of the farm, or by their employees, for purposes of operating or maintaining the farm.

8.1(c)(5) Non-Readily-Tradable Securities -- §6166(b)(7). A special election and definitions are provided in §6166(b)(7) to allow some deferral -- though on a less favorable basis -- to certain estates owning capital interests in a partnership or non-readily-tradable stock but which do not qualify for deferral under regular §6166. If the executor makes an election under this subsection so as to qualify for §6166 deferral, the five-year standoff period for beginning payments of estate tax installments and the special 4% interest rate of §6601(j) do not apply.

8.1(c)(6) Holding Company Election -- §6166(b)(8). Estates owning stock in a holding company may also qualify for §6166 if the executor makes a §6166(b)(8) election. In this instance, an estate is considered to own stock in the business company, the stock of which is held directly or indirectly through one or more holding companies. Further, to

⁴⁸ See, e.g., TAM 8451014; PLRs 8524037 and 9015009 (partnership only collected rents); but see rulings finding active conduct of a real estate rental service business, rather than mere management of investments, PLRs 9517006, 9223028, 8942018, 8829013, 8804029; 9634006.

qualify for the election the stock of all such companies -- holding or business companies -- must be "non-readily-tradable" stock, as defined under §6166(b)(7)(B).

8.1(c)(6)(A) The stock in the business company which the estate is deemed to hold is treated as voting stock "to the extent that voting stock in the holding company owns directly (or through voting stock of one or more other holding companies) voting stock in the business company."

8.1(c)(6)(B) A holding company is defined as any corporation holding stock in another corporation, and a "business company" is defined as any corporation carrying on "a trade or business" as defined in §6166. §6166(b)(8) has been held not to be either a clarification of prior law (the first §6166) or retroactive, with the result that stock in a bank holding company does *not* satisfy the trade or business requirement. See *Moore v. U.S.*, 87-2 USTC Para.13,741 (E.D. Tex. 1987).

8.1(c)(6)(C) §6166(b)(9)(B)(iii) provides another exception, which appears to allow a holding company that is also a business company to qualify directly under §6166(a)(1) for estate tax deferral. This exception applies to a parent corporation owning 20% or more in value of the voting stock of a subsidiary, or a subsidiary which has 15 or fewer stockholders, and 80% or more of the value of the assets of such subsidiary or parent is attributable to assets used in carrying on a trade or business. If these conditions are met, the parent and all such subsidiaries are treated "as one corporation" for purposes of applying the §6166(b)(9)(B)(ii) "passive asset" test, which defines a passive asset as "any stock in another corporation" (emphasis added). Apparently, if a parent and subsidiary are treated as one corporation there can be no stock "in another corporation," hence no "passive asset." For the purposes of this rule, when applying the test as to whether 80% or more in value of the assets of each corporation is attributable to assets used in carrying on a trade or business, the stock of a business company held by a holding company is not taken into account

8.1(c)(7) Deferral Not Available for Portion of Business Consisting of Passive Assets -- §6166(b)(9). The "closely held business amount" of §6166(b)(5) used in determining the portion of estate tax deferred under §6166(a)(2), as well as "the value of an interest in a closely held business" used in determining whether the estate qualifies for deferral under §6166(a)(1), excludes the portion of the interest in a closely held business attributable to "passive assets." These are assets not used in carrying on a trade or business, and include any stock in another corporation unless: (i) the stock is deemed to be held by the decedent by reason of the holding company election of §6166(b)(8); and (ii) the stock qualified under §6166(a)(1) as exceeding 35% of the adjusted gross estate.

8.1(d) Multiple Closely Held Businesses -- §6166(c). If 20% or more of the total value of each closely held business is held by the estate, the aggregate of all such holdings is treated as an interest in a single closely held business for determining qualification for §6166 estate tax deferral. For purposes of meeting the 20% requirement, an interest in a closely held business which represents an interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common, will be included in determining the value of the decedent's gross estate.

8.1(e) Loss of Right to Defer Payment of Estate Tax -- §6166(g). There are four circumstances which accelerate the estate's deferred obligation to pay estate taxes: (1) disposition of business interest or withdrawals from business; (2) distribution of insufficient income by the estate; (3) default in payment of installment amounts or interest; and (4) violation of lien condition under §6324A. The sale of some of the businesses' assets will not be treated as a disposition under §6166(g)(1)(A) if the proceeds are applied to reduce mortgage debt on encumbered assets of the operating business, or applied to the payment of business debts. A like-kind exchange under §1031 is not considered a disposition. The following distributions are treated as not triggering the acceleration rules: (1) a transfer of the decedent's property to a person entitled to it under the decedent's will, the applicable law of intestate succession, or under a trust created by the decedent; and (2) subsequent transfers of property by reason of death, so long as each transferee is a member of the family, as defined in accordance with the attribution rules of §267(c)(4).

8.1(f) Coordination of §303 and §6166. If the estate's interest qualifies for §303, then a decedent's stock may be redeemed by the corporation to pay estate taxes and administrative expenses without such redemption being characterized as a dividend; i.e., the redemption will be characterized as a sale or exchange of the stock subject to capital gain, rather than ordinary dividend treatment.

8.1(f)(1) In order to coordinate §303 with §6166, the value of the stock needs to exceed 35% of the excess of the value of the gross estate over the deductions allowed under §§2053 and 2054. §303 redemptions may be made within four years after the decedent's death, and during the §6166 deferral period, if the amount of taxes or administration expenses justifying §303 redemptions are paid within one year after the §303 redemption. For purposes of measuring distributions or withdrawals and the amount of the estate's interest in the business, certain redemptions to which §303 applies are (i) not treated as distributions or withdrawals and (ii) are considered as reducing the value of the estate's interest in the closely held business.

8.1(f)(2) The condition required for a §303 redemption not to be treated as a distribution, and for the acceleration base to be reduced by the amount of the §303 redemption, has caused controversy. However, the 1976 House Report on §303 stated that 303 and 6166 should operate in harmony as the extended period for redemption is intended to more closely correlate (the two sections), particularly in that it would allow the corporation to build up liquid assets and redeem stock so that the payment of the estate taxes might be made at any time throughout the period for making installment tax payments.

8.2 The Family Owned Business Deduction. The requirements for the new Qualified Family Owned Business Deduction are very similar to the requirements for the Special Use Valuation election under Code §2032A.

8.2(a) Prior Exclusion Rules. The Qualified Family Owned Business Deduction of Code §2057 began as an exclusion rather than as a deduction. Prior law permitted an executor to exclude up to \$1.3 million in value of a qualified family owned business interest from the taxable estate. Generally, the exclusion was available if an estate contained a substantial ownership interest in a family business and that interest was left to one or more "qualified heirs."

8.2(b) New Deduction Provision. Now an executor may elect to deduct an amount, which when combined with the unified credit, equals \$1.3 million of a qualified family owned business interest. Under §2057(a), the estate tax liability of an estate for which the executor elects the deduction is calculated as if the estate were allowed a maximum qualified family-owned business deduction of \$675,000 and an applicable exclusion amount under §2010 (i.e., the amount exempted by the unified credit) of \$625,000, regardless of the year in which the decedent dies. If the estate includes less than \$675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

Example: D dies in 2005, when the applicable exclusion amount is \$800,000, with an estate that includes qualified family-owned business interests valued at \$675,000 or more. The estate tax liability is calculated as if the estate were allowed a deduction of \$675,000, and the applicable exclusion amount is limited to \$625,000. If instead D's estate includes QFOBIs of \$500,000 or less, all of the QFOBIs could be deducted from the estate, and the applicable exclusion amount would be \$800,000. If D's estate includes QFOBIs valued between \$500,000 and \$675,000, all of the QFOBIs could be deducted from the estate, and the applicable exclusion amount would be calculated as the excess of \$1.3 million over the amount of the QFOBIs. Thus, if D's QFOBIs were valued at \$600,000, the applicable exclusion amount would be \$700,000.

8.2(c) Five Basic Requirements.

8.2(c)(1) The owner of the interest must have been a U.S. citizen or resident at the time of death.

8.2(c)(2) The interest must be a qualified interest in a family owned business.

8.2(c)(3) The value of the decedent's family owned business interest that are passed to a "qualified heir" must exceed 50 percent of value of the decedent's adjusted gross estate.

8.2(c)(4) The decedent or another family member must have materially participated in the business during at least five of the eight years preceding the decedent's date of death.

8.2(c)(5) The executor must file an election along with a recapture agreement signed by the heirs receiving the interest.

8.2(d) Family Business Interest Requirement. This involves a two-pronged test: (1) the decedent must have "owned" the interest, and (2) to be qualified the interest must represent ownership in a "family business." The ownership must be owned in one of the following ways: (1) 50 percent directly or indirectly owned by the decedent and/or members of the decedent's family; (2) 70 percent directly or indirectly owned by members of two families; or (3) 90 percent directly or indirectly owned by members of three families.

8.2(e) Prohibited Interests. A business whose principal place of business is outside the U.S.; an interest that was readily tradeable on a securities exchange any time within three years of decedent's death; and an interest in a business where more than 35 percent of the income of the trade

or business would qualify as personal holding company income, will not qualify for the deduction treatment.

8.2(f) Qualified Heirs. A qualified heir is a member of the decedent's family, or an individual who has been actively employed by the trade or business for a least 10 years prior to the decedent's date of death.

8.2(g) Conclusion. Is it worth it? The requirements of the new relief provision are complex and exacting. Are the potential tax savings worth the cost of compliance and the loss of flexibility the election imposes?

8.3 S Corporation Planning. A corporation must satisfy all the requirements of Code §1361; and may not: (a) have more than 75 shareholders; (b) have as a shareholder a person who is not an individual, other than an estate, certain trusts, and certain exempt organizations; (c) have a nonresident alien as a shareholder; and (d) have more than one class of stock. Further, certain corporations are ineligible for S corporation status, such as financial institutions using the reserve method of accounting, insurance companies, a corporation electing to use the §936 possessions tax credit, and a DISC or former DISC.

8.3(a) Number of Shareholders. An S corporation can have no more than 75 shareholders, and stock attribution rules do not apply, except in the case of a husband and wife who are U.S. citizens or residents, who are considered to be one shareholder whether they own the stock jointly or separately. The estate of either spouse also qualifies for this treatment, as long as a decedent spouse's estate is not a foreign estate. An estate that holds S corporation stock is considered as one shareholder (the estate, not the beneficiaries, is considered the shareholder). Regs. §1.1361-1(h) sets forth who the shareholders are for purposes of counting the number of shareholders when subchapter S stock is held by a trust. Each potential current beneficiary of an electing small business trust is counted as a separate shareholder.

8.3(b) Types of Eligible Shareholders. There are nine types of eligible S corporation shareholders: (1) individuals; (2) estates during the period of administration; (3) a voting trust; (4) a "grantor" trust, as that status is determined under §§673-677; (5) a trust treated under §678 as owned by an individual other than the grantor; (6) a qualified subchapter S trust (QSST); (7) a "will recipient" trust with respect to stock transferred to it pursuant to the terms of a will, but only for the two-year period beginning on the day on which the stock is transferred to it; (8) an electing small business trust, as defined in §1361(e); (9) a qualified tax-exempt shareholder, as defined in §1361(c)(6), i.e., a qualified retirement plan trust.

8.3(b)(1) Where the sole purpose for retaining stock of an S corporation in the estate is to facilitate the installment payment of the estate tax under §6166, the administration of the estate is not considered in existence beyond a reasonable period for §641(a)(3) purposes and the estate will be an eligible shareholder for the period during which the estate complies with the provisions of §6166.⁴⁹

⁴⁹ Rev. Rul. 76-23, 1976-2 C.B. 264.

8.3(b)(2) A grantor or §678 trust which continues in existence after the death of the deemed owner is permitted to remain as an S shareholder for two years after the deemed owner's death. The estate of the deemed owner is treated as the shareholder.

8.3(b)(3) An estate qualifies as a shareholder of an S corporation, and an executor or administrator does not need to affirm consent to the election. Regs. §1.641(b)-3(a) provides that an estate is terminated for federal income tax purposes after the expiration of a reasonable period for performance by the executor of the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, and bequests.

8.3(c) Trusts as S Corporation Shareholders.

8.3(c)(1) Trust All of Which Is Owned by One Individual. §1361(c)(2)(A)(I) provides that a trust all of which is treated as owned by one individual (whether or not the grantor) is an eligible S corporation shareholder. The deemed owner is treated as the shareholder and, thus, must be a U.S. citizen or resident. To satisfy the "all of which" test, an individual must be treated as owning both the income and corpus of the trust under one of the provisions of §§673-678. An individual will be treated as owning both the income and the corpus by reason of a power over or interest in both ordinary income and corpus. If this is the case, the individual takes all items of income, deduction, and credit, including capital gain and losses, into account in computing his income tax liability.

8.3(c)(2) Grantor Trust. A grantor trust is a trust all of which is owned by the grantor under one of the provisions of §§673-677. The grantor is treated as the owner of the trust if: (1) the grantor or the grantor's spouse has a reversionary interest in either the income or principal exceeding 5% of the value of the trust as of its inception (§673); (2) the grantor or the grantor's spouse has the power to control the beneficial enjoyment of the trust property without the approval or consent of an adverse party (§674); (3) the grantor or the grantor's spouse has certain administrative powers (§675); (4) the grantor or the grantor's spouse has the power to revoke the trust (§676); or (5) the income of the trust may be distributed to the grantor or the grantor's spouse or may be applied to the payment of premiums on life insurance policies on their lives (§677).

8.3(c)(3) GRAT and GRUT. A grantor retained annuity trust ("GRAT") and a grantor retained unitrust ("GRUT") are irrevocable trusts to which the grantor transfers property while retaining the right to receive an annuity or unitrust interest, respectively, for a term of years with the property thereafter passing to others, such as the grantor's children. A GRAT or GRUT qualifies to hold S corporation stock if the trust instrument includes provisions that cause the grantor to be taxed on all of the income earned by the trust, i.e., by making the trust a wholly grantor trust for income tax purposes. The grantor's retained annuity or unitrust interest is not sufficient, since it is not a right to all the income of the trust. There are a variety of provisions that can be added to a GRAT or GRUT to create wholly grantor trust status. For example, retention by the grantor of a §673 reversionary interest or certain §675 administrative powers results in the trust being a grantor trust for income tax purposes; e.g. the grantor having the power, acting alone and in a nonfiduciary capacity, to reacquire property of the trust by substituting other property of an equivalent value, causing the trust to be treated as a grantor trust under §675(4).

8.3(c)(4) §678 Trust. A trust all of which is treated under §678 as owned by an individual other than the grantor is also a permitted S corporation shareholder. An individual is treated as the owner of the trust if the individual has the power to vest all the principal or income in themselves, or has previously partially released or otherwise modified such a power while retaining such control as would subject the grantor of a trust to treatment as the owner thereof under §§671-677.

8.3(c)(5) Two-Year Trust. §1361(c)(2)(A)(ii) provides that a grantor or §678 trust which continues in existence after the death of the deemed owner is a permitted S corporation shareholder for a period of two years after the deemed owner's death.

8.3(c)(6) "Will Recipient" Trust. A trust that acquires its stock pursuant to the terms of a will is an eligible S corporation shareholder; however, the eligibility of a will recipient trust lasts only for a period of two years, beginning with the day on which the stock is distributed to the trust. The estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the two-year period beginning on the day that the stock is transferred to the trust.

8.3(c)(7) Voting Trust. A trust created to exercise the voting power of stock transferred to it may be an S shareholder. Each trust beneficiary is counted in determining the number of shareholders, and each beneficiary must be an eligible shareholder.

8.3(c)(8) Qualified Subchapter S Trust ("QSST"). In order for a trust to be eligible for QSST status, it must satisfy the requirements of Regs. §1.1361-1(j)(1)(ii) from the date the QSST election is made or from the effective date of the QSST election (whichever is earlier) throughout the entire period that the current income beneficiary and any successor income beneficiary is the trust income beneficiary. If the terms of the trust do not preclude the possibility that any of the QSST requirements are not met, the trust will not qualify as a QSST.

8.3(c)(8)(A) The trust instrument must require that it will have only one current income beneficiary. §1361(d)(3) permits a share of a trust to be treated as a separate trust for QSST purposes if it qualifies as a "substantially separate and independent share of a trust within the meaning of Section 663(c)." Each separate share also counts as one shareholder. The separate share rule may be applied even though separate and independent accounts are not maintained or required, and no physical segregation of assets is maintained or required.⁵⁰ The separate share rule has been followed when the trust is not a discretionary sprinkle trust but, instead, directs the trustee to distribute the income (and principal) to the beneficiaries in a certain way, for example, equally or in certain percentages.⁵¹

⁵⁰ See Regs. §1.663(c)-1(c). Regs. §1.1361-1(j)(3) references the §663(c) regulations in defining a separate and independent share for QSST purposes.

⁵¹ In Rev. Rul. 93-31 the IRS ruled that a separate share trust cannot qualify as a QSST if there is even a remote possibility that the trust corpus will be distributed during the current income beneficiary's lifetime to someone else. The trust provided that income is payable equally to B and

8.3(c)(8)(B) The current income beneficiary must be a U.S. citizen or resident.

8.3(c)(8)(C) All the income is, or is required to be, distributed currently to the income beneficiary; it is not necessary that the trust instrument provide that all the income be distributed to the current income beneficiary. As long as all income is in fact distributed to the current income beneficiary, and no other beneficiary, the requirement is met. PLR 8836057 provides that when a trust meets all the QSST requirements, and contains a provision allowing the beneficiary to elect annually to have the trustee retain all or a portion of the trust income does not change the status of the trust as a QSST.

8.3(c)(8)(D) The trust instrument must contain a provision that any principal distributed during the beneficiary's life may be distributed only to the beneficiary. If the terms of the trust are silent with respect to corpus distributions, and distributions to persons other than the current income beneficiary are permitted under local law, then the terms of the trust do not preclude the possibility that corpus may be distributed to someone other than the income beneficiary and the trust is not a QSST.⁵²

8.3(c)(8)(E) The trust instrument must require that the beneficiary's income interest must end on the beneficiary's death or the trust's earlier termination.

8.3(c)(8)(F) The trust instrument must require that if the trust terminates during the beneficiary's life, all the trust assets must be distributed to the beneficiary.

8.3(c)(8)(G) Various types of trusts created for other estate planning purposes also may qualify as QSSTs while others may not qualify.

- General Power of Appointment Marital Deduction Trust would qualify; however, the marital deduction may be disallowed with respect to that part of a marital trust which is funded with stock in a closely held business if the terms of the trust or any buy-sell agreement governing the stock do not either

C and that the trustee has discretion to pay corpus to B for B's health, education, support, or maintenance, after considering B's other income. Even though B's other income was so substantial that the possibility of exercise of the power to distribute corpus was remote, the IRS stated that C's share of the trust is not a QSST because of the possibility, even though remote, that C's share of corpus will be distributed to someone other than C during C's lifetime

⁵² See Regs. §1.1361-1(j)(1)(iii). In Rev. Rul. 93-79 the IRS ruled that a defective QSST retroactively reformed by a state court to prevent any distribution of corpus to a beneficiary other than the current income beneficiary was not retroactively recognized as a qualified S corporation shareholder, explaining that a retroactive change of the legal effect of a completed transaction does not have any retroactive effect for federal tax purposes. The IRS stated, however, that the trust reformation would be recognized prospectively, allowing the corporation to file a new S corporation election for a subsequent taxable year without waiting out the five-year period required by §1362(g).

allow stock transfers without the consent of an individual other than the surviving spouse, or give individuals other than the surviving spouse the right to purchase the stock for a price significantly below its fair market value.⁵³

- QTIP Trust - Two elections must be made when a QTIP trust is to qualify as a QSST: one by the executor to qualify the trust for the marital deduction and another by the beneficiary of the trust to qualify the trust as a QSST.
- A §2056A qualified domestic trust ("QDOT") cannot qualify as a QSST unless the beneficiary is a U.S. resident.
- §2503(c) Trusts. This trust, for the benefit of a minor, is designed to satisfy the present-interest requirement for the annual gift tax exclusion, and has only one income beneficiary. Only the income beneficiary qualifies for corpus distributions during his or her lifetime; and upon termination of the trust during the life of the beneficiary the trust assets are to be distributed to the beneficiary. Thus, a 2503(c) trust qualifies as a QSST, provided the trustee distributes, or is required to distribute, the income at least annually to the beneficiary.
- Charitable Remainder Trust - In Rev. Rul. 92-48 the IRS concluded that a charitable remainder annuity trust or unitrust cannot qualify as a QSST and vice versa. Consequently, assets other than S corporation stock must be used to fund charitable remainder trusts. The IRS based its ruling on the mutual exclusivity of charitable remainder trusts and QSSTs under the two distinct systems of income taxation applicable to the respective trusts. The QSST election causes the beneficiary of the trust to be treated as the owner of the portion of the trust consisting of S corporation stock under §678(a) and guarantees that the beneficiary is taxed on all the income earned by the trust relating to the stock. In contrast, the beneficiary of an income interest under a charitable remainder trust is only taxable on the unitrust or annuity amount, and the trust would therefore represent, in effect, two owners of S corporation stock: the income beneficiary and the trust.
- Unified Credit "Sprinkle" Trust may qualify as a QSST if it has only one beneficiary and the trust meets all the other QSST requirements. The typical unified credit sprinkle trust permitting the trustee to distribute income to the surviving spouse and issue does not qualify as a QSST. However, the terms of such a trust can be effectively modified by means of agreement or disclaimers.

8.3(c)(9) Electing Small Business Trust. The Small Business Job Protection Act of 1996 allowed an electing small business trust, defined in §1361(e), to be an S corporation

⁵³ See TAM 9147065

shareholder. This type of trust, unlike a QSST, may have multiple beneficiaries, accumulate income, sprinkle both income and principal among the beneficiaries, and serve as a generation-skipping vehicle. Therefore, additional options are available for both inter vivos and testamentary transfers of S corporation stock. To qualify for this treatment: (1) all beneficiaries of the trust must be individuals, estates, or charities and other organizations described in §170(c)(2)-(5); (2) no interest in the trust may be acquired by purchase; and (3) an election must be made by the trustee.

8.3(c)(9)(A) §1361(e)(1)(B) explicitly prohibits a QSST or tax-exempt trust from qualifying as an electing small business trust. §1361(e)(1)(C) defines acquisition by purchase as any acquisition having a cost basis under §1012. This requirement has the effect of mandating that all interests in the trust be acquired by gift or bequest. Charitable remainder annuity trusts and charitable remainder unitrusts also are prohibited by statute from qualifying as electing small business trusts.

8.3(c)(9)(B) The election to be treated as an electing small business trust is described in Notice 97-12, 1997-1 C.B. 385. Until the IRS publishes a form on which to make the election, it may be made by filing a statement with the IRS Service Center with which the S corporation files its income tax return.

8.3(c)(9)(C) There are explicit rules for determining how an electing small business trust is treated for purposes of the 75-shareholder limitation. §1361(c)(2)(B)(v) provides that each "potential current beneficiary" is treated as a shareholder, except that during any period when there is no potential current beneficiary, the trust is treated as the shareholder. Section 1361(e)(2) defines potential current beneficiary, with respect to any period, as any person who during that period is entitled to, or who may receive at the discretion of any person, an income or principal distribution. Therefore, care should be taken in defining potential beneficiaries so that the 75-shareholder limit is not exceeded inadvertently (e.g., by after-born children, contingent beneficiaries becoming potential current beneficiaries on the death of the original beneficiary, etc.).

8.3(c)(9)(D) Because of the multiple beneficiary and sprinkle possibilities of these trusts, they have the potential to add flexibility. For example, a credit shelter trust with multiple beneficiaries may qualify, as may a decedent's revocable grantor trust that becomes irrevocable at death, regardless of the number of permissible beneficiaries (subject to the 75 shareholder limit) and without the two-year post-death eligibility period limitation. Similarly, an irrevocable inter vivos trust allowing discretionary income and principal distributions can be established as a gifting device to take advantage of the §2503(b) gift tax annual exclusion. Allowing charities as contingent remainder beneficiaries allows the use of S corporation stock to make charitable gifts.

8.3(d) Estate Administration Considerations.

8.3(d)(1) S Election - The estate of a deceased shareholder need not file a consent to the S election, nor does it have the power to revoke the election, unless it owns more than

50% of the outstanding shares. If the estate transfers S corporation stock to a trust that meets the QSST requirements, the beneficiary of the trust must elect to have the trust qualify as a QSST within two months and 16 days of the transfer.

8.3(d)(2) Income Tax Considerations - An estate holding S corporation stock has distributable net income, even if the S corporation does not distribute currently all of its income. Thus, distributions by the estate to beneficiaries that would otherwise have been nontaxable, may be taxable to the beneficiaries.

8.3(d)(3) §303 Redemption - A §303 redemption may apply with respect to a deceased shareholder's interest in an S corporation. However, it is less important for an S corporation shareholder to have a redemption qualify as a sale or exchange rather than as a dividend, because the distribution is applied against basis. The direct taxation of the S corporation's income to its shareholders, whether or not distributed, and flow-through of all other corporate items, coupled with equivalent basis adjustments of the shareholders' shares, results in little gain or loss to the shareholder in connection with redemption distributions. If the S corporation has accumulated earnings and profits from C corporation years, any distribution is applied against basis to the extent of the AAA account. Distributions in excess of AAA are taxable as dividends to the extent of accumulated earnings and profits, and then tax-free to the extent of stock basis.

8.3(d)(4) §6166 Installment Payment - The executor or administrator may be able to elect to pay any estate taxes due in installments pursuant to §6166.

8.3(d)(5) Election of Fiscal Year for Estate - The executor should consider electing a fiscal year for the estate in order to defer income taxation of S corporation income in the event the estate is still open during any part of the calendar year following the year in which the shareholder died.

8.3(d)(6) Terminating the Election - The executor should determine whether the S corporation status is still advantageous. If termination is desirable, the executor must determine how and when the election can be terminated. If the estate owns more than one half of the shares of stock of the S corporation, the executor can revoke the election without the consent of the other shareholders. Considerations such as the passing through of income items and distributions of previously taxed income may make timing of the revocation important. Except when the revocation specifies a prospective date on which it is to become effective, a revocation made during the taxable year and on or before the 15th day of the third month of the taxable year is effective on the first day of such taxable year, and a revocation made after the 15th day of the third month of the taxable year is effective on the first day of the following taxable year. The executor can also effect the termination of the election without the consent of the other shareholders by either transferring the stock to an ineligible shareholder, or by transferring the stock to a sufficient number of transferees so that the number of shareholders exceeds the §1361(b) limit. In either case, the corporation's S status will end immediately. Before terminating the election, the executor must determine whether there are any agreements in effect which would prevent the termination, or which would make the estate or the beneficiaries liable to the other shareholders for any loss or tax incurred by the other shareholders on account of the termination. In addition, the executor

should consider whether or not the termination will later be advantageous to the beneficiaries when the S corporation stock is in their hands, since S corporation status cannot be reelected for five years unless the IRS consents.

8.3(d)(7) Making the Election - The executor should consider whether it would be advantageous to convert a C corporation of which the decedent was a shareholder into an S corporation after his or her death in the event the corporation meets all the eligibility requirements. Unlike termination of the election, however, the consent of all of the shareholders is required to make the S election. The executor must consent to the election for the estate. Factors to be considered by the executor before making the election include:

8.3(d)(7)(A) The Shareholders' Income Needs - If the corporation has been profitable and all of the beneficiaries have substantial income from other sources, the election may not be desirable. However, if the beneficiaries need additional income, an S election may be desirable. Under §1366(b), the character of any item of income, loss, or deduction is the same in the hands of the shareholder as it was to the corporation. This may be important, for example, if the beneficiary could use a capital loss to offset a capital gain.

8.3(d)(7)(B) The Business Needs of the Corporation - If the corporation needs to retain its earnings for business purposes, it may not be able to distribute sufficient cash to the beneficiaries to enable them to pay the tax on the undistributed taxable income. In addition, if the decedent was a dominant force in the business, his or her death may make it important to retain earnings within the corporation in the interest of survival or growth. The need to retain earnings may also arise where the corporation is obligated to redeem the decedent-shareholder's stock pursuant to a buy-sell agreement and must borrow the purchase price, thus forcing the corporation to accumulate earnings to repay the debt.

8.3(d)(7)(C) The Effect on Net Operating Loss Carry-overs - No carryforward or carry back items arising in a taxable year in which a corporation was a C corporation may be carried to a taxable year in which the corporation is an S corporation, but an S corporation year is treated as an elapsed year in determining the number of years these items may be carried forward or back. Thus, if the corporation has a net operating loss carryover, the S corporation election will cause the carryover to be unavailable during any S corporation year, and if the corporation continues to operate as an S corporation, the carryover ultimately will be lost. If the decedent-shareholder was unable to deduct the corporation's losses because of his or her low basis in the stock, the §1014 step-up in basis of the stock in the hands of the beneficiaries may make the deductibility of future losses a reason to make the election.

8.3(d)(7)(D) Loss of Fiscal Year - If a C corporation has an advantageous fiscal year which it desires to retain, making the election may cause the corporation to forfeit that fiscal year and switch either to a calendar year or other fiscal year "for which the corporation establishes a business purpose."

8.3(d)(7)(E) Employee Fringe Benefits - S corporations enjoy essential parity with C corporations for qualified plan purposes. However, S corporation benefits are limited severely for shareholders who own more than 2% of the outstanding S corporation stock or possess more than 2% of the total combined voting power of the S corporation stock, because §1372 treats such shareholders as though they were partners in a partnership. If the beneficiaries of the stock are actively involved in the business and enjoy such benefits, making the election may not be desirable.

8.3(e) Sale of Company - Post Closing Events. Assuming that a sale of the Company will not occur on December 31, then consideration must be given to post closing events. The following suggested form language explains the problem and addresses the issue.

If the Corporation's Shares are transferred pursuant to the terms of this Agreement, then it is agreed that in order to ensure that a selling shareholder is not affected by any Corporation post-sale taxable events, the Corporation and the Shareholders will use the "closing-of-the-books" income tax method whenever a Selling Shareholder sells all of tier stock on a day other than the last day of the Corporations's fiscal year. Under the "closing-of-the-books" method, the Selling Shareholder's allocation of items for the taxable year will be computed as if the Corporation's taxable year ended on the day of the Selling Shareholder's termination of interest. Further, it is understood and agreed that the Corporation will recognize two taxable years, the first of which will end on the date of such Selling Shareholder's termination of interest, and the second of which will be from the date of such sale until the end of the fiscal year. The parties will file all income tax returns consistent with the "closing-of-the-books" method.

9. FIDUCIARY BUSINESS EXAMINATION ISSUES.

9.1 Develop Your Checklist. In order to better understand the value of a business and in preparation for sale, it is imperative that the fiduciary commence, upon appointment, an examination of the business, an examination for conflicts of interest and develop safeguards to avoid self-dealing. This checklist is presented as a starting point in this examination.⁵⁴

9.2 Identify *Business Interested Parties and Potential for Conflicts.* Prepare a list that identifies each person who is connected to the business. Are any of these persons or organizations a beneficiary of any other trust or associated (client, customer or vendor) with the fiduciary? If so, determine the nature of such relationship, and whether a conflict exists.

9.2(a) All shareholders - percentage ownership interests and names of immediate family.

9.2(b) All officers - including honorary, emeritus, or "of counsel" relationships

⁵⁴ This checklist is not complete! This checklist has been prepared from a list of practical mistakes - use it with caution!

9.2(c) All members of the Board of Directors and advisory boards.

9.2(d) All advisors including accounting and law firms and owners of these advisors.

9.2(e) Substantial customers.

9.2(f) Substantial creditors - including the fiduciary itself, and the estate or trust.

9.3 Identify *Fiduciary Interested Parties and Potential for Conflicts*. Prepare a list that identifies all persons and organizations who might be affected by the business and determine if a conflict exists.

9.3(a) All Beneficiaries of the estate and their relationship to the fiduciary and other fiduciary relationships.

9.3(b) Customer Relationships of business to fiduciary and vice-versa.

9.3(c) Lending Relationships - does the fiduciary lend money to the business or to the beneficiaries.

9.3(d) Depository Relationships - what deposits are maintained by the business or beneficiaries.

9.3(e) Leasing Relationships.

9.3(f) Fiduciary Board of Directors, including community advisory committees.

9.3(g) Fiduciary Relationships with any one listed on business lists.

9.4 Disclose Conflicts. After performing conflicts check advise beneficiaries, their counsel, the court and whoever that a conflicts check has been made and you are satisfied that you may serve as fiduciary.

9.5 Initial Examination of Beneficiary Issues.

9.5(a) Confer with *each* beneficiary and determine their needs; financial abilities; concerns; desires; their attitudes about the business, and knowledge of any possible conflicts of interest. Document all findings - *ask if they have any ideas or suggestions for the sale of the business.*

9.5(b) Confer with *each* beneficiary's lawyer or other advisor and confirm or review your findings regarding your discussions with the beneficiary with them, and knowledge of any possible conflicts of interest. Ask for concurring opinion in writing.

9.6 Initial Examination of Business Issues. *Make immediate determination if business may continue operations on a profitable basis - and make due diligence examination of following.*

9.6(a) Identify the size of the business holding in relation to total outstanding ownership

interests - does fiduciary have effective or legal "control?"

9.6(b) Identify the size of the business holding in relation to other assets of estate.

9.6(c) Employ an independent accounting firm to conduct an examination of the business financial statements, income tax returns, and books and records and request a confidential reply.

9.6(d) Employ appraisers to commence independent valuation of business interests. Make an initial determination of whether one or two appraisals will be needed; who will review report of appraisals. Examine and compare appraisal issues to employee stock ownership plans.

9.7 Employ Counsel to Examine Legal Structure of Entity.

9.7(a) Business organization counsel along with probate counsel should be employed to conduct an in-depth examination of organization's articles of formation (incorporation or organization), by-laws, operating agreements, and obtain advice on the following matters.

9.7(b) Obtain Good Standing Certificates of state where Seller is incorporated; and states where business is qualified to do business. Is the business organization qualified to do business in all the states that it is doing business?

9.7(c) Review all minutes of Board of Directors and the minutes of committees, e.g., executive, nominating, compensation, and audit committees. Are these matters current? Has the Board of Directors (managers) approved compensation arrangements; loans from and to banks, and to insiders (officers and members of Board of Directors), and real estate transactions, etc.

9.7(d) Determine if stock restriction agreements are in effect. If so, then:

9.7(d)(1) Is restrictive transfer language "conspicuous" on the face of the stock certificates or other instruments which evidence ownership?

9.7(d)(2) Will agreement may affect the ability to sell stock and at what price?

9.7(d)(3) Will agreement be operative to deny "*transfer*" of certificate under probate law?

9.7(d)(4) Are there any corporate law restrictions on corporate redemption of decedent's shares and will corporate law restrictions adversely affect ability of corporation to redeem stock? Are there impairment of capital or redemption on pro-rata basis among all shareholders?

9.7(d)(5) What is the effect of such agreement if surviving spouse elects marital share under state law?

9.7(e) Should the Articles of Incorporation - Organization be revised to permit direct shareholder or member voting on all issues thereby doing away with Board of Directors or Managers? How are Directors elected - is cumulative voting required under law of state

incorporated under or under By-laws?

9.7(f) Inquire as to the existence of any partnership or joint venture affiliations, trusts and agency relationships.

9.7(g) Investigate any predecessor organizations and the term of any prior acquisitions, mergers or consolidations.

9.7(h) Determine legal authority to sell stock to outsiders vs. current shareholders.

9.8 **Develop Program for Monitoring of Business Activity.** Require an appropriate schedule of reports from officers and demand specific recommendations for action to secure business.

9.9 **Prepare Financial Analysis.**

9.9(a) Obtain financial statements for five preceding years, and if financial statements are not audited, determine if limited audit is necessary. Have financial statements reviewed by an independent accounting firm.

9.9(b) Working Capital Ratio - for at least three years.

9.9(c) Annual Inventory Turnover - for at least three years.

9.9(d) Aging schedule of accounts receivable.

9.9(e) Cash Deposits - Reserves vs. Liabilities - are cash resources being used wisely?

9.9(f) Obligations to Estate or Trust - should these obligations be paid - is it intended that they be paid?

9.10 **Review S Corporation Issues.**

9.10(a) Terminating the Election - Is the S corporation status still advantageous. Pass through items and distributions of PTI make timing of revocation important. Before terminating election, determine whether there are any agreements which prevent the termination, or which would make the estate or beneficiaries liable to other shareholders for any loss or tax incurred on account of termination. Will a termination of an election be advantageous to the beneficiaries when the S corporation stock is in their hands? (S corporation status cannot be reelected for five years unless IRS consents.)

9.10(b) Making the Election - Would it be advantageous to convert C corporation into an S corporation, consent of all shareholders is required, and following factors should be considered.

9.10(b)(1) The Shareholders' Income Needs - Determine shareholders need for additional taxable income. The character of any item of income, loss, or deduction is the same in the hands of the shareholder, and this may be important, for example, if the beneficiary could use a capital loss to offset a capital gain.

9.10(b)(2) Corporation's Business Needs - If the corporation needs to retain earnings for business purposes, it may not be able to distribute sufficient cash to the beneficiaries to enable them to pay the tax on undistributed taxable income. If decedent was a dominant force in the business, death may make it important to retain earnings for corporation's survival or growth, or to fund the corporation's obligation to redeem the decedent's stock.

9.10(b)(3) Effect on NOL Carry-overs - If the corporation has a NOL carryover, an S corporation election will cause the carryover to be unavailable during any S corporation year, and, possibly, ultimately lost. If the decedent was unable to deduct corporation's losses because of a low basis in the stock, the §1014 step-up in basis of the stock in the hands of the beneficiaries may make the deductibility of future losses a reason to make the election.

9.10(b)(4) Loss of Fiscal Year - If a C corporation has an advantageous fiscal year which it desires to retain, making the election may cause the loss of that fiscal year.

9.10(b)(5) Employee Fringe Benefits - S corporation benefits are limited for shareholders who own more than 2% of an S corporation's stock; if the beneficiaries are actively involved in the business making the election may not be desirable.

9.10(c) Sale of Company - consider affect of post sale events and consider imposing a "closing of the books" method for determining income.

9.11 Antitrust Implications. Consider possible antitrust considerations of any disposition or acquisition under Section 7 of the Clayton Act and other federal statutes, e.g., Hart-Scott-Rodino filing. Specifically, commence a review of possible purchasers and motives of any buyer.

9.11(a) Determine the business' relevant market products and market areas.

9.11(b) Review marketing practices and trade membership practices.

9.11(c) Inquire as to past antitrust problems of the business and any allegations or investigations or price fixing, monopolization, injunctions and consent decrees.

9.12 Bank Accounts. Obtain a list of all bank and escrow and investment accounts - review of conflicts, and financial resources and sufficiency of such amounts.

9.13 Employee Information. The following types of information should be carefully reviewed by the fiduciary's counsel.

9.13(a) Review all managing agreements, employment agreements, non-competition agreements, consulting agreements and secrecy agreements.

9.13(b) Determine if any oral employment agreements or company policies exist which could create employment rights, etc.

9.13(c) Review incentive compensation, deferred compensation, cash and stock bonus arrangements, e.g., (a) annual bonus arrangements for cash or stock; (b) long term arrangements for

cash or stock; (c) fixed versus discretionary plans; (d) "Golden Parachute" arrangements; ISOs; and (f) Non-qualified stock option plans.

9.13(d) Review all qualified plans including (a) defined benefit plans; (b) defined contribution plans; (c) Employee Stock Ownership Plans ("ESOPs"); and (e) Multi-employer plans.

9.13(e) Review all non-qualified deferred compensation plans, including Supplemental Employee Retirement Plans ("SERPs"); and Excess benefit plans; life insurance; insured or self-insured arrangements; Voluntary Employee Beneficiary Arrangements ("VEBAs") and with regard to such plans does the business' financial statements reflect the liability under all of such plans?

9.14 Insurance. Contact and obtain independent advice regarding adequacy of insurance coverage.

9.15 Inventory. Determine whether inventory is in the hands of vendors, at customer locations or otherwise, determine whether any inventory on hand is owned by someone other than the business, that is, consignment, work-in-process, demos and contract work. Determine obsolescence, marketability of inventory.

9.16 Labor Relations. Conduct a review of any collective bargaining contracts, and determine any specific contractual to notify or bargain with the union regarding the sale of the business, to provide severance pay; if closing a plant or making major changes in work assignments are contemplated, check restrictive, statutory, court and NLRB decisions.

9.17 Litigation. Obtain a complete litigation list and review auditor's attorney inquiry letters and replies for the prior five years, and have updated by current letter from counsel. Inquire as to the existence of consent decrees and applicable injunctions, etc. Inquire as to the potential exposure relating to any other activities of pertaining to the business.

9.18 Loans and Commitments. Obtain and review terms, binding effect, assignability, etc., of all business loans, including bank loans, bonds, industrial development bonds, and loans to officers, members of Board of Directors. What is effect of any possible conflicts of loans and any covenants in loan agreements on a sale of the business.

9.19 Franchise and Distributorships. Determine if there are any such agreements and ability to assign, including trademarks, patent, licenses, etc.

9.20 Properties. Obtain title opinions on real estate and check for environmental studies. Perform Uniform Commercial Code, tax and other lien searches in all applicable jurisdictions. Determine location and condition of all plants, machinery and equipment, and title to equipment. With regard to real property do the following.

9.20(a) Ascertain whether land or facilities have ever been used for the treatment, storage or disposal of hazardous wastes or hazardous substances and whether operation is subject to contingent liability for such activities.

9.20(b) Determine whether any surface area under which any coal is owned or leased by the

business is the subject of any petitions to designate the area as unsuitable for surface coal mining.

9.20(c) Determine whether any conditions or practices exist on any surface area owned by Seller or overlaying minerals being extracted by Seller which would constitute a common law nuisance.

9.21 Depreciation Schedules. Examine depreciation methods and determine reasonability and propriety, not only for accounting purposes, but also for economic substance.

9.22 Regulatory Considerations. Determine the requirements of all federal, state and local regulatory authorities as to the transfer, assignment or sale, permits or licenses, or both. Determine if new permits are required or if increased bond amounts will be required.

9.23 Securities Filings. Obtain copies of all filings made with the Securities and Exchange Commission ("SEC") and state securities agencies related to the Seller and its stock, including: 10Ks, 10Qs, and 8ks; Proxy or informational statements; Registration Statements, such as S-1s, S-7s, or S-8s; and Annual reports to shareholders.

9.24 Other Tax Matters. Obtain copies of all tax returns for all open years. Seek advice regarding the following tax elections.

9.24(a) Obtain list of all tax accounting methods and elections, cash or accrual, depreciation methods, last in first out or first in first out, etc.

9.24(b) Determine the effects of any recapture provisions; such as, Depreciation - IRC §1245 and §1250; LIFO Inventory - IRC §336.

9.24(c) If the business uses the completed contract method of accounting for long-term contracts, determine if a sale will accelerate or force conversion to percentage completion method.

9.24(d) Determine whether any persons that the business treats as an independent contractor could be classified as an employee by the IRS.

9.24(e) Does the corporation have a potential unreasonable accumulation of earnings problem, as defined in §531?

9.24(f) Who is the tax matters partner? Confer with the tax matters partner and confirm status of any tax issues. If no tax matters partner, then ask treasurer for tax status.

BANK CYA LETTER⁵⁵

Dear Advisory Committee Members:

As you may know, Mr. Doe recently transferred 2,325 shares of the common stock of our Bank's stock to the Family Irrevocable Trust. It is the policy of our Bank to require specific authorization to hold this security. Without this authorization, our Bank's policy is to sell this holding in order to avoid the possibility of any conflict or the appearance of a conflict.

If you wish us to retain this holding (including any stock dividends, stock splits, and related securities, such as those received as a result of an acquisition, merger, reorganization or recapitalization), you must sign this letter of direction. By signing this letter, you hereby approve, ratify and affirm the retention of these and any related shares. You further agree, on behalf of yourself and your successors, that our Bank and its affiliates and officers will not be held liable for any loss or depreciation in value or decrease or loss of income sustained by the Trust and its beneficiaries as a result of our following your directions. You further agree that all members of the Advisory Committee must agree to the provisions of this letter of instruction or we will liquidate this holding.

By signing this letter, you also understand and acknowledge that other officers, directors and employees of our Bank and our affiliates may be in possession of information concerning this security, at any given point in time, which, if disclosed to you might impact on your decision to give these instructions or to keep them in effect. However, the disclosure of such information to you or your acting upon such information might constitute improper actions under state and federal securities laws and other legal and ethical considerations. You therefore relieve us and our affiliates, as well as all our officers, directors, and employees and our affiliates, from any duty to disclose to you or to any other person any information, public or non-public, regarding the securities referred to in this correspondence and you release our Bank and our affiliates from any duty to take any action to sell (or purchase additional) such securities unless and until this direction is revoked in writing. You further understand that any sale of such securities upon your direction may be delayed or prohibited because of our Bank's policies which prohibit sales of its own securities during certain periods when insider information may (or may be deemed to) exist.

This direction shall remain in effect until revoked in writing.

Very truly,

I hereby acknowledge and understand the foregoing and agree to its provisions.

Advisory Board Member

⁵⁵Exhibit 1

CONFLICT RULES FOR LAWYERS⁵⁶Rule 1.7: Conflict of Interest: General Rule

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

- (1) The lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
- (2) Each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

- (1) The lawyer reasonably believes the representation will not be adversely affected; and
- (2) The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

Comments to Rule 1.7Loyalty to a Client

[1] Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined. If such a conflict arises after representation has been undertaken, the lawyer should withdraw from the representation. See Rule 1.16. Where more than one client is involved and the lawyer withdraws because a conflict arises after representation, whether the lawyer may continue to represent any of the clients is determined by Rule 1.9. See also Rule 2.2(c).

[2] As a general proposition, loyalty to a client prohibits undertaking representation directly adverse to that client without that client's consent. Paragraph (a) expresses that general rule. Thus, a lawyer ordinarily may not act as advocate against a person the lawyer represents in some other matter, even if it is wholly unrelated. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not require consent of the respective clients. Paragraph (a) applies only when the representation of one client would be directly adverse to the other.

[3] Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client. Paragraph (b) addresses such situations. A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client. Consideration should be given to whether the client wishes to accommodate the other interest involved.

⁵⁶Exhibit 2

Consultation and Consent

[4] A client may consent to representation notwithstanding a conflict. However, as indicated in paragraph (a)(1) with respect to representation directly adverse to a client, and paragraph (b)(1) with respect to material limitations on representation of a client, when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent. When more than one client is involved, the question of conflict must be resolved as to each client. Moreover, there may be circumstances where it is impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent.

Lawyer's Interests

[5] The lawyer's own interests should not be permitted to have adverse effect on representation of a client. For example, a lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee. See Rules 1.1 and 1.5. If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. A lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed interest.

Conflicts in Litigation

[6] Paragraph (a) prohibits representation of opposing partisan litigation. Simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (b). An impermissible conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests is proper if the risk of adverse effect is minimal and the requirements of paragraph (b) are met. Compare Rule 2.2 involving intermediation between clients.

[7] Ordinarily, a lawyer may not act as advocate against a client the lawyer represents in some other matter, even if the other matter is wholly unrelated. However, there are circumstances in which a lawyer may act as advocate against a client. For example, a lawyer representing an enterprise with diverse operations may accept employment as an advocate against the enterprise in an unrelated matter if doing so will not adversely affect the lawyer's relationship with the enterprise or conduct of the suit and if both clients consent upon consultation. By the same token, government lawyers in some circumstances may represent government employees in proceedings in which a government agency is the opposing party. The propriety of concurrent representation can depend on the nature of the litigation. For example, a suit charging fraud entails conflict to a degree not involved in a suit for a declaratory judgment concerning statutory interpretation.

[8] A lawyer may represent parties having antagonistic positions on a legal question that has arisen in different cases, unless representation of either client would be adversely affected. Thus, it is ordinarily not improper to assert such positions in cases pending in different trial courts, but it may be improper to do so in cases pending at the same time in an appellate court.

Interest of Person Paying for a Lawyer's Service

[9] A lawyer may be paid from a source other than the client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty to the client. See Rule 1.8(f). For example, when an insurer and its insured have conflicting interests in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's professional independence. So also, when a corporation and its directors or employees are involved in a controversy in which they have conflicting interests, the corporation may provide funds for separate legal representation of the directors or employees, if the clients consent after consultation and the arrangement ensures the lawyer's professional independence.

Other Conflict Situations

[10] Conflicts of interest in contexts other than litigation sometimes may be difficult to assess. Relevant factors in determining whether there is potential for adverse effect include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that actual conflict will arise and the likely prejudice to the client from the conflict if it does arise. The question is often one of proximity and degree.

[11] For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.

[12] Conflict questions may also arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may arise. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. The lawyer should make clear the relationship to the parties involved.

[13] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.

Conflict Charged by an Opposing Party

[14] Resolving questions of conflict of interest is primarily the responsibility of the lawyer undertaking the representation. In litigation, a court may raise the question when there is reason to infer that the lawyer has neglected the responsibility. In a criminal case, inquiry by the court is generally required when a lawyer represents multiple defendants. Where the conflict is such as clearly to call in question the fair or efficient administration of justice, opposing counsel may properly raise the question. Such an objection should be viewed with caution, however, for it can be misused as a technique of harassment. See Scope.

Rule 1.8. Conflict of Interest: Prohibited Transactions.

- (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
- (1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
 - (2) The client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
 - (3) The client consents in writing thereto.
- (b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation.
- (c) 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.
- (d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.
- (e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:
- (1) A lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
 - (2) A lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.
- (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
- (1) Such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;
 - (2) There is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
 - (3) Information relating to representation of a client is protected as required by Rule 1.6.
- (g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client consents after consultation, including disclosure of the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.
- (h) A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement, or settle a claim for such liability with an unrepresented client or former client without first advising that person in writing that independent representation is appropriate in connection therewith.

(i) A lawyer related to another lawyer as parent, child, sibling or spouse shall not represent a client in a representation directly adverse to a person who the lawyer knows is represented by the other lawyer except upon consent by the client after consultation regarding the relationship.

(j) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

- (1) Acquire a lien granted by law to secure the lawyer's fee or expenses; and
- (2) Contract with a client for a reasonable contingent fee in a civil case.

Comments to Rule 1.8

Transactions between Client and Lawyer

[1] As a general principle, all transactions between client and lawyer should be fair and reasonable to the client. In such transactions a review by independent counsel on behalf of the client is often advisable. Furthermore, a lawyer may not exploit information relating to the representation to the client's disadvantage. For example, a lawyer who has learned that the client is investing in specific real estate may not, without the client's consent, seek to acquire nearby property where doing so would adversely affect the client's plan for investment. Paragraph (a) does not, however, apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

[2] A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If effectuation of a substantial gift requires preparing a legal instrument such as a will or conveyance, however, the client should have the detached advice that another lawyer can provide. Paragraph (c) recognizes an exception where the client is a relative of the donee or the gift is not substantial.

Literary Rights

[3] An agreement by which a lawyer acquires literary or media rights concerning the conduct of the representation creates a conflict between the interests of the client and the personal interests of the lawyer. Measures suitable in the representation of the client may detract from the publication value of an account of the representation. Paragraph (d) does not prohibit a lawyer representing a client in a transaction concerning literary property from agreeing that the lawyer's fee shall consist of a share in ownership in the property, if the arrangement conforms to Rule 1.5 and paragraph (j).

Person Paying for Lawyer's Services

[4] Paragraph (f) requires disclosure of the fact that the lawyer's services are being paid for by a third party unless such payment is provided for in an agreement between the client and the third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest. Where the client is a class, consent may be obtained on behalf of the class by court-supervised procedure.

Limiting Liability

[5] Paragraph (h) is not intended to apply to customary qualifications and limitations in

legal opinions and memoranda.

Family Relationships Between Lawyers

[6] Paragraph (i) applies to related lawyers who are in different firms. Related lawyers in the same firm are governed by Rules 1.7, 1.9, and 1.10. The disqualification stated in paragraph (i) is personal and is not imputed to members of firms with whom the lawyers are associated.

Acquisition of Interest in Litigation

[7] Paragraph (j) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. This general rule, which has its basis in common-law champerty and maintenance, is subject to specific exceptions developed in decisional law and continued in these Rules, such as the exception for reasonable contingent fees set forth in Rule 1.5 and the exception for certain advances of the costs of litigation set forth in paragraph (e).

LETTER REQUESTING BIDS

Re: Sale of Shares of the Lincoln Company, Inc.

Dear _____:

ABC Bank, as executor of the Estate of Abraham Lincoln is preparing to sell its 57 percent ownership of the issued and outstanding shares of common capital stock of the Lincoln Company, Inc. ("Company").

We welcome a proposal by you under the following terms:

1. As the fiduciary for the Estate of Abraham Lincoln we have made a decision to pursue all opportunities to sell all of the Estate's shares of the Company. The proposed sale of stock will be subject to the terms of the buy/sell agreement, a copy of which has been provide to you. To date, most, but not all minority shareholders have indicated that they are willing to sell their interests. Accordingly, and subject to satisfactory completion of reasonable due diligence:

1.1 Please state in exact dollar terms the amount you would agree to pay in cash for 100 percent of the Company's stock, under conditions in which (i) all shareholders would receive proportional payments in accordance with their respective interests, and (ii) no additional consideration would be paid to any shareholder or beneficiary, or representative of any shareholder or beneficiary, in excess of the consideration paid for the shareholder's stock;

1.2 With the agreement that no later than 45 days after the Executor's acceptance of a non-binding letter of intent, all parties will enter into a mutually acceptable stock purchase agreement containing terms and conditions customary for transactions of this nature; and

1.3 With ABC being obligated to make only those representations and warranties set out on the attached Appendix entitled "Seller's Special Representations and Warranties."

2. In the event that not all minority shareholders are willing to sell their interests;

2.1 Please also indicate whether you would be interested in purchasing only the Estate's 57 percent interest in the Company, under conditions in which no additional consideration would be paid to any shareholder or beneficiary, or representative of any shareholder or beneficiary, in excess of the consideration paid for the Estate's interest. If so, please state in exact dollar terms the amount you would agree to pay in cash for the Estate's 57 percent interest in the Company.

2.2 Please also indicate the minimum amount of the Company's stock (greater than the Estate's 57 percent interest in the Company, but less than 100 percent) that you would want to purchase, under conditions in which no additional consideration would be paid to any shareholder or beneficiary, or representative of any shareholder or beneficiary, in excess of the consideration paid for the Estate's interest.

3. Your response must be received by this office, directed to my attention, no later than 4:00 p.m. EST on _____.

4. If any circumstances (such as corporate approvals or regulatory filings) will prevent you from being able to close this transaction in the next 60 days, we will still be interested in receiving a proposal, with an explanation of those circumstances, and a recognition that acceptance of a proposal involving any delay will require a premium above the price that otherwise might be paid by other potential purchasers.

5. If any other circumstances make you unwilling or unable to submit a proposal satisfying the above terms, but you believe that ABC and the beneficiaries might nevertheless be interested in considering a proposal under different terms, please let us know.

It is our intent to evaluate all proposals received by the __ deadline, and then arrange meetings with the three highest offerors to negotiate about material issues and obtain a conditional letter of intent with one of those three. At that we would intend to discontinue further discussions with all other offerors.

Very truly yours,

Estate of Abraham Lincoln,

BY: ABC Bank, Executor

SELLER'S SPECIAL REPRESENTATIONS AND WARRANTIES

1.1 **Fiduciary as Seller.** ABC Bank in its fiduciary capacity as Executor of the Estate of Abraham Lincoln ("Seller") makes the following *special representations and warranties*. Under no circumstances shall Seller be deemed as making any representation or warranties in its individual capacity or on behalf of assets of ABC Bank or the Seller other than with regard to the shares.

1.2 **Ownership of Stock.** The Seller is the lawful owner of 400 shares of the issued and outstanding shares of common capital stock of the Lincoln Corporation, (the "Shares") and such Shares are free and clear of all liens, encumbrances, restrictions and claims of every kind; Seller has full legal right, power and authority to enter into this Agreement, and to sell, assign, transfer and convey the Shares so owned by it pursuant to this Agreement; the delivery to the Purchaser of the Shares pursuant to the provisions of this Agreement will transfer to Purchaser valid title thereto, free and clear of all liens, incumbrances, restrictions and claims of every kind.

1.3 **Capital Stock.** The Company has an authorized capitalization consisting of 1000 shares of common stock, no par value per share, of which 616 shares are issued and outstanding and no shares are held as treasury stock. All such outstanding shares have been duly authorized and validly issued and are fully paid and non-assessable. There are no outstanding options, warrants, rights, calls, commitments, conversion rights, rights of exchange, plans or other agreements of any character providing for the purchase, issuance or sale of any shares of the capital stock of the Company.

1.4 **Organization.** To the knowledge of Seller, the Company is a corporation, duly organized, validly existing and in good standing under the laws of the State of Delaware.

1.5 **Duties Under the Will.** All proceedings required by the provisions of the Last Will and Testament of Abraham Lincoln to be taken in connection with the execution and delivery of this Agreement will have been duly and validly completed by the Closing. Seller has the power and authority to sell the shares for the consideration set forth in this Agreement.

1.6 **Financial Statements.** To the knowledge of Seller, the Company's Financial Statements have been prepared in accordance with generally accepted accounting principles consistently applied during the periods indicated, and fairly present the financial position and net worth of the Company as of the date on the Balance Sheet included in the Financial Statements, and the results of Seller's operations for the period indicated. Since the date of the last financial statements, there has been no material adverse change in and to the Company or the shares.

1.7 **No Litigation.** There is no litigation pending or threatened which would affect the Seller's right to convey the shares.

1.8 **Title to Properties.** To the knowledge of Seller, the Company has title to all properties purported to be owned by it.

1.9 **Laws.** To the knowledge of the Seller, the Company has complied with all material laws applicable to it.

ACCOUNTANTS REPORT

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MATTERS RESULTING FROM FINANCIAL STATEMENTS REVIEWS

Buy-Sell Agreements

Are there any buy-sell agreements? None are disclosed in the financial statements. If such agreements could bind the Company (rather than other stockholders), their existence and general terms should be disclosed. If no such agreements exist, you may want to consider the advisability of such agreements for certain shareholders or all of the shareholders.

Cash Value of Life Insurance

Regarding cash value of life insurance: The 1997 income tax return indicates \$41,820 of non-taxable "life insurance proceeds." The 1997 statement of cash flows indicates proceeds of \$261,996 were realized from "redemption of officer's life insurance policy." The non-taxable proceeds reported in the tax return is the difference between the \$220,176 December 31, 1996, cash surrender value, and the \$261,996 of cash proceeds reported in the 1997 financial statements. You may wish to ask for a more complete explanation of the transaction and the underlying reasons for the decision to cash in the policy.

LIFO

The financial statements disclose that _____ inventory is carried at LIFO cost which is not in excess of market value. There is no indication in the footnotes as to the amount at which the inventories would be reflected if they were carried at FIFO or similar cost. Such disclosure is required, and would be beneficial in analyzing the financial statements since LIFO generally is a tax deferral method and, in a rising market, tends to understate profits.

Asset Bases and Carrying Amounts

The financial statements do not reflect the dollar difference between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Although this information is not required to be disclosed, it is generally included in the notes to the financial statements because it provides very useful information to a stockholder or potential investor/purchaser of an electing "S" Corporation.

Previously Taxed Income

The financial statements do not indicate the amount of income in retained earnings previously taxed to the stockholders (through the financial statement date) that could be paid in future dividends free of tax to the stockholders. This is particularly useful information to stockholders of electing "S" Corporations.

Note Receivable as Current Asset

The financial statements include, as a current asset, an interest-bearing note receivable in the amount of \$729,786, which has been outstanding at least since December 31, 1994. The due date, which appears to have been extended annually, is indicated to be July 30, 1998 in the 1997 financial statements. If the note has been extended again, it may be appropriate to ask the following: Why does

the note continue to be carried as a current asset? Has the interest (at prime) been paid annually? Is the debtor a continuing customer? Should collateral be obtained?

Management Letter

Are the auditors issuing management comments at the conclusion of the annual audit? As a significant stockholder, you may be interested in seeing such comments and the related responses from management.

MATTERS RESULTING FROM TAX RETURNS REVIEWS

Missing Forms 8824

The 1994/1995 financial statements contain a footnote that the Company committed to build an _____ subsequent to December 31, 1995. Funding was going to be partially obtained by the use of \$600,000 of "trade-ins".

If the Company treated these trade-ins as a tax-free exchange of like-kind property, it seems a Form 8824 should have been included in the 1996 or 1997 tax return. The copies of the tax returns we received did not contain this form.

Further, considering the vast investment the Company has in vehicles, it would seem logical that the Company often exchanges old vehicles for new ones. Forms 8824 are also required for these type exchanges. None of the tax returns contain these forms.

Allocation of Expenses Attributable to Passive Income

The Company maintains a significant cash balance which appears to annually produce in excess of _____ interest/passive income. The regulations require that any expenses (personnel costs devoted to managing the related investments, etc.) be separately stated on the corporate income tax return as "portfolio deductions", as opposed to treating such expenses as regular operating expenses. Portfolio expenses pass through an S-corporation as miscellaneous itemized deductions to the shareholders; amounts probably not deductible on the shareholders' personal tax returns because of the limitation on the deductibility of itemized deductions. The tax returns do not reflect such an allocation.

Possibly, Company management can justify no allocation of expenses to the interest income, but it seems the Internal Revenue Service would have a difficult time accepting such a position.

Even if the Company should be allocating expenses to portfolio deductions, the amount at issue is probably not material.

Depreciation of Luxury Vehicles

Page 2 of the Forms 4562 contained in the 1995 and 1996 returns, reports two vehicles with zero (nil) business use, which implies 100% personal use. Presumably, such vehicles would only be provided to officer/shareholders. These vehicles were depreciated under the "normal" restrictions on luxury vehicles, but, possibly, could have been subject to the more restrictive straight line depreciation for use by greater than 5% shareholders when business use does not exceed 50%. This is the rule, even if total personal use is valued and reported to the officer/shareholder as additional W-2 compensation.

Even if this is the situation, the depreciation would only be a "timing difference" and, more likely than not, an immaterial amount.

Disclosure Issues

The financial statements state that the Company utilizes the LIFO method to value certain of its inventories. The 1995 Federal return (page 2, Schedule A) discloses that the LIFO method is utilized. The 1996 and 1997 returns contain no such similar statement.

The 1995 and 1996 returns reflect an answer to a question regarding accumulated earnings and profits (page 2, Schedule B) that such accumulated earnings and profits exist. The 1997 return does not contain a similar response.

If these are simply disclosure errors, we are not aware of any penalties which would be assessed for inadequate disclosure.

Officers' Life Insurance

Premiums paid for officers' life insurance (OLI) are not deductible in computing taxable income, even though they are considered an expense for financial statement purposes. Likewise, the increase in the cash surrender value of OLI, treated as income for financial statement purposes, is not considered to be taxable in computing taxable income.

The 1996 return, for example, reflects that nondeductible premiums were \$9,438 for the year, but the return does not reflect a decrease in financial statement income for the increase in cash surrender value of the OLI between 1995 and 1996, \$15,161. Possibly, the preparer of the return "netted" the income and expense reported on the financial statements, which would mean that the actual premiums were \$24,599.

At best case, the return is somewhat confusing on this issue. At worst case, the reduction in taxable income for the increase in the cash surrender value did not occur.

Accumulated Adjustments Account (AAA) and Other Adjustments Account (OAA)

These are complex provisions related to S-Corporations and a discussion of each is beyond the scope of this letter.

But, as reflected on the returns (page 4, Schedule M-2,), the Company is reporting no amounts as

OAA. For example, the portions of OLI, premiums that do not increase the cash surrender value of a policy (i.e., pure insurance element) are nondeductible/noncapital expenditures that should be reported as OAA. Likewise the insurance proceeds of \$411,820 reported on the 1997 return should have been reported as OAA as opposed to AAA.

This is another disclosure issue that probably has little probability of creating a reporting penalty. But, if the Company ever did distribute an amount exceeding the correct amount of cumulative AAA, the shareholders might very well be reporting an incorrect amount of taxable vs. non-taxable income.

PLANNING CONSIDERATIONS

Potential Conversion of the Company to a Limited Liability Company

Based on the balance sheet (Schedule L) contained in the 1997 return, it appears that the Company is annually liable for \$50,000 to \$60,000 of (State) License tax. Partnerships and LLCs are not subject to this tax. A potential method of avoiding this tax is for the Company to form an LLC, contribute its assets and liabilities to the LLC, elect for the LLC to be taxed as an S-corporation, liquidate the corporation, and then to distribute member interests in the LLC to the shareholders in the same percentage as stock previously owned. A _____ corporate tax return is still filed (as an LLC), but the LLC is not subject to the license tax.

We realize that this scheme could be considered a "sham", and if a similar scheme was taken for Federal purposes, Internal Revenue would surely challenge it as a sham. But, we have been verbally assured by senior members of the _____ Revenue Cabinet that, although, they disfavor this scheme, the Revenue Cabinet is powerless to challenge it because the statute provides that the license tax can only be assessed against corporations.

Potential Conversion of _____ to an LLC

The Company owns 50% of _____ Company, a joint venture. It would be fairly simple to convert the joint venture to a limited liability Company, with no tax consequences whatsoever. Conversion to an LLC may be advisable to insulate the assets of The _____ Company from exposure to potential liability arising from operations of the _____ Company.

Use of Significant Cash and Cash Equivalents

The financial statements indicate a large amount of cash and cash equivalents at year-end. It may be possible to increase earnings by using a significant portion of this low interest yielding cash to pay down the interest bearing debts of the Company, only borrowing temporarily during the year against available credit lines. The financial statements at December 31, 1997 indicate cash and cash equivalents totaling \$7,875,784 and total notes and mortgages payable of \$8,922,125. If you assume that debts of about \$6 million were liquidated for the last six months of the year by using the cash equivalents, the pre-tax earnings could be increased by around \$100,000 per year by saving the interest differential. Further, if the debt reduction were held over the end of the year, the corporate license tax savings would be around \$12,000, since debt is included in the definition of capital for purposes of this tax. This comment recognizes that a healthy balance sheet is required for success in the construction industry. However, we are suggesting that the Company could use its healthy

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borrowing power to obtain a short-term credit facility, as a substitute for long-term borrowings and increase net earnings as illustrated above.

Possible Sale of Company

The earnings of the Company reflect steady annual increases for the last several years, with a significant increase for 1997. The earnings pattern suggests that the Company could be a prime candidate for purchase, and that the present time may reflect the best opportunity for maximum realization of value. Many other factors should be considered, including but not limited to, age and depth of management; market saturation and competition in the area; and stockholders' considerations relative to diversification of investments.

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**VALUATION AND DISPOSITION OF
FURNISHINGS, ART AND COLLECTIBLES
AS UNIQUE ASSETS FOR ESTATES**

**Cassie Spencer
Vice President, Trust and Estate Services
Sotheby's
Chicago, Illinois**



**26th ANNUAL
MIDWEST / MIDSOUTH
ESTATE PLANNING INSTITUTE
July 16-17, 1999
University of Kentucky College of Law
Lexington, Kentucky**

**VALUATION AND DISPOSITION OF FURNISHINGS, ART AND COLLECTIBLES
AS UNIQUE ASSETS FOR ESTATES**

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**POST-MORTEM RESPONSIBILITY
FOR
PRE-MORTEM INCOME TAX LIABILITIES**

**Theodore B. Atlas
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Denver, Colorado**

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POST-MORTEM RESPONSIBILITY FOR PRE-MORTEM INCOME TAX LIABILITIES

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POST-MORTEM RESPONSIBILITY FOR PRE-MORTEM INCOME TAX LIABILITIES

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I. INTRODUCTION

A. Scope of Outline

This outline will provide an overview of select income tax issues arising in the estate administration setting, including the decedent's final Form 1040, income taxation of the surviving spouse and survivors, income tax basis adjustments arising as a result of death, post-death differences between probate estates and revocable trusts, and the liability of assets and parties for the decedent's income tax liabilities.

B. Income Tax Minimization is Important

It is the author's premise that insufficient attention is paid by practitioners to income tax minimization. Income tax issues impact almost all decedents and survivors (not just those wealthy clients with gift and estate tax problems), and significant dollar savings can be achieved.

C. Recommended Reference Materials

For in-depth treatment on this area and related topics, see the following resources, all of which are supplemented at least annually:

1. *Tax Guide for Survivors, Executors, and Administrators*, Publication #559 (Internal Revenue Service).
2. *Federal Income Taxation of Estates and Trusts*, Second Edition, by Howard M. Zaritsky and Norman M. Lane (Warren Gorham Lamont).
3. *Federal Income Taxation of Estates, Trusts, and Beneficiaries*, Second Edition, by M. Carr Ferguson, James J. Freeland, and Mark L. Ascher (Shepard's McGraw-Hill).

4. *Income Taxation of Fiduciaries and Beneficiaries*, by Byrle M. Abbin, David K. Carlson, and Mark Vorsatz (Little, Brown and Company).
5. *PPC's 1041 Deskbook*, by Hugh H. Sprunt, James F. Reeves, Dan W. Youse, and Blake T. Smith (Practitioner's Publishing Company).
6. *Post Mortem Tax Planning*, Second Edition, by Jerry Kasner (Shepard's McGraw-Hill).
7. *IRS Practice and Procedure*, Second Edition, by Michael I. Saltzman (Warren, Gorham & Lamont).

II. THE FINAL FORM 1040, PRIOR RETURNS, THE SURVIVING SPOUSE, AND BASIS DETERMINATION

A. General Income Tax Considerations

1. Notice of Fiduciary Relationship

- a. The executor [or if none, the testamentary trustee, residuary legatee(s), or distributee(s)] should file Form 56 with the IRS to advise the IRS of the fiduciary relationship. IRC §6903; Treas. Reg. §§601.503; 301.6903.
- b. A short-form certificate or authenticated copy of letters testamentary or letters of administration showing that the executor's authority is still in effect at the time the Form 56 is filed, otherwise an appropriate statement by the trustee, legatee, or distributee, should accompany the Form 56. Treas. Reg. §§601.503; 301.6903.
- c. The Form 56 must be signed by the fiduciary and must be filed with the IRS office where the return(s) of the person for whom the fiduciary is acting must be filed. Treas. Reg. §301.6903-1(b).
- d. Written notice of the termination of such fiduciary relationship (on Form 56) should also be filed with the same office of the IRS where the initial Form 56 was filed. The notice must state the name and address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of fiduciary relationship. Treas. Reg. § 301.6903-1(b).

2. Gathering Tax Background Information

a. Need for Information

It will be necessary to determine what income tax returns have or have not been filed by the decedent, and to examine such returns, in order to ascertain whether or not all required returns have been properly filed.

b. Ascertaining What Tax Returns Have Been Filed

The IRS will inform you what tax returns have been filed by the decedent. It is necessary for the executor to make a written request for a "Record of Account" from the appropriate region. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

c. Ascertaining the Amount of the Decedent's Income

The executor may not be certain that he or she has information concerning all of the decedent's income relating to years for which the executor will file income tax returns on behalf of the decedent. It is necessary to request in writing "All Information Returns" (you should be as specific as possible) in writing from the appropriate region. Information is available after August 1st relating to the prior year, and six years worth of information is kept in the IRS computers. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

d. Getting Copies of Prior Filed Tax Returns

Copies of prior income tax returns filed by the decedent can be obtained from the IRS via Form 4506. Consider requesting at the same time copies of gift tax returns filed by the decedent. Be sure to make your request to the proper region or district, based upon where the decedent filed the return in question. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied for a fee (\$23 per return last time the author checked). Call 1-800-829-1040 for details.

e. Contact District Disclosure Officer

Any questions concerning what information is available from the IRS, or procedurally how to get at such information, should be directed to the IRS District Disclosure Officer. Such person is usually very knowledgeable and helpful with regard to such matters.

3. Duty to File Returns and Pay Tax Due

a. Liability of Fiduciaries

- (1) The executor or administrator of the estate of a decedent, or other person charged with the property of a decedent, is required to file the final income tax return for such decedent. IRC §6012(b); Treas. Reg. §§1.6012-3(b)(1); 1.6012-1.
- (2) Pursuant to the concept of "fiduciary liability" the executor is personally liable for the income and gift tax liability of the decedent, at least to the extent that assets of the decedent come within the reach of such executor. 31 USC §3713.
- (3) Fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes the living or deceased debtor's property to other creditors before he satisfies a debt due to the United States. 31 USC §§3713(a) and 3713(b).
 - (a) Such liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate or of the insolvency and collective creditor proceeding involving a living debtor, the priority of 31 USC §3713(a) is applicable.
 - (b) The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States.
 - (c) The fiduciary must know or have reason to know of the government's tax claim.

b. Liability of Transferees

- (1) Transferee liability may make the transferee of property: (a) of a taxpayer personally liable for income taxes, (b) of a

decedent personally liable for estate taxes, and (c) of a donor personally liable for gift taxes. IRC §6901.

(2) Transferee liability at law exists under IRC §6901 if the government can prove:

- (a) The taxpayer transferred property to another person;
- (b) At the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for a tax;
- (c) There is a valid contract between the taxpayer-transferor and the transferee; and
- (d) Under the terms of that contract, the transferee assumed the liabilities of the taxpayer, including the obligation to pay the tax or specifically the obligation to pay the taxes of the transferor.

(3) Transferee liability at equity exists under IRC §6901 if the government can prove:

- (a) The taxpayer transferred property to another person;
- (b) At the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for the tax;
- (c) The transfer was made after liability for the tax accrued, whether or not the tax was actually assessed at the time of the transfer;
- (d) The transfer was made for less than full or adequate consideration;
- (e) The transferor was insolvent at the time of the transfer or the transfer left the transferor insolvent; and
- (f) The government has exhausted all reasonable efforts to collect the tax from the taxpayer-transferor before proceeding against the transferee.

c. Liability of Consenting Spouses

In the case of joint income tax returns, joint and several liability is imposed on husband and wife for that year's income tax liability. IRC §6013(d)(3).

d. General Tax Lien

After assessment, demand, and failure to pay, a general tax lien attaches automatically to "all property and rights to property, whether real or personal, belonging to the [taxpayer]". IRC §6013(d)(3).

e. Priority of Tax Claims

(1) In a probate setting, the state law rules relating to the time and place for filing claims don't apply to the tax claims of the United States. Board of Comm'rs of Jackson County v. U.S., 308 US 343 (1939); United States v. Summerlin, 310 US 414 (1940).

(2) Section 3713(a) of the Revised Statutes generally provides that a debt due to the United States be satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors.

(3) Although no exceptions are made in Section 3713(a) of the Revised Statutes for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. GCM 22499, 1941-1 CB-272 and Rev. Rul 80-112, 1980-1 CB 306.

4. Place for Filing Income Tax Returns:

a. The final Form 1040 should normally be filed in the internal revenue district in which is located the legal residence or principal place of business of the person making the return (i.e., based upon where the executor is located, which is not necessarily where the decedent filed his or her returns), or at the service center serving such internal revenue district. IRC §6091(b)(1)(A); Treas. Reg. §31.6091-1(a).

b. However, if such person has no legal residence or principal place of business in any internal revenue district, the return should be filed with the District Director, Internal Revenue Service, Baltimore,

Maryland, 21202, except as provided in the case of returns of taxpayers outside the United States. Treas. Reg. § 1.6091-2(a).

- c. However, the return made by a person outside the United States having no legal residence or principal place of business in any internal revenue district should be filed with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225, unless the legal residence or principal place of business of such person, or the principal place of business or principal office or agency of such corporation, is located in the Virgin Islands or Puerto Rico, in which case the return shall be filed with the Director of International Operations, U.S. Internal Revenue Service, Hato Rey, Puerto Rico 00917. Treas. Reg. § 31.6091-1(c).

5. Applicable Statutes of Limitations

a. Assessment of Additional Tax Due

- (1) Income tax must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC §6501(a).
- (2) The normal three year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC §6501(e)(1).
- (3) There is no limit on the statute of limitations where a false return was filed, there is a wilful attempt to evade tax, or no return was filed. IRC §6501(c).
- (4) The normally applicable statute of limitations is extended as to transferees --- for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC §6901(c).
- (5) The taxpayer and government can agree to indefinitely extend an income tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC §6501(c)(4).

b. Claiming Refund of Tax Paid

- (1) A tax refund claim must generally be filed within three years from the time the related return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed, within two years from the time the tax was paid. IRC §6511(a).
- (2) Special rules extend the time for filing a claim for refund in cases where the period for assessing tax has been extended and in other cases. IRC §§6511(c); 6511(d).
- (3) Equitable mitigation provisions exist that may be useful in cases where a refund or credit would otherwise be barred by the applicable statute of limitations. See IRC §§1311-1314; 1341.

c. Request for Prompt Assessment

The executor may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the executor by separately filing Form 4810. Treas. Reg. §301.6501(d)-1(b). It is not believed that this increases the audit exposure on such returns.

d. Discharge From Personal Liability

The executor may request a discharge from personal liability for income and gift tax liabilities of the decedent (which gives the IRS nine months to collect such taxes from the executor) by making a request for such a discharge (no official form) pursuant to IRC §2204. This does not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that this increases the audit exposure on such returns.

B. The Final Form 1040

1. Return Filing Requirements.

a. Applicable Rules and Definitions.

- (1) If client turned 65 on January 1, 1999, he or she is considered to be age 65 at end of 1998.
- (2) Gross income means all income received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of a home (even if part or all of gain may be excluded or postponed).
- (3) Social security benefits are not included unless the taxpayer is married filing separately and lived with his or her spouse any time during the year in question.

b. Income Tax Return Filing Thresholds. See IRC §6012(a).

- (1) If Single (including divorced and legally separated), under age 65 - Gross income of \$6,550 in 1996; \$6,800 in 1997; \$6,950 in 1998; and \$7,050 in 1999.
- (2) If Single (including divorced and legally separated), 65 or older - Gross income of \$7,550 in 1996; \$7,800 in 1997; \$8,000 in 1998; and \$8,100 in 1999.
- (3) If Head of Household, under age 65 - Gross income of \$8,450 in 1996; \$8,700 in 1997; \$8,950 in 1998; and \$9,100 in 1999.
- (4) If Head of Household, 65 or older - Gross income of \$9,450 in 1996; \$9,700 in 1997; \$10,000 in 1998; and \$10,150 in 1999.
- (5) If Married, Joint Return, both spouses under 65 - Gross income of \$11,800 in 1996; \$12,200 in 1997; \$12,500 in 1998; and \$12,700 in 1999.
- (6) If Married, Joint Return, one spouse 65 or older - Gross income of \$12,600 in 1996; \$13,000 in 1997; \$13,350 in 1998; and \$13,550 in 1999.
- (7) If Married, Joint Return, both spouses 65 or older - Gross income of \$13,400 in 1996; \$13,800 in 1997; \$14,200 in 1998; and \$14,400 in 1999.
- (8) Married, Filing Separately - Gross income of \$2,550 in 1996; \$2,650 in 1997; \$2,700 in 1998; and \$2,750 in 1999.

- (9) If a Single Dependent, under 65:
- (a) Unearned income of \$1 or more and all income more than \$600 (in 1996), \$650 (in 1997), and \$700 (in 1998 and 1999); or
 - (b) No unearned income, and earned income and all income more than \$4,000 (in 1996), \$4,150 (in 1997), \$4,250 (in 1998), and \$4,300 (in 1999); and
 - (c) If client is blind, add \$1,000 to these numbers in 1996 and 1997, and \$1,050 to these numbers in 1998 and 1999.
- (10) If a Qualifying Widow(er) with depended child, under age 65 - Gross income of \$9,350 (in 1996); \$9,550 (in 1997); \$9,800 (in 1998); and \$9,950 (in 1999). If client is blind, add \$800 to these numbers in 1996 and 1997, and add \$850 to these numbers in 1998 and 1999.
- (11) If a Qualifying Widow(er) with dependent child, 65 or older - Gross income of \$10,150 (in 1996); \$10,350 (in 1997); \$10,650 (in 1998); and \$10,800 (in 1999). If client is blind, add \$800 to these numbers in 1996 and 1997, and add \$850 to these numbers in 1998 and 1999.
- (12) If a Single Dependent, 65 or older
- (a) Earned income more than \$5,000 (in 1996), \$5,150 (in 1997), \$5,300 (in 1998), and \$5,350 in 1999,
 - (b) Unearned income more than \$1,600 (in 1996), \$1,650 (in 1997), and \$1,750 (in 1998 and 1999), or
 - (c) Gross income exceeds total of earned income (up to \$4,000 in 1996, \$4,150 in 1997, \$4,250 in 1998 or \$4,300 in 1999), or \$600 (in 1996), \$650 (in 1997), or \$700 (in 1998 and 1999), whichever is larger, plus \$1,000 (in 1996 and 1997) or \$1,050 (in 1998 and 1999); and

- (d) If client is blind, add \$1,000 to these numbers in 1997 and 1998, and add \$1,050 to these numbers in 1998 and 1999.
- (13) If a Married Dependent, under 65
- (a) Earned income exceeds \$3,350 (in 1996), \$3,450 (in 1997), \$3,550 (in 1998), and \$3,600 in 1999,
 - (b) Unearned income of \$1 or more and gross income was more than \$600 (in 1996), \$650 (in 1997), and \$700 (in 1998 and 1999); or
 - (c) Gross income was at least \$5 and spouse files a separate return on Form 1040 and itemizes deductions.
 - (d) For purposes of (a) and (b), if client is blind, add \$800 to these numbers in 1996 and 1997, and add \$850 to these numbers in 1998 and 1999.
- (14) If a Married Dependent, 65 or older
- (a) Earned income exceeds \$3,950 (in 1996), \$4,100 (in 1997), \$4,250 (in 1998), and \$4,300 (in 1999),
 - (b) Unearned income exceeds \$1,400 (in 1996), \$1,450 (in 1997), \$1,550 (in 1998 and 1999),
 - (c) Gross income exceeds total of earned income (up to \$3,350 in 1996, \$3,450 in 1997, \$3,550 in 1998, and \$3,600 in 1999), or \$600 in 1996, \$650 in 1997, and \$700 in 1998 and 1999), whichever is larger, plus \$800 (in 1996 and 1997) and \$850 (in 1998 and 1999); or
 - (d) Gross income was at least \$5 and spouse files a separate return on Form 1040 and itemizes deductions.
 - (e) For purposes of (a), b), and (c), if client is blind, add \$800 to these numbers in 1996 and 1997, and add \$850 to these numbers in 1998 and 1999.

- (15) If owe any special taxes, such as self-employment tax, alternative minimum tax, recapture taxes, excise taxes. etc.

c. Voluntary Income Tax Filing Situations

It will be desirable to file a return not otherwise required to be filed in order to collect a refund due to withheld income taxes, estimated tax paid, other refundable tax credits, etc., or possibly just to get the decedent "out of the computer" at IRS.

2. Computation of Tax Due on Final Form 1040

a. Income on the Final Form 1040

- (1) The final income tax return includes only those items that the decedent would have in such period under the decedent's method (i.e., cash or accrual) of accounting.
- (2) S corporation shareholders are taxed on their pro rata share of items of income, deduction and credits for year of death on their final form 1040 (via the proration method unless all of the shareholders agree to the closing of the books method). IRC §1366.
- (3) Historically, partnerships did not usually terminate for tax purposes on the death of a partner. Treas. Reg. §1.706-1(c)(3)(ii). This meant that the final form 1040 of a partner who died on any date other than December 31st reflected no partnership income, and the successor (usually the estate) was taxed on the decedent's share of partnership income for its entire year. Effective for partnership taxable years beginning after 1997, the taxable year of a partnership will close upon the death of a partner, causing the pre-death share of the partnership's income to be reported on the deceased partner's final Form 1040. TRA '97, §1246.
- (4) Dividends and interest received after date of death (but before the asset is retitled into the estate's name) will often have post-death income wrongfully reported as the decedent's income. In order to avoid IRS matching program problems, report on the final Form 1040 the full amount reported to the IRS on Form 1099s as taxable to the decedent, and back out those amounts received after date of death which are properly reportable on the estate's Form 1041.

- (5) Accrued interest on Series E and EE United States Savings Bonds (and previously accrued Series E or EE interest rolled into Series H or HH United States Savings Bonds) which has not yet been income taxed can be reported as income in the decedent's final year if so elected. IRC §454(a).
- (6) A cash basis decedent will often have a final paycheck (plus accrued vacation time, sick time, etc.) paid after death.
- (a) Such payment is an asset of the probate estate (and should be paid to the estate, not to the survivors directly), and should be reported as taxable to the estate (not the deceased individual).
 - (b) If payment of amounts due is made by the employer in the employee's year of death, no federal income tax is withheld, but Social Security tax, Medicare tax, and Federal Unemployment tax are to be withheld. IRS Publication #15 (1-98), Circular E, Employer's Tax Guide, Section 15.
 - (c) If payment of amounts due is made by the employer in any year subsequent to the year of the employee's death, no federal income tax, Social Security tax, Medicare tax, or Federal Unemployment tax are to be withheld. IRS Publication #15 (1-98), Circular E, Employer's Tax Guide, Section 15.
- (7) An income beneficiary of an estate or trust generally includes in gross income his or her share of such entity's income for its taxable year which ends with, or within, the beneficiary's tax year. IRC §§652(c) and 662(c). For example, all distributions made between July 1, 1997 and June 30, 1998 from an estate having a June 30 fiscal year end will be taxable to the distributee on his or her 1998 income tax return as if all such distributions were made on June 30, 1998.
- (8) But if a cash-basis income taxpayer is the beneficiary of an estate or trust in his or her year of death, the decedent's final form 1040 must nevertheless include any distributions of income actually received before death. Treas. Reg. §§1.652(c)-2 and 1.662(c)-2. In the example set forth in the prior paragraph, if the distributions were made in July and

August, 1997, and the distributee died in October, 1997, all such distributions would instead be taxable on distributee's final 1997 income tax return.

- (9) The IRS has held that the subsequent exercise by a donee of a transferable stock option is taxable to the employee at the time of exercise under IRC §83. See PLR 9616035 (4/19/96). If the employee dies before exercise, is there income on the final form, or does the income tax burden shift to the donee?
- (10) Income items, such as advances and draws against subsequent commission income, may be received with the possibility of having to be later repaid. Such items are income in the year received, pursuant to the "claim of right" doctrine.
- (11) Taxpayers may convert regular IRAs to Roth IRAs and report the tax due by reason of the conversion over a four year period (commencing in the year of conversion). IRC §408A. All such previously untaxed income resulting from such a conversion to a Roth IRA will be included as income on the decedent's final form 1040 unless the surviving spouse is the beneficiary of all of the decedent's Roth IRAs and elects to continue reporting the previously untaxed income under the four year rule. See proposed regulation, REG-115393-98 (Tax Analysts Doc. 98-115393-98), published 9/3/98, Fed. Reg. 9/3/98, Vol. 63 #171, at p. 46939 and 446,940.

b. Deductions on the Final Form 1040

- (1) Only deductions relating to items actually paid prior to death are generally deductible on a cash-basis taxpayer's final Form 1040.
- (2) A decedent's estate may not make a post-death IRA contribution on behalf of an individual who could have made a contribution for the year involved, nor can the executor make a post-death contribution to a spousal IRA on behalf on behalf of a decedent's unemployed spouse. PLR 8439066.
- (3) Medical expenses of the decedent paid out of the estate (but apparently not those paid by a revocable living trust) within one year after date of death may be deducted if so elected. This may require going back and amending a previously filed final form 1040. IRC §§213(c), 642(g).

- (4) Death of the Owner of a Passive Activity ("PAL") Asset
- (a) Congress enacted the passive activity loss ("PAL") rules to limit a taxpayer's ability to offset non-passive sources of income (active income, such as salary, and portfolio income, such as dividends and interest) with losses from passive sources (such as rental real estate).
 - (b) Death of the owner of a PAL does constitute a defined disposition of a PAL. IRC §469(g)(2).
 - (c) A deduction is allowable on the decedent's final Form 1040 only to the extent that the suspended passive activity loss exceeds the IRC §1014 basis step-up.
 - (d) For example, assume that the decedent had an asset having a fair market value of \$100, an adjusted basis before death of \$60, and a suspended PAL of \$50. The basis of such asset is stepped up by \$40 to its \$100 fair market value at the decedent's death, and a \$10 loss (i.e., the \$50 suspended loss, less the \$40 basis step-up at death) is deductible on the decedent's final Form 1040.
- (5) "... where the annuity payments cease by reason of death of the annuitant, and as of the date of cessation there is a unrecovered investment in the contract, and the amount of that unrecovered investment shall be allowed as a deduction to the annuitant for his or her last taxable year." IRC §72(b)(3)(A).
- (6) Certain unused investment tax credits on termination may be taken as a deduction on the final income tax return, and are a "miscellaneous itemized deduction" for purposes of the 2% of AGI deduction floor. IRC §196(b).
- (7) The decedent's right to claim a dependency exemption pursuant to IRC §152 may be impacted by the decedent's death. Death does not impact the relationship between the decedent and dependent. But death may cause the decedent to lose such dependency exemption by reason of having provided less than the required portion of the dependent's total support in the year of death.

c. Treatment of Open Transactions and Unused Carryforwards

- (1) Loss carryforwards (capital losses, NOLs, charitable deductions, etc.) attributable to the decedent die with the decedent. Rev. Rul. 74-175, 1974-1 CB 52.
- (2) Loss carryforwards attributable to the surviving spouse can continue to be carried forward by such surviving spouse. It is thus necessary to allocate such carryforward items between the decedent and the surviving spouse.
- (3) Certain unused qualified business credits that would otherwise be lost may be claimed as a deduction. IRC §196(b); Treas. Reg. §1.196-1(b).
- (4) The gain from the sale of a personal residence by the executor of an estate under an executory contract entered into by the decedent prior to death qualifies for the pre-TRA '97 IRC §121 exclusion relating to the exclusion of gain from the sale of a personal residence.. Rev. Rul. 82-1, 1982-1 CB 26, revoking Rev. Rul 70-459, 1970-2 CB 22.
- (5) There is mixed authority as to whether the decedent's estate or other successor in interest can make a post-death reinvestment of involuntary conversion proceeds in order to avoid recognition of income. Much authority would allow such a tax-free reinvestment. But it would appear necessary that the estate (and not the subsequent distributee) make such reinvestment. See Goodman Estate (CA 3, 1952), 199 F.2d 895, 42 AFTR 877, 52-2 USTC ¶9556; Morris Estate (CA 4, 1972), 454 F.2d 208, 29 AFTR2d 72-391, 72-1 USTC ¶9177, affg 55 USTC 636 (1971); Gregg Estate, 69 TC 468 (1977); Chichester v. U.S. (DC AL, 1978), 42 AFTR2d 78-5139, 78-1 USTC ¶9458; Rev. Rul. 58-407, 1958-2 CB 404. But see Jayne Estate, 61 TC 744 (1974); Rev. Rul. 64-161 CB 298, revoking Rev. Rul. 58-407, 1958-2 CB 404.

3. Other Final Form 1040 Issues and Considerations

a. Accounting Periods and Methods of Accounting

- (1) For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which the

decedent was alive. IRC §6012(b)(1); Treas. Reg. §1.6012-3(b)(1).

- (2) A decedent's final tax year thus ends with the date of his or her death. Treas. Reg. §1.451-1(b)(1).
- (3) The final return is filed and the tax paid as if the decedent had lived until the end of his or her last tax year (i.e., needn't annualize final return benefits such as exemption). Treas. Reg. §1.443-1(a)(2).

b. Return Filing and Tax Payment Deadlines

- (1) The decedent's final income tax return is due on the normal date that it would have been due if the decedent had not died (i.e., usually April 15th of the calendar year following the death of the decedent). Treas. Reg. §1.6072-1(b). This will frustrate survivors in the case of many smaller estates, where the only reason why settlement of a decedent's affairs cannot be completed is the need to file the final Form 1040 (which cannot be filed prior to January 1st following the decedent's date of death).
- (2) An extension of time to file the income tax return may be requested. IRC §6081.
- (3) An extension of time to pay the income tax due may be requested. IRC §6161.

c. Filing Status in Year of Death

- (1) A joint income tax return for the year of the decedent's death can be filed for the decedent's income through date of death and the surviving spouse's income for the entire year if so elected. IRC §6013(a).
- (2) Husband and wife status for a given year is determined at the time of death if one spouse dies before the end of the tax year. Thus an estate would have to file either "jointly" or as "married filing separately", and a surviving spouse (unless he or she remarried prior to year end and thus qualifies to file jointly with the new spouse) similarly must file either "jointly" or as "married filing separately" (i.e., not as single). IRC §6013(d)(1)(B).

- (3) A joint return can be filed where the taxable years of the decedent and surviving spouse are different only if such taxable years begin on the same day and end on different days because one of them died. IRC §6013(a).
- (4) No joint return with the decedent can be filed if the surviving spouse remarries prior to the end of the taxable year or if the tax year of either spouse is a 'short' year because of a change in accounting method. Treas. Reg. §1.6013-1(d)(2).
- (5) Normally the decedent's executor must consent to the filing of a joint return on behalf of a decedent. However, a surviving spouse can unilaterally file a joint return if: (a) No return has yet been made by the decedent for the tax year for which the joint return is made, (2) No executor has been appointed by the time the joint tax return is filed, and (3) no executor is appointed before the due date for filing the surviving spouse's tax return. Treas. Reg. §1.6013-1(d)(3).
- (6) The executor can disaffirm any joint return filed by the decedent's surviving spouse. IRC §6013(a)(3).
- (7) A joint final form 1040 should be signed by both the executor and surviving spouse, but the surviving spouse can sign on his or her own behalf and "as surviving spouse" if no executor has been appointed.
- (8) If a joint return is filed, there is joint and several liability for the entire tax due. IRC §6013(d)(3).
- (9) It is necessary to allocate the joint tax liability or joint refund between the decedent and the surviving spouse in order to determine what must be included (or can be deducted) on the Form 706 (Federal Estate Tax Return) of the deceased. Treas. Reg. §20.2053-6(f). See, Rev. Rul. 57-78, 1957-1 CB 30, clarifying Rev. Rul. 56-290, 1956-1 CB 445. Such determination may also be relevant to creditors or children from a prior marriage where all of the decedent's assets do not pass to the surviving spouse (i.e., imagine a case where the decedent's assets are placed in trust, income to the second spouse for life, remainder to the kids from the first marriage — the parties want the right amount, but no more, relating to the decedent's share of the taxes paid from the estate).

d. Execution of Final Return

The word "DECEASED" should be written across the top of the Final form 1040 and the date of the decedent's death should appear after the decedent's name in the name and address box at the top of the final form 1040. IRS Pub 559, (1996), page 3.

e. Estimated Income Tax Payments

The estate may not be required to file or pay estimated tax with respect to decedent's income on the final Form 1040. See IRC §6654; Treas. Reg. §§1.6015(b); 1.6153-1(a)(4).

f. Miscellaneous Elections

Miscellaneous elections for events occurring prior to death, such as for involuntary conversions and exclusion of gain from the sale of a personal residence. IRC §§121; 1033; 1034.

g. Claim for Refund

- (1) Generally, a person who is filing a return for a decedent and claiming a refund must file a Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, with the return.
- (2) However, if the person claiming the refund is a surviving spouse filing a joint return with the decedent, or a court-appointed or certified executor filing an original return for the decedent, Form 1310 is not needed.
- (3) But the executor must attach to the return a copy of the court certificate showing that he or she was appointed the executor. IRS Pub 559, (1996), page 3.

h. Taxes Due by Military and Other KIAs

- (1) Active duty military personnel and certain military or civilian employees of the United States who are killed in action, or die as a result of certain terroristic or military action, may have all of their income tax liabilities for the year of death and prior years excused. See IRC 692.

- (2) Certain survivor benefits paid by reason of the death of a public safety officer will be exempt from income taxation, effective for amounts received in taxable years beginning after 1996, with respect to individuals dying after that date. Section 1528 of TRA '97, amending IRC §101.

4. Planning Considerations for Final Returns

a. Adjust Estimated Income Tax Payments and Withholding

No estimated tax payments relating to the decedent's income need be made after the decedent's death, but the surviving spouse will want to amend his or her estimated tax declaration and withholding exemptions. IRC §6654.

b. Accelerate Income to Avoid Wasting Tax Benefits

It may be advantageous to cause income to be recognized on the final form 1040 where net operating losses, unused charitable deductions, unused investment tax credits, unused capital losses, or other tax benefits exist that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as electing out of installment sales reporting on installment notes receivable, electing to be taxed on accrued E and EE savings bond interest, the surviving spouse not electing to continue the installment reporting of conversion income resulting from the conversion of a regular IRA to a Roth IRA, etc.).

c. Accounting Method for Computing Flow-Through Entity Income

S corporation shareholders (and after TRA '97, partners in partnerships) are taxed on their pre-death share of income, deductions, and credits for the year of death on their final Form 1040. S corporation income is apportioned using the averaging method, unless the closing of the books (exact) method is elected. Partnerships use a closing of the books (exact) method, unless the averaging method is elected.

d. Offsetting Transactions by Surviving Spouse

The surviving spouse may want to recognize gains or losses, or accelerate income or deductions, so as to offset/utilize the losses,

gains, or high income of the decedent through the filing of a final joint return.

e. Coordinate With Other Fiduciaries

It is not uncommon for there to be wasted or under-utilized deductions and credits, or an unusually low effective income tax bracket, on the decedent's final form 1040. If a joint final return is to be filed, choice of a fiscal year (e.g., December 31st or sooner) and the making of distributions from the estate or trust that will carry out DNI that will be taxable to the surviving spouse in the year of death, should be considered to shift income onto the final return.

f. Possible Need to Recognize Gains or Losses

The surviving spouse may want to recognize gains or losses, so as to offset/utilize the losses or gains attributable to the decedent (and which opportunity will be lost if not utilized on the decedent's final Form 1040) in the event that a joint return is to be filed.

C. Income Taxation of the Surviving Spouse

1. Joint Return Option

The surviving spouse may file separately or join in the filing of a joint return for the year of death. However, if the surviving spouse is not remarried and does not file jointly, he/she must use married filing separately status in the year of the decedent's death. IRC §6013. Beware of the joint and several liability for all of the tax on a joint return that is created by filing jointly.

2. Continued Use of Joint Rates

A surviving spouse may be entitled to use joint tax rates for two additional years if he/she maintains a home for a dependent child. IRC §§1(a); 2(a).

3. Continued Use of Head of Household Rates

A surviving spouse may be entitled to use head of household tax rates while unmarried and not a surviving spouse if he/she maintains a home for a dependent child or other qualified dependent. IRC §§1(b); 2(b).

4. Adjust Own Withholding Status and Estimated Tax Payments

The surviving spouse will want to review and possibly amend his/her withholding status and/or estimated tax payments.

5. IRA Contribution by Nonworking Surviving Spouse

A nonworking surviving spouse can make a post-death spousal IRA contribution to the surviving spouse's own IRA for the year of the working spouse's death, provided that the working spouse had sufficient pre-death earnings, although no contribution can be made to the decedent's IRA. PLR 8527083.

6. Available AMT Exemption Amount

A "surviving spouse" as defined in IRC §2(a), for the year of the decedent's death and the succeeding two tax years, is entitled to an AMT exemption of \$45,000, reduced by 25% of any excess of AMTI over \$150,000 (rather than the normal AMT exemption applicable to single persons of \$33,750, reduced by 25% of any excess AMTI over \$112,500). IRC §§55(d); 55(d)(3).

7. Computation of Subsequent NOLs

An NOL incurred by a surviving spouse and carried back to a marriage year can only be applied against the surviving spouse's own income in such prior year. Rev. Rul. 65-140, 1965-1 CB 127. It does not matter that the surviving spouse was remarried in the loss year, nor that the surviving spouse resided in a community property state in the loss year. Rev. Rul. 71-382, 1971-2 CB 156.

8. Possible Grandfathered Interest Exclusion

A surviving spouse electing to leave life insurance proceeds payable by reason of his or her spouse's death with the life insurance company may exclude up to \$1,000 per year of interest income pursuant to provisions of IRC §101(d). Such provision still allows such exclusion with reference to amounts received with respect to deaths occurring on or before October 22, 1986. Section 1001(d) of Pub. L. 99-514 (TRA '86), amending IRC §101(d).

9. Community Property Basis Adjustment

The decedent's property is, of course, going to have its basis adjusted to fair market value pursuant to IRC §1014. Additionally, the surviving spouse's one-half interest in community property will also have its basis adjusted to fair market value at the decedent's death. IRC §1014(b)(6).

D. Basis Adjustments at Death

1. General Rule. IRC §1014

The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

2. Property Acquired From a Decedent

Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706 Federal Estate Tax Return:

a. Property in which the decedent had an interest. IRC §2033.

Any property owned by the decedent (i.e., probate property) is caught under this provision.

b. Dower or curtesy interests. IRC §2034.

The estate cannot ignore property which the surviving spouse can demand under dower, curtesy, or other state law provisions creating statutory or elective property rights. All of the decedent's property is thus included, although an offsetting marital deduction may be allowed.

c. Adjustments for gifts made within three years of decedent's death. IRC §2035.

Certain property and rights no longer held by the decedent are taxed as part of the decedent's estate, including life insurance on the decedent's life where incidents of ownership were given away within three years of the decedent's death, gift taxes on gifts made within three years of the decedent's death, and property in which the decedent released a IRC §2036, 2037, or 2038 power or interest within three years of his or her death.

d. Transfers with retained life estate. IRC §2036.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the use of (or income from) such property was retained until the decedent's death.

e. Transfers which take effect at death. IRC §2037.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get the property by surviving the decedent (i.e., Donor to Beneficiary for life, remainder to Donor if then living, otherwise to Beneficiary's descendants).

f. Revocable transfers. IRC §2038.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a prohibited power to alter, amend, or revoke the transferred property until the decedent's death.

g. Annuities. IRC §2039.

Annuities (including IRAs and other qualified plan benefits) passing to another at the decedent's death which arose from contributions made by the decedent (or an employer on behalf of the decedent) are included in the decedent's estate (although such assets will usually constitute income in respect of a decedent and get no basis step-up).

h. Joint interests. IRC §2040.

Some portion of property in which the decedent has an interest as a joint tenant (or tenant by the entirety) is included in the decedent's estate.

i. Powers of appointment. IRC §2041.

Property over which the decedent held too broad of a power of appointment (as defined in this section) will be deemed owned by the decedent for estate tax purposes.

j. Proceeds of life insurance. IRC §2042.

The proceeds of life insurance on the decedent's life where the decedent held a so-called "incident of ownership" is included in the decedent's estate for estate tax purposes.

k. Transfers for insufficient consideration. IRC §2043.

Some portion of an asset otherwise to all be included in the decedent's taxable estate may be excluded if a third party co-owner contributed separate funds towards the acquisition or maintenance of such property.

l. Certain property for which marital deduction was previously allowed. IRC §2044.

The assets in a QTIP marital trust established by a prior spouse of the decedent for the decedent's benefit are taxable as assets of the decedent at the decedent's death.

3. Exceptions to General Basis Rules

a. Exception if Elect Alternate Valuation

If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

- (1) Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.
- (2) If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no "pick and choose").
- (3) Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.
- (4) Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant

within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1C.B. 244.

b. Exception if Elect Special Use Valuation

- (1) If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.
- (2) If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f).
- (3) If no election is made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251.
- (4) It should be noted that no similar provision applies to IRC §2033A qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

c. Exception for Income in Respect of a Decedent ("IRD") Items

- (1) Items of income in respect of a decedent under IRC §691 are not entitled to stepped-up basis at the decedent's death. Examples of such items include IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

(2) Special Rules re Partnerships

The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Treas. Reg. §1.742-1.

(3) Special Rules re S Corporations

The basis of S corporation stock must be reduced by the income in respect of a decedent attributable to such stock.

IRC §1367(b)(4), effective with respect to decedents dying after August 20, 1996

(4) Certain Lifetime Constructive Sales

Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going "short against the box" during lifetime in order to lock in profit and pull out cash will no longer be able to be closed out income tax free after death, as the pre-death portion of the gain will be considered IRD taxable to the estate or other successor. TRA '97, §1001(d)(3), adding IRC §1259, effective (with complex exceptions) to constructive sales made after June 8, 1997.

d. Exception re Qualified Conservation Easement

A carryover of the decedent's income tax cost basis will occur with respect to that portion of a property which is excluded from the decedent's estate by reason of a qualified conservation easement. TRA '97, §508, amending IRC §§170, 1014, 2031, and 2032A, effective for decedents dying after 1997.

e. Exception re Certain Recently Gifted Property

Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. IRC §1014(e).

f. Exception re Previously Gifted Property

- (1) Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as IRC §§2035, 2036, 2037, or 2038 property) will be entitled to an IRC §1014 basis adjustment by reason of the decedent's death,
- (2) But the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Treas. Reg. §1.1014-3(d).
- (3) Conceptually difficult issues are raised when previously gifted property included in the decedent's estate (such as IRC §§2036, 2037, or 2038 property) has been sold and reinvested

in something else prior to the decedent's death. For estate tax purposes, the original property is deemed included in the decedent's estate. But if it has been sold, can the donee file an amended income tax return and claim the date of death value as the adjusted basis? See Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

g. Exception re Certain Spousal Joint Tenancies

- (1) The current rules re estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased spouse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.
- (2) Prior to 1982 (pursuant to TRA '1981), the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under IRC §2040 (and have its basis adjusted in IRC §1014).
- (3) Several cases have now held that the TRA '1981 amendments to IRC §2040(b)(2) did not repeal the effective date of IRC §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. See Gallenstein v. U.S., 975 F.2d 286 (6th Cir. 1992); Patten v. U.S., 116 F3d 1029 (4th Cir., 1997); Anderson v. U.S., 78 AFTR 2d 96-6557 (DC MD 1996), and Hahn v. U.S., 110 T.C. 14 (1998). The IRS does not agree with the holdings in these cases.

h. Exception re Community Property Interests

- (1) The survivor's one-half interest in community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. IRC §1014(b)(6).

- (2) It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided in a non-community property state at death.
- (3) Some states now allow community property to be held in joint tenancy, and it is unclear whether the joint tenancy or community property rules will apply to such arrangements. See Estate of Wayne-Chi Young, 110 T.C. No. 24, Doc. 98-14934 (1998).

4. Special Basis Transitional Dates Under IRC §1014

a. Death after 12-31-51

IRC §1014 applies to property transferred to a revocable trust. Treas. Reg. §1.1014-2(a)(3).

b. Death after 10-21-42 but before 12-31-47

Basis of surviving spouse's share of community property was the greater of its adjusted basis or its estate tax value.

c. Death after 12-31-47

The surviving spouse's one-half share of community property assumes the same basis as the decedent's share.

d. Death between 1-1-51 and 12-31-53

The survivor's interest in a joint and survivor annuity received a basis adjustment if the decedent's interest was includable in his/her gross estate.

e. Death after 12-31-53

All property acquired from a decedent by reason of death receives a stepped-up basis.

f. Death after 8-26-37

The decedent's stock or securities in a foreign corporation which is a foreign personal holding company receives a basis which is the lower of the fair market value at date of death or the decedent's basis.

5. Other Basis Issues

a. Appraisal

The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC 2032. The appropriate values will appear of the Form 706.

b. When no Form 706 is Required

Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

c. Impact on Depreciation, Depletion, etc.

Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent's gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

d. Elective Partnership Basis Adjustments

A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner's death. IRC §754

e. Appreciated Undistributed Dividends Due Decedent

The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon

which authority you believe. Compare Manufacturers Hanover Trust Company v. U.S., 410 F.2d 77 (1969) and Connecticut National Bank v. U.S., 937 F.2d 90 (1991),

f. Post-Death Capital Gains and Losses

- (1) All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. IRC §1223(11).
- (2) Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment.
- (3) Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of \$3,000 per year.
- (4) It is common to have post-death capital losses. For example, imagine a decedent owning only a home appraised at \$100,000 which is sold 1-2 months after date of death for a net of \$92,000 after commissions and other selling expenses of \$8,000. The \$8,000 of selling expenses, which will be taken on the income tax return (after all, there is no estate tax return due to deduct such expenses on), cause an \$8,000 long-term capital loss on the seller's income tax return.

g. Certain Joint Spousal Trusts

It has been suggested that husband and wife can create a single trust with their collective assets (called a "joint spousal trust"), wherein the first to die has a general power of appointment, with the result that all of the their collective assets will have their basis adjusted to fair market value upon the death of the first spouse to die. This author does not believe such technique works. See 30 University of Miami School of Law, Philip E. Heckerling Institute on Estate Planning (1996), ¶206.

III REVOCABLE TRUSTS VS. PROBATE ESTATES

A. Lifetime Income Tax Consequences

Logically a revocable living trust which is a grantor-type trust, fully taxable to it's grantor during the grantor's lifetime, should be disregarded for all income tax purposes during the grantor's lifetime. Unfortunately, this not always the case, and inconsistent income tax treatment results:

1. S Corporation Stock

A revocable living trust is a an eligible shareholder for the purpose of holding title to stock in an S corporation during the grantor's lifetime. IRC §1361(c)(2)(A)(i).

2. Section 1244 Stock

Shareholders otherwise entitled to ordinary loss treatment upon the sale of their stock in a qualifying corporation will lose this benefit if such stock is transferred to a trust. IRC §1244(d)(4).

3. Public Utility Stock

The former tax-free dividend reinvest provision which allowed owners of qualified public utility stock to elect to reinvest dividends on a tax-free basis is available to the grantor of a revocable trust who is deemed to own the trust owing such stock for income tax purposes.

B. Effect of Grantor's Death

1. A revocable living trust typically allows the grantor, but no one else, to revoke it and thus becomes irrevocable at the grantor's death.
2. The income, deductions and credits attributable to such a grantor-type trust prior to the grantor's death will be reflected on the deceased grantor's final Form 1040.
3. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 C.B. 171. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number on income earned after the grantor's death.

4. If a grantor-type revocable living trust was not exempt from filing trust income tax returns or obtaining a taxpayer identification number during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old taxpayer identification number relating to items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

C. Post-Mortem Income Tax Differences

1. Separate Taxpaying Entities

Unless the provisions of TRA '97's new IRC §646 are elected to treat the revocable trust as a part of the probate estate, the revocable living trust becomes a separate taxpaying entity after the grantor's death, thus providing an added run up the tax bracket ladder (i.e., on the estate's return as well as the trust's tax return) and the advantage of separate exemptions (\$600 for the estate and either \$100 or \$300 for the trust). IRC §§1(e) and 642(b).

2. Loss Recognition in Related Party Transactions

After TRA '97, an estate is still allowed to recognize some losses for income tax purposes (i.e., losses resulting from the funding of a pecuniary gift), but losses in other taxable transactions between an estate or trust and its beneficiaries are not allowed to be recognized for tax purposes. IRC §267(b)(5).

3. Fiscal Year Tax Reporting

An estate is allowed to choose a fiscal year for income tax reporting purposes, but a revocable living trust must utilize a calendar year for reporting its income after the grantor's death. IRC §645(a).

4. Gain on Sale of Depreciable Property

Taxable transactions between a trust and its beneficiary will result in all gain being ordinary income, but gain in taxable transactions between an estate and its beneficiary will result in ordinary income only to the extent of the recapture amount. IRC §1239.

5. Throwback Rules

Estates are not subject to the throwback rules with respect to accumulated income from prior tax years, but some domestic trusts and all foreign trusts are still (post-TRA '97) subject to throwback rules. IRC §§665-669.

6. Quarterly Estimated Tax Payments

Estates and (since TAMRA) revocable trusts are not required to make estimated income tax payments during their first two taxable years. IRC §6654(k). However, estates have less flexibility than trusts inasmuch as trusts can elect to have estimated income tax payments deemed distributed to the beneficiary in any year, but estates can only do so in their last year. IRC §643(g).

7. Charitable Set Aside Deduction

Estates having a charitable residuary beneficiary can deduct amounts which are set aside for ultimate distribution to charity. IRC §642(c). Post 1969-Act trusts are not entitled to the IRC §642(c) deduction, which makes it difficult for trusts to avoid income tax on capital gains realized unless a current year distribution of such gains can be made to charity.

8. Charitable Deduction if Have Unrelated Business Income

Estates have a potentially unlimited charitable income tax deduction. IRC §642(c). But trusts having unrelated business income that is contributed to charity are subject to the percentage limitations on deductibility applicable to individuals. IRC §681(a).

9. Passive Activity Loss Limitations

An estate (but not a trust) in its first two taxable years after death may deduct up to \$25,000 of losses with respect to rental real estate against other income if the decedent was an active participant with respect to such real estate at the time of death. IRC §469(i)(4).

10. Low Income Housing Project Investments

An estate (but not a trust) is exempt from the passive loss limitations for its first two taxable years with respect to qualified low income housing project investments acquired before 1987 in which the decedent was a qualified investor at the time of death. IRC §469(i)(6)(b).

11. Ability to Hold S Corporation Stock

An estate qualifies to hold to hold S corporation stock for a reasonable period of time, but a revocable trust can continue as an S corporation shareholder for only two years after the grantor's death. IRC §§1361(b)(1)(B) and 1361(c)(2)(A)(ii).

12. Discharge From Personal Liability

The executor (or personal representative) and a trustee may have personal liability for a decedent's income and gift tax returns, but only an "executor" (as specially defined in IRC §6905(b), which does not include a trustee) is entitled to a written discharge for personal liability for such taxes. IRC §§267(b)(5) and 6905.

13. Medical Expenses Paid Within One Year of Death

Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if so elected. IRC §§213(c); 642(g). Apparently the decedent's revocable trust is not accorded similar treatment.

14. Amortization of Reforestation Expenses

Estates qualify for IRC §194 amortization of reforestation expenditures, but trusts do not.



LIFETIME GIFTS

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LIFETIME GIFTS:
Why Make Gifts? Which Asset To Give Away?
How Much To Give Away? How To Bind the IRS?

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LIFETIME GIFTS

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This paper will address several questions which are important to those of your single clients who own more than \$1 million and those of your married clients who together own more than \$2 million. Why should a lifetime gift program be considered? What assets might be given away? How much should be given away? How can the Internal Revenue Service be bound by your client's valuation of the gift?

A. WHY SHOULD YOUR CLIENT CONSIDER A LIFETIME GIFT PROGRAM?

Many clients are reluctant to make lifetime gifts. "I may need that money later." "My children are scoundrels." "My children may get a divorce." "My grandchildren are just babies." "If you had lived through the Depression, you would not make gifts either." "I may get sick."

The reasons not to make lifetime gifts are legion. So why, indeed, should a client make gifts before death?

1. Is traditional estate planning enough? I am convinced that there is a level below which "traditional estate planning" is adequate. If you represent a single person with less than \$1 million or a married couple with less than \$2 million in assets, a traditional estate plan (with a

credit trust created at the death of the first spouse) may shelter all the assets from tax due to the increasing applicable credit amount under Section 2010(c) of the Internal Revenue Code of 1986, as amended (hereafter, the "Code").

Depending on the years in which each spouse dies, this traditional estate plan for a married couple can shelter somewhere between \$1.3 million (if both spouses were to die in 1999) and \$2 million (if both spouses were to die in 2006 or later).

If ownership of their life insurance were also given to their children or to the trustee of an irrevocable life insurance trust, the amount which can be protected by this traditional estate plan can grow to larger amounts.

The converse of this belief is equally true. If your married clients today own more than \$2 million and have done only "traditional" estate planning, significant avoidable estate tax will be paid at the death of the surviving spouse.

2. What if your clients already own more than \$2 million? What if the value of their assets continues to appreciate? They already own more than can be protected by a traditional estate plan and they have no present plan to die, of course. Today's tax problem is only growing worse over time, as the value of their estates continues to grow.

The good news for this couple comes from the numerous strategies which exist to shelter even more than \$2 million from estate tax. These strategies include (among other things) grantor retained income trusts (GRATs and GRUTs), charitable lead trusts (CLATs and CLUTs), charitable remainder trusts, qualified personal residence trusts, sales to freeze estate values and more. Lifetime gifts can play an important role in this program.

3. **“But I already have a will!”** A significant problem is presented by the client’s protestation that “I already have a will.” No matter that it was prepared years ago, that the client never understood what it said even when it was signed and that the value of his or her assets has appreciated dramatically in the years since. “I already have a will” leads too many of our clients to believe that no more needs to be done and that no more could be done anyway.

One of our great challenges as advisors and counselors is to convince clients that more needs to be done and that more can be done. The old estate plan they created five (or more) years ago may be totally inadequate in view of increased asset values, new planning strategies and altered family situations.

If both the husband and wife were to die this year with their existing assets and their existing estate plan, what would happen? How much tax would be due? Where would the cash come from to pay the tax? How much will their children inherit and when will they receive it? Who will run the family business? It is likely that most of our clients could not answer these questions.

Our clients’ natural tendencies to put off estate planning is compounded by the fact that most of our significant clients have multiple advisors. There are accountants, lawyers, financial planners, insurance professionals, bank loan officers and so forth all giving advice.

The success of your efforts at updating your clients’ estate plan may depend on your seeking input from these other advisors, perhaps before you present planning ideas to your clients. If the advisors narrow down the planning strategies in advance, you can together present a coordinated plan(s) to the clients.

"But I already have a will." *Do you know what it says?* "No." *Do you know what will happen when you die with that will?* "No." *Don't you think we should find out?* "Well, so long as it doesn't cost me anything to find out!"

4. **You should do this work for your most significant clients.** It should be relatively simple for you and your clients' other advisors to look at a client's current financial statement and their current wills and trust agreement, so that you can tell them what, indeed, would happen were they to die with their existing estate plan. My experience is that most clients are not at all happy with these results, particularly if their estate plan was prepared some years ago.

You should be willing to invest a modest amount of (no charge) time to gauge the adequacy of your best clients' current estate plans. If you truly are a counselor to these clients, you owe it to them to make this effort.

If, as a result of this inquiry (coordinated with the other advisors), a significant client determines that an update of his or her estate plan is needed, your reward (both in a fee and, more importantly, as a counselor to these significant clients) for this initial (no charge) time will be bountiful.

5. **The tax on future appreciation.** The full range of sophisticated estate planning options (GRATs, CLATs and so forth) is beyond the scope of this paper. Nevertheless, the general objective of many of these techniques is simply stated: give assets away now before they appreciate even further.

Indeed, your clients will be in the 55% estate tax bracket for those assets which are in excess of \$3 million. Because your clients are not dying today, that essentially means that the Internal Revenue Service stands ready (indeed, eager!) to take 55% of all the future appreciation which occurs after today.

Your client who works 70 hour weeks at the family business is really a junior partner to the IRS, which will take 55% of the growth from now on! How hard should your client work under those circumstances?

A major tax planning strategy, therefore, is to make lifetime gifts which will not only reduce the assets subject to tax, but which will shift some of this future appreciation to the next generation. If the subsequent growth increases the value of assets already owned by the children and grandchildren (or trusts for their benefit), that growth will not later be taxed when your clients die.

B. WHAT ASSETS MIGHT BE GIVEN AWAY?

The primary goal of a lifetime gift program is not only to reduce the value of your client's net worth for tax purposes, but also to shift future appreciation to the next generation. Therefore, the strategy is to give away those assets which your client reasonably believes will appreciate most rapidly over the balance of his or her lifetime.

If your client gives away assets which later depreciate in value, you have not helped the cause of tax reduction. Those depreciating assets could have been held until death and given away at their then lower value.

If your client gives away assets which later grow in value, that subsequent appreciation in value will not later be subject to the 55% estate tax when your clients die. The children and grandchildren will receive 100% of this subsequent growth, rather than only 45%.

It is certainly true that the subsequent growth will, in all likelihood, be subject to capital gains tax if and when the appreciating assets are later sold. But would your client's children rather pay 20% capital gains tax (payable later and only if the asset is sold) or 55% estate tax (payable within nine months of the death of the second parent whether or not the asset is sold)? That is usually an easy choice for most people.

There are several considerations when your clients consider which assets to give away:

1. Cash gifts. For most of our clients, cash gifts are the preferred alternative. Cash is easy! Everyone wants to receive cash! So why not give cash? There are several reasons to consider gifts of other assets:

- cash will appreciate in the hands of the donee only if it is invested. It certainly would not have appreciated in the hands of the donor (if held as invested cash and not given away). Therefore, a lifetime gift of cash fails to satisfy the strategy of giving away those assets most likely to appreciate in the hands of the client;
- many clients do not have that much cash. Frequently, assets must be sold to raise the cash to be given away, resulting in the payment of capital gains taxes by your clients; and

- cash gifts are “dollar for dollar gifts.” Your client’s net worth goes down by \$1 and the donee’s net worth goes up by \$1. There is no leverage. Your client should give away more than 100 cents on the dollar if that is possible

2. Gifts of marketable securities. Some clients will make lifetime gifts of marketable securities because they want to shift the future growth in value of those securities to their children. Recall that your client’s cost basis will pass to the donees. Code Section 1015.

While lifetime gifts of marketable securities will satisfy the goal of shifting appreciation to the children, there is no discount in the valuation of the stocks which are given away. That is, the value is easily determined from the stock market.

Once again, these are “dollar for dollar gifts.” Your client’s net worth goes down by the value of the securities and the donee’s net worth increases by the same amount. While your client does shift future appreciation to the children or grandchildren, there is no leverage in how much is given away.

3. Gifts of non-marketable securities. Many of our clients are the owners of successful family businesses. These businesses may be organized in any number of ways: C or S corporations; general, limited, family, or limited liability limited partnerships; limited liability companies; sole proprietorships; or otherwise.

The value of the enterprise may have increased dramatically over time and your client may reasonably believe that these trends will continue in the future. Indeed, there may be an organized family business succession plan (with potential new owners identified and trained),

along with a plan to transfer control and ownership to these new owners over time or when your clients die. If there is not such an organized business succession plan, there should be!

If your client were to make lifetime gifts of small equity positions in the family business, the value of the gifts should be entitled to lack of marketability and minority interest discounts. There is a two step valuation: (i) the business as a whole is appraised as a going concern with no discount; and (ii) discounts are then applied to determine the tax value of the small interests which are given away.

These discounts can increase the amount your client can give away. If the appraisers determine that a 33% discount can be taken, for example, your client can make a gift of an equity position in his or her company which appears to have a value of \$15,000, but which really has a gift tax value of only \$10,000 because of the discount. A 33% discount enables you to increase the amount which can be given away by 50%.

For those of our clients who wish to retain control of the family business even after making lifetime gifts (perhaps all of them!), the gift might be of preferred stock (in a C corporation), non-voting stock (in an S corporation), limited partnership interests (in a family partnership) or non-managing interests (in an LLC). Your client can give away value, but can keep control.

Lifetime gifts of equity interests in a family business produce at least four benefits:

- the future growth in value of the asset which is given away will escape estate tax when your client later dies;
- your clients' children will have an equity "stake" in the success of the enterprise;

- your client can give away more than 100 cents on the dollar because of the discounts; and
- the business can be structured so your client can give away value, while maintaining full control of the enterprise.

4. Gifts of fractional interests in real estate or tangible assets. Similar valuation discounts are available in the case of lifetime gifts of real estate (farm ground, horse farms, commercial real estate and so forth) and of tangible personal property (works of art, horses, valuable motor vehicles, significant antiques and the like).

Suppose your client owns commercial real estate with a present value of \$1 million. It is appreciating in value over time. If no lifetime gift is made by this client, the full date of death value of the real estate will be subject to estate tax. There will be no valuation discounts. All the appreciation which hereafter occurs will also be taxed.

If that client had, instead, made a lifetime gift of an undivided 1.3% interest in this real estate to each of his four children, tax savings are possible. Each gift appears to have a value of \$13,333. If a 25% discount were taken to reflect a lack of marketability (what can you do with an undivided 1.3% interest in a building?), the tax value of the gift is only \$10,000.

Your client can give away fractional interests to his four children having an undiscounted value of more than \$53,300, while he is treated as having given away only \$40,000 for gift tax purposes. If his wife also made similar gifts, another \$53,300 can be given away.

The result of these gifts is an ownership of the commercial real estate which is divided among the four children (2.6% each), the mother (44.8%) and the father (44.8%). No one has control.

There are these benefits of the lifetime gifts:

- the value of the lifetime gifts might be reduced by 25% to reflect a lack of marketability, thereby increasing the amount which can be given away;
- the later growth in value of what is given away will not later be taxed when your clients die; and
- the estate tax value of the interests retained by your clients can also be discounted to reflect the fact that their retained interests are also not marketable.

These same strategies can be employed by your clients who own significant collections of art, antiques, horses and motor vehicles. You not only discount the value of what is given away, but you can also discount the value of what is retained.

C. HOW MUCH SHOULD BE GIVEN AWAY?

It is difficult to encourage some clients to make lifetime gifts. If you have successfully shown your significant clients the benefits of a lifetime gift program, however, there are three levels of lifetime gifts and benefits of each:

1. \$10,000 annual gifts. Gifts of a present interest which do not exceed \$10,000 per donee per year will escape estate tax under Code Section 2503(b) and will use up no part of your client's applicable credit amount otherwise available under Code Section 2505. Gifts of a future

interest (an irrevocable trust, for example, which will benefit children or grandchildren only years into the future) can be converted into gifts of a present interest with use of a Crummey Power.

For those of your clients who regularly make annual gifts of \$10,000 to their children and grandchildren, you should remind them that this is a "use it or lose it" tax provision. If this client were to die during a year in which no annual gift had yet been made (she was waiting to pass out the checks at Christmas, for example), the ability to shelter those dollars from tax is lost.

It is better to make these annual exclusion gifts *as early as possible each year*. If your client were to die later during the year, the gift already will have been made. Some clients pass out checks at Christmas or at Hannukkah which are dated January 1 of the following year. The children and grandchild carefully hold those checks and then cash them on the first business day of the year.

2. Give away the applicable credit amount now. Remember that one goal of a lifetime gift program is to shift future appreciation to the children and grandchildren. The more that your client gives away now, the more appreciation that is passed to subsequent generations.

If your client only makes \$10,000 annual gifts, it is difficult to make a meaningful reduction in the value of your client's net worth (even with valuation discounts). The later appreciation in value of these small gifts will also provide little comfort to your client, who sees the value of his or her retained assets continue to grow. Even after making these annual gifts, the client's net worth continues to increase.

Therefore, there is benefit from making larger gifts. Why should this client retain the applicable credit amount until death? While the usefulness of this tax free amount is growing as

it increases from \$650,000 to \$1 million, the even faster appreciation in the value of your client's net worth diminishes the usefulness of the credit.

Those clients who today own significant assets might consider giving away more than \$10,000 per donee per year. Gifts in excess of this level, of course, will "use up" some (or all) of the client's applicable credit amount. However, no gift tax will be paid so long as the gift remains below that level.

That means each client can this year give away as much as \$650,000 plus \$10,000 per donee. Remember that the \$10,000 annual exclusion is measured on a per donee basis, while the \$650,000 applicable credit amount is a one time benefit allowed the donor (who can divide it up among as many donees as the client wishes). As the applicable credit amount increases over the next several years, this client can continue to make gifts in excess of the \$10,000 level.

A married couple today can give away up to \$1.3 million without having to pay any gift tax. Indeed, this same couple will be able to give away \$2 million by 2006, when the applicable credit amount is fully phased in.

a. Valuation discounts can be used to increase dramatically the amount which can be given away within these limits. Suppose your clients own a family business with a present value of \$10 million. They have four children.

If the valuation report supports a 33% discount for lifetime gifts of a minority interest in the family business which is non-marketable, your clients together could give away \$2.1 million in value without having to pay any gift tax. That is, a gift of 19.5% of the business to their

children has a proportionate value of \$1,950,000; however, a 33% discount reduces the gift tax value to only \$1,298,700.

In addition, your clients can each give to each of their four children another \$10,000 (after discount). Once again, the 33% discount enables your clients to give away stock which has a proportionate value of \$15,000, but which has an after discount gift tax value of only \$10,000. Four gifts of \$15,000 to each of their four children from each of your clients removes another \$120,000 in value from their net worth, even though these gifts of non-marketable minority interests have a gift tax value of only \$80,000.

Your client could have a buy-sell agreement to keep the business in the family even if one of the children were later to go through a divorce or bankruptcy.

These combined gifts (annual exclusion gifts and gifts of both applicable credit amounts) will remove over 20% of the value of the business from the clients' taxable estates. As the business continues to appreciate over the balance of your clients' lifetimes, more than 20% of that subsequent growth will escape taxation when your clients later die.

b. "Delayed" gifts to the children can increase even further the amount which can be given away without having to pay any gift tax. If assets are placed into a grantor retained annuity trust (a GRAT) or a charitable lead annuity trust (a CLAT), a present value analysis can reduce significantly the value of the gift.

The amount of the gift is only the present value of the children's right to receive these assets years into the future and only after an annuity has been paid in the meantime to either the

clients themselves (in a GRAT) or to charity (in a CLAT). This present value depends on how long the children must wait to receive the gift and how high the annuity rate is in the meantime.

Gifts to a GRAT or a CLAT can receive two discounts: (i) the first discount reflects the fact that your clients are funding the trust with only a minority position in the family business which has no market for resale; and (ii) the second discount reflects the reality that the child receives nothing today, but must wait years to receive the gift.

Suppose your clients (age 55) put non-voting stock of their S corporation into a grantor retained annuity trust which will pay them a 7% annuity for 10 years, after which the remaining trust assets will be distributed to their children? The present value of the children's right to receive these assets ten years from now is worth only 53% of the value of what is put into the trust today (assuming the 7520 rate is 7%).

Your clients could put \$3,700,000 worth of non-voting stock into this trust. The gift tax value of that stock, after a 33% lack of marketability and minority interest discounts, is only \$2,464,200. Because the children have to wait ten years to get it (with a 7% annuity being paid to your clients in the meantime), the amount of the gift is only 53% of that value or \$1,306,000. A minority interest and lack of marketability discount of more than 33%, a longer term for the GRAT or a higher annuity rate will reduce the value of the gift even more.

Your clients will receive a number of benefits from this lifetime gift:

- 37% of the company is now owned by a trust for the next generation, which means that 37% of the future growth in value of the company will escape estate taxation when your clients later die (assuming they outlive the term of the GRAT);

- the gift tax value of what they have given away is only the amount of their combined applicable credit amounts even though they are reducing their net worth by almost three times that amount. Now that's leverage!
- your clients' retention of the voting shares means they will maintain control of the company even after the gift;
- a 7% annual annuity on the discounted value of the non-voting stock held in the GRAT is only a 4.7% annuity on the undiscounted value of the stock. That is, the 7% annuity (based on the gift tax value of the shares put in the trust [or \$2,464,200 in this example]) is only 4.7% of the real value of what is put in the trust (\$3.7 million in this example);
- the compensation paid to your clients from the business might be reduced during the ten year term of the GRAT, so that the company can distribute its earnings in the form of dividends. Your clients will receive 63% of those dividends because they have retained that much of the stock; the GRAT will receive 37% of the dividends, out of which your clients will then receive the fixed annuity;
- at the expiration of the ten year term of the GRAT, the trust will terminate and the shares held in the trust will be distributed tax free to the children (including ten years of appreciation). However, the children will receive only non-voting shares. Your clients will retain the voting shares and can exercise those votes to determine whether to continue the dividend program; and
- Your clients may, in addition, make annual gifts of up to \$10,000 (after discount) per donee per year.

While a full discussion of the tax savings potential of "delayed" gifts through the use of GRATs and CLATs is beyond the scope of this paper, it is important that we as advisors understand how our clients can increase dramatically the amount which they can give away without exceeding the amount of the applicable credit amount.

There are several goals of a lifetime gift program that consumes the applicable credit amount:

1. shift appreciation to the next generation, so the more your clients give away, the more appreciation is moved;

2. give away more than 100 cents on the dollar, by taking minority interest and lack of marketability discounts and discounts for the present value of gifts which will be completed only years into the future;
3. give an incentive to the children (through ownership of an equity position) to help the family business succeed;
4. leave your clients in control of their family business; and
5. pay no dollars to the Internal Revenue Service today.

All these goals can be achieved.

3. Even larger gifts. Some (although not many) clients may be willing to make lifetime gifts of even larger amounts, thereby causing the payment of gift tax. Why would anyone do such a thing?

There may be at least two reasons to do so:

Shift even more appreciation. The more that is given away, the more appreciation that can be shifted to the next generation. While the example given earlier showed how clients could put up to 37% of the value of their \$10 million business into a ten year GRAT, they still were left with 63% of all the subsequent appreciation being taxed when they later died. If they had given away more than \$3.7 million dollars, even more future appreciation could have been shifted to the children, although gift tax will have to be paid; and

Do not pay tax on the tax itself. If gift tax is paid by your client, the amount of the gift tax paid will be included in your client's gross estate under Code Section 2035(b) when he or she later dies only if the client dies within three years of paying the gift tax. If the client lives more than three years after paying the gift tax, then the gift tax itself is not subject to estate tax. The "exclusive" nature of the gift tax system is in contrast to the "inclusive" nature of the estate tax system, in which an estate pays estate tax on the dollars which are actually used to pay the estate tax itself.

Nevertheless, it is difficult to convince clients that they are better off by "pre-paying" any tax!

D. HOW CAN THE INTERNAL REVENUE SERVICE BE BOUND BY YOUR CLIENT'S VALUATION?

Gifts in excess of the \$10,000 annual exclusion provided for gifts of a present interest by Code Section 2503(b) are required to be reported on a gift tax return (Form 709). Gifts of a present interest which have a value of less than \$10,000 per donee do not need to be reported on Form 709.

1. **The old rules.** If a gift tax return was filed and if gift tax was paid, the statute of limitations for an examination of the return would have expired three years from the due date of the gift tax return or three years from the date on which the gift tax was paid, whichever was later. Code Section 2504(c). If the statute had run, the value of the gift was the amount reported on Form 709, *so long as gift tax was paid.*

Rev. Rul. 70-398, 1979-2 CB 339 mandated the use of the applicable credit amount to lifetime gifts which were in excess of the \$10,000 per donee exclusion. The donor could not "hold back" the applicable credit amount for later use and elect to pay gift tax now, so as to start the statute of limitations running under Code Section 2504(c). In addition, the donor's use of his or her applicable credit amount was not a "payment" for purposes of Code Section 2504(c). Rev. Rul. 84-11, 1984-1 CB 201.

If no gift tax was paid (because the gifts were under \$10,000 per donee or because the gifts were collectively less than the donor's applicable credit amount), the value of the gift could later be redetermined when the donor died. Rev. Rul 84-11, 1984-1 CB 201.

2. How estates were harmed by the IRS position. The Internal Revenue Service took the position that Code Section 2504(c) prevented it from revaluing gifts (so long as gift tax was paid) for gift tax purposes only. It did not prevent the IRS from revaluing those lifetime gifts for purposes of calculating the "adjusted taxable gifts" for purposes of the estate tax calculation, when no gift tax was paid when the gift tax return was filed.

The effect of this recalculation of the decedent's lifetime adjusted taxable gifts was to move into higher estate tax brackets those assets which were held until your client's death, thereby increasing the amount of estate tax payable. For estates which were already in the 55% estate tax bracket, this adjustment was not of great significance; however, the "mid-size" estate frequently found itself with a significantly increased estate tax burden as a result of this adjustment in the value of the decedent's lifetime gifts.

This position was initially upheld in the Estate of Smith, 94 TC 872 (1990), acq. 1990-2 CB 1; and was subsequently reaffirmed in the Estates of Prince, TCM 1991-208; Levin, 986 F.2d 91 (4th Cir. 1993); Evanson, 30 F.3rd 960 (8th Cir. 1994); and Stalcup, 792 F. Supp. 714 (DC Okla. 1991).

An example of the results of the Service's ability to revalue gifts when the donor later died was given by Edward Kessel and Kathleen A. Stepenson in the January, 1998 issue of Estate

Planning:

Example 1A

Adjusted Taxable Gifts (1990 return)		\$300,000
Tentative Taxable Estate 1997		<u>700,000</u>
Taxable		\$1,000,000

Estate Tax		\$345,000
Less: Section 2010 Credit	\$192,800	
Section 2011 Credit	18,000	
Tax on ATG	<u>-0-</u>	<u>210,800</u>
Net estate tax		\$135,000

Example 1B

Adjusted Taxable Gifts (1990 return)		\$300,000
Audit Adjustment to ATG		250,000
Tentative Taxable Estate 1997		<u>700,000</u>
Taxable		\$1,250,000

Estate Tax		\$448,300
Less: Section 2010 Credit	\$192,800	
Section 2011 Credit	18,000	
Tax on ATG	<u>-0-</u>	<u>210,800</u>
Net estate tax		\$237,500
Estate Tax Before Audit Adjustment		<u>135,000</u>

Tax Caused by Adjustment		\$102,500
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Our clients who made lifetime gifts of hard to value assets (real estate, closely held business interests and the like) were left in the uncomfortable position of knowing the IRS could later revalue those gifts at death, no matter how many years later that might be.

The only way to enforce the three year statute of limitations was to make such a large gift that the applicable credit amount was used up and gift tax was actually paid on gifts in excess of that amount. Because few clients were ever willing to pay gift tax, the Internal Revenue Service essentially had no statute of limitations on the revaluation of gifts for estate tax purposes.

3. How the law was changed. This problem was solved by the Tax Reform Act of 1997, as later revised by the Internal Revenue Service Restructuring and Reform Act of 1998.

Code Section 2504(c) was amended to drop the requirement that gift tax had to be paid before the valuation on the gift tax return would become final and binding on even the IRS. Section 2001(f) was added to the estate tax provisions to add the same prohibitions on the revaluation of adjusted taxable gifts in the calculation of the estate tax when the donor later died. The Service is subject to the three year statute of limitations whether or not gift tax is paid. Smith and its progeny have been legislatively overruled.

This relief comes at a cost, however. Code Section 6501(c)(9) was enacted to provide that the gift tax statute of limitations does not begin to run on a gift unless it is disclosed on a gift tax return "in a manner adequate to apprise the [IRS] of the nature" of the gift.

Code Section 6501(c) extends the “unlimited” statute of limitations to all unreported and inadequately disclosed lifetime gifts. The Service can now seek the payment of additional gift tax, along with interest and penalties, in those situations. See also Prop. Regs. 301.6501(c)-1(f)(1).

These new rules apply to all gifts made after August 5, 1997. Prop. Regs. 20.2001-1(b); 25.2504-2(b); and 301.6501(c)-1(f). Gifts made before that date are still subject to the old rules, so the Service may still revalue those post 1976 adjusted taxable gifts (unless gift tax was paid) when those clients later die. Prop. Regs. 20.2001-1(a) and 25.2504-2(a).

4. “Adequate” disclosure to the IRS. The Service issued proposed regulations on December 22, 1998, which appear in the Federal Register, Volume 63, Number 245. These proposed regulations detail the rules which must be followed before the gift has been “adequately disclosed,” so as to start the statute of limitations running.

Prop. Reg. Section 301.6501(c)-(f)(2) provides that the gift tax return must have a “complete and accurate description of the transaction.” It lists the following items which must be disclosed:

1. A description of the property given and any consideration received by the donor;
2. The identity of the donor and the donee and the relationship between them;

3. A "detailed description" of the valuation method used to determine the value shown on the gift tax return, including a description of any discounts taken.

If the gift is of an interest in a non-marketable security, the description must set forth a complete:

"description of any discount claimed in valuing the entity, including a statement regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return."

The existing rules which apply to the disclosure of Chapter 14 gifts are made applicable to all gifts, so the donor must also supply the business' balance sheets and statements of net earnings, operating results and dividends paid for each of the five years immediately before the gift. Regs. 301.6501(c)-1(e)(2)(iii).

4. The tax identification number of the trust (if the transfer is to a trust), along with "a brief description of the terms of the trust;"
5. Any restrictions on the transferred asset which were considered when the property was valued for gift tax purposes; and
6. A statement of all facts regarding the transaction

"that reasonably may be expected to apprise the Internal Revenue Service of the nature of any potential controversy concerning the gift tax treatment of the transfer, or in lieu of this statement, a concise description of the legal issues presented by the facts. In addition, a statement describing any position taken that is contrary to any temporary or final Treasury regulations or revenue rulings."

Although not mentioned in the Proposed Regulations, your client should also check the box on the top of Schedule A of Form 709 if the value of any item on the gift tax return “reflect[s] any valuation discount.” If your client fails to check this box, he or she runs the risk that there has not been “adequate disclosure” even if the other items are provided.

5. Will the information be available? What should your client do if he or she cannot get the required information, particularly as it relates to financial information from a family business? While the Regulations requiring detailed financial information for purposes of Chapter 14 gifts merely state that the taxpayer “should” provide this information, recall that the purpose is to start the statute of limitations running on the valuation of the gift.

If your client cannot obtain the financial information, I suggest that the gift tax disclosure give a full explanation of the steps which were taken to obtain it. If the taxpayer is in control of the family business, a statement that the information is not available will probably not be convincing. If, on the other hand, the taxpayer is not in control of the business and if the gift is of an insignificant interest in the business, the company’s refusal to provide otherwise confidential financial information may be more persuasive. But has there been “adequate disclosure” for purposes of Code Section 6504?

6. How does “adequate disclosure” help our clients? If your client’s Form 709 follows these rules and there is, in fact, adequate disclosure to the IRS, the gift tax statute of limitations will expire three years after the filing of the return IF, within that three year period:

1. the IRS does not contest the value;
2. the IRS specifies the value and the taxpayer does not timely contest that value;
3. a court determines the value; or
4. there is a settlement agreement between the taxpayer and the IRS.

If at least one of those things has occurred, the Service cannot later challenge the value, either for gift or for estate tax purposes. Prop. Regs. 20.2001-1(c).

These new rules prevent the IRS from raising issues about valuation. The Proposed Regulations state that the Service may still make adjustments to prior gifts if the adjustment has nothing to do with valuation.

Examples might include

1. the qualification of gifts for the \$10,000 annual exclusion because of the use (or misuse) of a Crummey power;
2. the question of whether excessive compensation paid a child is really a gift;
3. the question of whether a business transfer was made in the ordinary course of business (for full and adequate consideration) or was made with a donative intent (for less than full and adequate consideration);
4. the component of a sale which is later determined to be a gift;
5. the entrepreneur who provides services after retirement (for less than full and adequate consideration) to a business now owned by the children; or
6. the children's use of real or personal property with inadequate rent being paid.

E. LIFETIME GIFT PLANNING UNDER THE NEW RULES.

It seems clear that a gift tax return must be filed for every gift made by our clients if we expect the statute of limitations to run in three years. Failure to file a gift tax return with “adequate disclosure” will permit the Service to revalue the gift for estate tax purposes when your client later dies, no matter how many years after the gift that may be.

Clients should file a Form 709 even for gifts of non-marketable assets which they reasonably believe have a value of less than \$10,000 per donee.

Suppose a client makes a gift of non-voting stock in the family business and obtains an appraisal report both to value the business and to justify minority interest and lack of marketability discounts. This client may give each child an interest in his or her business which has a value of \$15,000 before discount and only \$10,000 after discount.

That client may reasonably wonder about the need to file a gift tax return for this transaction. Nevertheless, the statute of limitations will not begin to run unless a Form 709 is filed and there is adequate disclosure to the IRS. If the Service does not question the valuation reported on the return within three years, it cannot later do so; if no return is filed, on the other hand, the Service is free to question the value at any time.

There may be some benefit in having a client make small gifts now, which are adequately disclosed on a gift tax return. If the Service does not question the value of these gifts (either because of the small size of the gift or because of inadequate IRS staffing or both), its ability to do so will expire in three years. If your client then makes larger lifetime gifts, you may argue that the Service’s “approval” of the earlier gifts prevents it from questioning the same valuation methodology when it is used with the later, larger gifts.

1. **How will the IRS find unreported gifts?** Obviously, lawyers and accountants must advise their clients to obey the law and to report gifts to the IRS as required by the law. A client cannot justify not filing a return on the theory that “they’ll never know about it.”

In addition, it is reasonable to expect the Service to become even more diligent in the examination of estate tax returns when our clients later die. If a business owner dies with less than all of the business reported on Form 706, do not be surprised if the Service wonders where the rest of it went!

We can and must advise our clients to file gift tax returns for all gifts (even those below \$10,000) if there is a gift of non-marketable securities or other hard to value assets. Even though these regulations are merely proposed, it is a foolish taxpayer who will refuse to follow them.

2. **Why would a client not made full disclosure?** In circumstances where valuation discounts have been taken, it is critically important to justify them. Are these discounts bogus? If not, then why hide it? Indeed, if your father were to give you non-voting stock in his family business, would you really think it was worth 100 cents on the dollar? Of course not. These discounts are legitimate, but you client should be prepared to defend them.

Even in situations where your client is taking an aggressive position (with respect to valuation issues or otherwise), it is frequently better to disclose all the facts now and have battle with the Service at a time when your client can participate. If your client fails to disclose the transaction (or to make “adequate disclosure” under the proposed regulations), the lawyer and accountant may easily end up having to do battle with the IRS only after the death of your client.

3. If you know there will be a fight with the Service, why put it off until after your client's death? You will not have the active assistance of your client on factual issues under those circumstances and you may also need to explain to the client's family why this battle is even going on. "My father would never have gone through with this transaction if he had known he would have to fight the IRS!" Even if you have written evidence in your files that your client assumed these risks, why have the fight later when the client is dead?

F. CONCLUSIONS

Many of our clients today own more assets than can be sheltered by "traditional" estate plans. A credit trust plan can shelter \$2 million at best for a married couple. As the value of our clients' assets continues to appreciate, the tax bite will grow only worse. Indeed, the 55% tax on all future appreciation is a significant obstacle to overcome.

We should advise our clients of the benefits of a lifetime gift program. Give away assets now which the client reasonably believes will appreciate in the future. The more that your clients give away, the more appreciation that can be shifted to future generations.

Encourage your clients to permit you to see where they are today. If your most significant client were to die this year with his or her present estate plan and today's assets, how much tax would be due? Where will the children get cash to pay that much tax? Will 6166 really work under some realistic cash flow scenarios? Who will inherit the remaining assets and at what ages? Who will end up running the family business?

If your client is not happy with those answers, you have some work to do. A lifetime gift program may play an important part in the general update of that client's personal estate plan and family business succession plan.

Eric A. Manterfield

July 11, 1999

PROFESSIONAL ETHICS AND TAX TACTICS

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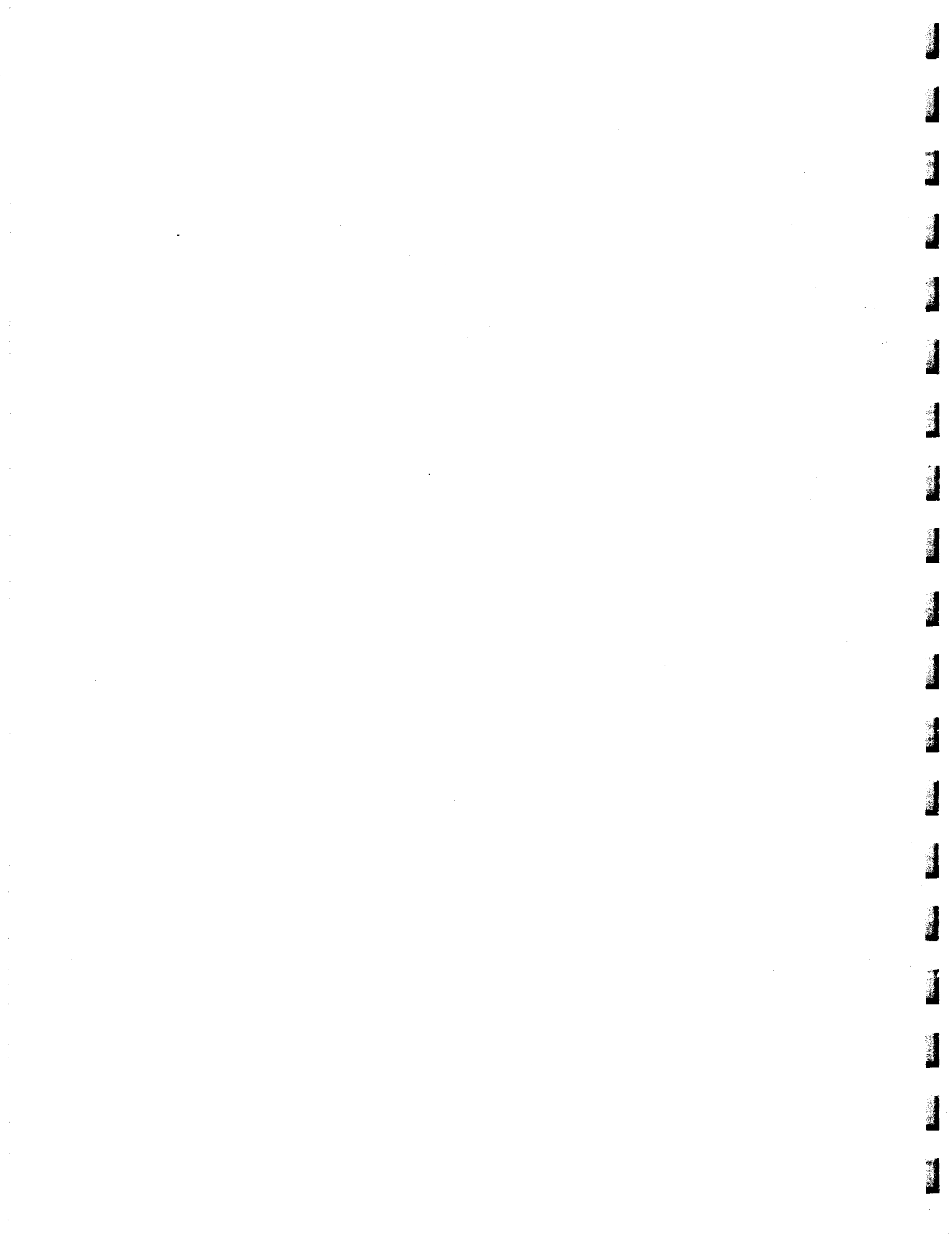
SECTION H



PROFESSIONAL ETHICS AND TAX TACTICS

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Professional Ethics and Tax Tactics

John T. Bondurant and James W. Turner, Jr.

All professionals are governed by ethical rules in representing their clients. Each practice area has distinctive features that give rise to unique ethical considerations. One such feature in the estate planning and administration area is dealings with governmental tax authorities, especially the Internal Revenue Service.

These dealings may be broken down into three main categories:

1. Tax return preparation and related advice.
2. Representation in connection with tax return audits.
3. Tax planning and implementation.

This discussion will touch on each of these areas, with particular emphasis on representation of taxpayer clients in connection with federal estate and gift tax return audits, since the elimination/reduction of inheritance taxes in Kentucky and elsewhere has considerably reduced controversies between estates and state tax representatives.

Attached to this outline are three resource items:

1. "Guidelines to Tax Practice Second" by Frederic G. Corneel, which appeared in 43 *Tax Lawyer* 297 (1990) (Annex A).
2. "Standards of Tax Practice Statement 1999-1" dealing with IRS computational errors, which was prepared by the Committee on Standards of Tax Practice of the Section of Taxation of the American Bar Association and will at some time be published in the Section's Newsletter (Annex B).
3. Six scenarios that represent the types of ethical questions that are encountered in estate planning and administration (Annex C).

GUIDELINES TO TAX PRACTICE SECOND

*Frederic G. Corneel**

The Tax Lawyer Vol. 43, No. 2 (Winter 1990)

In 1978, the ABA Tax Section Committee on Standards of Tax Practice published suggested Guidelines for Tax Practice for consideration by firms engaged in civil tax practice.¹ According to advices received at the time, scores of firms did indeed adopt the 1978 Guidelines, often with changes that evidenced thoughtful reflection.

That was more than a decade ago. Since then we have had a flood of tax shelters, and although that has now receded, it has left behind the large number of new penalties and compliance provisions which affect all tax practice, whether or not related to tax shelters. Malpractice claims arising out of tax work, which were virtually unheard of before the Seventies, have become an everyday occurrence. The growing complexity of the tax law with its pressure for ever more specialization, the increase in the fees charged for tax advice, and the growth in the size of the firms, all contribute to the "depersonalization" of the practice and thereby increase the need for a conscious effort to maintain ethical professional standards.

Therefore, a year or two ago, the author came to believe that it was time for a Guidelines for Tax Practice Second. They evolved over a period of time at various tax institutes.² Most recently, they were examined by the Committee on Standards of Tax Practice, and the following reflects the comments of a good number of its members.³

These guidelines are in no sense official; indeed, it would be a mistake to try to develop official guidelines. Guidelines should suit the condition and circumstances of the firm that adopts them. They should be straightforward, without the sanctimony and hypocrisy which is all too common in efforts of this kind. They should reflect what others may reasonably expect of us; and, just as important, what we need to do to feel good about ourselves. A large national firm with offices in many cities should have different guidelines than a small criminal tax law boutique.

Indeed, the precise resolution of a particular question is often less important

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¹*Guidelines for Tax Practice*, 31 *TAX LAWYER* 551 (1978).

²Southern Tax Lawyer Institute, Fall 1987; Bentley Tax Institute, January 1988; Annual Virginia Conference on Federal Taxation, June 1988.

³The Committee under the chairmanship of Thomas G. Bost, Los Angeles, Cal., reviewed drafts of these Guidelines Second and members Michael C. Durst, Chicago, Ill.; Paul J. Sax, San Francisco, Cal.; Mark G. Ancel, Los Angeles, Cal.; David E. Watts, New York, N.Y.; Gersham Goldstein, Portland, Or.; Terrence G. Perris, Cleveland, Ohio; Bernard Wolfman, Cambridge, Mass.; and many others, both members and nonmembers of the Committee, contributed helpful suggestions. The Committee took no official action, however, with respect to this version of the Guidelines and the responsibility is entirely the author's.

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than that the question was noted and considered. To illustrate, the earlier Guidelines suggested that if the Service makes a mathematical mistake in favor of our client, for example, by understating a bill based upon an agreed settlement, that we should ask the client's permission to inform the Service. Subsequently, Professor Wolfman called our attention to an informal opinion of the ABA Committee on Ethics that indicated an ethical obligation to call "scrivener's errors" to the attention of the other side without consulting the client, since consultation with the client, and the client's order not to disclose, might cause the lawyer to become involved in improper conduct.⁴

Therefore, an earlier draft of Guidelines Second stated that the norm should be correction without consultation. I was moved to accept that position not so much by the ABA Opinion as by reflection on a frequently repeated personal experience: When, by mistake, I give the cashier two bills that are stuck together, they return my extra bill without asking the store owner. She is right to assume that she was hired to act as a decent register clerk; we, as lawyers, have a right to assume that we have been hired to act as decent lawyers. Another Boston firm, after carefully considering the matter, disagreed. I have found the new practice quick and easy and intend to adhere to it. But what matters is that both firms gave the question thought.⁵

Some are concerned that the adoption of guidelines may make the defense of a malpractice claim against the firm more difficult. I do not know of any evidence to support this fear;⁶ in any event, adoption and adherence to appropriate guidelines should substantially reduce the risk of actions or failures to act that are likely to give rise to such claims.

I suggest that tax firms or tax departments circulate these guidelines to their members with a view to discussing the changes that might best serve their particular needs. As revised, the guidelines should then be adopted and given to every new lawyer who joins the firm. In addition, every year or two a lawyer in the firm might be asked to update the authorities cited and recommend changes in light of new developments and experience.

As law firms grow in size and turnover in tax department personnel quickens, the guidelines can play an increasingly important role in maintaining professional standards. As before, the author would appreciate hearing of firms' adoption, revision and practical experience with the guidelines.

Frederic G. Corneel

⁴ABA Comm. on Ethics and Professional Responsibility; Informal Op. 1518 (1986).

⁵Guidelines Second now waffles on this point. See *infra* note 44.

⁶It is true that in spite of the expressed intent of their authors, rules of professional responsibility adopted by bar associations and courts have been taken by many courts as also setting forth standards on which clients can rely in dealing with lawyers. But unlike the official disciplinary rules, the guidelines, when adopted by a particular lawyer or firm, are not intended to set forth norms of general application on which malpractice liability might be based. Indeed, as pointed out earlier in this introduction, the guidelines are expected to vary from firm to firm.

GUIDELINES TO THE TAX PRACTICE OF _____
(name of firm)

I. INTRODUCTION

All lawyers are subject to the rules of professional ethics, requiring them to work competently and carefully for their clients, free from any prohibited conflict of interest and preserving their clients' confidences. These rules apply equally to the tax lawyer. Nevertheless, each field of practice has its own special problems which necessitate approaches specifically suited to that field.

As a result of the "self-assessment" tax system, clients must apply tax law to their own conduct. Uncertainties created by the complexities of the law, doubts as to its fairness, widespread publicity about the exploitation of loopholes, and low audit coverage which, unlike any other lottery, skew the odds of the tax lottery in favor of the client, all tend to make the average person think of a tax lawyer not so much as an expert in the law, but as an expert in what the client might get away with on the client's return.

This attitude on the part of many clients increases the need for us to adhere to the highest ethical standards in our tax practice and to make it clear to our clients that this firm insists on such adherence. Obviously, we try to do all we can to help our clients achieve their business and personal goals at the lowest tax cost, by performing our work with an understanding for their needs, competently, efficiently, and with dedication, imagination, and intelligence. But we work for tax reduction only to the extent we can do so ethically. In the long run that standard is likely to work best for most of our clients; in any event, it is essential to this firm's practice and that of each lawyer who participates in our practice.

Questions of professional responsibility should not be resolved merely on the basis of individual conscience, but on the basis of rules applicable to the entire office. With this in mind, we are publishing and circulating to every attorney in the firm guidelines to our tax practice, with the exception of criminal tax practice and tax litigation in the courts, as these involve other considerations. Familiarity with these guidelines and adherence to them should assist us in continuing the kind of practice we can enjoy and of which we can be proud. The firm expects each attorney involved in tax matters to adhere to these guidelines, accepting them not as technical rules of law to be avoided by the clever exercise of lawyerly skills, but rather as a guide to a satisfying professional life and to the building of a professional environment in which we can be comfortable in the knowledge that others in the firm bring to bear the same standards.

While the guidelines seek to reflect applicable legal authorities, they are not intended as a text of the rules governing the legal obligation of our clients to the Internal Revenue Service or of the legal obligations of lawyers either to the Service or to clients.

II. OUR RELATIONSHIP TO OUR CLIENTS

The word "client" comes from the same root as the word "incline," that is, "lean." The client leans on us for support to clarify the impact of taxes on the

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client's affairs; to reduce the tax burden within the limits of the law; to strike the right balance between the quality of our work and the cost to the client; and to be a stalwart defender of the client's interests in struggles with the Service.

We should do our best to justify the client's confidence, but the client does not control the ethical and legal standards by which we practice our profession. We are responsible for our actions and unethical or illegal conduct can never be justified on the basis of client pressure.

Similar considerations bear on the quality of our work. There is a clear relationship between the quality of our work and the time devoted to it. Just as clearly, there is a relationship between the time devoted to work and its cost. The client is the one who has the final word on fees and may seek to limit the scope of our work either for reasons of economy or because of time pressures. We, however, are the ones who must be satisfied with the quality of our work. Where the client does not authorize the expenditure of time necessary for a fully researched and carefully considered conclusion, we should make a conscious choice among the alternatives:

We may decline to do the work; or

We may undertake it, knowing that we will not be adequately compensated;

or

We may limit the scope of our work in accordance with the limitations placed upon us.

The last alternative is generally the least desirable. Inadequate work on small jobs is likely to breed a general carelessness. Further, the last alternative is not always available. Except for emergencies, we should refuse to represent a client in matters before a court or in dealings with the Service or other third parties unless we are satisfied that we can provide quality representation. Where the last alternative is available, as in advice to a client, we should make sure that the client understands the risks resulting from our limited work. For our own protection as well as that of the client, such warning should usually be in writing.⁷

Nor is the client necessarily our friend forever. Tax planning and tax reporting are complex and, although we try to do our best, mistakes and disappointments are bound to occur and malpractice claims have become common. Our best defense against such claims is doing a first class job, providing clear warnings of potential costs and risks, keeping the client fully and currently informed of the development of the case, and maintaining a complete record.⁸

⁷MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(c) (1984), permits limiting the scope of the lawyer's work after consultation with the client. See also MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.1 comment (1984), under the subtitle *Thoroughness and Preparation*, noting that the nature of the individual case partly determines the scope of the lawyer's work.

⁸For articles discussing legal malpractice and providing suggestions on how to avoid such a charge, see Burrell, *Legal Malpractice of the Tax Attorney*, 34 TAX EXEC. 259 (1982); Mossner, *Legal Malpractice-How to Avoid It*, MICH. B.J. 244 (1984); Phillips, *Attorneys' Personal Liabilities in Tax Counselling*, 54 WIS. B. BULL. 30 (1981); Portuondo, *Abusive Tax Shelters, Legal Malpractice, and Revised Formal Ethics Opinion 346: Does Revised 346 Enable Third Party Investors to Recover From Tax Attorneys Who Violate Its Standards?*, 61 NOTRE DAME L. REV. 220 (1986); Comment, *Legal Liability of the Professional Tax Practitioner*, 26 EMORY L.J. 403 (1977); O'Malley, *How to*

To accommodate both the need to warn the client of potential risks and at the same time preserve the confidentiality of our communications, we may confine the record of warnings to our own files or mark communications that go to the client "privileged and confidential." In particular, we should be careful not to disseminate such writings to non-privileged recipients, such as accountants or investment bankers.

III. OUR RELATIONSHIP WITH THE GOVERNMENT

Our relationship with the Service, state, or local tax department should be professional and courteous. We, however, should avoid extending any kind of personal favor that might be interpreted as an effort to obtain improper favorable treatment. Furthermore, it is a violation of Internal Revenue Service rules to imply to our clients that we are in a position to obtain special treatment.⁹ At times our relationship is clearly adversarial; but we are adversaries in a contest in which we observe the rules, a contest that is not a personal one between us and the government representatives.

Particularly where the client is under a legal obligation to disclose facts, as in connection with a tax return or in responding to questions on audit, we may be under pressure to compromise either our obligation to keep information received in connection with the representation of a client confidential, or our obligation to be truthful to the tax collector.¹⁰ The following discussion suggests ways of dealing with this problem in specific situations. The basic rule which applies throughout is simple: we will not voluntarily disclose confidential information unless so authorized by the client and we will not lie to the Service.¹¹ We will do our best to resolve any conflict between these two principles, and if we cannot do so, we will resign.

Our obligation to the government includes an obligation to "the system." In addition to representing our clients, we should also seek to contribute to improvement of the tax laws and their administration. If in connection with such

Avoid Legal Malpractice Suits, 33 PRAC. LAW. 13 (1987); Routh, *Liabilities of Tax Preparers: An Overview*, 13 CAP. U.L. REV. 479 (1984); Tinsley & Pease, *Guidelines for Protecting the Tax Practitioner from Criminal Liability*, 40 TAX'N. ACCT. 94 (1988).

⁹Treas. Cir. 230, 31 C.F.R. § 10.51(c) (1988); see also MODEL RULES OF PROFESSIONAL CONDUCT Rule 8.4(e) (1984) (declaring such action to be a professional misconduct).

¹⁰MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1984), generally prohibits unauthorized disclosure of confidential information relating to the client. A number of ethics opinions also prohibit disclosure to the tax authorities of information as to tax derelictions by non-clients unless such disclosure is legally mandated or authorized by the client. See Ala. Op. 8389, ABA/BNA Lawyer's Manual on Professional Conduct [hereinafter ABA/BNA] 801:1056-57; Ariz. Op. 82-13, ABA/BNA 801:1313; N.Y. City Op. 81-100, 801:6331; N.C. Op. 374, ABA/BNA 801:6617-18.

¹¹Lying to the Internal Revenue Service is not only unethical but illegal. See Treas. Cir. 230, 31 C.F.R. § 10.51(b) (1988), which includes in "disreputable conduct" for which a practitioner may be disbarred from practice before the Service "giving false or misleading information, or participating in any way in giving false or misleading information . . . [whether in testimony, a return or otherwise] knowing such information to be false or misleading." See also I.R.C. § 6701 (aiding and abetting) & I.R.C. § 7206(2) (aiding or assisting in false return); 18 U.S.C. § 1001 (1982) (person making a false statement to government agency is guilty of felony).

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effort we take a position because it will be helpful to our clients, we should make it clear that we are acting in a representative capacity.¹²

Law review articles are another area where we should be careful to advance positions we believe will be of general benefit, rather than merely helpful to individual clients. In taking positions we must be careful, however, not to harm our clients through the use of confidential information. Further, our advocacy of policies and positions may have an impact on our subsequent ability to represent clients effectively in particular matters.¹³

While these guidelines are intended to assure our adherence to ethical principles arising in our practice as representatives of taxpayers, it is important to the preservation and functioning of "the system" that government employees also adhere to ethical standards. When we observe departures from such standards by government employees, we should work for correction as individuals, as a firm and through our bar associations.

IV. ADVICE CONCERNING TAX REPORTING

A. Tax Return Preparation and Advice

The tax return is the principal focus for a tax lawyer's struggles with ethical issues. This is true whether the issue arises in connection with return preparation or in planning a transaction which must eventually be reflected on a return. Indeed, giving advice on the reporting of a major item on a return may make the lawyer an "income tax preparer" for purposes of the applicable penalty regulations, even though the lawyer does not actually participate in making the entries on the return.¹⁴ Even when our work does not fall within the statutory definition of "return preparation," for instance, when the transaction is prospective or the advice does not relate to a major item, the ethical considerations are largely the same. Therefore, most of the following discussion is applicable to advice concerning tax reporting whether or not we act as return preparers.

B. Taxpayers and Return Preparers

1. Return preparation is a two-party effort, involving the client and the return preparer. Each has responsibilities to bring to the task: knowledge of the relevant law comes from the return preparer; the relevant facts come from the client. A failure by either may occasion problems for both.

2. The preparation of returns is not the practice of law, although it may be part of such practice if performed by a lawyer.¹⁵ Being a return preparer in a

¹²MODEL RULES OF PROFESSIONAL CONDUCT 3.9 (1984).

¹³Obviously a lawyer will have a hard time being a spokesperson for a particular law or view of the law if he has previously written in opposition to it.

¹⁴I.R.C. § 7701(a)(36) as supplemented by Regs. § 301.7701-15(b)(2) defines who is an income tax return preparer.

¹⁵Graves, *Attorney Client Privilege in Preparation of Income Tax Returns: What Every Preparer Should Know*, 42 TAX LAWYER 577, 613-17 (1989).

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particular case may hamper us in other aspects of our role as lawyer. Information given in connection with return preparation may not be privileged.¹⁶ Therefore, at the outset of the engagement, we should consider the relationship between our responsibility as return preparer and our role as lawyer, and consider discussing with the client any problems that we can foresee which may arise during the course of the representation.

a. We may advise a client even though his return may run the risk of incurring a penalty. As return preparers, however, we will seek to avoid participation in a return likely to subject us to penalties.¹⁷

b. If, subsequent to our preparation of a return, it comes to our attention that there was a clear and material error on the return, we may wish to withdraw from the representation unless the error is corrected, although the client may not be under a legal obligation to make a correction.¹⁸ We are obliged not to mislead the Service, and by continuing under the circumstances we may do so.¹⁹ Indeed, we may from time to time be asked to assist in the defense of a client who has filed a fraudulent return. If we should ever learn, however, that a client asked us to be return preparers of a fraudulent return, we would immediately terminate all further representation.²⁰

c. In return preparation, the tension between the quality service we insist on providing and the client's desire to minimize costs is particularly strong. We should not hesitate to point out to the client less expensive return preparation alternatives than we are willing to provide.

¹⁶See *United States v. Windfelder*, 790 F.2d 576, 579 (7th Cir. 1986); *Graves*, *supra* note 15; *see generally*, Spahn, *Making and Breaking the Attorney-Client Privilege*, 35 *PRAC. LAW.* 61 (1989) (summarizing principles of attorney-client privilege and offering suggestions for its creation and maintenance). *See also* *Hartz Mountain Industries, Inc. v. Commissioner*, 93 T.C. 521 (1990), where use of house counsel's affidavit was held to waive the privilege.

¹⁷For negligence penalties applicable to return preparers, see I.R.C. § 6694, as amended by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106; *see also generally* but relating to the law prior to its 1989 amendment, Rev. Proc. 80-40, 1980-2 C.B. 774; Rev. Ruls. 80-262 through 80-266 issued in connection therewith; Arzoo, *Preparer Penalties and Compliance*, 18 *TAX ADVISER* 36 (1987); Thomas, *The Negligent Return Preparer: Avoiding Section 6694(a)*, 63 *TAXES* 831 (1985); Buchholz & Paley, *Minimizing Your Exposure to Tax Preparer Liability: A Checklist Approach*, 18 *PRAC. ACCT.* 75 (1987). In 1986, the Treasury proposed an amendment to Circular 230 under which imposition of § 6661 substantial underpayment penalties on the client would be taken as evidence of improper practice by the adviser. The ABA and AICPA opposed this proposal. *See AICPA Comments on Circular 230*, 18 *TAX ADVISER* 275 (1987). *But see* Wolfman, *Circular 230*, 36 *TAX NOTES* 832 (Feb. 23, 1987); Johnson, "True and Correct" Standards for Tax Return Reporting, 43 *TAX NOTES* 1521 (June 19, 1989).

¹⁸*See infra* parts IV.E. and V.B. (more detailed discussion of the impact of the discovery of error on a return on our relationship with the client).

¹⁹Any withdrawal from representation must be handled in such a way as not to disclose confidences or unduly prejudice the client. ABA Comm. on Professional Ethics, Formal Op. 314 (1965); AICPA Statement on Responsibilities in Tax Practice No. 7 (rev. 1988); *See also* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16 comment (1984).

²⁰MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16(b)(1)-(3); *see also* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 comment (1983). ("A lawyer may not continue assisting a client in conduct the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent.").

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C. Diligence

We owe it to our clients and ourselves to be diligent in the preparation of returns. This duty includes making reasonable efforts to obtain all relevant information from the client, reviewing last year's income tax return for any changes, obtaining confirmation as to the client's record keeping procedures (where they are relevant to the tax result), considering the tax position of other related taxpayers (to the extent known to us), and researching any doubtful questions of law.

As return preparers, we are not under any obligation to audit our client's records; but if information given to us raises questions in our minds, we should ask them and not proceed further unless we are reasonably satisfied.²¹

D. Valuation

A difficult factual issue frequently arising in the preparation of returns is the value of property transferred. Most tax practitioners are not appraisers and should generally let others make the valuation. It is entirely proper, however, to assist the appraiser in preparing the report. Indeed, we should use our lawyering skills to ensure that the report is sensible and will withstand scrutiny, because thereby we serve both the system and our clients.

The Code now imposes various special penalties for overvaluation and undervaluation of property and also requires the services of a qualified appraiser in certain situations. We must advise the client of these rules so that the client can be aware of the risks involved. Further, while there is nothing wrong in either the appraiser or the preparer giving the client the benefit of the doubt where the value is uncertain, any valuation involved in a return that we prepare must be responsibly done, make sense, be well-reasoned, and be internally consistent.²²

Even though we may be well-qualified to make an informed judgment as to a particular property, we should nevertheless consider whether our representation of the client as advocate before the Service may not undercut our effectiveness as an impartial appraiser.²³

E. Conformity to Law

1. A tax return involves the application of law to facts. Where the law is clear, we follow the law.²⁴

²¹AICPA Statement on Responsibilities in Tax Practice No. 3 (rev. 1988). This same approach also applies to relying on forms K-1, brokers' statements and similar third party information.

²²See I.R.C. § 6662(c)-(g) (valuation penalties); see also I.R.C. § 6664(c) (requiring, *inter alia*, a qualified appraisal by a qualified appraiser for relief from penalty). For the requirements of a qualified appraiser, see Regs. § 1.170A-13(c)(5). These regulations refer to other provisions of law under which appraisers may be subject to the aiding and abetting penalty and also may be subject to proceedings conducted by the Secretary of the Treasury for a determination to have their appraisals disregarded.

²³See MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.7(1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-102(A) & DR 5-101(B) (1980) (lawyer being a witness and advocate in the same proceeding).

²⁴See generally AICPA Statement on Responsibilities in Tax Practice No.1 (rev. 1988); ABA

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2. It is appropriate to assist the client in structuring a transaction and reporting it on the return in the way least likely to be subject to audit, provided we do not mislead the Service. However:

a. We will not participate in the preparation of a return containing a clear error or frivolous position merely to have "a bone to throw" to the agent on audit in the hope that the error will not be discovered, or because the client cannot afford or wants to postpone a current tax payment.

(i) We should remind the client of the exposure to penalties, interest, future audit procedures, and other potentially adverse consequences that may flow from overreaching in tax matters.

b. We will not participate in the preparation of a return where the client fails to answer a question on the return in order to save taxes.²⁵

c. When it is appropriate to use estimates on a return, we may indicate that it is an estimate, and, in any event, we will not do so in a manner likely to imply greater accuracy than in fact exists.²⁶ For instance, if we believe an amount is about \$2000, we should write "\$2000" or "\$2000 (est'd)." We should not write "\$1984.76."

3. When the application of the law to the facts is not clear, there are frequently many choices, all within permitted limits, relating both to the position to be taken and the nature of the disclosure on the return. Positions and disclosures range from the entirely safe and certain to be accepted by the Service, to aggressive positions, which may result in a lesser tax burden, but involve the risk of challenge by the Service, to interest not being deductible, and of possible civil penalties in addition to the accounting, legal and administrative costs involved in resolving a tax controversy. Within the limits indicated below, it is up to the client to make the choice; it is up to us to explain the potential benefits and hazards.

4. There have been ongoing discussion and controversy about the degree of assurance the taxpayer and the taxpayer's advisor must have in the correctness of the return. These discussions should not obscure our *general rule*: returns should be prepared carefully and should be believed to be correct. This basic rule by itself does not provide the answer to the problems that arise when the law is not clear or where the client intentionally and with full advice decides to test the limits of the permissible. Even then, our general commitment to "good returns" provides the background against which the specific situation will be considered. In any case, no matter how urgent the client's needs, we will not

Comm. on Ethics and Professional Responsibility, Formal Op. 352 (1985) (lawyer's advice in regard to a tax return should be governed by good faith and the realistic possibility for success should the matter be litigated).

²⁵See AICPA Statement on Responsibilities in Tax Practice No. 2 (rev. 1988) (discussing answers to questions on returns). Our commitment to answering a question depends, of course, on our conviction that the Service is legally authorized to ask the question. At times, rather than completing a form, we may attach a statement which provides all relevant information but in a manner more helpful to the client than the official form.

²⁶See AICPA Statement on Responsibilities in Tax Practice No. 4 (rev. 1988).

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participate in a return that falls below either the standards of Circular 230 or the rules set forth in applicable ABA Opinions of Ethics.²⁷

a. When a client decides to take an aggressive position, we should usually explain the risks to make sure that the client is aware of what is involved. We should make a record of our warning and of the technical support for the client's position to protect this firm against possible claims from the client or the Service. We should, however, make such record in a manner that preserves the confidentiality of our communications.²⁸

b. The general view of tax return professionals is that the applicable rules of professional ethics that bar assistance to a client engaged in "violation of law" are intended solely to prohibit participation in criminal conduct. With respect to client conduct that may lead to certain lesser civil penalties—such as a penalty under section 6662 (which now includes the substantial underpayment penalty of old section 6661)—the professional's obligation is merely to warn the client.²⁹ Nevertheless, it would be highly unusual for this firm to participate in conduct certain to lead to civil tax penalties; indeed we will generally not participate when a civil penalty to the taxpayer would more likely than not result if the return were audited and all of the facts were presented to a court. Further, we will not serve as return preparers if it appears more likely than not that we would be subject to any preparers' penalty if all the facts were known to the Service.³⁰

c. Both as a matter of statutory law and as a matter of the common law of taxation, the risk of penalties resulting from aggressive positions may generally be reduced by riders or explanatory statements attached to the return.³¹ No matter

²⁷The principal current opinion is ABA Comm. on Professional Ethics, Formal Op. 314 (1965), as modified by ABA Comm. on Ethics and Professional Responsibility, Formal Op. 352 (1985). Opinion 85-352 is reproduced in 39 TAX LAWYER 613 (1988). The same volume also contains an explanation of the background, *Report of the Special Task Force on Formal Opinion 85-352*, 39 TAX LAWYER 613 (1988).

²⁸See *supra* last paragraph in part II.

²⁹See Durst, *The Tax Lawyer's Professional Responsibility*, 39 U. FLA. L. REV. 1027 (1987).

³⁰The INTERNAL REVENUE AUDIT MANUAL, Part IV, 4297.9(7)(f) (1987), instructs agents to consider imposition of preparer penalties whenever considering substantial underpayment or valuation penalties. The House Committee Report on the 1989 Civil Penalty Legislation states, however, as part of its Administrative Recommendations to the Service, in section c.3, to instruct its employees not to threaten imposition of preparer penalties during the course of an examination, Appeals conference, or other proceeding.

The preparer penalty provisions in I.R.C. § 6694, as amended by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, now follow the ethical guidelines for lawyers and accountants proposed by the ABA and the AICPA. If an understatement of tax liability on a return is due to a position of which the return preparer knew or should have known that it did not have a realistic possibility of being sustained on its merits and such position was not disclosed or was frivolous, the preparer is subject to penalty "unless it is shown that there is reasonable cause for the understatement and such person acted in good faith." For a discussion and matrix of the negligence penalty provisions for taxpayers and return preparers resulting from the 1989 revisions, see Banoff, *Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns*, 68 TAXES 40 (1990).

³¹Substantial understatement penalties under I.R.C. § 6662(d) may be reduced by the amount attributable to "any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return." For relevant authority prior to the penalty provision amendments made by the Omnibus Budget Reconciliation Act of 1989,

how complete the disclosure, however, we must in good faith believe that the taxpayer's position is not frivolous.³²

F. Prior Years' Returns

If we discover an error in a prior year's return that is not barred by the statute of limitations, whether or not of our own creation, we must advise the client of the error.³³ We should explain that present law does not mandate the filing of an amended return, but that a tax that is owed is a debt that should be paid and, therefore, in general an amended return should be filed to correct any clear and material errors.³⁴

1. Although there is no legal obligation to file an amended return, the implications of an uncorrected error on future years' returns must be considered. An uncorrected error having an effect on future returns cannot knowingly be carried forward.

2. If correction gives rise to risk of penalty, we must describe the risk and explore ways of paying the tax due that will minimize exposure to the penalty. In any situation involving potential fraud charges, however, we should carefully explain to the taxpayer the benefits and hazards of the various options available, including any constitutional right not to cooperate with the Service. A lawyer who does not have criminal tax practice experience should consult with one who has such experience.

a. When a clear and material error was made on a return prepared by this firm or in an audit in which we acted as the client's representative, we should explain to the client our own interest in an appropriate correction, and suggest that if the client wants advice not colored by such interest, the client should consult another adviser. Indeed, we may be required to insist that the client consult another advisor, where our own interest is sufficiently disparate from that of the client.

Pub. L. No. 101-239, 103 Stat. 2106, see I.R.C. § 6661(b)(2) (1986); Rev. Proc. 86-27, 1986-1 C.B. 562; Rev. Proc. 87-48, 1989-2 C.B. 645; Rev. Proc. 8837, 1988-2 C.B. 560.

³²The AICPA and the ABA formerly did not suggest the explanatory riders were ethically required, although they might be prudent. See AICPA Statement on Responsibilities in Tax Practice, No. 1 [.02d] (rev. 1988); ABA Comm. on Professional Ethics, Formal Op. 314 (1965). More recently, these organizations have agreed that where a position has less chance of success than the "realistic possibility of success" standard, it may nevertheless be taken on a return if adequately disclosed and not frivolous. See *AICPA Comments on Circular 230*, 18 TAX ADVISER 275 (1987). With respect to return items not involving tax shelters, disclosure may avoid the substantial underpayment penalty. See I.R.C. § 6661(b)(2)(B)(ii); Rev. Proc. 86-22, 1986-1 C.B. 562; Rev. Proc. 87-48, 1987-2 C.B. 645; Rev. Proc. 88-37, 1988-2 C.B. 560. As a result of the Omnibus Budget Reconciliation Act of 1989, disclosure that satisfies § 6662(d)(2)(B)(ii) would also protect the preparer against penalty unless the position was frivolous. I.R.C. § 6694(a)(3).

³³31 C.F.R. § 10.21 (1988). For planning correction of erroneous transactions, see *infra* note 49 and supporting text.

³⁴See generally Ronan, *Do Clients Have a Duty to File Amended Tax Returns?*, 33 PRAC. LAW. 25 (1987); AICPA Statement on Responsibilities in Tax Practice No. 6 (rev. 1988). See also Harris, *On Requiring the Correction of Error Under the Federal Tax Law*, 42 TAX LAWYER 515 (1989). A failure to correct a clear and material error in a refund claim before the refund is paid appears particularly serious.

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b. When we were preparers of a return that we subsequently learned contains a clear and material error,³⁵ and the client decides not to amend the return, we should consider whether the circumstances are such that we should no longer represent the client either in tax matters in general or, specifically, in any audit of the return.³⁶

c. As already stated, if we should ever learn that a client asked us to assist in the preparation of a fraudulent return, we would immediately terminate all further representation.³⁷

3. If a client has failed to file returns for prior years and pay the taxes due, he is under a clear legal obligation to do so and usually the best advice is to report and pay. Nevertheless, this involves the same balancing of benefits and risks as described under part IV.E.1. with respect to erroneous returns.

4. When we must respond to an independent auditor's letter and know of a clear error on a prior year's return that is not barred by the period of limitations, we must carefully consider whether this is a "contingent liability" to be disclosed by the client to the auditors. In that connection, it is relevant whether we believe it more likely than not that the claim will be asserted by the Service. Nevertheless, we must be certain that, by our silence, we do not mislead the auditors as to our client's situation, particularly since our client's refusal to correct a return containing a clear and substantial error may have a bearing on the auditor's reliance on the client's statements generally.³⁸

V. AUDIT REPRESENTATION

A. Nature of Proceeding

1. A tax audit is the first step and often also the last step in a potentially adversarial legal proceeding.

The following recommendations address audits when either the taxpayer has the burden of proof or when the Service may reasonably infer that we do not know the taxpayer's position to be clearly wrong. Obviously, when the audit is tending toward the direction of fraud charges, the client is entitled to take a position of "prove it" toward the Service and our role becomes pretty much that of an advocate in an adversarial proceeding.

2. Some lawyers handle audits on a superficial basis, in the hope that with only a little effort they can convince the agent to drop whatever questions the agent may have raised. Our firm's general approach is to persuade the client to

³⁵The term "clear and material error" does not include a position that was appropriate under the law in effect at the time of filing the return nor one that does not have a significant effect on the tax liability. See AICPA Statement on Responsibilities in Tax Practice No. 1 (rev. 1988). See also I.R.C. § 6662(d)(2)(B)(i) which precludes substantial underpayment penalty for any underpayment due to "the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment." (emphasis added).

³⁶See ABA Comm. on Professional Ethics, Formal Op. 314 (1965).

³⁷See *supra* note 20 and supporting text.

³⁸See generally Fuld, *The Statement of Policy Regarding Lawyers' Responses to Auditors Requests for Information*, 31 BUS. LAW. 1709 (1976) (the impact on the attorney-client privilege by clients' responses to auditors requests).

authorize us to do a thorough and first class job. While at times the result may be an unnecessary expenditure of time and money, far more often a thorough preparation of the client's case will permit an earlier termination of the audit and a settlement of the controversy on terms favorable to the client. Superficial work, on the other hand, frequently leads to inconsistencies, as facts and legal theories developed in later stages of a proceeding do not coincide with earlier communications to the Service. Such inconsistencies undermine the lawyer's credibility and persuasiveness, thereby reducing the client's prospects for success.

Where the matter is small or the client's funds are limited, it may make sense to do less than a "full court press." Within the limits of our professional responsibility, the decision is the client's.³⁹

3. The Service representatives will have substantial knowledge and experience, while the client may not be aware of all the legal aspects of his particular situation. Unlike lawyers who are usually barred from having contact with the opposing party except through the opposing party's lawyer, Service agents are not similarly restricted.⁴⁰ Clients, however, need and are entitled to the same protection as in other proceedings when the other side possesses legal expertise that they lack.

While a lawyer or other representative need not be present at all stages of an audit, we should at the outset seek to review with the client the legal aspects of the audit, particularly any weak spots in the client's situation.

4. Frequently we can do a better job representing a client at an appeals conference if the client is not present. When we believe this to be the case, we should point this out to the client, leaving the final decision to the client.⁴¹

5. Both we and the client should cooperate with the Service, where this can be done without harm to the client's situation. We must remember, however, that it is not the Service but the courts that have the last word in determining what information—including information relating to third parties—the Service has a right to obtain from the client. In a particular case, there is nothing wrong with politely informing an agent that a summons will be required or that the propriety of a summons that has been issued will be tested in court.

6. Taxpayers have a right to periodically eliminate from their files papers no longer needed under applicable record keeping requirements, including memoranda and drafts regarding tax planning. Once an audit has started, however, any destruction of potentially relevant documents is improper.⁴²

³⁹See *supra* part II. (discussing the impact of costs on the work undertaken by attorneys).

⁴⁰See I.R.C. § 7520(b)(2) (giving taxpayers the right to consult with an attorney or other authorized representative, but this right must be specifically requested).

⁴¹The Service requires a summons to compel attendance by the taxpayer. I.R.C. § 7520(c).

⁴²Record retention requirements are set out in § 6001 and in *Guide to Record Retention Requirements in the Code of Federal Regulations*, NAT'L ARCHIVES AND REC. AD. (rev. 1986). MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.4(a) comment (1984), bar advising the destruction or concealment of evidence once a controversy has started or can be foreseen. See also I.R.C. § 7203 (punishes the willful failure to maintain required records as a misdemeanor); I.R.C. § 7206(5) (classifies as fraud the willful withholding or destruction of certain documents); I.R.C. § 7210 (deals with the failure to obey a summons).

B. Truthfulness in Dealings with the Service

1. We must at all times be truthful with the Service and use our best efforts to ensure that the client is also truthful.

a. To preserve our reputation for integrity and reliability we must, in communications to the Service, be clear as to the source of any facts we assert. "The corporation made all relevant elections on a timely basis" is a legitimate statement if we know it to be a fact. If we do not know it, we should say, "We are informed by John Jones, Treasurer of the corporation, that it made all relevant elections on a timely basis."⁴³

b. When we become aware of a clear and material error on the client's return, we should generally urge the client to permit disclosure, particularly when the proceeding involves the general correctness of the return rather than focusing on a specific issue. See part IV.E. above. (For instance, we should do so if we find during the course of an audit that a deduction was taken for a particular expenditure that was clearly non-deductible). Also, any mathematical mistakes whether made by ourselves, the client, or the Service, should be disclosed to the Service.⁴⁴

c. If, in an appropriate case, the client refuses to make the necessary correction or disclosure, in general, we should withdraw from further representation; the need to withdraw is particularly strong when we were the preparers of what is now known to be an erroneous return or when we may otherwise be understood by the Service to have participated in a misrepresentation by the client.

(i) Withdrawal from the engagement must be carefully undertaken so as to balance the desire or obligation to withdraw against the requirements that confidences not be disclosed and the client's interest not be otherwise prejudiced.

(ii) It may be helpful to remind the client that, during the course of an audit, it is customary for the auditing agent to ask whether the taxpayer or taxpayer's representative is aware of any matters requiring adjustment. If there is an undisclosed problem, and we have decided to continue representation in spite of the client's refusal to authorize disclosure, we must provide a truthful answer.

2. Difficult questions occasionally arise whether, in order to avoid misleading the Service, the lawyer should disclose information not known to the Service.

⁴³MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.3 comment (1984) ("... an assertion purporting to be on the lawyer's own knowledge, . . . may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of reasonably diligent inquiry.").

⁴⁴ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1518 (1986), counsels disclosure of a "scrivener's error" to the opponent without consultation with the client, since raising the issue of disclosure with the client might involve the lawyer in fraud if the client refuses to authorize disclosure. *But see* Chicago Bar Ass'n Prof. Resp. Com., Op. 864, in ABA/BNA, LAWYER'S MANUAL ON PROFESSIONAL CONDUCT, Vol. 4, No. 20, 345 (1988). In a particular case, it may be preferable first to consult with the client and urge disclosure.

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Generally, in an audit, as in other adversarial proceedings, our obligation to tell the truth does not require disclosure of all relevant facts and law.⁴⁵

a. Excepting only the situations referred to in part V.B.1.b. above, we are under no legal or ethical obligation to volunteer to the Service information adverse to the client or to urge the client to do so. Nevertheless, in our dealings with the Service, we can often serve our client most effectively by frank recognition of the problems with our client's case and then explaining why, in spite of these problems, our client should prevail.

b. There is no obligation to call the attention of the Service to apparent legal or factual inconsistencies in a settlement that was arrived at fairly. A settlement is an agreement between the taxpayer and the Service relating to "the bottom line," and inconsistencies with facts or rules of law not agreed to are irrelevant.⁴⁶ Nor must the settlement agreement be followed in future years unless it specifically so provides.⁴⁷

VI. TAX PLANNING

A. Complexities of Tax Law

Tax law has grown to the point where no one can possibly know all of the rules and approaches to various business and personal planning problems. Research, continuing education, the use of checklists, and consultation with others are all essential to prevent harm to our clients and malpractice exposure to the firm. We should not hesitate to suggest to the client consultation with experts outside our office whenever that appears in the client's best interest.

B. The Interest of Clients and Others

In tax planning we seek to assist our clients, within the limits of the law, to achieve their personal and economic objectives at the least tax cost.

1. We are likely to do our best planning if before turning to the legal technicalities, we seek to obtain a clear understanding of the "big picture"—for example, the overall strategic planning goals of the client—with which the tax plan should be consistent.

2. Frequently a form of transaction chosen by our client will have tax consequences for those with whom he is transacting business. Examples are situations

⁴⁵MODEL RULES OF PROFESSIONAL CONDUCT Rule 4.1(b) (1984), requires disclosure by the lawyer when "necessary to avoid assisting a fraudulent or criminal act by a client, unless disclosure is prohibited by Rule 1.6" (which protects confidential information except to prevent crimes likely to result in death or serious bodily harm or to protect the lawyer's interest). MODEL RULES OF PROFESSIONAL CONDUCT Rule 4.1 comment (1984), states: "A lawyer is required to be truthful when dealing with others on the client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts."

⁴⁶See ABA Comm. on Professional Ethics, Formal Op. 314 (1965). See also Comeel, *Ethical Guidelines for Tax Practice*, 28 TAX L. REV. 1, 21-22 (1972). There is no obligation on taxpayer's counsel to educate the Service as to the Internal Revenue Code. Therefore, the Tax Court refused to set aside a settlement where the Service lost approximately \$700,000 due to the ignorance of its counsel. See *Stamm International Corp. v. Commissioner*, 90 T.C. 315 (1988).

⁴⁷See AICPA Statement on Responsibilities in Tax Practice No. 5 (rev. 1988).

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where our client is borrowing or lending money, buying or selling a business, acting as franchisor or franchisee, etc. While as a matter of professional ethics our responsibility to non-clients may be limited to recommending representation by counsel, we should generally consider the tax consequences for all concerned, so that the client can make an informed choice that takes into account the resulting tax benefits and burdens of all.

3. We must remember that in addition to the client who pays us, others may rely on our advice. Examples are investors in a partnership promoted by our client; both husband and wife for whom we are preparing estate plans, even though only one will pay for our services; employees of a corporate client who rely on our advice as to the tax consequences of a compensation plan; and many more. In appropriate cases, we should recommend that they consult with another counsel or adviser. In all events, any written advice to clients should be worded so that it will not confuse or mislead non-clients who are likely to rely on it.

C. Plans Must Be Conditioned on Compliance with Tax Law

A tax plan should not be suggested without taking into consideration how the transaction should be reported and what the consequences of an audit of the return are likely to be. We will not suggest and we should counsel against plans that are bound to fail if all of the facts become known to the Service. We will not participate in transactions entirely lacking in economic substance and intended solely to conceal or mislead.

1. It is unethical to assist the client in the preparation of evidence designed to mislead the Service, such as a bill to a corporate client that includes, without disclosing, the cost of personal services to the owner of the corporation.⁴⁸ On the other hand, it is entirely proper to advise clients on the best ways of documenting legitimate positions.

2. At times the client in ignorance of the tax law has taken steps resulting in adverse tax consequences or has failed to take steps to prevent such consequences. It is not unethical to make every effort to correct this result, provided that this can be done without destruction of existing documents, backdating of new documents or other steps intended to mislead the Service as to what in fact happened.⁴⁹

D. Borderline Plans

We should remember that our objective in tax planning is to produce a good tax plan, a plan that works. A plan that is not sustained on audit or by litigation was not a good plan, no matter how brilliantly conceived, unless the client desired to consummate the transaction despite the possibility or probability of

⁴⁸ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1517 (1988), superseding Informal Op. 1494 (1982), requires disclosure on the corporate bill both of the personal services (without necessarily disclosing their nature) and the amount of the bill applicable to them.

⁴⁹Banoff, *Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942 (1984).

adverse tax consequences. The decision whether to risk the adverse consequences of borderline plans should be the client's, based upon our advice.

Clients are less well-informed than we are as to whether a proposed plan involves ethical but risky "skating on thin ice" or whether it involves "walking on water," that is, a breach of law. We must make the difference clear to them, and explain that being on the right side of this line is vital to our working with them on their tax plans. Lawyers' lectures to clients on morality are likely to be resented and useless, but clients can understand that we do not want to jeopardize continuing to make our living in our accustomed way. Further, it is often helpful to tell clients that if they do something clearly wrong, they can never thereafter be comfortable, that they will always be hostage to all who know or may come to know of their breach of law.

1. It would be unusual for us to suggest or recommend a plan which in our view would more likely than not result in negligence or similar penalties to the client if all the facts became known to the Service. Indeed, in planning, our standards are likely to be higher than in planning returns, since there will usually be opportunities in planning to reduce the risk of challenge.

2. Clients contemplating proceeding with a highly aggressive tax plan should make certain in advance that their tax return preparer will be willing to sign the return.

3. Sometimes we are blinded by our own brightness. If we have devised what we consider to be a particularly clever tax plan, we should remember the maxim, "If it is too good to be true, it isn't," and view each aspect and the overall plan through the eyes of an ambitious Service agent, determined to collect as much as possible. Finally, we should ask another experienced tax practitioner to review our plan and opinion carefully, both as to the technical details and as to the overall concept.

E. Tax Shelter Plans

We will not assist in the offering of a tax shelter program in which the tax benefits are important to the success of the investment unless it is substantially more likely than not that the material tax benefits will, in fact, be available to the investors. The degree of assurance we require as to the availability of the tax benefits depends upon the importance of the tax benefits to the success of the investment.⁵⁰

1. We should decline to participate in a tax opinion on a shelter program unless this firm also handles the balance of the legal work or has confidence in the other counsel involved and has adequate opportunity to explore any matters considered potentially troublesome. Familiarity with all of the facts is vital to such an opinion.

⁵⁰ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (rev. 1982), and 31 C.F.R. § 10.33 (1988), set forth ethical guidance for tax shelter opinions. Although they authorize "negative opinions," this firm will not undertake representation in such offerings.

F. Following Up

A perfectly good tax plan may be spoiled in its implementation: there may be a failure to execute the proper documents, to make a timely filing of notices or elections, or to pay the amount necessary to avoid a gift or a dividend. We should make every effort to have our engagement in a tax planning matter also cover the implementation.

The desirability of assuring proper implementation of a plan that we helped create is very different from assuming any obligation to advise with respect to future changes in the law that may have a bearing on plans we have devised or on the repetition in future years of acts that we have previously approved. Most clients understand that nothing is less constant than the tax law and that what is right today may be wrong tomorrow. But it is a truth worth repeating both to our clients and ourselves.

VII. ASSURING AN ETHICAL TAX PRACTICE

A. Like charity, the maintenance of professional standards begins at home. We expect all who work here to comply fully with all aspects of Federal, state, and local tax law in meeting their personal tax obligations.⁵¹

B. We can help maintain ethical standards by wide discussion among all tax specialists of any ethical questions arising in our practice and of any court decisions, rulings, ABA opinions, AICPA statements or other developments having a bearing on professional standards in tax practice. Doubtful questions should not be resolved without such discussion based upon careful research.

C. The foregoing guidelines must be applied to all of our clients, without reference to their monetary importance to the firm. We must recognize, however, that our financial interest in a matter may affect our judgment as to whether a contemplated course is proper. Accordingly, if we have doubts as to the propriety of a particular action and the matter is material from the firm's point of view—either by risking the loss of an important client or by exposing the firm to the charge that it engaged in misconduct—it is imperative to have a full and complete discussion of the matter with one or more uninvolved partners in the firm. In some cases, it may be advisable to obtain the opinion of outside counsel.

D. We want everyone working here to feel comfortable with the standards observed in our tax practice. Suggestions for improvement are always welcome. If anyone has any questions concerning the propriety of any action or plan, involving either that person or someone else in the firm, those questions should be promptly discussed—first, with the individual involved and then with any partner or partners in whose judgment the individual reposes confidence. Remember, the ultimate responsibility for your own conduct is solely your own.

E. There is now a growing and ever-changing body of law, regulations,

⁵¹This is also a condition for practice before the Service. 31 C.F.R. § 10.51(d) (1985).

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opinions, court decisions, and literature bearing on the conduct of a tax practice. Therefore, research is essential to the proper resolution of problems that may arise. The authorities cited are intended to facilitate the beginning of such research.⁵²

⁵²The best current general text on the subject is B. WOLFMAN & J. HOLDEN, *ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE* (2d ed. 1985). The ethical requirements for practice before the Treasury Department are set forth in 31 C.F.R. §§ 10.3, 10.4. Circular 230 should be carefully reviewed because it specifies all kinds of disreputable conduct that may result in disciplinary action by the Treasury even though not directly related to dealings with the Service. *Id.* at § 10.51. See generally Shapiro, *Professional Responsibility in the Eyes of the IRS*, 17 *TAX ADVISER* 136 (1986). The recently revised AICPA Statements on Responsibility in Tax Practice offer the best detailed discussion on the points they cover. Needless to say, tax lawyers are lawyers and the state law disciplinary rules apply to the conduct of tax practice. For bar association opinions bearing on the conduct of tax practice, see ABA/BNA, *LAWYER'S MANUAL ON PROFESSIONAL CONDUCT* (1988), and more generally *THE RESTATEMENT OF THE LAW ON LAWYERS* (now in preparation).

Tax Lawyer, Vol. 43, No. 2

STANDARDS OF TAX PRACTICE
STATEMENT 1999-1

American Bar Association
Section of Taxation
Committee on Standards of Tax Practice
(Unofficial guidance)

Issue Presented

This Statement addresses the issue of counsel's responsibilities upon discovering a computational error made by the Internal Revenue Service in the client's favor that is unrelated to any affirmative representation or omission of either the client or counsel.

The issue arises in a number of contexts. A computational error may surface either before or after the client has determined the correct tax calculation. A computational error may involve a tribunal, as in the settlement or decision in a docketed tax case. Documents filed by the parties with the court may carry the error, as in a stipulated decision document filed in Tax Court, or may not, as in general stipulations for dismissal filed in District Court. Computational errors by the Internal Revenue Service may create a reduced deficiency, but can also result in an erroneous refund being received by the client.

Applicable Rules

Rule 1.6(a) of the ABA Model Rules prevents a lawyer from revealing confidential information relating to representation of a client, unless the client consents to disclosure after consultation or there is implied authorization to disclose in order to carry out the representation.

Rule 4.1(a) prevents a lawyer from knowingly making a false statement of material fact to a third person. Rule 4.1(b) prevents a lawyer from knowingly failing to disclose a material

fact to a third person, but only where disclosure is necessary to avoid assisting a fraudulent act by the client and then only if disclosure is not prohibited by Rule 1.6.

Rule 1.2(d) prevents a lawyer from knowingly counseling a client to engage in, or assist a client in, conduct that is criminal or fraudulent. In this regard, Rule 8.4(c) proscribes conduct involving dishonesty, fraud, deceit or misrepresentation.

Under Rule 3.3(a), a lawyer may not knowingly make a false statement of material fact to a tribunal or fail to disclose to a tribunal a material fact necessary to avoid assisting a client in a fraudulent act. These duties to a tribunal continue through the conclusion of the proceedings and specifically apply even if compliance requires a lawyer to disclose a confidence otherwise protected under Rule 1.6.

Rules 1.4(a) and (b) require a lawyer to keep the client reasonably informed about the status of the matter and to explain the matter to the client, to the extent reasonably necessary to permit the client to make informed decisions.

Rule 1.16(a) requires a lawyer to withdraw from representation if called upon to act in violation of the rules of professional conduct. Under Rule 1.16(b), a lawyer may (but need not) withdraw if withdrawal is without material adverse effect on the client, or if the client (i) persists in action involving the lawyer's service that counsel believes to be fraudulent or (ii) persists in pursuing an objective that counsel considers repugnant or imprudent.

An error in calculating the correct tax liability can be computational, such as an arithmetic mistake, or clerical, such as a typographical mistake. Computational errors can also be conceptual, such as where the calculation depends on the application or interpretation of a particular Code section. The computational error need not relate to the tax liability, but can occur with respect to penalties or interest. Courts generally have not been reluctant to correct clerical errors. *See Holland v. Commissioner*, 64 T.C.M. (CCH) 1433 (1992); *In re Catt*, 96-2 U.S.T.C., par. 50,422 (E.D. Wash. 1996). An arithmetic error, rather than a conceptual error, can be corrected by the Internal Revenue Service without the need for a statutory notice of deficiency. I.R.C. § 6213(b)(1) and (g)(2). An arithmetic error generally is not subject to dispute. This is not necessarily the case with conceptual errors, where the courts are more reluctant to permit correction. In *Stamm International Corp. v. Commissioner*, 90 T.C. 315 (1988), for example, the Tax Court refused to allow the Internal Revenue Service to withdraw a stipulated settlement upon discovering its unilateral mistake of not considering the application of a Code provision in calculating the settlement amount. The Tax Court held that silence by the taxpayer's counsel, although misleading, was not the equivalent of a misrepresentation in that case.

Two local bar association opinions have held that a computational error in a client's favor constituted a client confidence under the applicable state professional rules of conduct and thus counsel was not permitted to disclose. Chicago Bar Ass'n Op. 86-4; Dallas Bar Ass'n Op. (8-23-89) (apparently involving a tribunal.)

The ABA has opined that a lawyer may not deliberately or affirmatively mislead the IRS in settlement negotiations, either by affirmative misstatements or by silence and may not permit

the client to mislead, while at the same time noting that a lawyer need not disclose weaknesses in a client's case even if an unjust result occurs. Formal Opinion 314 (April 27, 1965). This Opinion is also explicit that the Internal Revenue Service is not a tribunal.

In *United States v. McRee*, 7 F.3d 976 (11th Cir. 1993), a taxpayer was convicted for converting government property by cashing an erroneously issued refund check, even though the taxpayer did nothing to induce issuance of the refund.

ABA Informal Opinion 86-1518 (Feb. 9, 1986) determined that counsel had a duty to disclose an inadvertently omitted provision from a contract when presented for signature because the omission involved merely a scrivener's error. The ABA assumed for purposes of discussion that the scrivener's error was a client confidence and reasoned that counsel had implied authority to disclose under Model Rule 1.6 because the parties had already reached a meeting of the minds. The Informal Opinion did not address counsel's duty if the client wished to exploit the error.

Discussion

When counsel learns that the Internal Revenue Service has made a computational error of tax, penalty or interest in the client's favor, the information gained is a client confidence under Rule 1.6(a), which generally may not be disclosed without the client's consent, unless otherwise provided in the Model Rules or by other law. Confidentiality applies to all information obtained about the client relating to the representation and not just communications from the client. But Model Rule 8.4(c) provides that a lawyer may not engage in conduct that is dishonest.

The lawyer's ethical obligations will depend on the circumstances; thus, this Statement recognizes that different conclusions should be reached in different factual situations. There is nonetheless a common theme. A client should not profit from a clear unilateral arithmetic or clerical error made by the Internal Revenue Service, and a lawyer may not knowingly assist the client in doing so. This is not the case, however, if the computational error is conceptual, such that a reasonable dispute still exists concerning the calculation.

Docketed Case

If the parties in a docketed case are required to document the amount of the client's tax liability or overpayment, such as in a decision document filed in Tax Court or in a judgment entered on a counterclaim in U. S. District Court or the U. S. Court of Federal Claims, counsel must disclose an error to the court. Model Rule 3.3(a)(1). Because counsel knows that the deficiency is understated, or refund overstated, counsel cannot file a document with the Court that contains an incorrect deficiency or overpayment without making a false statement to a tribunal. Disclosure of the error may be made in this situation without the consent of, or consultation with, the client. Rule 3.3(b) specifically requires disclosure notwithstanding that the error is a client confidence under Rule 1.6.

Where the parties need not document the amount of the tax liability or refund, as is generally the case in the U.S. District Courts or the U.S. Court of Federal Claims, the dismissal document generally does not contain the false statement of material fact. Nonetheless, under Model Rule 3.3, counsel owes a greater duty to a tribunal than is owed to an opposing party, and

the rules of conduct should not vary depending on the particular forum. Disclosure is required, and may be made without consulting the client.

Settlement of Non-Docketed Case

A lawyer must disclose a clear arithmetic or clerical calculation error (but not a conceptual error) the amount of which is not de minimis to the Internal Revenue Service, if there exists express or implied authority from the client to make the disclosure. Whether implied authority exists is a question of fact. Implied authority will generally exist where the terms of a settlement have been reached and the Internal Revenue Service then commits a unilateral arithmetic or clerical error in the computation of the tax, penalty or interest owed or refund due. Implied authority generally will not exist if the calculation error is conceptual; that is, for example, it depends on the application or interpretation of a Code section for which a reasonable dispute could exist.

In refund situations, the cashing of an erroneous refund check can constitute a criminal violation for converting government property. A lawyer who knows that a miscalculation will result in an erroneous refund cannot become an instrumentality in creating the erroneous refund. However, the potential crime is a client confidence that generally cannot be disclosed, unless express or implied authority to do so exists.

Therefore, in non-docketed cases involving refunds or deficiencies, if the client refuses to consent where there is no implied authorization, counsel must withdraw from the engagement because the failure to act would constitute a violation of Rule 8.4(c) and Rule 1.2(d). *See* Rule 1.16(a). Counsel need not withdraw if express consent is withheld and the error is conceptual.

These principles can be illustrated by the following examples:

Example 1: After the terms of a settlement in a non-docketed case have been reached, the Internal Revenue Service in calculating the deficiency inadvertently misplaces a decimal point so that the recomputed deficiency is reflected as \$25,189.01, instead of \$251,890.10. This error is entirely clerical. Implied authority to disclose ordinarily would exist, absent an extraordinary circumstance such as the client's prior express direction to the contrary. Therefore counsel must disclose and need not consult with the client. *See* Example 3. If implied authority to disclose does not exist and express consent is withheld by the client, counsel must withdraw. Where the case is docketed, disclosure is required irrespective of the client's express or implied consent.

Example 2: As part of the terms of a settlement reached with the Internal Revenue Service Office of Appeals, the client is entitled to claim a \$100,000 deduction, which was originally reflected on Schedule C of his federal income tax return. Counsel believes that this deduction is more likely attributable to a passive activity, but the issue was not raised at Appeals and the Internal Revenue Service computation treated the deduction as non-passive. The taxpayer would not currently benefit from the deduction if it was related to a passive activity. This error is conceptual, as the application of Section 469 to the settlement computation is highly factual and is subject to some reasonable dispute. Counsel may not disclose this error without express consent from the client. Implied authority to consent does not exist because the issue was not addressed in the settlement negotiations and there was no meeting of the minds on the point. The result does not change where the failure to consider Section 469 resulted in a refund or if the case was docketed.

Example 3: The client agrees to settle a non-docketed tax case after the client calculates the deficiency to be approximately \$150,000. Counsel later receives the Internal Revenue Service recomputation reflecting a deficiency of only \$125,000 and learns that the difference resulted from a multiplication error. Because this error is entirely arithmetical, as to which there can be no reasonable dispute, counsel must disclose the error. Implied authority to disclose exists because the client agreed to settle knowing that the revised deficiency would be approximately \$150,000. If the multiplication error resulted in a revised deficiency of \$149,900, disclosure would not be necessary because the error is de minimis.

Example 4: In Example 3, assume the client accepted the settlement terms in principle, subject to the Internal Revenue Service recomputation, but estimated a \$100,000 revised deficiency. Upon receiving the Internal Revenue Service recomputation, the client and counsel learn that the Internal Revenue Service erroneously determined the deficiency to be \$125,000 and the correct revised deficiency was actually \$150,000. Implied authority does not exist here because the correct amount is not consistent with the client's stated expectation. This is so notwithstanding that the IRS computational error is entirely arithmetic. Under these circumstances, the lawyer may not disclose the error to the Internal Revenue Service absent express consent from the client. If the client refuses to consent, the lawyer must withdraw.

CONCLUSION

A lawyer must disclose a clear arithmetic or clerical error in the client's favor in a case docketed in court. In a non-docketed case, a lawyer must disclose a clear unilateral arithmetic or clerical error if there exists express or implied consent. If the client refuses express consent where there is no implied authorization, counsel must withdraw.

This Standard of Tax Practice Statement is issued for the guidance of tax practitioners. It was prepared by the Committee on Standards of Tax Practice of the Section of Taxation of the American Bar Association. The Statement was reviewed before issuance by the Council of the Section of Taxation. The Statement has not been approved by the Section or by the American Bar Association and should not be construed as policy of those entities. The ABA Standing Committee on Ethics and Professional Responsibility has indicated that it has no objection to the issuance of the Statement. The Reporter for this Statement was Donald P. Lan, Jr. of Dallas, Texas. The Chair of the Committee on Standards of Tax Practice was Leslie S. Shapiro of Washington, D.C., the Vice Chair was Linda Galler of Hempstead, New York, and the Chair of its Subcommittee on Standards of Tax Practice Statements was Charles Pulaski of Phoenix, Arizona.

1. Sue Smith, the mother of your good friend and client, Bob Smith, dies leaving an estate of \$2.5 million in equal shares to Bob and his brothers, Bill and John. Bob is named as executor and retains you to represent him. Among other things you arrange for an appraiser to value the contents of the family residence. The day before the appraisal is to take place, Bob informs you that he and his brothers and their wives have gone through the house and removed a substantial number of personal items, including jewelry and silver, which they have divided among themselves. None of these items are specifically referred to in the will.

Should you

- a. Arrange with Bob to have these items made available to the appraiser and included in the appraisal?
 - b. Confirm with Bob that the items taken are of relatively minor value and advise him that they need not be included in the appraisal?
 - c. Advise Bob that technically they should be included in the estate and leave it up to him as to whether they should be included in the appraisal?
2. Fred Fox has recently inherited a vacation home from his mother that he wants to give to his children, their spouses and his grandchildren as annual present interest exclusion gifts. To facilitate this (and perhaps obtain some valuation discounts) you advise Fred to transfer the home to an LLC and then give units in the LLC. When you mention to Fred that in order to use his and his wife's \$20,000 annual exclusions it will be necessary for them to file gift tax returns and agree to split the gifts, he asks if there is any way by which this could be avoided. Should you tell Fred that he can transfer an interest in the property to his wife, who can in turn transfer that interest to the LLC in return for units that she can transfer to the intended donees?
 3. Since Kentucky no longer requires that safe deposit boxes be inventoried, you do not become aware until after the federal estate tax return (prepared by your office) has been filed that the box contained \$100,000 of bearer tax-exempt bonds in an envelope labeled "Property of Pamela," a lady friend of the widower decedent who did not have access to the box. Under the tax payment clause in the decedent's Will, any estate and inheritance taxes on these bonds will be paid out of the residuary estate, which is left to the decedent's two children.

What advice do you give to the executor (one of the children)?

4. The decedent owned a substantial number of shares in a closely held corporation. As the attorney for the executor, a daughter who also owns a significant number of shares in the corporation, you obtain a qualified appraisal of the shares of \$1,500 per share, both at the date of death and as of six months thereafter. Seven months after death, the corporation's

shareholders receive an unsolicited offer for all of the stock at \$5,000 per share, which the shareholders accept a month later.

- a. At what value do you report the stock on the estate's federal estate tax return?
 - b. Do you disclose on the return the sale of the stock for \$5,000 per share?
 - c. Would it make any difference if the offer were the result of "discussions" that had commenced prior to the decedent's death?
 - d. If the offer/acceptance had not occurred until after the estate tax return had been filed, but before it was audited, would you mention the disposition to the IRS attorney?
 - e. If the offer did not occur until after the IRS attorney had proposed to settle for \$2,000 per share, would you mention it to the IRS attorney or settle quickly?
5. With your assistance, Joe Jones establishes an irrevocable trust and transfers \$1,300,000 of assets to it, intending for him and Mrs. Jones to agree to split their gifts so as to use both of their applicable credit amounts and GST exemptions. In the middle of the night it suddenly occurs to you that, since Mrs. Jones is a potential distributee of the trust, she cannot effectively consent to split the gifts.

What, if anything, can you do to avoid Mr. Jones having to pay a substantial amount of gift tax?

6. You and an IRS attorney are negotiating the resolution of her audit of your client's federal estate tax return and you have tentatively agreed on a disposition of all of the issues. You have calculated the approximate deficiency and have obtained authority from your client to settle on the basis of your computation. When the IRS attorney sends you her computation of the resulting deficiency, you quickly notice that she has made a mathematical error that has resulted in a substantial understatement of the deficiency.

Do you

- f. Inform the IRS attorney of the error;
- g. Ask the client if you may tell the IRS attorney about the error; or
- h. Accept the attorney's calculation.

Would your response be different if the error were in the application of the tax law to the agreed facts?

Would your response be different if the error were in a factual matter that did not originate with you or your client (such as the valuation of a listed security)?

What obligation, if any, do you have if the IRS representative proposes to settle a disputed estate tax situation for a fixed dollar amount, based on a calculation that she provides you that reflects a misunderstanding of the applicable facts or a misapplication of the law to the facts?

What is your obligation to the IRS representative if you realize that the statute of limitations for the issuance of a notice of deficiency will expire before you are expected to respond to a proposed settlement offer?

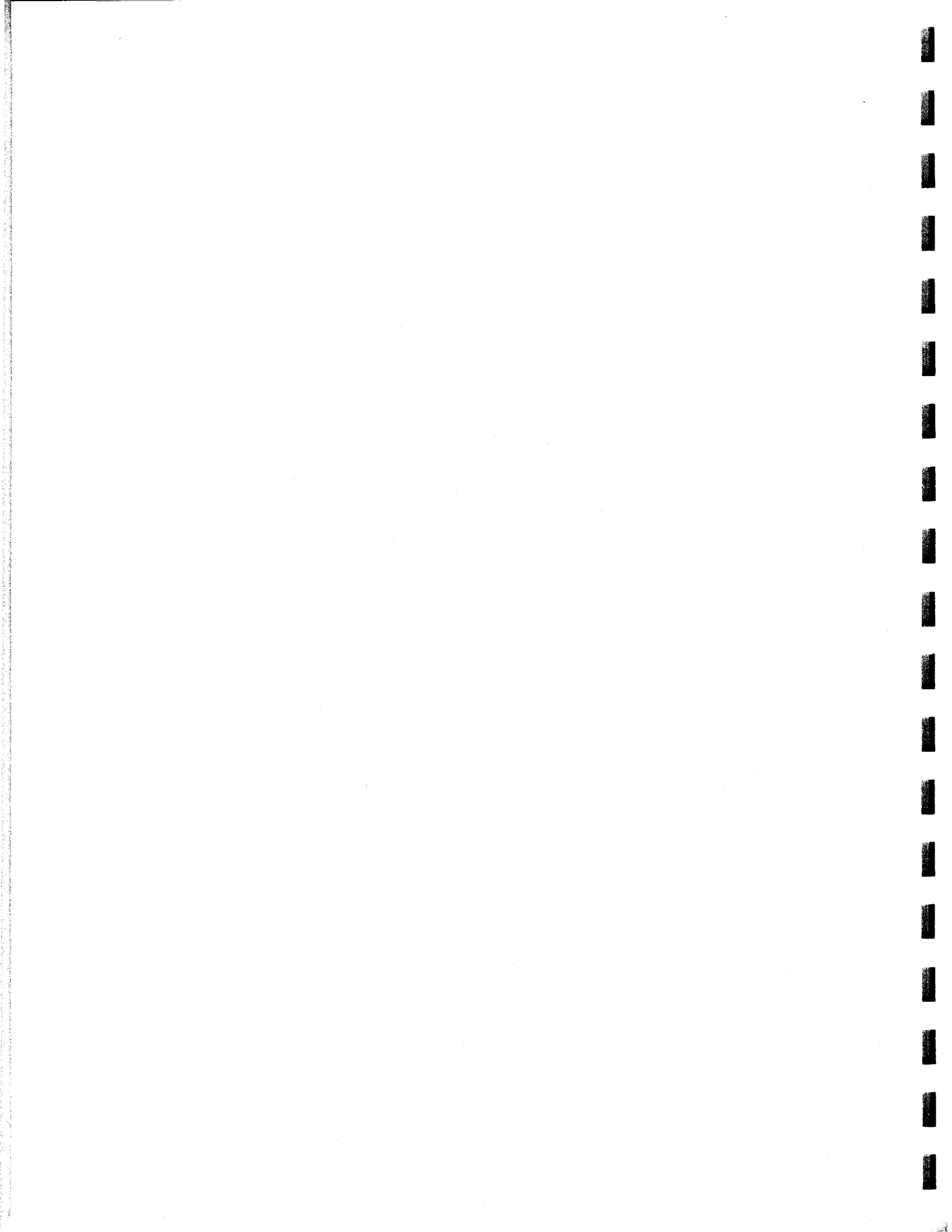
NOTE: Some of the above scenarios are derived from a questionnaire prepared by Frederic G. Corneel for the ALI-ABA Course of Study "Sophisticated Estate Planning Techniques," September 9, 1994, in Boston.



CONTESTED ESTATES:

**A Practical Analysis of Strategies For the Plaintiff
In Will Contest Litigation**

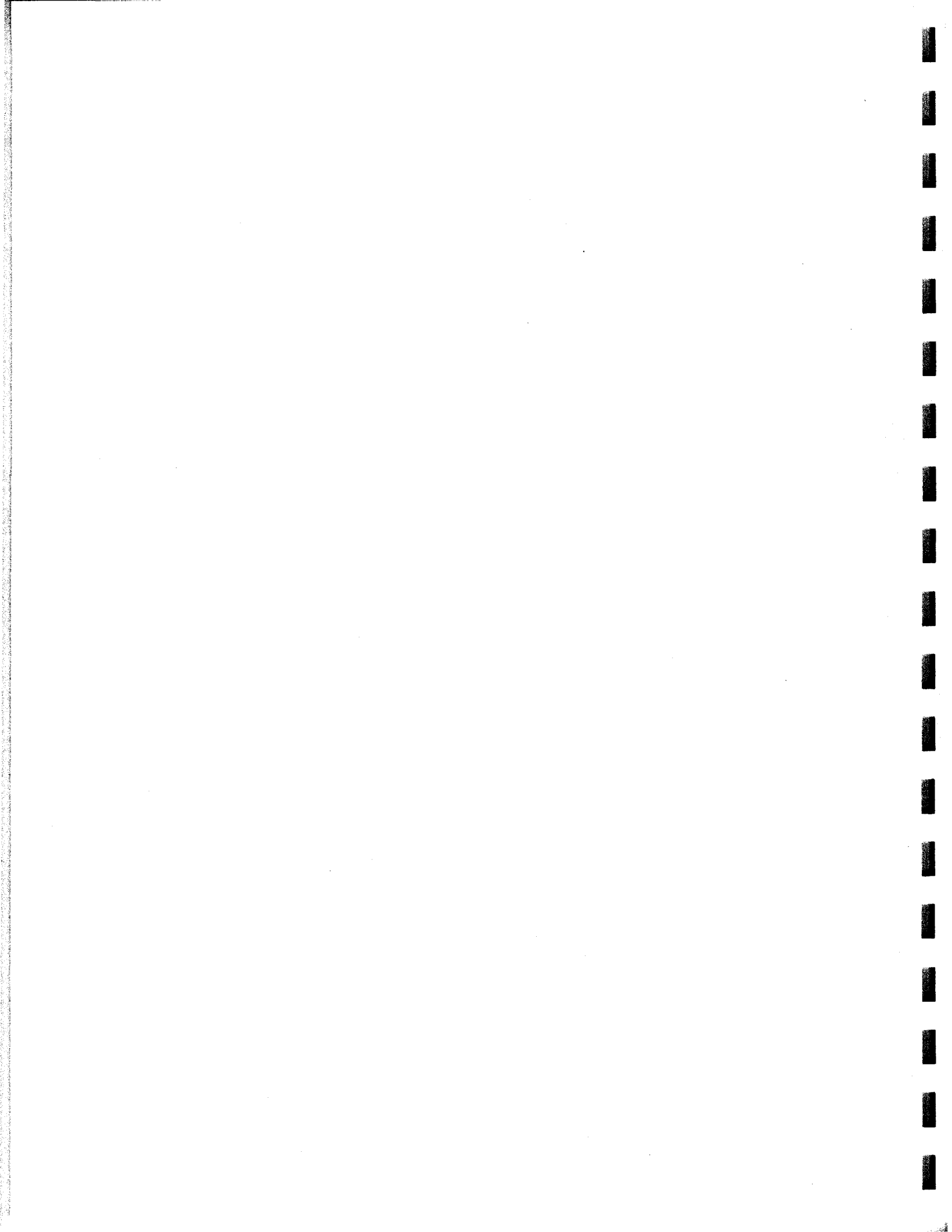
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**CONTESTED ESTATES:
A Practical Analysis of Strategies for the Plaintiff
In Will Contest Litigation**

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I. INTRODUCTION

From the point of view of the Plaintiff in a will contest case, the essence of the matter is to convince a jury that it should reject the challenged will. Counsel for the Plaintiffs in such an endeavor will normally rely on one or more of the following themes: (a) the testator did not really know what he/she was doing in making out the will; (b) the testator was talked into the will by a domineering and controlling personality, i.e. the undue influencer, who must be portrayed as a bad person, selfish, aggrandizing and ruthless; (c) the testator could not have truly intended to sign such a mean-spirited and unfair document and must, therefore, have been laboring under a delusion; and (d) much more rarely, the will is a forgery and the testator did not, in fact, sign it. This paper therefore addresses the question of how Plaintiff's counsel can foster or advance one or more of the foregoing points, and also addresses how different strategies may be utilized to achieve the goals of the Plaintiff in such litigation.

II. CHOICE OF PARTIES

A. **Which Defendants to Sue.** Until 1992, the Plaintiff had little choice in who should be named as a party defendant in a will contest case. KRS 394.260 required that "...all necessary parties should be brought before the court by the Plaintiff". That phrase had been uniformly determined by the courts of Kentucky to refer to all beneficiaries, e.g., Security Trust Company vs. Swope, Ky., 118 S.W.2d 200 (1938); McComas v. Hull, Ky., 118 S.W.2d 540 (1938); Russell vs. Grumbley's Executor, 160 S.W.2d 321 (1942). However, in West vs. Goldstein, Ky., 830 S.W.2d 379 (1992), the Supreme Court in a 4-3 decision by Justice Leibson, departed from the previous rule. In Goldstein, Plaintiffs had elected, presumably for strategic reasons, not to join as parties defendant to the action, two elderly ladies who were the recipients of relatively small specific bequests

under the will which Plaintiffs contested. The Plaintiffs' main strategy was to make out the Defendant as a greedy and controlling presence in the testatrix's life. Apparently they felt that joining the two elderly specific legatees would tend to dilute that strategy. Defendant made a motion to dismiss based on the absence of necessary parties; the trial court overruled. On appeal, the Court of Appeals reversed and held, pursuant to the then existing precedent, that the omission of the specific legatees as defendants was fatally defective. On discretionary review, the Supreme Court reversed the Court of Appeals and readmitted the Circuit Court judgment, holding that, at least in the circumstances presented in Goldstein, the specific legatees were not necessary parties. In dissent, Justice Lambert commented:

“By omitting certain parties, the contestant can, in effect, permit the jury to rewrite the will invalidating those bequests which it deems inappropriate, safe in the knowledge that proper bequests have been or will be satisfied.”

Following Goldstein, it was unclear exactly how far this logic would be extended. However, in Kesler vs. Shehan, Ky., 934 S.W.2d 254 (1996), the Supreme Court seemed to offer some clarification. One of the issues in Kesler was whether an appeal was defective when some of the parties adversely affected by the judgment were not named as parties to the appeal. In holding the appeal defective, the Court noted the rule in Goldstein did not apply because the omitted parties were residuary beneficiaries rather than specific legatees and because there was no waiver of rights as against the omitted legatees. It would therefore appear that the rule in Goldstein will likely only apply where the omitted beneficiaries are recipients of specific bequests and where the Plaintiff affirmatively waives all claims against those beneficiaries. Nevertheless, the rule does clearly give a Plaintiff a leg up, in that as favorable parties such as charities, elderly

people, small children, grandchildren or close friends who receive only specific bequests under a challenged document will not have to be sued. This clearly enables the Plaintiff to focus the case (and the subject of the jury's inquiry) solely on the party or parties that the Plaintiff feels are the most attractive targets.

B. Which Plaintiffs Should Be Named. Unlike the parties named as beneficiaries in a challenged will, the parties who elect to file suit are not required to be an all inclusive class. That is, any one or more of the persons aggrieved by the action of a District Court in admitting to probate an allegedly defective will has the right to sue individually. See Security Trust Company, supra (holding that the trial court committed no error in failing to require the contestants to join all other heirs of the testator as parties). However, as a practical matter, it is seldom advantageous for a family unit not to speak as one mind on the issue of contesting the will. That is, it is hard to think of circumstances in which it is more advantageous for fewer than all of the aggrieved parties to participate in the litigation. Indeed where fewer than all of the potential will contestants are parties, some interesting questions arise in the context of potential settlement of the case. Will a Defendant be willing to settle with some of the heirs while other potential contestants remain in the wings? If a Defendant insists upon a release from persons who are not parties to the suit, can the Plaintiffs obtain such releases, or will they necessarily dilute the available pool of settlement money if they do so? If that problem can be overcome, what happens if, in fact, other contestants do bring another suit?

III. PLEADING STRATEGY

A. Grounds to Set Aside the Will. Obviously, the pleader will ordinarily set forth as many grounds to challenge the will as the limits of Rule 11 will permit. There is

seldom any advantage in failing to include any potential ground if there is reasonable basis for it to be pleaded. In this regard two matters deserve note. The great bulk of will contest cases are pleaded on the basis of both lack of testamentary capacity and undue influence. Even when one or the other of those grounds appears somewhat weak, it is usually advantageous to assert both grounds, as a relatively small amount of evidence is then required to submit both grounds to the jury. The rule, as frequently noted, is that where there is some evidence of undue influence and some evidence of lack of capacity, the quantum of proof sufficient to take the case to the jury is less than would be the case for either grounds standing alone. See Burke vs. Burke, Ky. App., 801 S.W.2d 691 (1990). The second matter is the provision of Civil Rule 9.02 which requires averments of fraud or mistake to be pleaded with particularity as to the circumstances constituting same. It is a frequent defense ploy to attempt to compel the Plaintiff to specifically aver the acts of undue influence. Since undue influence, as the cases noted below reflect, is seldom practiced in the open, to require the Plaintiff to plead it with particularity can be burdensome if not impossible. A recitation of the colorable badges of undue influence which the pleader reasonably believes to exist should suffice.

B. Joinder of Inter Vivos Claims. Frequently the party benefited by a challenged will has also benefited from inter vivos transactions with the decedent. These may include outright gifts during the testator's lifetime, the creation of joint survivorship interests, or questionable transactions made by the wrongdoer while holding a power of attorney for the deceased. The issue frequently raised is whether causes of action challenging these transactions may be joined with the will contest case, and perhaps more significantly, if they can be simultaneously tried with the issues of the will contest.

Again, until the Goldstein case it was not at all clear that the Plaintiff could join the inter vivos claims or try them simultaneously with will contest claims. However, Goldstein, supra, relying on KRS 24A.120 and CR 18.02, dealing with dependent claims, held that the trial court properly conducted a combined trial covering all of such issues between the parties. And from a strategic point of view, it is almost always to the Plaintiff's benefit to include all of the claims against the Defendant that one might have. In the normal undue influence case, Plaintiff desires to paint a picture of the wrongdoer which portrays him/her as a pervasively self-aggrandizing person. The more questionable or suspicious transactions that one can point to, the greater the odds of prevailing on the entire case. Another aspect of the Goldstein decision which is significant is its approval of submitting for decision in the Circuit Court action, the validity or invalidity of other wills which were not presented to the District Court. A defensive strategy where numerous testamentary documents have been executed is to simply fall back to each earlier document in time in which the Defendant still may participate as a beneficiary. If it is desired to attack all of those documents, it is much easier to do so in one trial than to have a series of trials each over the respective prior documents. Under Goldstein, Circuit Courts now clearly have jurisdiction to entertain a contest of prior wills which were not acted on by the District Court.

IV. DISCOVERY STRATEGY

A. Timing and Method of Discovery. There is no one set formula for the timing, nature and sequence of discovery. That is a matter which depends on the individual case and upon the individual preference of counsel. It is believed, however, that in most cases it makes more sense to obtain financial and medical records in advance of depositions as

those materials may furnish the grounds for important lines of inquiry. However, there are certainly circumstances under which a quick deposition of the adverse party may be desirable to lock in certain testimony before Defendant's counsel has full knowledge of the circumstances.

B. Production of Financial Records. In undue influence cases, the Defendant is almost always involved to some degree in handling money before the testator's death. To the extent that one can demonstrate inappropriate, inadequately documented, unauthorized or otherwise suspicious transactions, the case is enhanced. However, it is not unusual for the Defendant to have discarded those records as he/she is usually in possession of them at the time of testator's death. Thus, relatively expensive and slow recovery of microfilm records from banks may be necessary.

C. Production of Medical Records. If the testator had been hospitalized or regularly saw a physician, it is essential to obtain those records in advance of any medical depositions. It may also be necessary to obtain such records if one seeks to utilize the services of an expert witness on the subject of the testator's mental state at the time of the will. These records would include not only hospital but private physician records, and a review of such documents is essential in any case in which the testator's mental state is at issue.

V. EVALUATION OF THE CASE FOR SETTLEMENT PURPOSES

With today's emphasis on mediation and alternate dispute resolution mechanisms, it is appropriate for Plaintiff's counsel to consider settlement in virtually every case. Obviously, as a general rule, only cases where the parties are significantly at odds should be taken to trial.

However, the reasons underlying the desirability of settlement in will cases is even stronger than in other types of legal actions, e.g. damage suits. In an action for money damages, the jury is entitled to fix the elements of damages, frequently compromises between the Plaintiff's demand and the Defendant's plea for exoneration occur. That is not possible in a will contest case. The instructions submitted to the jury by the court allow only for the jury to find for or against the challenged will. The Plaintiff will win everything or will take nothing. Settlement thus holds benefits for everyone. However, before entering into mediation or other efforts to settle the case it is obviously important for counsel to evaluate the case as accurately as possible. Attorneys not familiar with this type of litigation frequently undervalue will cases. Defense counsel may believe that there is no solid evidence in support of the claims made, that juries are fundamentally conservative, that the Plaintiff – usually family members – were insufficiently attentive to the deceased or that they may be easily portrayed as undeserving or greedy. Obviously it is the job of Plaintiff's counsel to dispel those notions if possible and if not, then to point out the extent of the Defendant's exposure. Plaintiff's counsel and defense counsel may somewhat more frequently be able to agree in an evaluation of a case of testamentary incapacity but may have great difficulty in evaluating claims of undue influence. Defendants will simply assert that there is no proof of undue influence, that the attorney who wrote the will and witnesses to the instrument adequately sustain that it was the voluntary act of the testator and generally that the Plaintiff's case is all smoke and mirrors. On the other hand, Plaintiff's have an exceedingly powerful weapon in their arsenal – the concept of “badges of undue influence”. The concept has been around for a long time. The case most frequently cited is Belcher vs. Somerville, Ky. 413 S.W.2d 620 (1967). However, the principal has been restated and

reaffirmed as lately as the 1990 case of Burke vs. Burke, supra. In general, the badges of undue influence are said to be:

1. A physically weak, mentally impaired testator;
2. An unreasonable will;
3. A lately developed close relationship between the testator and the principal beneficiary
4. Participation by the beneficiary in the preparation of the will;
5. Possession of the will by the beneficiary after it is written;
6. Efforts by the beneficiary to restrict contacts between the testator and the natural objects of his/her bounty; and
7. Absolute control of testator's business affairs.

These factors – each of which is merely a circumstance – essentially enables Plaintiff's counsel to make out a case of undue influence based purely upon circumstantial evidence. In fact, it is frequently stated in the law that merely the circumstance of an unnatural disposition when coupled with slight evidence of the exercise of undue influence is sufficient to take the case to the jury. See Williams vs. Vollman, Ky. App. 738 S.W.2d 849 (1987) and cases cited therein. Logically, one can conclude that a Defendant may be objectively innocent of overreaching and yet found culpable given the right set of circumstances. While that may be true, it does not lessen the legal exposure of the Defendant and for purposes of settlement, exposure is the crucial point which Plaintiff's counsel will want to hammer on. Again, exposure can mean the Defendant loses everything, unlike other civil cases where the issue of the degree of exposure may be the heart of the dispute. To sum up, for purposes of settlement, Plaintiff's counsel will want to stress two questions:

- (a) How will Defendant's conduct appear to the jury? and

(b) Do the circumstances of the challenged will pass the “smell test”?

Of course, Plaintiff’s counsel must also be aware that each of the circumstances cited may have a reasonable explanation. Counsel must also take into account the recent case of Bye vs. Mattingly, Ky., 975 S.W.2d 451 (1998) in which the Supreme Court restated at length many of the traditional principles applicable to undue influence and testamentary incapacity cases. Bye does not really cover any new ground or make any new law, but definitely reiterates the burdens which the Plaintiff in such a case must bear. Plaintiff’s counsel will need to be ready to fend off the Defendant’s attempt to extend Bye and to rely upon it in the settlement process.

VI. EVIDENCE ISSUES

A. **Use of Experts.** The use of expert witnesses in will contests is subject to the identical rules and other forms of civil action. Under Kentucky Rules of Evidence, Section 702, an expert witness’s testimony is admissible if the expert’s “specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue...” and if the witness is “...qualified as an expert by knowledge, skill, experience, training or education...” Expert testimony in will contest cases usually involves medical experts, disputed document experts, accountants or attorney experts.

1. Medical Experts. Use of medical testimony in will contest cases is common. However, most medical experts are treating physicians who have actual knowledge of the testator’s condition. Unless the issue of incapacity is clear-cut, most treating physicians are reluctant to opine as to testator’s testamentary capacity on a given date unless they actually saw the testator on that date. Therefore, medical experts, generally psychiatrists or neurologists, are frequently utilized to offer an opinion based upon the other medical evidence admissible in

the case as to whether testator possessed testamentary capacity on the date of the will. To avoid the "ultimate fact" rule, the testimony to be elicited frequently addresses sub-elements of testamentary capacity, i.e., whether the testator in the opinion of the expert possessed sufficient mind to know the natural objects of his/her bounty, the nature and extent of his/her bounty, and was able to formulate a fixed plan to dispose of the estate. Obviously, the strength of a medical expert's testimony is no greater than the medical records and other facts upon which the opinion is based. However, in most cases a medical expert's opinion is well received by a jury.

2. Disputed Document Experts. If forgery or the substitution of pages in a will is at issue, a disputed document examiner may be not merely desirable but necessary to make Plaintiff's case.

3. Accounting Experts. In cases in which undue influence is demonstrated among other ways, by evidence of the amount of control of the testator's business affairs, or if there are a large number of apparently unauthorized or inappropriate transactions, it is not uncommon to utilize the services of a CPA to schedule all of the transactions and testify regarding his/her findings. Such an expert can also be helpful if tracing of funds is necessary as is sometimes required if the wrongdoer has attempted, consciously or subconsciously, to launder the funds removed from the decedent's estate prior to death.

4. Legal Experts. A legal expert may be called to clarify for the jury the process of executing the will and the scrivener's duties with respect thereto. This evidence is sometimes objected to as irrelevant and most trial courts will not

permit Plaintiff's counsel to get into the area of whether the scrivener met the standard of practice in connection with the preparation of the contested will. However, under the authority of Kesler vs. Shehan, supra, it is clearly appropriate for such evidence to be used to rebut testimony offered by the scrivener of the will that he/she was careful about ascertaining whether the will was the product of undue influence.

B. Proving Lack of Testamentary Capacity. In order to prove testamentary capacity it is not necessary to adduce evidence from either the testator's treating physician or physicians or from an expert medical witness. Rather, lay persons who have had an opportunity to observe the testator's conduct may give opinions as to testator's mental capacity. This has been the rule in Kentucky since at least the case of Murphy's Executor vs. Murphy, 142 S.W. 1018 (1912). The view is also consistent with the Kentucky Rules of Evidence, Section 701, which permits opinion testimony by lay witnesses which are rationally based on the witness' perceptions and are helpful for a clear understanding of the matter in controversy. Therefore, Plaintiff's counsel will need to investigate, locate and discover individuals who have some foundation or background of knowledge about the testator and who are willing to express their opinion that based on their perceptions that the testator did not have the requisite elements of testamentary capacity. On the other hand, expert opinion alone unsupported by either medical records or supporting testimony of factual witnesses is insufficient to sustain the Plaintiff's burden of proof. Fischer vs. Heckerman, Ky., App. 772 S.W.2d 642 (1989). A further difficulty for the Plaintiff in sustaining a case of testamentary incapacity is the so-called "lucid interval" rule. Restated in the recent Bye decision, supra, the lucid interval rule

holds that a generalized or non-specific dementia or condition of mental impairment is not of itself sufficient to demonstrate that testator lacked testamentary capacity if the testator had lucid intervals, i.e., periods of time in which the mental impairments abated and testator could interact, think, reason and speak relatively normally. Anyone with exposure to individuals suffering from dementia, senility or related neurological deficits is aware that mental acuity is not a static thing, but frequently varies significantly from day to day and even from hour to hour. The Plaintiff will frequently have difficulty finding witnesses, lay or expert, who have knowledge of the testator's precise mental state at the time of execution of a will. The issue normally devolves to an inquiry as to whether the testator ever had lucid intervals after a given point in time which, to assist the Plaintiff's case, must be answered in the negative. Other than testimony of witnesses, other frequently employed techniques to demonstrate lack of capacity involve medical records, particularly hospital or nursing home records, which reflect disorientation, confusion, forgetfulness, dementia or conduct or activities inconsistent with normal mental functioning, i.e. aggressive behavior, wandering, inability to perform simple mental tasks, etc. Nurses' notes and observations from medical charts are frequently full of these sorts of episodes which can be most helpful to the Plaintiff's case.

C. Proof of Undue Influence. As discussed above, proof of undue influence is normally based upon evidence tending to establish the presence of one or more of the badges of undue influence. Another aspect of undue influence which is usually found is the existence of a confidential, i.e. fiduciary or quasi fiduciary, relationship between the Defendant and the testator. Undue influence is never presumed, however, no matter how strong the relationship between the parties, as the Bye case has re-emphasized. However,

the reliance, dependence and vulnerability components of the relationship are strong evidence, if coupled with other aspects of overreaching. As the cases recite, undue influence is a species of fraud and is rarely practiced in daylight; e.g. see McKinney vs. Montgomery, Ky., 248 S.W.2d 719 (1952). Furthermore, each component relied upon to establish the undue influence may well be insufficient standing alone; however, it is the effect of all the circumstances taken together which show the undue influence. Walls vs. Walls, Ky. 99 S.W. 969 (1907). Other aspects or components of proof of undue influence are discussed in Section V above.

D. Declarations of the Deceased. It is uniformly held that direct declarations of the deceased, whether offered by interested parties or not, are admissible in a will contest in order to demonstrate the relationship between the parties, the susceptibility of the decedent to undue influence, the testator's state of mind, and possible other relevant issues. Hall vs. Childress, Ky., 420 S.W.2d 398 (1967); Welch's Administrator vs. Clifton, Ky., 1725 S.W.2d 221 (1943). However, those authorities hold that such declarations while admissible, are not themselves direct evidence of undue influence. Hence, a case cannot be pitched solely upon the statement that for example the testator said, "Momma made me write that will". However, such testimony would be admissible for the purpose of showing susceptibility to undue influence and, in one Kentucky case, the testimony that the testator had made a will to "keep down the hell at home" was held admissible; Powell vs. Powell's Administrator, Ky., 78 S.W.2d 152.

E. Testimony by Counsel for Defendants. A rather interesting problem which occurs with amazing frequency is where the scrivener of the will represents the Defendant executor in the probate proceeding in District Court, and also represents the

Defendant in the will contest action in the Circuit Court. Thus, the attorney, who is clearly a material witness, is also actively defending the Circuit Court action. This would appear to be a violation of Rule 3.7(a) of the Kentucky Rules of Professional Conduct, which requires that a lawyer not act as advocate at a trial in which the lawyer is likely to be a necessary witness. While the Rule states several exceptions, none would appear to be applicable. Nevertheless, many attorneys rely on Adams vs. Flora, 445 S.W.2d 420 (1969), as grounds to remain in the role of attorney for the Defendant in the will contest case. The Adams case has not been overruled and whether its holding has been abrogated by the above cited disciplinary rule is yet to be determined by the Supreme Court. That point aside, however, counsel for Plaintiff will also need to consider the practical aspect of the situation. Is it better to make a motion to disqualify Defendant's counsel or is it more advantageous to Plaintiff's case to put the adversary in the unseemly position of being crossed-examined during a trial at which defense counsel is serving as an active advocate? That is a decision which, in consultation with the client, will need to be made on a case by case basis.

F. Evidence Post-dating the Contested Will. As a general and broadly stated rule, evidence of events or circumstances which occur after the date of the challenged will is not relevant. However, this rule must be taken in context of the nature of the case. For purposes of testamentary capacity, clearly the testator's condition at a remote time after the will was executed has no bearing on the condition at the time of the will. However, some cases have permitted medical evidence of circumstances within a brief time after the execution of the will, i.e. days or weeks, as likely indicating mental condition as of the date of the will. The point is buttressed if the medical expert is able or willing to state

that the condition could not have changed to any great degree in the interim. In an undue influence case, however, there is somewhat more latitude and a greater probability of admission of evidence occurring after the date of the will. This is because one must differentiate between direct evidence of undue influence on one hand and circumstances on the other hand, some of which occur after the date of the will, which nonetheless may indicate that undue influence existed at the time of the will's making. For example, at least two of the commonly stated badges of undue influence clearly imply conduct or actions after the date of the will – possession of the will by the undue influencer and keeping the testator in seclusion. At least one foreign case has held that evidence of a spouse's indifference to the testator's welfare and her disposition to exercise undue influence (which occurred more than two years after the will was admissible). See Neill vs. Brackette, Mass., 135 N.E. 690 (1922). Therefore, the Rule might be able to be stated as follows: the undue influence must affect the will and therefore must have occurred on or before its making, but the evidence that undue influence was exercised may be based upon circumstances which exist or occur after the date of the will's making.

VII. CONCLUSION

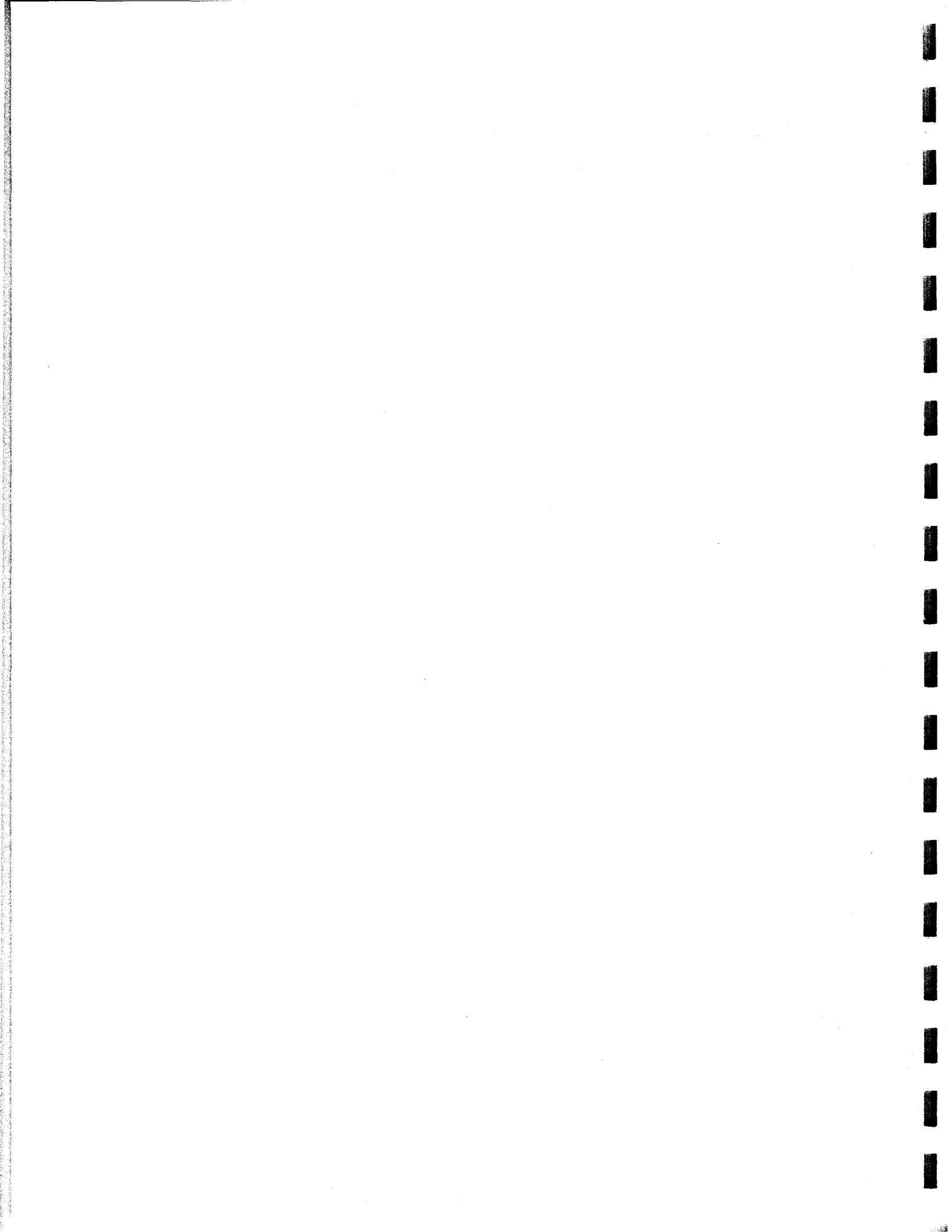
It can reasonably be argued that will contest litigation is just like any other form of litigation and is or should be the province of litigators as opposed to probate or estate attorneys. However, it is submitted that a stronger case can be made that the specific substantive and procedural rules applicable to will contests are quite different from garden variety criminal or civil cases; and that this type of litigation should be considered more appropriately as a facet of probate and estate law. It is clear that strategies for success in such litigation are relatively unique, given the great weight placed on circumstantial evidence, the nuances of family

relationships, the winner-take-all-nature of such cases and the extraordinary emotional context in which many of these cases take place. For some light reading on the subject, consider "In the Presence of Enemies", a novel by William J. Coughlin (St. Martin's Paperbacks, 1993). Although it slightly gives away the story, you might find it interesting to know that the young probate lawyer was victorious over the old, grizzled trial lawyer.

CONTESTED ESTATES:

Preserving the Will Against Attack

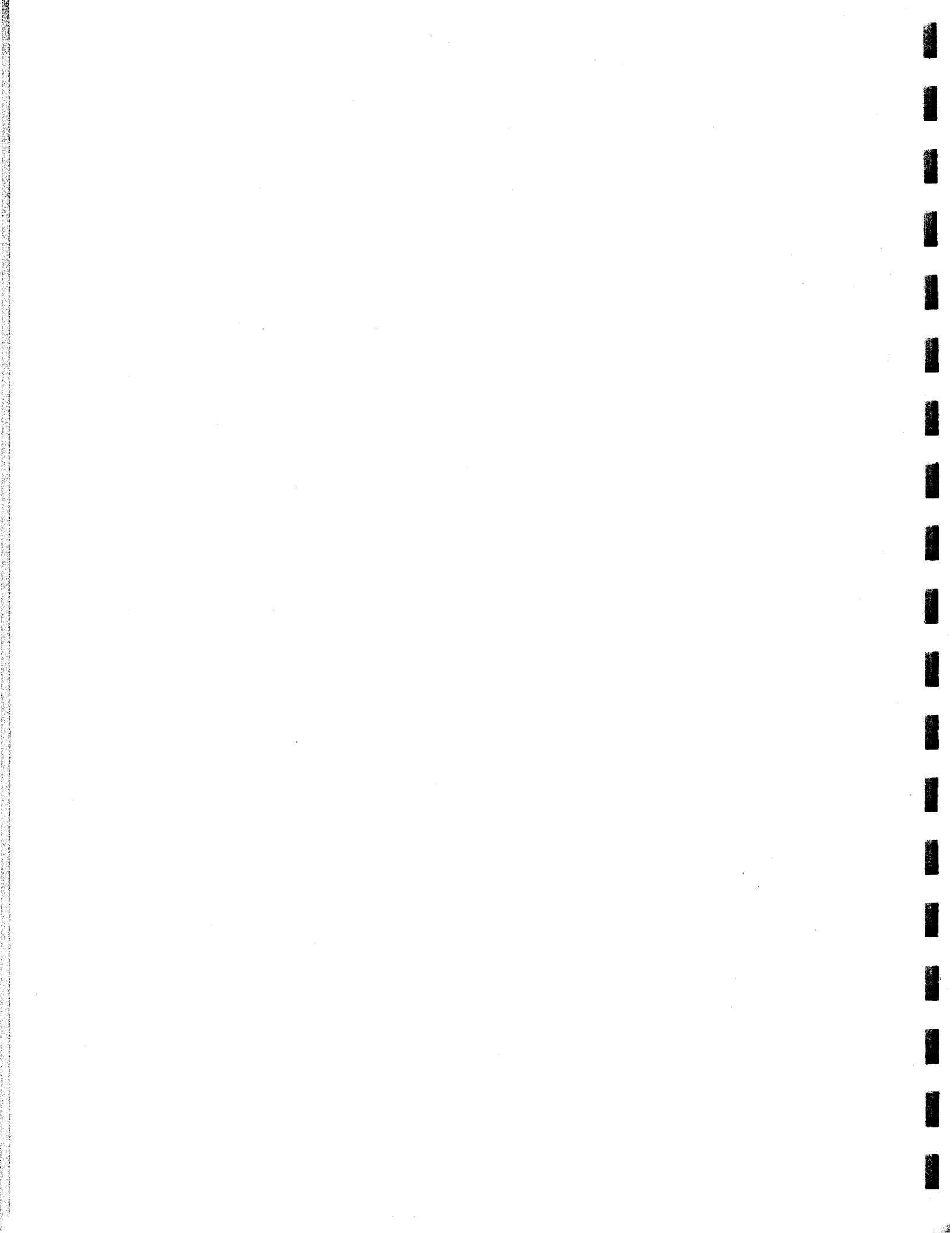
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**CONTESTED ESTATES:
Preserving the Will Against Attack**

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CONTESTED ESTATES: Preserving the Will Against Attack

I. OVERVIEW

A. Before:

- **Burke v. Burke, Ky. App., 801 S.W.2d 691 (1991) (will contest successful)**

Husband widowed after 53 years of marriage in February 1985, moved from Ohio to Pike County in June 1985, and decided to remarry several weeks later to woman he had not known previously. Remarried on July 20; executed new will on July 27 leaving everything to her; died August 17. Two children challenged new will on grounds of undue influence and lack of testamentary capacity; conflicting evidence concerning whether testator began drinking heavily and was incapacitated by grief after first wife's death. Jury found "the document probated was not the will of" the decedent. Widow appealed that there was a "complete lack" of evidence of either undue influence or incapacity. Court of Appeals affirmed, although acknowledging that "we are not unmindful of the possibility that the jury invalidated this will simply because it seemed unfair."

Court candidly notes "A survey of the law on this subject yields a series of contradictory statements and policies. On the one hand courts stoutly proclaim the policy of carrying out the wishes of the deceased, even if they are arbitrary or unfair. ... The testator must have sufficient mind to know his property, the objects of his bounty and his duties to them ... ; but he is perfectly free to ignore the latter if he is otherwise of sound mind. 'Every man possessing the requisite mental powers may dispose of his property by will in any way he may desire, and a jury will not be permitted to overthrow it, and to make a will for him to accord with their ideas of justice and propriety.' ... There must be some specific evidence of circumstances from which it can be reasonably inferred that undue influence was in fact exercised. ... To justify setting aside a will the influence exercised must be such that it 'obtains dominion over the mind of the testator to such an extent as to destroy his free agency in the disposal of his estate, and constrains him to do that which he would not have done if left to the free exercise of his judgment.' ...

"After issuing these stern admonitions, however, the law reverses itself somewhat to lower the contestant's burden of proof when allegations of undue influence are coupled with an unequal or unnatural disposition, allegations of mental incapacity, or both. ... '[W]hen slight evidence of the exercise of undue influence and the lack of mental capacity is coupled with evidence of an unequal or unnatural disposition, it is enough to take the case to the jury.'" (Citations omitted.)

- **Fischer v. Heckerman, Ky. App., 772 S.W.2d 642 (1989) (reversing dismissal of will contest)**

Decedent suffered heart attack and stroke on February 7, 1986, and executed will during hospital stay on February 14, 1986. He died on April 8, 1986, leaving none of \$1 million

estate to his two surviving relatives, who challenged will based on lack of mental capacity and undue influence by one or more of the beneficiaries. After trial court granted summary judgment to beneficiaries, Court of Appeals reversed on both grounds.

As to lack of capacity, Court ruled that expert testimony should have been permitted to address effects of medical developments on testator's capacity because those effects "are beyond the pale of common knowledge." Moreover, Court held that there was a genuine issue of fact about capacity presented by lay testimony.

- **Williams v. Vollman, Ky. App., 738 S.W.2d 849 (1987) (reversing dismissal of will contest)**

Testator died at 91 on February 19, 1985. Both testator's wife and one daughter had died in May 1984, and testator had never been told. Appellant, a granddaughter, challenged the will prepared four or five months before testator's death by her cousin, a grandson, on grounds of lack of mental capacity and undue influence. The will disinherited the testator's only living child and all of his grandchildren except one, to whom the testator left his house and an adjoining lot to the grandson. After trial court granted directed verdict to grandson on grounds that there was no evidence of probative value of mental incapacity or undue influence, Court of Appeals reversed on grounds that there was evidence of undue influence.

B. After:

- **Bve v. Mattingly, Ky., 975 S.W.2d 451 (1998) (will contest unsuccessful)**

Elderly testator's wife dies in March 1989, and he hires appellant as housekeeper in May 1989. In July 1989, accompanied by appellant, testator executes new will leaving her entire estate except for \$100. In July 1990, testator is adjudged partially disabled, and a limited guardian is appointed for him. In September 1990, he is admitted to hospital and diagnosed suffering from Alzheimer's disease. Thereafter, petition filed with Breckinridge District Court seeking to allow testator to marry appellant. At May 1991 hearing, testator testifies that he was misled about petition, he does not want to marry appellant, and he is afraid of her. Court denies petition, and appellant is terminated as housekeeper. In October 1991, testator executes new will, leaving estate to second cousin and brother-in-law. Testator dies in August 1992, and appellant challenges October 1991 will. Jury unanimously decides against appellant, and Supreme Court affirms despite 1990 adjudication of partial disability.

"Kentucky is committed to the doctrine of testatorial absolutism.' ... The practical effect of this doctrine is that the privilege of the citizens of the Commonwealth to draft wills to dispose of their property is zealously guarded by the courts and will not be disturbed based on remote or speculative evidence. ...

"Given this Court's consistent attitude toward the virtually absolute right of the citizens

of the Commonwealth to make wills, it would be incongruous for us now to announce a new rule of law which restricted these rights which we have held in such high regard for so long. **While the clear policy of the Commonwealth is that our citizens who are no longer able to fully care for themselves must be protected from the various societal predators, we will restrict their testamentary rights only when it is absolutely necessary and even then only to the degree required to defend their interests.**"

- **See also Wallace v. Scott, Ky. App., 844 S.W.2d 439 (1992) (will contest unsuccessful)**

Widow involved in litigation beginning in 1955 with her two children after she paid half of the purchase price but was made only one-third owner under the deed. Upon resolution of that litigation, she stated "That's the last they'll ever get off me." Shortly afterwards, man began working on the farm, and ten years later he moved into the house with her. In 1973, widow prepared will, and prepared codicil in 1975, leaving life estate to man, with remainder to Methodist Home. After she died in 1988, two children challenged will based upon lack of mental capacity and exercise of undue influence. Trial court granted summary judgment and Court of Appeals affirmed (even after Steelvest, Inc. v. Scansteel Service Center, Inc., Ky., 807 S.W.2d 476 (1991)).

Court noted "appellants were unable to discover any evidence of sufficient probative value to demonstrate even the slightest indication of lack of mental capacity." Court emphasized that "The burden of proof is on contestants ... to overcome the presumption of capacity by substantial evidence." Likewise, reviewing the "badges" of undue influence enumerated in Golladay v. Golladay, Ky., 287 S.W.2d 904 (1955), court again noted that "the burden of proof is on appellants to establish undue influence with evidence of substance," and found no basis for such a finding.

II. SUMMARY OF WILL CONTEST PROCEDURES

A. Requirements For Making a Will:

"To validly execute a will, a testator must: (1) know the natural objects of her bounty; (2) know her obligations to them; (3) know the character and value of her estate; and (4) dispose of her estate according to her own fixed purpose." Bye, 975 S.W.2d at 455.

B. Procedure For Contesting a Will:

In circuit court, within two years of district court's probate action; must name all beneficiaries who are "necessary parties"; may restrain further distributions.

KRS 394.240(1): "Any person aggrieved by the action of the district court in admitting a will to record or rejecting it may bring an original action in the circuit court of the same county to contest the action of the district court. Such action shall be brought within two (2) years after the

decision of the district court.”

- A person is “aggrieved” so as to create standing only if the will deprives the person of some benefit the person would otherwise receive, such as by intestacy or under a previous will. Wells v. Salyers, Ky., 452 S.W.2d 392 (1970); Egbert v. Egbert, Ky., 217 S.W. 365 (1920).
- Although Kentucky law formerly required that all beneficiaries must be named as parties in a will contest, that is no longer required under KRS 394.260. West v. Goldstein, Ky., 830 S.W.2d 379 (1992) (contestant must only name a beneficiary who is a “necessary party” within meaning of CR 19.01).
- Statute further provides that “The parties may, in the same action, or in a separate action if the validity of the will is not in issue, seek construction, interpretation or reformation of a will.” West v. Goldstein, Ky., 830 S.W.2d 379, 381 (1992) (unlike previous statutory framework, a will contest suit is “no longer strictly limited to whether the particular instrument probated or rejected in the district court is the will of the testator”).
 - Cf. Mullins v. First American Bank, Ky. App., 781 S.W.2d 527, 528 (1989) (upholding circuit court decision that it lacked jurisdiction to rule on validity of codicil neither admitted nor rejected by district court; “it should be clear that the statutes, read together, require (1) that all proceedings for the admission to probate of a will or codicil be commenced in the district court; (2) that the district court must either admit or reject the instrument; and (3) that the district court retains jurisdiction over the matter until such time as a will contest, or adversary proceeding, is commenced in the circuit court.”)
- Pursuant to KRS 394.240, contestant should lodge notice of the action “in the office of the county clerk of the county in which the will was admitted to probate or rejected,” but failure to do so will not justify dismissal, Justice v. Conn, Ky. App., 724 S.W.2d 227 (1987), discussed in West v. Goldstein, Ky., 830 S.W.2d 379, 381 (1992).

C. Restraining Further Distributions

KRS 394.250: “An action filed in the circuit court, pursuant to KRS 394.240, shall not, unless taken within twelve (12) months from the entry of the district court’s order, prevent the appointment of an administrator or executor by the district court or the settlement, distribution, and division of the decedent’s estate. The circuit court in which proceedings are pending may make an order restraining the further distribution and division of the estate.”

D. Removal of Personal Representative

KRS 395.160: The district court may remove a personal representative for several reasons, including the personal representative becoming “incapable to discharge the trust.” This has been construed to include mismanagement of the estate. Stafford’s Exrs v. Spradlin, Ky., 193 S.W.2d

474 (1946). The Circuit Court presumably has this power also, see Mullins v. First American Bank, Ky. App., 781 S.W.2d 527 (1989) (apparently holding that filing of a will contest action vests the Circuit Court with jurisdiction over all probate matters related to the proceeding until the conclusion of the action).

III. GROUNDS FOR CONTESTING A WILL

“Merely being an older person, possessing a failing memory, momentary forgetfulness, weakness of mental powers or lack of strict coherence in conversation does not render one incapable of validly executing a will. ... ‘Every man possessing the requisite mental powers may dispose of his property by will in any way he may desire, and a jury will not be permitted to overthrow it, and to make a will for him to accord with their ideas of justice and propriety.’” Bye v. Mattingly, Ky., 975 S.W.2d 451, 455-56 (1998) (citations omitted).

A. Lack of Capacity

“The inquiry as to capacity is three-fold. First, did the testator know the natural objects of his bounty, and his obligations to them. Second, could he make a rational survey of his estate. Third, did he dispose of that estate according to a fixed plan of his own.” Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing Bennett v. Kissinger, 231 S.W.2d 74, 75 (1950).

Bye Raises “Rebuttable” Burden of Proof to Great Heights:

“The burden is placed upon those who seek to overturn the will to demonstrate the lack of capacity. ... The presumption created is a rebuttable one, so that evidence which demonstrates conclusively that the testator lacked testamentary capacity at the time of the execution of the will results in nullifying that will.” Bye, 975 S.W.2d at 456, citing Warnick v. Childers, Ky., 282 S.W.2d 608, 609 (1955); Pfuelb v. Pfuelb, 275 Ky. 588, 122 S.W.2d 128 (1938).

that sounds manageable, but ...

“In Kentucky there is a strong presumption in favor of a testator possessing adequate testamentary capacity. This presumption can only be rebutted by the strongest showing of incapacity.” Bye, 975 S.W.2d at 455, citing Williams v. Vollman, Ky. App., 738 S.W.2d 849 (1987); Taylor v. Kennedy, Ky. App., 700 S.W.2d 415, 416 (1985).

“The degree of mental capacity required to make a will is minimal. ... The minimum level of mental capacity required to make a will is less than that necessary to make a deed, ... or a contract.” Bye, 975 S.W.2d at 455, citing Nance v. Veazey, Ky., 312 S.W.2d 350, 354 (1958); Creason v. Creason, Ky., 392 S.W.2d 69 (1965); Warnick v. Childers, Ky., 282 S.W.2d 608 (1955).

-- Accord, Warren v. Sanders, Ky., 287 S.W.2d 146, 149 (1956) ("Testamentary capacity requires a lower degree of mental capacity than contractual or business capacity, especially so where the plan of the testamentary disposition in the will and codicil at hand was so simple and uncomplicated. [Citations omitted.] And mere weakness of mental power will not prevent a person from making a valid will.").

and "minimal" really means "minimal"...

"Appellant seeks to have the 1991 will declared invalid as it was executed following the 1990 adjudgment of partial incapacity. While a ruling of total or partial disability certainly is evidence of a lack of testamentary capacity, it is certainly not dispositive of the issue. This Court has upheld the rights of those afflicted with a variety of illnesses to execute valid wills. Tate v. Tate's Ex'r, Ky., 275 S.W.2d 597 (1955) (testator suffered deafness and retarded speech); Bush v. Lisle, 89 Ky. 393, 12 S.W. 762 (1889) (testator was blind); In re: McDaniel's Will, 25 Ky. 331 (1929) (testator was paralyzed); Bodine v. Bodine, 241 Ky. 706, 44 S.W.2d 840 (1932) (testator was an epileptic). We have not disturbed the testatorial privileges of those who believed in witchcraft ... spiritualism ... or atheism. ... While none of these cases absolutely parallels the instant case, we recite them here to demonstrate how this Court has always taken the broadest possible view of who may draft a will no matter what their infirmity." Bye, 975 S.W.2d at 456.

especially with application of "lucid interval doctrine"...

Evidence of "lucid interval" may permit probate of will by otherwise incapable testator. "When a testator is suffering from a mental illness which ebbs and flows in terms of its effect on the testator's mental competence, it is presumed that the testator was mentally fit when the will was executed. This is commonly referred to as the lucid interval doctrine." Bye, 975 S.W.2d at 456 (citations omitted).

-- "In the present case there is no question that Mr. McQuady suffered from Alzheimers disease. Accordingly, under the doctrine he is presumed to have been experiencing a lucid interval during the execution of the will. ... Appellant has failed to offer this Court evidence which demonstrates that the testator did not have a lucid interval during which he executed the 1991 will. In sum, let it suffice to say that in the instant case a presumption of a lucid interval of testamentary capacity was appropriate." *Id.*

B. Undue Influence

What it is:

"Undue influence is a level of persuasion which destroys the testator's free will and replaces it with the desires of the influencer." Bye, 975 S.W.2d at 457. "In discerning whether influence on a given testator is 'undue,' courts must examine *both* the *nature* and the *extent* of the

influence. ... The essence of this inquiry is whether the testator is exercising her own judgment.”

- **“First, the influence must be of a type which is inappropriate.”**
 - “Influence from acts of kindness, appeals to feeling, or arguments addressed to the understanding of the testator are permissible.” Bye, 975 S.W.2d at 457.
 - See, e.g., Sivils v. Bank One, Lexington, N.A., No. 95-CI-4050 (Fayette Cir. Ct. Fourth Div. June 25, 1999) (granting summary judgment and dismissing will contest alleging undue influence by Birmingham-Southern College; finding no evidence supporting any “badges of undue influence” and concluding “All of these actions are typical of fund-raising efforts by universities when a contributor has a history of giving to the institution. If the Court were to find that these actions were undue influence, no university or other charitable institution could ever send out a fund-raising letter and follow-up thank-you letters.”).
 - “Influence from threats, coercion and the like are improper and not permitted by the law.” Bye, 975 S.W.2d at 457, citing Lucas v. Cannon, 76 Ky. 650 (1878).
- **“Second, the influence must be of a level that vitiates the testator's own free will so that the testator is disposing of her property in a manner that she would otherwise refuse to do.”** Bye, 975 S.W.2d at 457, citing See v. See, Ky., 293 S.W.2d 225 (1956); Rough v. Johnson, Ky., 274 S.W.2d 376 (1955).

“Undue influence is a subtle thing and can rarely be shown by direct proof. In many instances the facts and circumstances leading up to the execution of the desired instrument must be relied upon to establish its existence.” Creason v. Creason, Ky., 392 S.W.2d 69, 74 (1965), quoting McKinney v. Montgomery, Ky., 248 S.W.2d 719 (1952).

When it must have been exercised:

“[A] contestant must also show influence prior to or during the execution of the will. ... The influence must operate upon the testator at the execution of the will. If the influence did not [a]ffect the testator, then such conduct is irrelevant. Bodine v. Bodine, 241Ky. 706, 44 S.W.2d 840 (1932); Walls v. Walls, 30 Ky. L. Rep. 948, 99 S.W. 969 (1907). However, even if the influence occurred many years prior to the execution of the will, but operates upon the testator at the time of execution, it is improper and will render the will null and void. Id.”

“Badges of undue influence”:

“To determine whether a will reflects the wishes of the testator, the court must examine the indicia or badges of undue influence.” Bye, 975 S.W.2d at 457. “Such badges include:

“a physically weak and mentally impaired testator,

“a will which is unnatural in its provisions,

- “The burden of proof is on appellees, as proponents of the will, to explain the disposition. Gibson v. Gipson, Ky., 426 S.W.2d 927, 929 (1968); and Sutton v. Combs, Ky., 419 S.W.2d 775, 776 (1976). There is not, however, a per se unnatural will. Clark v. Johnson, 268 Ky. 591, 105 S.W.2d 576, 580 (1937). Instead, it is a factual issue which can be explained satisfactorily by proponents. Nunn [v. Williams, Ky.] 254 S.W.2d [698,] at 700 [(1953)].” Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 646 (1989).

“a recently developed and comparatively short period of close relationship between the testator and principal beneficiary,

“participation by the principal beneficiary in the preparation of the will,

“possession of the will by the principal beneficiary after it was reduced to writing,

“efforts by the principal beneficiary to restrict contacts between the testator and the natural objects of his bounty, and

“absolute control of testator's business affairs.” *Id.* citing Belcher v. Somerville, Ky., 413 S.W.2d 620 (1967); Golladay v. Golladay, Ky., 287 S.W.2d 904, 906 (1955).

C. Insufficient Age, Improper Execution or Revocation

KRS 394.020 -- Persons competent to make – What may be disposed of: Any person of sound mind and eighteen (18) years of age or over may by will dispose of any estate, right, or interest in real or personal estate that he may be entitled to at his death, which would otherwise descend to his heirs or pass to his personal representatives, even though he becomes so entitled after the execution of his will.

KRS 394.040 – Requisites of a valid will: No will is valid unless it is in writing with the name of the testator subscribed thereto by himself, or by some other person in his presence and by his direction. If the will is not wholly written by the testator, the subscription shall be made or the will acknowledged by him in the presence of at least two (2) credible witnesses, and in the presence of each other.

- Proponent of the will must establish due execution of the will. Williams v. Vollman, Ky. App., 738 S.W.2d 849, 850 (1987).
- “If a will (or, in this case, a codicil) appears rational, proof of proper execution creates a presumption of its legality.” Cruse v. Leary, Ky. App., 727 S.W.2d 408, 411 (1987), citing Simpson v. Sexton, Ky., 311 S.W.2d 803 (1958).

IV. ADDITIONAL PRACTICE ISSUES

A. Burden of Contest May Be Easier If Multiple Grounds for Contesting Will

- “There is authority for the proposition that mere assertion of challenges based upon both undue influence and lack of capacity makes it easier for contestants to get to the jury. Creason v. Creason, Ky., 392 S.W.2d 69 (1965); and Gibson [v. Gipson], Ky.,] 426 S.W.2d [927,] at 928 [(1968)]. But the evidence presented must not merely be a scintilla. It must be of sufficient character, substance, and weight to furnish a firm foundation for a jury's verdict.” Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 646 (1989).
- “When a contest is pitched on both mental incapacity and undue influence, evidence that tends to show both need not be as convincing as would be essential to prove one or the other alone.” Creason v. Creason, Ky., 392 S.W.2d 69, 74 n.1 (1965), quoting Roland v. Eibeck, Ky., 385 S.W.2d 37 (1964).
- “[A]n unequal or unnatural disposition by itself is not enough to show undue influence, but when coupled with slight evidence of the exercise of undue influence ... it is sufficient to take the case to the jury.” Williams v. Vollman, Ky. App., 738 S.W.2d 849, 851 (1987), quoting Bennett v. Bennett, Ky., 455 S.W.2d 580, 582 (1970).
- “[W]here there is gross inequality in the disposition of the estate among the natural objects of testator's bounty, or where the will is unnatural, such facts, when unexplained and when corroborated by even slight evidence of want of testamentary capacity, or of undue influence, are sufficient to take the case to the jury.” Pardue v. Pardue, Ky., 227 S.W.2d 403, 406 (1950), quoting Allen v. Henderson, Ky., 184 S.W.2d 885, 886 (1945).

B. Lay Witnesses And Expert Testimony

1. Lay testimony

- Declarations of the testator are generally admissible. Atherton v. Goslin, Ky., 239 S.W. 771 (1922). The Dead Man's Statute, KRS 421.210(2), does not apply to will contest cases, so the parties may freely testify about their relations, conversations and transactions with the testator. Gay v. Gay, Ky., 215 S.W.2d 92 (1948).
- Opinion testimony about capacity from lay witnesses is admissible so long as opinions are based on facts which themselves are both admissible and sufficient to support finding of capacity or incapacity. See Hendren v. Brown, Ky., 364 S.W.2d 329, 332 (1962) (“opinion testimony as to the mental capacity of [the testator] is

admissible to the extent it is based upon observable conditions”); Warren v. Sanders, Ky., 287 S.W.2d 146, 148 (1956) (“Opinions of witnesses are insufficient to take a will contest case to the jury, unless the facts upon which the opinions are based tend to establish lack of mental capacity.”) (citation omitted).

- A wide range of proof involving the testator's background and relations with the parties is allowed in undue influence cases. Welch's Administrator v. Clifton, Ky., 172 S.W.2d 221 (1943).

2. Expert testimony

- Fischer v. Heckerman, Ky. App., 772 S.W.2d 642 (1989) (testator suffered heart attack and stroke on February 7, 1986, and executed will during hospital stay on February 14, 1986. He died on April 8, 1986, leaving none of \$1 million estate to his two surviving relatives, who challenged will based on lack of mental capacity and undue influence by one or more of the beneficiaries. Court of Appeals ruled that expert testimony should have been permitted to address effects of medical developments on testator's capacity because those effects “are beyond the pale of common knowledge”).

V. SAMPLE JURY INSTRUCTIONS:

From West v. Goldstein, Ky., 830 S.W.2d 379 (1992) (Westerfield, Jeff. Cir. Ct.), which are drawn from 2 J. S. Palmore & R. W. Eades, Kentucky Instructions to Juries, § 50.01-.03, at 393-95 (4th ed. 1989).

Instruction No. 1: For purposes of these instructions:

- 1) A person has testamentary capacity in making a will if at the time of its execution she has such mental capacity as to enable her to know the natural objects of her bounty, her obligation to them, the character and value of her estate, and to dispose of it according to a fixed purpose of her own.
- 2) Undue influence is any influence obtained over the mind of the deceased to such an extent as to destroy her free agency and lead her to do against her will what she would otherwise refuse to do, whether exerted at one time or another, directly or indirectly, if it so operated upon her mind at the time she signed the paper. [But any reasonable influence resulting from acts of kindness or from appeals to the feeling or understanding, and not destroying free agency, is not undue influence.]

Interrogatory No. 1:

Do you believe from the evidence that Pretty Polly lacked testamentary capacity at the time she executed the Will dated July 18, 1999 or that she was induced by undue influence exerted upon her by Snidely Whiplash to sign the Will? YES/NO _____

BYE v. MATTINGLY
975 S.W. 2^d 451 (Ky. 1998)

Mary Ruth BYE, Appellant,

v.

Sylvia Ann MATTINGLY, Successor Administratrix Cum, Testamento Annexo, of the Estate of William Louis McQuady, Richard Keith McQuady, and Acracia G. Beavin, Appellees.

No. 97-SC-208-DG.

Supreme Court of Kentucky.

Sept. 8, 1998.

Testator's former housekeeper brought action against executor of testator's estate and beneficiaries, challenging validity of will on grounds of undue influence and lack of testamentary capacity. The Breckinridge Circuit Court, Ronnie C. Dortch, J., upheld will. Former housekeeper appealed. The Court of Appeals, 1996 WL 531751, affirmed. After granting discretionary review, the Supreme Court, Stephens, C.J., held that: (1) pursuant to presumption arising under lucid interval doctrine, testator had requisite testamentary capacity; (2) will was not result of undue influence; and (3) any error resulting from permitting judge for same circuit to testify as rebuttal character witness for attorney, after former housekeeper sought to discredit will by discrediting attorney as drafter, was harmless.

Affirmed.

Wintersheimer, J., concurred in the result.

1. Wills ⇨52(3)

Pursuant to presumption arising under lucid interval doctrine, testator who suffered from Alzheimer's disease and had been adjudged partially disabled had requisite testamentary capacity at time he executed contested will, given failure of party challenging will's validity to show that testator did not have lucid period at will execution.

2. Wills ⇨52(1)

There is a strong presumption in favor of a testator possessing adequate testamen-

tary capacity which can only be rebutted by the strongest showing of incapacity.

3. Wills ⇨53(2)

Testamentary capacity is only relevant at the time of execution of a will.

4. Wills ⇨21

Any order purporting to render a person per se unable to dispose of property by will is void ab initio, as such a ruling on testamentary capacity would be premature.

5. Wills ⇨53(1)

Kentucky is committed to the doctrine of testatorial absolutism, whose practical effect is that the privilege of citizens to draft wills to dispose of their property is zealously guarded by the courts and will not be disturbed based on remote or speculative evidence.

6. Wills ⇨31

Degree of mental capacity required to make a will is minimal.

7. Wills ⇨31

Minimum level of mental capacity required to make a will is less than that necessary to make a deed or a contract.

8. Wills ⇨50

To validly execute a will, a testator must (1) know the natural objects of her bounty, (2) know her obligations to them, (3) know the character and value of her estate, and (4) dispose of her estate according to her own fixed purpose.

9. Wills ⇨31, 32, 47

Merely being an older person, possessing a failing memory, momentary forgetfulness, weakness of mental powers or lack of strict coherence in conversation does not render one incapable of validly executing a will.

10. Wills ⇨316.2

Every man possessing the requisite mental powers may dispose of his property by will in any way he may desire, and a jury will not be permitted to overthrow it, and to make a will for him to accord with their ideas of justice and propriety.

11. Wills ⇨24

While a ruling of total or partial disability is evidence of a lack of testamentary capacity, it is not dispositive of the issue.

12. Wills ⇨52(3)

Under "lucid interval doctrine," when a testator is suffering from a mental illness which ebbs and flows in terms of its effect on the testator's mental competence, it is presumed that the testator was mentally fit when the will was executed.

See publication Words and Phrases for other judicial constructions and definitions.

13. Wills ⇨52(1)

Burden is placed upon those who seek to overturn a will to demonstrate the lack of testamentary capacity.

14. Wills ⇨52(3)

Presumption of testamentary capacity created under lucid interval doctrine is a rebuttable one, so that evidence which demonstrates conclusively that the testator lacked testamentary capacity at the time of the execution of the will results in nullifying that will.

15. Wills ⇨156, 158

Testator's will was not result of undue influence; although testator suffered from partial disability when will was executed and beneficiary, as testator's limited conservator and guardian, had complete control of testator's affairs, no other indicia of undue influence existed.

16. Wills ⇨155.1

"Undue influence" is a level of persuasion which destroys the testator's free will and replaces it with the desires of the influencer.

See publication Words and Phrases for other judicial constructions and definitions.

17. Wills ⇨155.2

In discerning whether influence on a given testator is "undue," courts must examine both the nature and the extent of the influence.

18. Wills ⇨155.2, 155.4

To be "undue" influence, influence on testator must be of a type which is inappropriate; influence from acts of kindness, appeals to feeling, or arguments addressed to the understanding of the testator are permissible.

19. Wills ⇨155.3

Influence on testator from threats, coercion and the like are improper and not permitted by the law.

20. Wills ⇨159

To be "undue" influence on testator, influence must be of a level that vitiates the testator's own free will so that the testator is disposing of her property in a manner that she would otherwise refuse to do.

21. Wills ⇨155.1

Essence of undue influence inquiry is whether the testator is exercising her own judgment.

22. Wills ⇨155.1

In addition to demonstrating that undue influence was exercised upon the testator, a contestant asserting undue influence must also show influence occurring prior to or during the execution of the will; undue influence exercised after the execution of the will has no bearing whatsoever upon whether the testator disposed of her property according to her own wishes.

23. Wills ⇨159

To support undue influence claim, influence must operate upon the testator at the execution of the will; if the influence did not affect the testator, then such conduct is irrelevant.

24. Wills ⇨159

Even if undue influence occurred many years prior to the execution of the will, but operates upon the testator at the time of execution, it is improper and will render the will null and void.

25. Wills ⇨155.1, 156

To determine whether a will reflects the wishes of the testator, the court must examine the indicia or badges of undue influence, including a physically weak and mentally im-

paired testator, a will which is unnatural in its provisions, a recently developed and comparatively short period of close relationship between the testator and principal beneficiary, participation by the principal beneficiary in the preparation of the will, possession of the will by the principal beneficiary after it was reduced to writing, efforts by the principal beneficiary to restrict contacts between the testator and the natural objects of his bounty, and absolute control of testator's business affairs.

26. Wills ⇨163(1)

When a contestant seeks to claim that undue influence was employed upon a testator, the burden is upon the contestant to demonstrate the existence and effect of the influence.

27. Wills ⇨163(1)

Merely demonstrating that the opportunity to exert undue influence existed is not sufficient to sustain the burden of proving that such influence was exerted.

28. Wills ⇨156

When undue influence and a mentally impaired testator are both alleged and the mental impairment of the testator is proven, the level of undue influence which must be shown is less than would normally be required since the testator is in a weakened state.

29. Wills ⇨163(2)

No presumption of undue influence arises from a bequest by a testator who has a confidential relationship with the beneficiary.

30. Wills ⇨163(2)

When a testator has a confidential relationship with one who receives a benefit under a will, such a transaction should be examined and placed into evidence before the jury, but no presumption of wrongdoing is created.

31. Guardian and Ward ⇨69

Contract between a guardian and ward creates a presumption against the transaction which must be rebutted by the guardian with clear and convincing evidence.

32. Wills ⇨393.1

Supreme Court is particularly disinclined to set aside a jury's decision in which it has found a will to be valid.

33. Wills ⇨163(4)

Presumption of undue influence arising from grossly unreasonable will in which principal beneficiary actively participated in will's execution did not apply to will in which beneficiary's participation was merely to drive testator to and from lawyer's offices.

34. Wills ⇨163(4)

In those instances in which a will is grossly unreasonable and the principal beneficiary actively participated in its execution, a presumption of undue influence arises.

35. Wills ⇨163(4)

If the will contestant can offer evidence that will is grossly unreasonable and principal beneficiary actively participated in its execution, then the burden of persuasion on undue influence claim shifts to the proponents of the will, but it does not relieve the contestants of the continuing burden of proof.

36. Wills ⇨400

Any error resulting from permitting judge for same circuit to testify as rebuttal character witness for attorney, after will contestant sought to discredit will by discrediting attorney as drafter, was harmless, given that judge was subpoenaed by will proponents, and thus his testimony was permissible under ethical rules, and testimony was relatively brief and limited in scope. Sup.Ct. Rules, Rule 4.300, Code of Jud.Conduct, Canon 2, subd. B.

O. Grant Bruton, Louisville, Kentucky, for appellant.

Kenton R. Smith, Steven R. Crebessa, Brandenburg, Kentucky, for appellees.

STEPHENS, Chief Justice.

The testator, William Louis McQuady, and Alberta Beavin McQuady were married for forty-five years prior to Ms. McQuady's death on March 23, 1989. In October of 1988, the McQuadys executed identical wills

which left the surviving spouse in possession of the entire estate. In the event that there was no surviving spouse, all realty was to pass to Richard Keith McQuady, a second cousin once removed to William McQuady, and all personalty was to pass to Samuel Thomas Beavin, brother of Alberta Beavin McQuady. Accordingly, on Ms. McQuady's death, the entire estate passed to Mr. McQuady.

Following his wife's death, Mr. McQuady retained Mary Ruth Bye, appellant in this matter, to act as his housekeeper. Mr. McQuady was unable to see and required assistance to overcome this disability. During their marriage, Ms. McQuady had performed all tasks related to maintaining the household and Ms. Bye was to perform these tasks as part of her duties. Ms. Bye assumed her position as housekeeper in May of 1989.

On July 17, 1989, Mr. McQuady, accompanied by Ms. Bye, visited Herbert O'Reilly of Hardinsburg who had drafted the 1988 wills the McQuadys had executed. Mr. McQuady executed a new will that left his entire estate, save a hundred dollar bequest to St. Mary of the Woods Church, to Ms. Bye.

Subsequent to the execution of the 1989 will, Ms. Bye arranged for a garage to be constructed on Mr. McQuady's property. Following completion of the garage Mr. McQuady's car was never actually stored in the garage. However, at trial Ms. Bye testified that her car was periodically parked inside the garage. The relevance of this event was that it sparked concern in Mr. Beavin and Mr. Richard McQuady with regard to the use of Mr. William McQuady's money by Ms. Bye. The construction of the garage concerned Mr. Beavin and Richard McQuady as the McQuadys had lived in a frugal fashion during their forty-five year relationship and Mr. McQuady possessed an older automobile which had never been garaged in the past.

On May 18, 1990, the petition of Mr. Beavin and Mr. Richard McQuady to appoint a guardian/conservator for William McQuady was heard. As a result of that hearing the Breckinridge District Court appointed Mr. Beavin as a Limited Conservator and Limit-

ed Guardian for Mr. McQuady. Following the hearing, Mr. McQuady's health declined and he was admitted to the hospital on September 21, 1990. Mr. McQuady was diagnosed as suffering from Alzheimer's disease. It should be noted that the effects of Alzheimer's disease can be accentuated by poor health and/or poor treatment.

After Mr. McQuady was diagnosed with Alzheimer's disease, a petition seeking to permit Mr. McQuady to marry Ms. Bye was filed with the Breckinridge District Court. On May 17, 1991, a hearing was held in Breckinridge District Court to determine whether the petition of William McQuady to marry Ms. Bye should be granted. At that hearing Mr. McQuady testified that although he had signed the petition, he was misled in regard to the nature of the document. Mr. McQuady stated that he was told by the Byes not to worry about it and just sign it. The document was prepared by Ellen Bye, daughter of appellant.

During the course of this hearing, Mr. McQuady emphatically stated that he did not want to get married to Ms. Bye. He also stated that he was afraid of Ms. Bye. The court denied the petition to marry. Ms. Bye's services as housekeeper were subsequently terminated.

Five months after the hearing on the petition to marry, Mr. McQuady executed a new will. The net effect of the will executed October 29, 1991, was to re-enact the will he had executed in 1988, in effect leaving his personalty to Mr. Beavin and his realty to Mr. Richard McQuady. The 1991 will was drafted by Alton Cannon and was executed in his office. Richard McQuady drove William McQuady to Mr. Cannon's Law Offices, but Richard McQuady never participated in any discussion or activities regarding the will. William McQuady and Mr. Cannon privately discussed the will that Mr. McQuady desired. When the will was actually executed Mr. Cannon, Mrs. Sheila Cannon and William McQuady were the only three persons present.

On August 7, 1992, William McQuady died. Mr. Beavin was appointed executor of McQuady's estate. Appellant then brought

the instant action, challenging the validity of the 1991 will on grounds of undue influence and lack of testamentary capacity. Mr. Beavin died on October 5, 1993 and Sylvia Mattingly, Mr. Beavin's daughter, was appointed by the Breckinridge Circuit Court to serve as a party-defendant in place of Mr. Beavin in his capacity as executor.

Following a five day trial, a jury returned a unanimous verdict for appellees. During the course of the trial Judge Samuel Monarch, a sitting judge on the Breckinridge Circuit Court, was called by appellees to testify as a witness. Judge Monarch had not been listed by appellees on their witness list. Judge Monarch testified as to the honesty and veracity of his former partner in legal practice, Alton Cannon. Appellants appealed the verdict to the Court of Appeals. A divided panel upheld the trial court. *Bye v. Mattingly*, Ky.App., 97-CA-1874-MR (Sept. 20, 1996). This Court granted discretionary review. We now affirm the Court of Appeals.

There are several issues which the parties have brought before this Court. First, whether a partial disability judgment against an individual removes that person's testamentary capacity. Second, whether a partial disability judgment creates a presumption that a testator lacks testamentary capacity. Third, whether a fiduciary relationship between a limited conservator/guardian and his ward creates a burden on the limited conservator/guardian to demonstrate the non-existence of undue influence. Fourth, whether it is proper for a circuit judge who sits in the same court as the instant trial to testify as a character witness. We shall respond to each of these issues in turn.

I. JUDGMENT OF DISABILITY PURSUANT TO KRS 387.500 ET SEQ. AND TESTAMENTARY CAPACITY.

[1] On July 9, 1990, pursuant to KRS 387.500 *et seq.*, William McQuady was adjudged partially disabled in the Breckinridge District Court. Appellants urge this Court to rule that the effect of such judgment was to remove McQuady's capacity to draft a will or in the alternative that a presumption against testamentary capacity was created by

the judgment. We decline to make either such ruling.

[2-4] In Kentucky there is a strong presumption in favor of a testator possessing adequate testamentary capacity. This presumption can only be rebutted by the strongest showing of incapacity. *Williams v. Vollman*, Ky.App., 738 S.W.2d 849 (1987); *Taylor v. Kennedy*, Ky App., 700 S.W.2d 415, 416 (1985). Testamentary capacity is only relevant at the time of execution of a will. *New v. Creamer*, Ky., 275 S.W.2d 918 (1955). Thus any order purporting to render a person per se unable to dispose of property by will is void *ab initio*, as such a ruling on testamentary capacity would be premature. This is not to say that such an order is irrelevant, but rather it is not dispositive of the issue of testamentary capacity.

[5-7] "Kentucky is committed to the doctrine of testatorial absolutism." J. Merritt, 1 Ky.Prac.—Probate Practice & Procedure, § 367 (Merritt 2d ed. West 1984). See *New v. Creamer*, Ky., 275 S.W.2d 918 (1955); *Jackson's Ex'r v. Semones*, 266 Ky. 352, 98 S.W.2d 505 (1937). The practical effect of this doctrine is that the privilege of the citizens of the Commonwealth to draft wills to dispose of their property is zealously guarded by the courts and will not be disturbed based on remote or speculative evidence. *American National Bank & Trust Co. v. Penner*, Ky., 444 S.W.2d 751 (1969). The degree of mental capacity required to make a will is minimal. *Nance v. Veazey*, Ky., 312 S.W.2d 350, 354 (1958). The minimum level of mental capacity required to make a will is less than that necessary to make a deed, *Creason v. Creason*, Ky., 392 S.W.2d 69 (1965), or a contract. *Warnick v. Childers*, Ky., 282 S.W.2d 608 (1955).

[8-10] To validly execute a will, a testator must: (1) know the natural objects of her bounty; (2) know her obligations to them; (3) know the character and value of her estate; and (4) dispose of her estate according to her own fixed purpose. *Adams v. Calia*, Ky., 433 S.W.2d 661 (1968); *Waggener v. General Ass'n of Baptists*, Ky., 306 S.W.2d 271 (1957); *Burke v. Burke*, Ky.App., 801

S.W.2d 691 (1990); *Fischer v. Heckerman*, Ky.App., 772 S.W.2d 642 (1989). Merely being an older person, possessing a failing memory, momentary forgetfulness, weakness of mental powers or lack of strict coherence in conversation does not render one incapable of validly executing a will. *Ward v. Norton*, Ky., 385 S.W.2d 193 (1964). "Every man possessing the requisite mental powers may dispose of his property by will in any way he may desire, and a jury will not be permitted to overthrow it, and to make a will for him to accord with their ideas of justice and propriety." *Burke v. Burke*, Ky.App., 801 S.W.2d 691, 693 (1991) (citing *Cecil's Ex'r's v. Anhier*, 176 Ky. 198, 195 S.W. 837, 846 (1917)).

[11] In the instant case Mr. McQuady executed wills in 1988, 1989 and 1991. Appellant seeks to have the 1991 will declared invalid as it was executed following the 1990 adjudgment of partial incapacity. While a ruling of total or partial disability certainly is evidence of a lack of testamentary capacity, it is certainly not dispositive of the issue. This Court has upheld the rights of those afflicted with a variety of illnesses to execute valid wills. *Tate v. Tate's Ex'r*, Ky., 275 S.W.2d 597 (1955) (testator suffered deafness and retarded speech); *Bush v. Lisle*, 89 Ky. 393, 12 S.W. 762 (1889) (testator was blind); *In re: McDaniel's Will*, 25 Ky. 331 (1829) (testator was paralyzed); *Bodine v. Bodine*, 241 Ky. 706, 44 S.W.2d 840 (1932) (testator was an epileptic). We have not disturbed the testatorial privileges of those who believed in witchcraft¹, spiritualism² or atheism.³ While none of these cases absolutely parallels the instant case, we recite them here to demonstrate how this Court has always taken the broadest possible view of who may execute a will no matter what their infirmity.

[12] When a testator is suffering from a mental illness which ebbs and flows in terms of its effect on the testator's mental competence, it is presumed that the testator was mentally fit when the will was executed.

1. *Schildnecht v. Rompf's Ex'r*, 9 Ky.Law Rep. 120, 4 S.W. 235 (1887)

2. *Compton v. Smith*, 286 Ky. 179, 150 S.W.2d 657 (1941).

This is commonly referred to as the lucid interval doctrine. *Warnick v. Childers*, Ky., 282 S.W.2d 608, 609 (1955); *Pfuelb v. Pfuelb*, 275 Ky. 588, 122 S.W.2d 128 (1938). See *In re Weir's Will*, 39 Ky. 434 (1840); *Watts v. Bullock*, 11 Ky. 252 (1822). Alzheimer's is a disease that is variable in its effect on a person over time. It is precisely this type of illness with which the lucid interval doctrine was designed to deal. By employing this doctrine, citizens of the Commonwealth who suffer from a debilitating mental condition are still able to dispose of their property.

[13, 14] The lucid interval doctrine is only implicated when there is evidence that a testator is suffering from a mental illness; otherwise the normal presumption in favor of testamentary capacity is operating. The burden is placed upon those who seek to overturn the will to demonstrate the lack of capacity. *Warnick*, 282 S.W.2d at 609; *Pfuelb*, 275 Ky. at 588, 122 S.W.2d at 128. The presumption created is a rebuttable one, so that evidence which demonstrates conclusively that the testator lacked testamentary capacity at the time of the execution of the will results in nullifying that will.

In the present case there is no question that Mr. McQuady suffered from Alzheimers disease. However, under the doctrine he is presumed to have been experiencing a lucid interval during the execution of the will. The wisdom of this doctrine is demonstrated by Mr. McQuady's testimony during the hearing on the petition for marriage in Breckinridge District court. During that hearing Mr. McQuady was very lucid and demonstrated a complete grasp of the circumstances in which he found himself. Appellant has failed to offer this Court evidence which demonstrates that the testator did not have a lucid interval during which he executed the 1991 will. In sum, let it suffice to say that in the instant case a presumption of a lucid interval of testamentary capacity was appropriate.

3. *Woodruff's Ex'r v. Woodruff*, 233 Ky. 744, 26 S.W.2d 751 (1930).

Given this Court's consistent attitude toward the virtually absolute right of the citizens of the Commonwealth to make wills, it would be incongruous for us now to announce a new rule of law which restricted these rights which we have held in such high regard for so long. While the clear policy of the Commonwealth is that our citizens who are no longer able to fully care for themselves must be protected from the various societal predators, we will restrict their testamentary rights only when it is absolutely necessary and even then only to the degree required to defend their interests.

II. FIDUCIARY RELATIONSHIPS AND THE PRESUMPTION OF UNDUE INFLUENCE.

[15-21] Undue influence is a level of persuasion which destroys the testator's free will and replaces it with the desires of the influencer. *Nunn v. Williams*, Ky., 254 S.W.2d 698, 700 (1953); *Williams v. Vollman*, Ky. App., 738 S.W.2d 849, 850 (1987). In discerning whether influence on a given testator is "undue", courts must examine both the nature and the extent of the influence. First, the influence must be of a type which is inappropriate. Influence from acts of kindness, appeals to feeling, or arguments addressed to the understanding of the testator are permissible. *Nunn*, 254 S.W.2d at 700; *Fischer v. Heckerman*, Ky.App., 772 S.W.2d 642, 645 (1989). Influence from threats, coercion and the like are improper and not permitted by the law. *Lucas v. Cannon*, 76 Ky. 650 (1878). Second, the influence must be of a level that vitiates the testator's own free will so that the testator is disposing of her property in a manner that she would otherwise refuse to do. *See v. See*, Ky., 293 S.W.2d 225 (1956); *Rough v. Johnson*, Ky., 274 S.W.2d 376 (1955). The essence of this inquiry is whether the testator is exercising her own judgment. *Mayhew v. Mayhew*, Ky., 329 S.W.2d 72 (1959); *Copley v. Craft*, Ky., 312 S.W.2d 899 (1958).

[22-24] In addition to demonstrating that undue influence was exercised upon the testator, a contestant must also show influence prior to or during the execution of the will. Undue influence exercised after the execu-

tion of the will has no bearing whatsoever upon whether the testator disposed of her property according to her own wishes. *Bennett v. Bennett*, Ky., 455 S.W.2d 580 (1970); *Wallace v. Scott*, Ky.App., 844 S.W.2d 439 (1992); *Fischer v. Heckerman*, Ky.App., 772 S.W.2d 642 (1989). The influence must operate upon the testator at the execution of the will. If the influence did not affect the testator, then such conduct is irrelevant. *Bodine v. Bodine*, 241 Ky. 706, 44 S.W.2d 840 (1932); *Walls v. Walls*, 30 Ky.Law Rep. 948, 99 S.W. 969 (1907). However, even if the influence occurred many years prior to the execution of the will, but operates upon the testator at the time of execution, it is improper and will render the will null and void. *Id.*

[25] To determine whether a will reflects the wishes of the testator, the court must examine the indicia or badges of undue influence. Such badges include a physically weak and mentally impaired testator, a will which is unnatural in its provisions, a recently developed and comparatively short period of close relationship between the testator and principal beneficiary, participation by the principal beneficiary in the preparation of the will, possession of the will by the principal beneficiary after it was reduced to writing, efforts by the principal beneficiary to restrict contacts between the testator and the natural objects of his bounty, and absolute control of testator's business affairs. *Belcher v. Somerville*, Ky., 413 S.W.2d 620 (1967); *Golladay v. Golladay*, Ky., 287 S.W.2d 904, 906 (1955).

Applying these badges to the 1991 will, it is clear that no undue influence was present. Given the fact that a partial disability order was in place when the will was executed, there is no question that the testator was physically and mentally weak. Similarly, since a disability order was in place, Mr. Beavin had complete control of the testator's business affairs. However, none of the other badges are present with respect to the 1991 will.

[26-28] When a contestant seeks to claim that undue influence was employed upon a testator, the burden is upon the contestant to demonstrate the existence and effect of the influence. *Nunn v. Williams*, Ky., 254

S.W.2d 698, 700 (1953). Merely demonstrating that the opportunity to exert such influence is not sufficient to sustain the burden of proof. *Id.* When undue influence and a mentally impaired testator are both alleged and the mental impairment of the testator is proven, the level of undue influence which must be shown is less than would normally be required since the testator is in a weakened state. *Creason v. Creason*, Ky., 392 S.W.2d 69 (1965); *Sloan v. Sloan*, 303 Ky. 180, 197 S.W.2d 77, 80 (1946).

[29, 30] In Kentucky no presumption of undue influence arises from a bequest by a testator who has a confidential relationship with the beneficiary. *Palmer v. Richardson*, 311 Ky. 190, 197, 223 S.W.2d 745, 749-50 (1949); *McAtee v. McAtee*, 297 Ky. 865, 874, 181 S.W.2d 401, 405 (1944); *Kiefer's Ex'r v. Deibel*, 292 Ky. 318, 166 S.W.2d 430, 433-34 (1942); 1 Ky. Prac.—Probate Practice & Procedure, § 555 (Merritt 2d ed.1984). There is no question when a testator who has a confidential relationship with one who receives a benefit under a will, such a transaction should certainly be examined and placed into evidence before the jury, but no presumption of wrongdoing is created. In fact, it is not uncommon or inappropriate for a testator to make such a bequest to one who has provided comfort and support to the testator. *Ecklen's Ex'r v. Abbey*, 283 Ky. 449, 141 S.W.2d 863 (1940); *Karr v. Karr's Ex'r*, 283 Ky. 355, 141 S.W.2d 279 (1940).

[31] We wish to note that in making this ruling we are not disturbing the well-settled rule that a contract between a guardian and ward does indeed create a presumption against the transaction which must be rebutted by the guardian with clear and convincing evidence. *Meade v. Fullerton's Adm'x*, 266 Ky. 34, 98 S.W.2d 1, 2 (1936). The distinction between a bequest in a will and a transaction between two parties is that a will gift does not involve conflicting interests. However, in a transaction, the parties are placed in an adversarial relationship in which each party is attempting to maximize his or her own benefit without regard to the other. Accordingly, all contracts between a ward and guardian are due a much higher level of

scrutiny and thus the presumption against them is created.

[32] Accordingly, since no presumption against the validity of the 1991 will exists, the burden was on the appellant to show that the 1991 will was procured through undue influence. A jury unanimously found that the 1991 will was not procured by undue influence. Nothing appellant has offered this Court even comes close to rising to the level necessary to set the jury's verdict aside. This Court is particularly disinclined to set aside a jury's decision in which it has found a will to be valid. *Rodgers v. Cheshire*, Ky., 421 S.W.2d 599 (1967).

Appellant's argument, based on the idea that because the testator had been adjudicated as mentally infirm, he was more susceptible to undue influence, is indeed an interesting one. However, for some reason appellant urges this Court not to examine the 1989 will, procured under suspicious circumstances (under which she benefitted) but rather only apply its undue influence analysis to the 1991 will. We decline her invitation to do so. If testator was in a mentally feeble condition in July of 1990, then it is certainly possible—in fact likely—that he was in a similar condition one year earlier when he willed his entire estate to appellant. We find appellant's argument unpersuasive. However, as we find no undue influence in the execution of the 1991 will, we have no occasion to fully review the circumstances surrounding the enactment of the 1989 will.

[33-35] There is a presumption which has some potential application to the instant case. In those instances in which a will is grossly unreasonable and the principal beneficiary actively participated in its execution, a presumption of undue influence arises. *Hollon's Ex'r v. Graham*, Ky., 280 S.W.2d 544 (1955); *Gay v. Gay*, 308 Ky. 539, 215 S.W.2d 92 (1948). If the contestant can offer evidence of such activities, then the burden of persuasion shifts to the proponents of the will, but it does not relieve the contestants of the continuing burden of proof. *Gay*, 308 Ky. at 539, 215 S.W.2d at 92; *Kiefer's Ex'r v. Deibel*, 292 Ky. 318, 166 S.W.2d 430 (1942).

The executions of the 1989 and 1991 wills are virtually identical in their facts. In 1989, Ms. Bye drove the testator to a lawyer and Ms. Bye was not privy to the drafting nor execution of the will. Following the execution ritual, Ms. Bye drove the testator home. In 1991, the same circumstance was repeated with Mr. Beavin driving testator to and from the lawyer's offices. Under neither of these circumstances can we say that Ms. Bye nor Mr. Beavin actively participated in the execution of the respective wills. Accordingly, this presumption does not apply in the instant case.

III. APPEARANCE OF SITTING CIRCUIT JUDGE AS A WITNESS AT TRIAL IN HIS OWN COURTHOUSE.

[36] During the course of the trial, appellant sought to discredit the 1991 will by discrediting its drafter, Alton Cannon. Appellant now complains that she was unfairly surprised when appellees were permitted to call Circuit Judge Samuel Monarch, who sits in the Breckinridge Circuit Court where this case was tried, as a character witness to rebut appellant's attacks on Mr. Cannon. Appellant asserts, *inter alia*, that it was improper for Judge Monarch to be permitted to testify as a witness in the very courthouse in which he was then sitting as a Circuit Judge. Appellant further complains that he had presided over the same panel of veniremen and at least two of the jurors had been jurors in a previous trial which Judge Monarch had conducted. It should be noted that Judge Monarch recused himself from participating in the instant case due to his previous relationship with Alton Cannon.

Obviously it is preferable that a sitting jurist never be called upon to testify in a trial, particularly within the jurisdiction over which he presides and very particularly in front of a panel of veniremen over which he originally presided. While this Court does not agree with appellant's characterization of appellees conduct as the "ultimate Home Cookin'" ploy, we are in general agreement

that this was a very unfortunate situation which should be avoided whenever possible. However, we find singularly unconvincing appellant's argument that she was "blind-sided" by Judge Monarch's surprise appearance, particularly after she placed Mr. Cannon's credibility in issue in the first place.

As the trial record clearly reflects, appellant decided to attempt to denigrate Mr. Cannon's reputation in an attempt to cast the execution of the 1991 will into doubt. This was a perfectly permissible trial strategy. However, appellant cannot now speak out of the other side of her mouth and say that she had no idea that a character witness might be called to rebut her assault. Appellees are under no obligation to warn appellant of their possible response to appellant's every conceivable course of action.

Under Canon 2(b) of the Code of Judicial Conduct, codified at SCR 4.300, a "judge should not . . . testify voluntarily as a character witness." Judge Monarch was served with a subpoena by appellees. Accordingly, he did not testify voluntarily within the meaning of Canon 2(b). Since Judge Monarch's testimony was permissible, given its relative brevity and limited scope, any error which may have occurred was certainly harmless.

Accordingly, for the foregoing reasons the judgment of the Court of Appeals is affirmed.

COOPER, GRAVES, JOHNSTONE,
LAMBERT and STUMBO, JJ., concur.

WINTERSHEIMER, J., concurs in result only.

