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

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ESTATE PLANNING
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**Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
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**NOTABLE DEVELOPMENTS
OF INTEREST TO ESTATE PLANNERS**

1999-2000

**Turney P. Berry
Ogden Newell & Welch
Louisville, Kentucky**



**1999 - 2000 NOTABLE DEVELOPMENTS OF INTEREST
TO ESTATE PLANNERS**

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**1999 - 2000 NOTABLE DEVELOPMENTS OF INTEREST
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A. INCOME TAX MATTERS

1. **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.

2. **Final Regulations on Estate Separate Share Rules.** The IRS statement of the General Separate Share rule is as follows:

The proposed regulations define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries (for example, rights to income or gains from specified items of property) are not affected by economic interests accruing to another beneficiary or class of beneficiaries. The proposed regulations conclude that there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has.

Generally, the final regulations clarify the definition and narrow the application of the separate share rules that are in the proposed regulations. The final regulations generally define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by economic interests accruing to another beneficiary or class of beneficiaries. The final regulations add "nor are affected by" to clarify the definition of a separate share. Under this revised definition, a separate share generally exists only if it includes both corpus and the income attributable thereto and is independent from any other share. Thus, income earned on assets in one share (first share) and appreciation and depreciation in the value of those assets have no effect on any other share. Similarly, the income and changes in value of any other share have no effect on the first share.

The separate share rules do not change the traditional understanding of payments of sums or specific property under section 663(a)(1):

The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.

On a related issue the explanation states:

Under these final regulations, any pecuniary formula bequest that is entitled to income and to share in appreciation or depreciation under the governing instrument or local law constitutes a separate share under the general definition.

Further, under a special rule, a pecuniary formula bequest that is not entitled to income or to share in appreciation or depreciation is also a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments. This provision regarding three or fewer installments parallels the specific bequest requirements in section 663(a)(1).

One important area of clarification deals with the income tax consequences of a spouse's elective share. This issue attracted considerable discussion when the proposed regulations were issued. The IRS explanation states:

The proposed regulations provide that a surviving spouse's statutory elective share constitutes a separate share of an estate. As a result, the surviving spouse may be taxed on the estate's gross income only to the extent of the surviving spouse's share of that income under state law.

One commentator recommended that separate share treatment for a surviving spouse's elective share should be reconsidered. Elective shares should be a matter of further study because they are forced by state law, differ from state to state, and usually are part of an acrimonious conflict. Another commentator requested clarification of whether a surviving spouse's statutory elective share is included in the subchapter J estate. Further, this commentator recommended that an elective share that is not entitled to income or appreciation should be excluded from the subchapter J estate, but an elective share that is entitled to income and appreciation should be included in the subchapter J estate.

Conversely, other commentators agreed that separate share treatment should apply to a surviving spouse's statutory elective share regardless of whether the surviving spouse is entitled to income and shares in appreciation or depreciation. One commentator suggested that the separate share examples in the proposed regulations be revised to track more closely the Uniform Probate Code model because it will likely be adopted by most states.

These final regulations do not change the result of the proposed regulations. However, under these final regulations, a surviving spouse's elective share that under local law is entitled to income and to share in appreciation or depreciation constitutes a separate share under the general definition. Further, under a special rule in the final regulations, a surviving spouse's elective share that is not entitled to income or does not share in appreciation or depreciation is also a separate share.

The final regulations make some changes to the section 645 election:

The proposed regulations provide that a qualified revocable trust that elects under section 645 to be treated as part of the decedent's estate for income tax purposes constitutes a separate share. In response to comments, these final regulations include a reference that the electing revocable trust itself may have two or more separate shares. These final regulations further provide that qualified revocable trusts within the definition of section 645(b)(1) are subject to the separate share rules applicable to estates rather than trusts whether or not an election is made to be part of the estate.

The final regulations make several other points:

1. Separate shares come into existence "at the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate share exists."
2. In response to commentators' concerns about making adjustments after IRS audits the final regulations provide that a fiduciary must use a "reasonable and equitable method to determine the value of each separate share and the allocation of taxable income to each share. This approach gives the fiduciary

flexibility, within limits, in applying the separate share rules. However, redeterminations in value of those separate shares must be taken into account.”

3. When calculating distributable net income for a separate share income as determined under section 643(b) must be allocated to each share based on the instrument or applicable state law. With respect to IRD under section 691(a) the explanation states:

These final regulations clarify that such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether a share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount allocated to each share is based upon the relative value of each of those shares that could potentially be funded with such amounts.

4. No change is made to rules under Treas. Reg. S 1.663(c)-2 that an expense attributable solely to one separate share of a trust is not available as a deduction under another.

5. Interest owed on pecuniary bequests or delayed estate distributions is treated as a payment of interest by the estate and not a distribution for purposes of sections 661 and 662. Section 163(h) disallows a deduction for personal interest and Treasury regards that provision as determinative.

6. The effective date provisions have been modified from the proposed regulations:

These final regulations are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see section 601.601(d)(2)(ii)(b)). For trusts other than qualified revocable trusts, section 1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

3. **Application of Section 1014.** Suppose Personal Representative values an asset on an estate tax return at 100, which value is accepted by the Internal Revenue Service. Beneficiary who inherits the asset sells it for 110. May beneficiary claim that 110 was the asset's actual fair market value at date of death?

TAM 199933001 considers a similar situation: the beneficiaries inherited corporate stock which was redeemed by the company seven years after the decedent's death. The IRS cited the following relevant authority:

Section 1.1014-3(a) of the Income Tax Regulations provides that the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax shall be deemed to be its fair market value.

In Rev. Rul. 54-97, 1954-1 C.B. 113, the Service held that for the purpose of determining the basis under section 113(a)(5)(the predecessor of section 1014) of property transmitted at death (for determining gain or loss on the sale thereof or the deduction for depreciation), the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence.

There are two issues: first, does the duty of consistency estop the beneficiary, and, second, can the beneficiary rebut the presumption of estate tax correctness which clear and convincing evidence.

As to the first issue, in Shook v. U.S., 713 F.2d 662 (11th Cir.1983), the court held that Mrs. Shook was not estopped because, the IRS recited,

The court found nothing in the record to suggest that anyone other than the decedent's executors and their attorney had or exercised any authority in handling the resolution of the estate's tax liability. In addition, Mrs. Shook never had any contact with the IRS in connection with settling the decedent's estate nor did the IRS rely on any representation made by her. Finally, the court found that the executor's attorney's discussion of the estate's tax settlement with Mrs. Shook and the obtaining of an expression of her approval was a prudent measure based on the parties' animosity and not a legal necessity. Thus, the court was unwilling to extend the estoppel doctrine to an estate beneficiary for "merely indicating approval of the executor's handling over which they have total control and the beneficiary none."

4. **Deductibility of Legal Fees.** In 1990, Red Stevens established a revocable trust. He died in 1991. The trust provided for certain payments to be made to his son by a prior marriage with the remaining assets passing into a marital trust with wife as trustee, son sued wife, as trustee, claiming lack of capacity and undue influence and seeking to void the trust. Trustee wife defended and won.

In Ruby Jean Stevens v. Commissioner, T.C. Memo. 1999-259, the issue was, are the legal fees deductible? The court held that the fees must be capitalized. The opinion states:

Section 212 authorizes a deduction for ordinary and necessary expenses paid or incurred for, inter alia, the management, conservation, or maintenance of property held for the production of income. /5/ To satisfy the requirements of section 212, the expenditure must be reasonable in amount and must bear a reasonable and proximate relationship to the management, conservation, or maintenance of property held for the production of income. See Bingham Trust v. Commissioner, 325 U.S. 365, 370 (1945).

The terms "management", "conservation", and "maintenance" have been construed to refer to the protection, safeguarding, or upkeep of physical assets and not to the taxpayer's retention of ownership of the property. See United States v. Gilmore, 372 U.S. 39, 44 (1963); Reed v. Commissioner, 55 T.C. 32, 42 (1970); Duntley v. Commissioner, T.C. Memo. 1987-579. Therefore, to be deductible under section 212, professional expenses must be directly connected or proximately related to the management, conservation, or maintenance of the property. See Bingham Trust v. Commissioner, supra at 375; Duntley v. Commissioner, supra.

Conversely, expenditures paid or incurred in defending or perfecting title to property, such as legal expenses in a suit to quiet title to real estate and expenses paid to protect one's right to property of a decedent as a beneficiary under a testamentary trust, constitute a part of the cost of property and are not deductible expenses. See Woodward v. Commissioner, 397 U.S. 572, 575 (1970); Boagni v. Commissioner, 59 T.C. 708, 711-712 (1973); sec. 1.212-1(k), Income Tax Regs.; see also sec. 1.263(a)-2(c), Income Tax Regs., which classifies "The cost of defending or perfecting title to property" as a capital expenditure.

Petitioner contends that the disallowed professional fees at issue in this case are deductible under section 212, because (1) defending against the lawsuit protected her taxable income stream, and (2) the fees were ordinary and necessary expenses incurred in that effort. Petitioner also contends that the disallowed professional fees qualify as ordinary and necessary litigation expenses incurred in connection with the performance of her duties of administration within the meaning of section 1.212-1(i), Income Tax Regs.

Respondent contends that the disallowed professional fees represent capital expenditures within the meaning of section 263, because the fees were incurred to defend the validity of the Trust and its title to Trust property. We agree with respondent.

Whether professional fees incurred in connection with litigation are deductible expenses under section 212, or are capital expenditures under section 263, requires an examination of the origin of the claims giving rise to the professional fees. See *United States v. Gilmore*, supra at 49 ("the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal'"); *Boagni v. Commissioner*, supra at 712-713.

* * *

Petitioner cites *Estate of Kincaid v. Commissioner*, T.C. Memo. 1986-543, in support of her contention that, where the origin of the claim was the prevention of conduct which would be detrimental to her interest as income beneficiary, the litigation costs are deductible. Petitioner argues that, just like the taxpayer in *Estate of Kincaid*, she defended the lawsuit in her capacity as income beneficiary to prevent impairment of the production and collection of income from Trust assets.

* * *

In the case before us, however, it is clear that the lawsuit had nothing to do with alleged abuses in the administration of the Trust. In fact, the lawsuit was a direct attack on the validity of the Trust. Garland's claims -- undue influence, lack of capacity, conversion, fraud, etc. -- were all alternate theories to invalidate the Trust and gain a larger share of his father's estate. Each claim for relief was based on allegations that Mr. Stevens was mentally incompetent and that petitioner caused, induced, deluded, misled, forced, and/or otherwise unduly influenced Mr. Stevens to execute the Trust. None of the claims included allegations of mismanagement or waste of Trust assets, or diversion of Trust income.

Garland's claims originated in his attempt, albeit unsuccessful, to invalidate the Trust and acquire an interest in the Trust assets. Unlike the *Estate of Kincaid* case, the professional fees were incurred by petitioner in a dispute over title to property between Garland and the Trust. Such expenses are nondeductible capital expenditures. See secs. 1.212-1(k) and 1.263(a)-2(c), *Income Tax Regs.*; see also *Boagni v. Commissioner*, 59 T.C. at 713; *Arthur H. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931, 938 (1972); *Seidler v. Commissioner*, 18 T.C. 256 (1952); *Duntley v. Commissioner*, T.C. Memo. 1987-579.

Petitioner bases a second argument for deductibility of her professional fees on the fact that she incurred the expenses in her role as Successor Trustee. Petitioner argues that her fiduciary duty to defend the Trust renders the professional fees deductible as ordinary and necessary expenses of Trust administration, citing section 1.212-1(i), *Income Tax Regs.* There is no higher or more important duty than defending a trust against attack, petitioner contends, and thus her legal fees must be deductible. Respondent counters that, since the legal fees associated with petitioner's duties of administration originated in the defense of the Trust, the fees are capital expenditures under the origin-of-the-claim test.

5. **General Partner Fees.** It is often suggested that a general partner charge a fee for managing a family partnership. In Matthew W. Norwood, et ux. v. Commissioner, T.C. Memo. 2000-84; No. 1332-00 (March 13, 2000), the court held that a general partner's interest automatically gave use to self-employment income, regardless of the general partners' activities.

6. **Application of Section 121 to Trust.** In PLR 200018021 the IRS determined that section 121 (allowing a \$250,000 or \$500,000 capital gain exclusion for the sale of a residence) does not apply to a residence held by a trust, because the taxpayer -- the trust -- is not using the residence as a residence. The exception is for a grantor trust (such as a revocable trust or, generally, a QPRT).

7. **Court-Ordered Payments Deductible.** In Sharon Purcell DiLeonardo v. Commissioner, T.C. Memo. 2000-120 (2000), the court held that the income beneficiary of a trust may deduct payments ordered after the taxpayer objected to a trustee's accounting. The objections were determined to be frivolous and the payments were essentially sanctions. The opinion states:

In general, if the origin and character of the claim arise out of a taxpayer's personality as a seeker after profit rather than satisfier of human needs, it does not matter that the taxpayer's expenditures are made because of the imposition of a sanction to compensate the victims of the taxpayer's improper actions. See, e.g., Ostrom v. Commissioner, 77 T.C. 608 (1981), in which the taxpayer was allowed to deduct his payment of a jury award of damages imposed on account of the taxpayer's fraudulent misrepresentation on which the plaintiff had relied to his detriment. To the same effect are the cases described in Ostrom v. Commissioner, 77 T.C. at 611-613. In the instant case, the origin and character of the claim from which the liability arose are petitioner's personality as a seeker after profit. This is not affected by whether petitioner won or lost the underlying litigation or even by whether the California Court imposed the obligation on petitioner because that Court concluded that petitioner had acted in bad faith and out of vindictiveness.

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.

The Work Incentives Improvement Act of 1999 (H.R. 1180) eliminates the income tax deduction for these kinds of arrangements.

4. **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.

5. **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.

6. **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."

7. **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.

8. **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.

9. **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.

10. **Division of Charitable Lead Trust.** In PLR 199929021 the IRS allowed three children -- co-trustees of one lead trust -- to divide the trust into three shares without adverse income or transfer tax consequences or self-dealing penalties.

11. **Borrowing by Charitable Remainder Trust to Make Payment.** Prop. Reg. § 1.643(a)-8 provides:

(a) **Purpose and Scope.** This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules and should be interpreted in a manner consistent with this purpose. This section applies to all charitable remainder trusts described in section 664 and the beneficiaries of such trusts.

(b) **Deemed Sales by Trust.**

(1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year for which a distribution of an annuity or unitrust amount from the trust is due, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount --

(i) Is not characterized in the hands of the recipient as income from the categories described in section 664(b)(1), or (3), determined without regard to this paragraph (b); and

(ii) Was made from an amount received by the trust that was not--

(A) A return of basis in any asset sold by the trust, determined without regard to this paragraph (b); or

(B) Attributable to cash contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522.

(2) Any transaction that has the purpose or effect of circumventing the rules in this paragraph (b) shall be disregarded.

(3) For purposes of paragraph (b)(1) of this section, "trust assets" do not include cash or assets purchased with the proceeds of a trust borrowing, forward sale, or similar transaction.

(4) Proper adjustment shall be made to any gain or loss subsequently realized for gain or loss taken into account under paragraph (b)(1) of this section.

(c) **Examples.** The following examples illustrate the rules of paragraph (b) of this section:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of \$2 million to a charitable remainder unitrust with a unitrust amount of 50 percent of the net fair market value of the trust assets and a two-year term. The stock has a total basis of \$400,000. In Year 1, the trust receives dividend income of \$20,000. As of the

valuation date, the trust's assets have a fair market value of \$2,020,000 (\$2 million in stock, plus \$20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows \$990,000 against the value of the stock. The trust then distributes \$1,010,000 to the beneficiary as dividend income. The rest of the distribution, \$990,000, is attributable to an amount received by the trust that did not represent either a return of basis in any asset sold by the trust (determined without regard to paragraph (b) of this section) or a cash contribution to the trust with respect to which a charitable deduction was allowable. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore, in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold \$990,000 of stock and as having realized \$792,000 of capital gain (the trust's basis in the shares deemed sold is \$198,000). Thus, in the hands of the beneficiary, \$792,000 of the distribution is characterized as capital gain under section 664(b)(2) and \$198,000 is characterized as a tax-free return of corpus under section 664(b)(4).

Example 2. Adjustment to trust's basis in assets deemed sold. The facts are the same as in Example 1. During Year 2, the trust sells the stock for \$2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(2) of this section, the trust's basis in the stock is \$1,192,000 (\$400,000 plus the \$792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of \$908,000.

Example 3. Distribution of cash contributions. Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to \$x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the \$x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

(d) **Effective Date.** This section is applicable to distributions made by a charitable remainder trust after October 18, 1999.

The explanation states:

The proposed regulations provide that, to the extent that a distribution of the annuity or unitrust amount from a charitable remainder trust is not characterized in the hands of the recipient as income from the categories described in section 664(b)(1), (2), or (3) (determined without regard to the rules in these proposed regulations) and was made from an amount received by the trust that was neither a return of basis in any asset sold by the trust (determined without regard to the rules in these proposed regulations) nor attributable to a contribution of cash to

the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, the trust shall be treated as having sold, in the year for which the distribution is due, a pro rata portion of the trust assets. Any transaction that has the purpose or effect of circumventing this rule will be disregarded. For example, a return of basis in an asset sold by a charitable remainder trust does not include basis in an asset purchased by the charitable remainder trust from the proceeds of a borrowing secured by previously contributed assets.

12. **Interpretation of Term "Fair Market Value" for Charitable Contributions.** At issue is Arbor Powers Associates Ltd. v. Commissioner, T.C. Memo. 1999-213, was whether a charitable contribution should be determined on the basis of "fair market value" or "value in use." The taxpayer, a partnership, employed an expert to determine that the fair market value of certain property partially given and partially bought by the University of Michigan was \$9 million valued using a hypothetical willing buyer and willing seller present. However, the experts testified that the property "valued in use" was actually \$12.2 million. The experts stated that "valued in use" meant the value as it was actually being used which by the University of Michigan. The court stated the "\$12.2 million figure from which Arbor relies was derived not by employing the applicable standards but by employing an improper standard which took into account the specific buyer, University of Michigan, and its characteristics. Even if we were to agree with Wieme [the taxpayer's expert] "Value of Use" to University of Michigan was \$12.2 million, and we stopped short of so doing, this would not aid Arbor in its quest for charitable contribution deduction since that figure does not represent the "fair market value" of Wolverine Tower on the valuation date within the meaning of the regulations."

13. **Community Foundation Variance Power.** Consideration of the nature and scope of the power of a community foundation to redirect a charitable fund under its control from a charity selected by the donor to a charity selected by the foundation was at issue in Matter of the Laura Spelman Rockefeller Memorial (NYLJ October 21, 1999, p. 29) rendered by Surrogate Eve Preminger. The Surrogate held that the New York Community Trust Distribution Committee acted improperly when it changed the beneficiaries of a fund 28 years previously but applied a 6-year statute of limitations. The opinion states:

The crux of this dispute is not the method of review or other procedural aspects of the process. It is whether the Distribution Committee, in 1971, after conducting its investigation uncovered sufficient negative information to support the determination that continuation of payments to CSS [Community Service Society] was undesirable. The principal argument relied on by the NYCT at trial was that the uncertainty caused by CSS's changed operating methods justified termination of funding. CSS contends that exercise of the variance power required more than uncertainty about the success of its new directions. The NYCT argues that uncertainty alone may constitute undesirability and thus serve as a basis for exercising the various power.

The Court rejects the contention that uncertainty about future developments may be, in and of itself, undesirable. Change is inevitable. Uncertainty frequently accompanies change. The premise of the various power is that change will occur and that the Distribution Committee, composed of uniquely qualified individuals, will respond to change with a considered analysis of its impact on the funds under its control. A conclusion that uncertainty about the effect of change could justify exercise of the variance power would eliminate the obligation of the Distribution Committee to evaluate the consequences of the change. This would be a direct violation of the Resolution which requires not only a change in circumstances but one that renders continuation of distributions unnecessary, undesirable, impractical or impossible. It would also undermine the utility of community foundations. Instead of promoting flexibility and creativity, the variance power would discourage beneficiaries, through fear of

losing funding, from making changes, and from healthy experimentation.

This does not mean that a Distribution Committee is required to continue payments to a designated beneficiary while it watches the organization put scarce charitable resources to ineffective use or that it must wait for an organization's demise before acting. Once a community foundation's Distribution Committee acquires information to support the conclusion that the change will jeopardize the ability of the organization to carry out its mission or otherwise adversely affect the organization or its work to such a degree that a donor of the fund would be likely to redirect it, exercise of the variance power would be a proper response.

* * *

Alternative bases for exercise of the variance power suggested either at trial or in the contemporaneous record -- unionization of CSS's caseworkers, its operating deficit, its large endowment and the increase in government welfare spending through "Great Society" programs and otherwise -- neither alone nor together support the exercise of the variance power against CSS. Unionization created short-term difficulties that did not, and could not have been expected to, have any meaningful impact on the long-term future of CSS. CSS's operating deficit did not indicate anything negative about the organization's management but demonstrated only that the current needs of the organization outpaced its current receipts. In the face of this deficit, neither CSS's endowment nor expected receipts from government programs or other resources justified a conclusion that CSS had no need for the funds held for its benefit at the NYCT.

Community foundations increasingly displace perpetual charitable trusts. There is little if any law in the appropriate exercise of variance powers. Thus, the case is significant.

14. **Securities Purchased on Margin Give Rise to UBIT.** The Second Circuit has decided Henry E. & Nancy Horton Bartels Trust v. United States, 85 AFTR2d Par. 2000-572; No. 98-6141 (April 11, 2000). A trust that was a supporting organization as defined in section 509(a)(3) bought securities on margin. The opinion states:

Under the plain language of the UBIT, the purchase of securities on margin is a purchase using borrowed funds; therefore, under section 514(c), the securities are subject to an "acquisition indebtedness." See Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347, 348-51 (3d Cir. 1980). Thus, the margin-financed securities constitute "debt-financed property" under section 514(b)(1). As "debt-financed property," section 512(b)(4) and section 514(a)(1) require that the income derived from these securities be treated "as an item of gross income derived from an unrelated trade or business" (in the proportion that the basis of the property bears to the amount financed), and, therefore, this income is included in the section 512 computation of unrelated business taxable income. See, e.g., id. (holding securities purchased on margin are subject to UBIT, as margin-financed securities are debt-financed property, and section 514(a) requires treating income derived therefrom as income from unrelated trade or business). Thus, Taxpayer's reliance on Supreme Court decisions construing "trade or business" in other contexts and under the general test for determining unrelated business taxable income is misplaced because section 512(b)(4) and section 514(a)(1) require that Taxpayer's income derived from margin-financed securities be treated as income derived from an unrelated trade or business.

The opinion rejected the argument that because there was no unfair competition there was no UBIT. The court rejected a final argument:

Next, Taxpayer argues that its margin-financed securities are not "debt-financed property" because section 514(b)(1) defines "debt-financed property" as

property that is "held to produce income," and this phrase should be interpreted to include only "periodic" income. We find no merit to this argument for at least two reasons. First, Taxpayer cites no authority for this construction of section 514(b)(1), and there is nothing in the statutory language or legislative history of the UBIT supporting this restrictive interpretation. Second, the applicable regulation specifically construes "income" under section 514(b)(1) as including both capital gains and recurring or "periodic" income (e.g., dividends). In this respect, Treasury Regulation section 1.514(b)-1(a) defines "debt-financed property" as

any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. THE TERM "INCOME" IS NOT LIMITED TO RECURRING INCOME BUT APPLIES AS WELL TO GAINS FROM THE DISPOSITION OF THE PROPERTY.

Treas. Reg. section 1.514(b)-1(a) (emphasis added). Although Taxpayer urges us to reject the Commissioner's interpretation of the UBIT, we must sustain the regulation unless it is "unreasonable and plainly inconsistent" with the statute. *Fulman v. United States*, 434 U.S. 528, 533 (1978); *Bingler v. Johnson*, 394 U.S. 741, 749-51 (1969).

Section 61(a) of the Code broadly defines income to include "all income from whatever source derived," and lists, as examples, both periodic income (e.g., dividends and interest) and nonperiodic income (e.g., compensation for services; gross income derived from business; and gains derived from dealings in property). 26 U.S.C. section 61(a)(1), (2), (3), (4), (7). There is nothing in the statutory language to suggest that this general definition of "income" is inapplicable to section 514(b)(1) or to justify limiting section 514(b)(1) to "periodic" income. Moreover, the legislative history of the UBIT does not indicate that Congress intended to tax only "periodic" income under those provisions. /3/ Accordingly, we reject Taxpayer's argument that section 514(b)(1)'s reference to "debt-financed property" includes only "periodic" income.

15. **Partner Recognized Gain on Contribution.** Treas. Reg. § 1.1001-2(c) was upheld in Maxine Goodman, et al. V. United States, 85 AFTR2d Par. 2000-339; No. 98-8649-CIV- HURLEY/LYNCH (December 22, 1999)(S.D. Fla). The opinion states:

Plaintiffs filed suit pursuant to 28 U.S.C. Section 1346(a)(1) alleging that the treatment a \$1,181,047.00 charitable contribution as a bargain sale with concomitant capital gain under Internal Revenue Code ("code") sections 752(d) and 1011(b) was incorrect. In other words plaintiff seeks a refund of \$173,769 assessed by and payed to the Internal Revenue Service ("IRS"). Plaintiff asserts that the there is no basis in the code for the IRS to use section 752(d) in applying section 1011(b) to charitable contributions of partnership interests. Instead, plaintiffs argue that the transaction should be controlled by section 752(b) which would allow the taxpayer to offset his distribution gain against his basis under sections 752(b) and 731(a).

A judgment on the pleadings is appropriate only when it is demonstrated" beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957) (applying standard for a motion to dismiss). For the purpose of the motion for judgment on the pleadings, the complaint is construed in the light most favorable to the plaintiff, and all facts alleged by the plaintiff are accepted as

true. See *Hishon v. King & Spaulding*, 467 U.S. 69, 73 (1984).

Plaintiffs however, cannot prove a set of facts which would entitle them to legal relief. Their contention that section 1011(b) is inapplicable because it governs only the sale of property and not a gift, is erroneous. Section 752(d) plainly states that the treatment of partnership-related liabilities upon the sale or exchange of partnership interests is governed by the law applicable to the sale or exchange of any other property. For the bargain sale of any other property to charities, section 1011(b) applies. The plain language of section 1011(b) applies to sales to a charitable organization and the regulations applying section 1011(b) to gratuitous transfers of encumbered property to charities is reasonable. See *Ebben v. C.I.R.*, 783 F.2d 906, 914 (9th Cir. 1986).

In addition, Revenue Ruling 75-194, 1975-1 Cum. Bull. 80, considers the tax consequences for a limited partner's charitable contribution of his interest in a limited partnership subject to nonrecourse liabilities. It states:

[P]ursuant to sections 752(d) and 1011(b), the amount of the [donating taxpayer's] share of partnership liabilities at the time of the transfer constitutes an amount realized by [taxpayer]. Based on the foregoing, a bargain sale within the meaning of sections 170 and 1011(b) has occurred.

Accordingly in the instant case, [taxpayer] has a recognized gain on the transfer equal to the excess of the amount realized by L over that portion of the adjusted basis of L's partnership interest (at the time of the transfer), allocable to the sale under section 1011(b) of the [c]ode.

Rev. Rul. 75-194, 1975-1 Cum. Bull. 80.

16. **LLC as Grantor of Charitable Remainder Trust.** PLR 199952071 determined that an LLC may be the grantor and recipient of a term of years charitable remainder trust.

17. **Charitable Bequest of Deferred Compensation.** PLR 200002011 dealt with a bequest to charity of the following items by a corporate executive:

During the course of Taxpayer's employment, he has elected to defer receipt of certain amounts to which he was entitled, consisting of (1) compensation that had been payable to Taxpayer but the receipt of which he elected to defer pursuant to Corporation's deferred compensation plan, (2) shares of Corporation stock that had been payable to Taxpayer as a result of his exercise of compensatory stock options granted to him by Corporation, the receipt of which he elected to defer pursuant to Corporation's deferred stock option plan. Furthermore, Taxpayer negotiated with Corporation for the Corporation to provide a death benefit to his estate or designated beneficiaries upon his death. Collectively, these three items are referred to as the deferred compensation.

Pursuant to Taxpayer's agreement with Corporation with respect to the deferred compensation, Taxpayer may designate any one or more beneficiaries within a certain class, which would include charitable organizations, to whom the deferred compensation would be payable in the event of his death.

Taxpayer intends to name as the designated beneficiaries of the deferred compensation one or more charitable organizations, each of which qualifies for tax-exempt status pursuant to section 501(a) as an organization described in section 501(c)(3).

During the course of his employment with the corporation, Taxpayer also has

been granted certain rights (options) to purchase shares of Corporation stock at specified option prices. No option price was less than the fair market value of the stock to which it applied on the date the option was granted.

It is represented that the options are the type of options commonly known as "nonstatutory options" because they do not meet the requirements for special income tax treatment under sections 421 through 424 ("statutory options"). It is further represented that at the time of their grant, the options did not have a readily ascertainable fair market value.

Pursuant to Taxpayer's agreement with Corporation under which the options were granted, in the event of his death, Taxpayer may transfer the options by will to any one or more beneficiaries within a certain class, which would include charitable organizations. Taxpayer intends to bequeath the options under his will to one or more of the charitable organizations.

The IRS ruled:

1. Taxpayer's estate will be eligible for a federal estate tax charitable deduction under section 2055(a) for the deferred compensation passing to the charitable organizations and for the value of the options passing to the charitable organizations.

2. The deferred compensation to which the charitable organizations will become entitled following Taxpayer's death will be income in respect of a decedent under section 691 which will be included in the gross income of the charitable organizations in the year in which the charitable organizations receive such income.

3. When, following Taxpayer's death, the charitable organizations exercise the options which Taxpayer bequeaths to them under his Will, the charitable organizations will recognize income in respect of a decedent under section 691 which will be included in the gross income of the charitable organizations.

The IRS referred to the application of section 83 as follows:

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, the excess of -- (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-1(d) provides that if substantially nonvested property has been transferred in connection with the performance of services and the person who performed the services dies while the property is still substantially nonvested, any income realized on or after such death with respect to the property under this section is income in respect of a decedent to which the rules of section 691 apply. In such a case the income in respect of the property shall be taxable under section 691 (except to the extent not includible under section 101(b)) to the estate or beneficiary of the person who performed the services, in accordance with section 83 and the regulations thereunder.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value (determined in accordance with section 1.83-7(b)) at the time the option is granted. If section 83(a) does not apply to the grant of the option because it does not have a readily ascertainable fair market value at the time of the grant, sections 83(a) and 83(b) will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the test to be applied in determining whether an option has a readily ascertainable fair market value. However, section 1.83-7 is silent regarding the transfer of a nonstatutory option in a non-arm's length transaction.

18. **What is in a CRT?** John T. Jorgl v. Commissioner, TCM 2000-10, considered an interesting issue. The taxpayers transferred a corporation (a child care center) into a charitable remainder trust which sold the corporation. Of the sale proceeds \$300,000 were allocated to a covenant not to compete for the officers of the corporation, who were the taxpayers. The \$300,000 was paid to the trust and the taxpayers tried to avoid paying income tax on it. The court held that income tax was owed.

19. **IRA Proceeds and Qualified Plan Proceeds - IRD Consequences.** In PLR 199939039 the IRS ruled that a private foundation would have IRD when it received IRA and qualified plan proceeds but that the decedent's estate would not have IRD.

20. **Lead Trust May Invest in FLP.** PLR 200018062 determined that the investment by a charitable lead trust in a limited partnership would not be self-dealing nor would payments to the general partners be prohibited transactions. The issue of excess business holdings was not considered.

21. **Division of CRT to Meet 10% Test.** In PLR 200022014 the IRS allowed a trustee to divide a trust, pursuant to court order, so that instead of being one trust with four beneficiaries, and flunking the 10% remainder interest rule of section 664(d)(2)(D), it became four trusts each with one beneficiary.

C. **SECTION 408 -- IRAs AND RETIREMENT PLANS**

1. **Qualified Plan Benefits and IRAs Payable to QTIP Trust.** The IRS has made Rev. Rul. 89-89 obsolete and replaced it with Rev. Rul. 2000-2, 2000-2 IRB 305 (January 18, 2000). The holding of the ruling is:

An executor may elect under § 2056(b)(7) to treat an IRA and a trust as QTIP when the trustee of the trust is the named beneficiary of the decedent's IRA, the surviving spouse can compel the trustee to withdraw from the IRA an amount equal to all the income earned on the IRA assets at least annually and to

distribute that amount to the spouse, and no person has a power to appoint any part of the trust property to any person other than the spouse.

The ruling is in accordance with Treas. Reg. S 20.2056(b)-5(f)(8) which provides that if a spouse may demand all the income of a trust that will give the spouse the necessary entitlement to all of the income to meet the requirements of section 2056. Provisions in trust documents that require a trustee to demand all the income should be modified.

2. **Spousal Rollovers.** In PLR 199918065 IRA payments in excess of the decedent's remaining applicable credit amount were to be made to a marital deduction trust which gave the surviving spouse an unlimited power of withdrawal. The surviving spouse and a trust company were co-trustees of the marital trust and were named as beneficiaries of the IRA. The IRS allowed the rollover.

In PLR 199942052 the IRS allowed a surviving spouse to roll over proceeds paid to a revocable trust because the spouse was the sole trustee and could allocate assets between a marital deduction power of withdrawal trust and a credit shelter trust and, in fact, did distribute the IRA proceeds to the marital trust where they were drawn.

3. **Effect of Facility of Payment Clause on Designated Beneficiary Rules.** The IRS determined in PLR 199912041 that a revocable trust that became irrevocable upon the grantor's death would not qualify as a designated beneficiary under section 401(a)(9) for qualified plan benefits because the revocable trust allowed the trustee to pay amounts needed to pay claims, administration expenses, and taxes to the grantor's estate. The IRS decided that a facility of payment clause to create the estate as a beneficiary and only individuals, in certain trusts, may be "designated beneficiaries."

4. **Distributions Over Oldest Life Expectancy.** PLR 200011072 considered the following facts:

Individual A reached his required beginning date, as that term is defined in section 401(a)(9), on April 1, 1990, and he died on July 11, 1998. Distributions from Plan X to Individual A prior to his death were based on his single, recalculated life expectancy. Individual A executed a trust instrument on September 14, 1989 (the "1989 Trust"), and on October 30, 1989, Individual A designated the 1989 Trust as the beneficiary of his account under Plan X. You represent that the 1989 Trust is valid under state law. Individual B, Individual A's daughter, was named trustee of the 1989 Trust.

Your authorized representative asserts that, pursuant to its terms, the 1989 Trust became irrevocable at the death of Individual A. Article IV of the 1989 Trust provided that the trust property be divided into two trust estates, Fund 1 and Fund 2, at the death of Individual A. Article V provided that upon Individual A's death, Individual B was entitled to the income and principal of Fund 1 subject to a standard. Article V further provided that the remainder of assets under Fund 1 be paid and distributed to each child of Individual B then living or to the lineal descendants of each child. The 1989 Trust also entitled Individual B to the income and principal, subject to a standard, of Fund 2. Under the terms of the 1989 Trust, Individual B could appoint the remainder of any property in Fund 2, but the appointment was limited to her lineal descendants. Your authorized representative asserts that the Plan X administrator was provided a copy of the trust instrument at the time minimum distributions commenced. Individual B is older than any of her lineal descendants referenced above as potential remaindermen of 1989 Trust property.

Based on the above facts and representations, you request a ruling that for purposes of determining the required minimum distributions incident to the death of Individual A, Individual B is treated as the designated beneficiary of

Individual A's account under Plan X and, therefore, required minimum distributions from Plan X may be made over Individual B's single life expectancy as the beneficiary with the shortest life expectancy of all potential beneficiaries existing at the time of Individual A's required beginning date.

The Service granted the requested ruling.

D. SECTIONS 671-678 -- GRANTOR TRUST RULES

1. **Income Tax Consequences of Powers of Withdrawal** PLR 199942037 involved a trust with Crummey powers and a gift of subchapter S stock. The IRS ruled that the minor child who is the beneficiary of the trust and who had the power of withdrawal would be treated as the owner of the trust under section 678(a) whether or not the child withdrew the property or allowed the right to withdraw to lapse.

PLR 200022035 confirms that a person who has a 5 x 5 withdrawal right over a trust will be the owner under section 678 of an ever increasing fraction of the trust.

2. **Grantor Trust Status for GRAT.** PLRs 200001013 and 200001015 approved grantor trust status for GRATs which provided that the retained annuity would first be paid from income, gave the nonadverse trustee the power to pay additional income to the grantor/annuitant, and the grantor/annuitant would have a general testamentary power of appointment during the term. The ruling states:

Under the terms of the of Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under section 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under section 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term. Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of section 671 during the Trust term.

If the trust had income and capital gains in excess of the annuity the trustee was required to reimburse to grantor for the excess income tax owed. The ruling is silent about the effect of the section 675(4)(c) power which was described as follows:

Section VII.A of the Trust provides that at any time during the Trust term, Taxpayer is to have the power, exercisable in a nonfiduciary capacity (either personally or by an attorney-in-fact under a power of attorney expressly referring to this power), without the consent or approval of any person in any capacity, to reacquire any property held by the Trust by substituting other property having the same fair market value (determined without regard to the nature of the assets or the relative value of the asset to any person having an interest in the Trust).

The taxpayer also asked whether the trust would be included in the taxpayer's estate under section 2036 if the grantor survived the trust term. The ruling was favorable.

E. SECTION 1361 - S CORPORATIONS

1. **Power to Make Distributions From ESBT.** PLR 199930035 proved ESBT status for a trust in which the trustee could distribute income and principal among the grantor's descendants and could divide the trust property among separate trusts for the grantor's descendants, per stirpes. Specifically, the IRS determined that the trustee's power to create separate trusts would not affect qualification of the single trust as ESBT. The IRS noted that if the trust property were divided, each separate trust would have to qualify under section 1361(c)(2)(A) and each beneficiary of the trust would have to be described in section 1361(b)(1).

F. SECTIONS 2031 and 2512 -- VALUATION

1. **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.

The case is on appeal.

2. **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%.

3. **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.

4. **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.

5. **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 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.

6. **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.

The Sixth Circuit has reversed and remanded to the Tax Court the case of Estate of Pauline Welch v. Commissioner, 85 AFTR2d Par. 2000-534, No. 98-2007 (March 1, 2000), for a determination of the appropriate built in gains discount. The opinion gives no guidance on the calculation

7. **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].

8. **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.

9. **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.

10. **Aggregation of Interest.** The Tax Court followed Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999) in the Estate of Ambrosinia Blanche Lopes v. Commissioner, T.C. Memo. 1999-225.

11. **Comparison With Public Companies.** In Estate of Brookshire v. Commissioner, 76 T.C.M. 659 (1998) the Tax Court accepted the taxpayer's expert valuation of Brookshire Grocery Company, comparing it to certain public companies. The court allowed a 40% discount for lack of marketability.

Valuation of two private held telephone companies was at issue in Barnes v. Commissioner, 76 T.C.M. 881 (1998). The Tax Court largely accepted the opinion of the taxpayer's expert who compared the privately held companies that issue in the case to 10 local or regional publicly traded telephone companies with respect to price earnings ratios, dividends, price compared with cash flow, etc. The IRS argued that actual dividend payments were irrelevant and that only dividend paying capacity should be considered but the court disagreed finding that 6 of the 10 guideline companies paid out greater dividends than the privately-held companies. The court noted that the donees of the non-voting stock at issue had no right to participate in any decision related to the company and thus could not force the companies to pay dividends.

The court rejected the argument of taxpayer's expert in one regard, holding that no premium should be allowed in calculating the discount rate used to capitalize the companies to sort earnings. The court held that the taxpayer's expert did not show that the companies were riskier than other comparably sized companies, primarily because all telephone companies are highly regulated.

The Tax Court also allowed substantial discounts of 40% of lack of marketability for one of the companies

and 45% for the other company. The court noted that the donor's family has controlled the companies for more than half a century and intend to keep control. Interestingly, the court pointed to the fact that a voting trust had been created, and life insurance has been purchased, as part of an estate plan, as indicating the intent to maintain the companies in the family. The court also noted that there had been no outside sales of the companies.

The court also allowed an additional discount for the non-voting stock, even though the voting stock was a minority interest of 3.66% based on the testimony of the taxpayer's expert.

12. **Valuation of S Corporation Shares.** Walter L. Gross, Jr., et ux., et al. v. Commissioner, T.C. Memo 1999-254, involved the value of S corporation shares. The court did not allow the taxpayer to reduce the assumed cash-flow of the S corporation as if it were a C corporation. That is, the Court rejected "tax-affecting" the earnings. Arguably this is contrary to the training and audit handbooks of the IRS itself. The court also allowed a 25% marketability discount.

13. **Bank Stock.** At issue in Estate of James Waldo Hendrickson v. Commissioner, T.C. Memo 1999-278, was the valuation of stock in a closely-held bank in a small Indiana town. The opinion is a useful review of the application of appraisal factors generally. In particular, however, two findings are interesting.

The decedent owned 1499 shares, of 3000, which is 49.97%. One child owned 85 shares and the decedent's ex-wife owned 610 shares. There were 29 other shareholders, each with at least 3 shares. The court found that the decedent's shares should be valued as a control block.

The court applied a 30% lack of marketability discount as well.

14. **Blockage and Fractional Interest Discounts for Real Property.** In Estate of Eileen K. Brocato v. Commissioner, TC Memo 19990424, the court allowed an 11% blockage discount and a 20% fractional interest discount, largely accepting the taxpayer's expert, for 8 apartment complexes of between 12 and 45 units each.

In Estate of William Busch v. Commissioner, T.C. Memo. 2000-3 (2000), the court allowed a 10% fractional interest discount for a 50% interest in real estate the highest and best use of which was residential. The court rejected the taxpayer's expert's claim of a 40% discount finding that discount to be based on studies of partnerships and REITS. The court gave no justification for 10% but did note that it would be "more than adequate to accommodate reasonable costs of partition" on the facts of the case.

Pending in the Tax Court is Estate of Eileen Kerr Stevens v. Commissioner, No. 22643-97, in which the IRS, on brief, cites its expert in ceding between a 10% and 20% discount for fractional interests in commercially leased real estate. The brief states that the costs of partition are one factor the expert relied on.

15. **Majority of Operating Company.** In Estate of Beatrice Ellen Jones Dunn v. Commissioner, T.C. Memo. 2000-12, the court valued a 62.96% interest in a heavy equipment rental business. The court applied a 5% discount for built-in capital gains, without useful discussion, and a 15% discount for lack of marketability, agreed to by the experts for the taxpayer and IRS. Under Texas law a shareholder cannot compel liquidation of a corporation without 66.67% of the vote. The IRS conceded a discount of 7.5% for lack of a super-majority.

16. **Closely-Held Company With an ESOP.** In Estate of Sam Homer Marmaduke v. Commissioner, T.C. Memo. 1999-342, the decedent died owning 22% of Hastings Books, Music & Video, Inc., a retailer. The decedent's family owned 57% and an ESOP owned 21%. By general agreement, the value of the whole company was \$100,000,000 on the date of death. Within a year of death there were a number of transactions involving small blocks of stock that used a value of \$47 per shares, about a 20% discount.

Judge Swift determined that a discount below \$47 per share was warranted, and valued the stock at \$41.51 per shares, a 30% discount.

17. **Tax Court Values Decedent's Stock in Two Nonpublicly Traded Corporations.** The value of one-third of a farm corporation and 12% of a family owned bank were at issue in Estate of Helen J. Smith v. Commissioner, T.C. Memo 1999-368. The case was mostly a taxpayer victory because Judge Gale was more persuaded by the taxpayer's experts. One point is especially instructive. In valuing the farm corporation the court accepted an expert's opinion that the valuation would be based 70% on assets and 30% on earnings.

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.

In PLR 199942025 the estate made a protective election under section 2032 which would become effective only if the date of death value of the decedent's gross estate, and the estate tax and generation skipping tax, is higher than the value of the gross estate determined under section 2032 using the appropriate alternate valuation date. The facts were that the estate included a large block of publicly traded stock all of which was disposed of within the six months after the decedent's death. The estate intended to take a blockage discount which would reduce the value as of the date of death, but which might be disallowed by the IRS on audit.

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.

In Estate of Carolyn J. Rogers v. Commissioner, T.C.M. 2000-133, the court reached a different conclusion from that of Thompson.

In Estate of Thompson v. Commissioner, T.C. Memo. 1998- 325, we concluded that the taxpayer had failed to identify comparable real properties and cash rentals within the meaning of section 2032A(e)(7), where the expert's adjusted net lease income per acre figures were more akin to an appraisal, which is expressly prohibited by section 20.2032A-4(b)(2)(iii), Estate Tax Regs., rather than an accurate calculation of actual cash rents.

In Estate of Thompson we concluded that the expert's report was completely unreliable as to whether any of eight properties were indeed comparable to the subject property for the following reasons. First, the alleged comparable properties ranged in size from 44 acres to 34,365 acres, compared to the subject property of 2,929 acres. In addition, the expert made no adjustments due to differences in location, land quality, or timber type/maturity. Moreover, no description of the properties was contained in the expert's report.

In decedent's estate here, five out of seven tracts share nine out of the nine applicable features set forth in section 20.2032-4(d), Estate Tax Regs. For decedent's estate, the range in size of comparables is much tighter: comparables of 261 to 1,665.28 acres (for subject properties ranging from 65-1670 acres). Furthermore, Dr. Haney excluded potential comparables because of differences in location, land quality, and timber type/maturity. Dr. Haney excluded the potential comparable in Fayette County because of location; he excluded a Pickens County tract with somewhat different slope and soil. Further, Dr. Haney

proposed a 10-percent reduction to four of the subject properties, because of the superior quality of timber on the five leased tracts. As noted previously, however, such a reduction is inappropriate as appraisals are not true measures of the actual cash rental value of comparable property. Moreover, petitioner provided detailed descriptions of the subject properties and the leased properties in the original estate tax return; more detailed descriptions of the leased properties are provided in the leases and Dr. Haney's reports.

The eight leases in Estate of Thompson were entered into over a 27-year period, some with no rent escalation clause. For those leases with no rent escalation clause, the expert claimed to have applied the "Producer Price Index" (PPI) in an effort to calculate the market rental value of those properties for the 5-year period preceding decedent's death. Petitioner requested that we take judicial notice of Report 807, Escalation and Producer Price Indexes: A Guide for Contracting Parties issued by the U.S. Department of Labor, Bureau of Labor Statistics in September 1991 for the purpose of establishing that the PPI can be applied to contract rents to calculate accurately fair market rents for future years in the absence of escalation clauses, as the expert claimed to have done. We determined in Estate of Thompson that:

Report 807 does not support the proposition that market rents for the relevant period can be accurately calculated from contract rents entered into several decades beforehand via the application of the PPI for purposes of section 2032A(e)(7)(A) for those leases which do not themselves contain rent escalation clauses. Rather, Report 807 provides guidance to contracting parties with respect to the use of price adjustment clauses at the time the contract is entered into. * * *

In Estate of Thompson the average gross cash rental for the 5 years preceding the decedent's death was determined by the expert on the basis of his "personal knowledge * * * what I thought would be the indicated market rent for what I knew about the whole business, and that's it." Furthermore, the expert testified that he validated his estimate of the cash rental rate for the timberland by reference to the prevailing rate for cropland during the relevant period, of which there was no evidence.

In decedent's estate here, the special use valuation of the five estate tracts is based exclusively on actual cash rents from the five leased tracts for the 5 years preceding decedent's death. All five leases for the five leased tracts contain rent escalation clauses; as escalated, the leases constituted the prevailing rents during the statutory period on that type of land. Both the actual rents and State and local property taxes were explained and are fully substantiated with original source data. There is no adjustment to rents because petitioner used only actual current rents during the statutory period.

Respondent also asserts that the five estate tracts and the five leased tracts are not comparable in any manner in regard to the rental values. Respondent contends that the regulations require that "generally accepted real property valuation rules" be applied to determine comparability of the property. Sec. 20.2032A-4(d), Estate Tax Regs. Respondent asserts that the maximum period allowed under real estate valuation rules is 5 years prior to the valuation date. On brief, respondent states this argument as follows:

Leases that establish the applicable rents are leases that would have been negotiated and entered into during the five-year period. Leases that were negotiated more than five years prior to the date of death do not accurately reflect the economic conditions at the date of death and the current rental values of comparable lands. Comparability must be

based on numerous factors, no one of which is determinative. See sec. 20.2032A-4(d), Estate Tax Regs. All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A. See *id.* However, respondent seeks to exclude the comparable land on the basis of one factor and one factor only (the age of the leases -- which is not even one of the factors enumerated in the regulations).

Neither the statute nor the regulations support respondent's position in that respect. In this case, the parties stipulated that the typical timber lease in effect in western Alabama between 1987 and 1991 was entered into in the 1950's, 1960's, and early 1970's and was a long-term timber lease. Respondent's argument would exclude every lease executed before August 19, 1987, which would effectively operate to prevent estates in Alabama from using section 2032A(e)(7) to value timberland since the typical timber lease in effect in western Alabama between 1987 and 1991 was entered into in the 1950's, 1960's, and early 1970's.

Respondent has submitted an original and two rebuttal reports from his expert, Richard Maloy. Mr. Maloy contends that, "Comparable leases must have been negotiated under recent (5-year period of analysis) dates to ensure comparability of economic conditions." Mr. Maloy is simply parroting respondent's primary legal argument that would inject an arbitrary requirement for application of section 2032A(e)(7) -- that is, as a matter of law no lease can be considered unless it was executed within 5 years of the date of death. We have stated before, in *Alumax v. Commissioner*, 109 T.C. 133, 171 (1997): "We shall disregard any opinion of an expert that constitutes nothing more than that expert's legal opinion or conclusion about a particular matter."

Mr. Maloy further states the following: "Lease comparability under section 2032A(e)(7) would require recent leases, foreseeable within the 5-year average. This is relatively easy in row crop valuation, but generally eliminates the use of this section in timber land valuation."

Two consecutive paragraphs establish that the protection afforded farms by section 2032A was intended to apply to timberland. Section 2032A(e)(7) sets forth the "Method of valuing farms." Section 2032A(e)(4) and (5) leaves no doubt that timber operations are included under section 2032A(e)(7) and (8). Furthermore, factor (7) under section 20.2032A-4(d), Estate Tax Regs., obviously contemplates that rented timberland may be comparable property.

As stipulated, the leases represented the typical timber leases in effect in western Alabama during the 5-year statutory period. Moreover, the inflation-adjusted rents paid under these leases constituted the prevailing rents in effect during the statutory period. All of the leases on the five leased tracts have escalation clauses. Moreover, in contrast to the fatal "judgment call" as to the annual rents in *Estate of Thompson v. Commissioner*, T.C. Memo. 1998-325, the parties have stipulated the precise, actual annual gross rents for the statutory period.

Consequently, with their escalation clauses, the stipulated rents constitute the prevailing rents actually paid on comparable land in western Alabama under the typical/standard lease in effect during the statutory period. Once the unleased and the leased land are determined to be comparable (as we have found), section 2032A(e)(7) permits petitioner to use for valuation purposes the average annual gross cash rents for the 5 calendar years preceding decedent's death.

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 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. **Sale of Remainder Interest.** Section 2702 does not apply to residences. Where a client has a long life expectancy the sale of remainder interest in a residence may be more attractive than a qualified personal residence trust. This transaction will be effective, however, only if section 2036 does not apply to the sale of a remainder interest.

In Estate of Cyril I. Magnin, 184 F.3d 1074 (9th. Cir. 1999) the court followed D'Ambrosio v. Commissioner, 101 F.3d 309 (3rd. Cir. 1996) and Wheeler v. United States, 116 F.3d 7489 (5th Cir. 1997) to hold that the term "adequate and full consideration" under section 2036(a) refers only to the amount of the remainder interest of the transferred property. The Service's position was that in order for adequate and full consideration to be present the sale must be for the value of the entire property rather than just the value of the remainder interest. The policy arguments supporting the court's decision were that the purpose of section 2036(a) is to prevent depletion of a decedent's estate and the true fair market value of a remainder interest must track the value of a life interest in order to be consistent under the Internal Revenue Code.

The Circuit Court remanded the case to the Tax Court for determination from the value of the consideration in the case.

3. **Stock Transferred to Partnership is Includable in Gross Estate.** TAM 199938005 is very important in the family limited partnership context. At issue was whether closely-held stock owned by a partnership which the decedent could vote as general partner in the partnership would be included in the decedent's gross estate under section 2036(b). The IRS described the transaction as follows:

Decedent and his brother each owned a 50 percent interest in Corporation represented by W voting and X nonvoting shares of common stock. In Year 1, in conjunction with the renegotiation of Corporation's revolving credit agreement with Bank, Bank required the shareholders to devise a plan of management and ownership succession.

On Date 1 in Year 1, Decedent and his brother carried out the following transaction. Each transferred 55 percent of his stock to a family limited partnership (Partnership) (Y shares of voting and Z shares of nonvoting common) in exchange for 10 general partnership units, 1,000 Class A limited

partnership units, 100 Class B limited partnership units, and 100 Class C limited partnership units. /1/ Also on Date 1, Decedent transferred 50 Class B units to Child 1, 50 Class B units to Child 2, 50 Class C units to Child 3, 50 Class C units to Child 4, and his remaining partnership units and stock to a revocable trust of which he was trustee (Trust). Under the terms of Trust, at his death, Trust assets passed to his four children.

In a letter dated one month before Date 1, the estate planning attorney for Decedent and his brother states that he has enclosed a draft of a new first Article to the partnership agreement of Partnership and a "draft of a gift trust that could be used to receive the B and C units that are intended to be given to the children at this time." The letter suggests that Decedent and his brother could create identical separate trusts or joint trusts with the end result being a single trust for each child to hold the child's B or C units.

Article 8.3 of the partnership agreement authorized the general partners to vote the shares of Corporation as follows:

Prior to the death of the survivor of [Decedent] and [his brother], the General Partners will have complete discretion regarding the voting of any Controlled Corporation's shares; provided, however, that if the General Partners cannot agree about how the shares of [Corporation] should be voted on any issue, then each General Partner shall vote a number of the Partnership's shares bearing the same proportion to the total shares owned by the Partnership that the number of General Partnership Units held by that Partner bears to the total number of General Partnership Units outstanding.

At his death on Date 2, Trust held Decedent's 10 general partnership units, his 1,000 Class A limited partnership units, and 22.5 percent of the outstanding stock in Corporation. On the federal estate tax return, the estate included in Decedent's gross estate, the date of death value of the 22.5 percent stock interest in Corporation and of the 10 general partnership units and 1,000 Class A limited partnership units.

The IRS concluded as follows:

In this case, in view of the ownership of the Corporation stock by Partnership and Trust, and the decedent's right to vote the stock, Corporation was a controlled corporation for purposes of section 2036(b)(2) with respect to Decedent, between the date of transfer to Partnership and Decedent's date of death.

Further, the transfer of Decedent's Y shares of voting stock to Partnership is properly viewed as a transfer of the stock, for purposes of section 2036(b), for less than adequate consideration. That is, Decedent, in substance, transferred the stock to Partnership in exchange for 10 general partnership units and 1000 Class A limited partnership units. The 100 Class B and 100 Class C units passed to Decedent's children, pursuant to an integrated plan, at the moment Partnership was formed. /2/ Thus, these units cannot properly be viewed as received by Decedent in exchange for the transfer of his stock to Partnership. Because Decedent did not receive all of the consideration for his transfer of stock to Partnership, Decedent transferred the stock for less than adequate consideration for purposes of section 2036(b). In addition, it is doubtful that the transfer to the family owned partnership designed to produce an estate freeze could be characterized as a "bona fide" sale.

As a general partner, Decedent retained the right to vote the Y shares. In this regard, the statutory language expressly states that the statute applies where the

decedent retains "either directly, or indirectly" the right to vote the stock. The legislative history indicates that the statute applies regardless of the capacity in which the decedent exercises the voting rights. The statute applies where the stock is voted by the decedent indirectly through a fiduciary, and accordingly, would necessarily apply where the decedent holds the voting rights directly, as a fiduciary. Accordingly, Decedent's retention of the right to vote Corporation stock in his capacity as a general partner constitutes the retention of the right to vote the transferred stock for purposes of section 2036(b).

The Service rejected the argument that because the decedent could only vote the stock in conjunction with the other general partner, section 2036(b) would not apply. In part that was because each general partner could vote a proportionate number of shares according to the provisions of the partnership agreement. In addition, the IRS specifically stated that "under section 2036(b), the retained right to vote transferred stock constitutes the retained enjoyment of the stock, and the legislative history indicates that the statute applies regardless of the capacity in which a decedent exercises the voting rights. Thus, we believe the statute applies even if the voting powers only exercisable by decedent in conjunction with another."

The proposed regulations under section 2036 agree with the ruling with respect to the ability vote the stock only in conjunction with someone else. Prop. Reg. § 20.2036-2(c). A transfer of non-voting stock by gift will not be included in a decedent's gross estate merely because the decedent retains voting stock. Prop. Reg. § 20.2036-2(a).

The provisions of 2036 must be examined whenever voting stock is to be given by means of a partnership over which the donor retains control.

I. SECTION 2040 -- JOINT INTERESTS

No Developments.

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

1. Power of Appointment Among Descendants. PLR 199938024 solved a significant drafting problem for a taxpayer. A decedent's son was given the power to appoint by Will among the "Grantor's issue and the spouses of such issue." The issue before the Service was whether the son had a general power of appointment. The Service determined that because the power was testamentary, the son could not appoint to the son or the son's creditors during the son's life and the son's estate and the creditors of the son's estate were not within the class of permissible appointees. Some states mandate the same result under applicable state law (e.g., Maryland). On the other hand, a broader power, might be a general power even if testamentary. See e.g. Dickinson v. Wilmington Trust Co., 734 A.2d 605 (Del. Cha. 1999) (A testamentary power to appoint to "such person or persons" as the power holder designated would be general).

A similar issue arose in TAM 200014002:

In the instant case, Decedent was a life income beneficiary and a co-trustee of the trust created under Item Seven of Spouse's will. The will directed the trustees to pay to Decedent all of the trust income for her comfort and support and for the comfort, education, and support of the children of Spouse and Decedent. The will further provided that should the income payable to Decedent be insufficient for her comfort and support and for the comfort, education, and support of the children of Spouse and Decedent, the trustees were authorized to encroach upon the trust corpus in such amounts as they deemed necessary, in their discretion.

However, as was the case in Rev. Rul. 54-153, under Mo. Ann. Stat. section 456.540.4, at the time of her death, Decedent, as both beneficiary and co-trustee, was prohibited from exercising her trustee powers to make discretionary distributions of trust principal to herself. Consequently, under Missouri law, as

co-trustee and life beneficiary, Decedent held no power to invade trust principal for her own benefit. Thus, as provided in Rev. Rul. 54-153, Decedent was prohibited by the Missouri statute from participating in decisions to distribute trust corpus to herself. Accordingly, because Decedent did not have a power to appoint corpus to herself, or for her benefit, (whether or not limited by an ascertainable standard) no part of the value of the trust created under Spouse's will is includible in Decedent's gross estate under section 2041.

K. SECTION 2042 - LIFE INSURANCE

No Developments.

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. PLR 200020011 approved a commercial loan to pay interest owed under section 6166 was reasonable and necessary under section 2053(a)(2). The estate represented as follows:

The represented facts are as follows: Decedent died on Date 1. Decedent's niece (Niece), also Decedent's conservator, is the principal beneficiary of Decedent's estate. Decedent's estate was initially administered by Bank. After the filing of the Estate (and Generation-Skipping Transfer) Tax Return on Form 706 and prior to the issuance of the closing letter dated Date 2, Bank resigned and Niece succeeded Bank as the personal representative of Decedent's estate.

Decedent's federal estate tax return reported a gross estate of a. Of the total gross estate, b represented the value of real estate, including a closely-held business interest in the form of a commercial shopping center. The shopping center was valued for federal estate tax purposes at c and thus comprised approximately w percent of the value of Decedent's gross estate. This percentage of business assets met the percentage requirements for purposes of the election under section 6166. Decedent's estate elected under section 6166(a), therefore, to defer payment of the federal estate tax attributable to the value of the shopping center and to pay the estate tax in installments together with annual payments of interest on the unpaid portion of the federal estate tax liability during the deferral period. To date, the estate has made the required payments.

It has been represented that Niece, the personal representative and principal beneficiary of Decedent's estate, received approximately x percent of Decedent's estate. It has been further represented that Niece holds a y percent direct interest in the commercial shopping center and, as well, currently operates the shopping center. The remaining z percent is held in a trust for the benefit of Niece's daughter.

Decedent's estate represents that it has had difficulty obtaining operational lines of credit because of the federal tax lien resulting from the election under section 6166 and that the future payments required under section 6166 would cause a strain on the cash flow of the commercial shopping center. Decedent's estate further represents that the majority of other gross estate assets have been liquidated to pay estate taxes. Accordingly, Decedent's estate has determined that it is in the best interests of the closely-held business to obtain a commercial loan for the purpose of paying off the deferred estate taxes in full. To date, such a loan has been secured and the deferred estate taxes have been paid in full.

It has been represented that a loan has been secured and the deferred estate taxes have been paid in full. Inasmuch as the applicable loan documents contain a prepayment option, however, it has been further represented that the loan documents will be amended to provide that the loan may not be prepaid, and upon default all interest that would have been owed throughout the loan term must be paid in full at the time of default. Decedent's estate represents that it will not deduct the interest attributable to the loan as an administration expense until the loan documents have been amended to remove any possibility of prepayment.

The IRS 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. **Environmental Claims.** In Estate of Robert L. Snyder v. United States, 84 AFTR2d Par. 99-5255, the decedent owned contaminated property in this revocable trust at death. The estate, after considerable negotiation, settled with the EPA for \$750,000 and wanted to deduct that amount under section 2053. The IRS originally denied a deduction because the claim was speculative but after it became fixed, because of the settlement, raised the argument that no deduction in excess of the probate estate could be taken. The court gave the argument short shrift:

The term "property subject to claims," as used in section 2053(c)(2), does not make a distinction between a probate versus a non-probate asset. Rather, it expressly provides that "the term 'property subject to claims' means property INCLUDABLE in the gross estate of the decedent WHICH, or the avails of which, would BEAR THE BURDEN OF THE PAYMENT OF SUCH DEDUCTIONS in the final adjustment and settlement of the estate" 26 U.S.C. section 2053(c)(2) (emphasis added). The Revocable Trust's assets are subject to and bear the burden of the payment of the EPA claims under Ohio law. Thus, the plain language of the statute dictates that the Revocable Trust's assets fall within the definition of "property subject to claims."

The government argues that "in the final adjustment and settlement of the estate" means "in the probate estate." Thus precluding plaintiff from deducting the EPA settlement from the Revocable Trust. It states that the "property subject to claims" must be within the jurisdiction of a state probate court, surrogate court, orphans' court, or other court which exercises jurisdiction over the final adjustment and settlement of a decedent's estate. We find this interpretation overly narrow.

The government cites a third circuit case, Wilson v. United States, 372 F.2d 232 (3rd Cir. 1963) to support this proposition. However, under the Pennsylvania law applicable in Wilson, no part of the spendthrift trust in question could have been seized for the payment of the debts of the deceased. In the instant case, the value of the trust has been reduced by the EPA liability.

4. **Post-Death Events.** The IRS has non-acquiesced in Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999), rev'g, 108 T.C. 412 (1997). The IRS notice states:

Decedent died on November 16, 1990. At her death, Exxon had a claim against the estate that was being adjudicated in a United States District Court. In February 1991, the court ruled in favor of Exxon and referred the case to a Special Master to determine the amount of the liability. In April 1991, Exxon presented to the estate its \$2,482,719 damages calculation. The executors deducted that amount on the estate tax return, which was filed in July 1991. On February 10, 1992, the estate settled the claim for \$681,840 and paid this amount on or about March 10, 1992. The Commissioner determined that the estate was only entitled to a deduction for the amount actually paid, and the estate filed a petition in the United States Tax Court.

The Tax Court upheld the Commissioner's determination that the claim against the estate should be limited to the amount actually paid. The Tax Court held that, "[w]here a claim is disputed, contingent, or uncertain as of the date of the decedent's death, the estate is not entitled to a deduction until the claim is resolved and it is determined what amount, if any, will be paid. It is this latter amount that is allowed as a deduction." 108 T.C. at 419.

The United States Court of Appeals for the Fifth Circuit reversed, holding that the amount deductible was the fair market value of the claim on the date of death, rather than the amount paid to settle the claim as argued by the government, or the full amount of the claim as argued by the estate. The Fifth Circuit relied on the decision in *Ithaca Trust v. United States*, 279 U.S. 151, 155 (1929). In that case, the Supreme Court concluded that a post-death event (the premature death of the life tenant of a charitable remainder trust) should not be taken into account in determining the amount of the charitable deduction allowable under the predecessor to section 2055. The Fifth Circuit remanded the case to the Tax Court to determine the value of the claim at the date of death with the instruction that the court was "neither to admit nor consider evidence of post-death occurrences when determining the date-of-death value of Exxon's claim." 198 F.3d at 526.

* * *

We disagree with the Fifth Circuit's reasoning and conclusion. Because the section 2055 deduction involves different concerns, we do not believe that *Ithaca Trust* precludes consideration of post-death events in determining the amount deductible under section 2053 for claims against the estate. The Fifth Circuit's reliance on *Propstra v. United States*, 680 F.2d 1248, (9th Cir. 1982), and *Estate of Van Horne v. Commissioner*, 720 F.2d 1114 (9th Cir. 1983), aff'g, 78 T.C. 728, 734 (1982), cert. denied, 466 U.S. 980 (1984) was also misplaced. *Propstra* and *Van Horne* involved claims that were certain and enforceable at death, and in both cases, the Ninth Circuit limited its holding to "certain and enforceable" claims, noting that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims." *Propstra*, 680 F.2d at 1253.

Every court, except the Fifth Circuit, that has addressed the section 2053(a)(3) issue where the claim is contested, contingent, or unenforceable on the date of death, has considered post-death events in determining the allowable deduction. *Gowetz v. Commissioner*, 320 F.2d 874 (1st Cir. 1963), aff'g sub nom., *Taylor v. Commissioner*, 39 T.C. 371 (1962); *Estate of Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir.), cert. denied, 280 U.S. 603 (1929); *Estate of Courtney v. Commissioner*, 62 T.C. 317 (1974); *Estate of Cafaro v. Commissioner*, T.C. Memo. 1989-348. See also *Estate of Van Horne*, 720 F.2d 1114 and *Propstra*, 680 F.2d 1248. But cf., *Commissioner v. Strauss*, 77 F.2d 401 (7th Cir. 1935).

M. SECTIONS 2056 AND 2056A - MARITAL DEDUCTION

1. 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.

The facts in Richard Salyer, et al. v. United States, 84 AFTR2d Par. 99-5477, No. 98-6243 (November 4, 1999), decided by the Sixth Circuit on appeal from the Eastern District of Kentucky, were interesting. Life insurance was paid to an irrevocable trust that did not qualify for the marital deduction, but which was included in the gross estate of the decedent because it was transferred to the trust within 3 years of the decedent's death. The decedent's revocable trust contained the following funding clause:

3.01.a. Share Number One shall be an amount equal to the maximum value of gross estate which when subjected to the federal Estate Tax will result in no tax liability for the year in which Donor's death occurs. The maximum value of the total gross estate which will not result in a federal Estate Tax may be determined by reference to IRC Section 2010, which provides the amount of the unified credit, and to IRC Section 6018, which describes the maximum gross estate which may exist before a federal Estate Tax return is required to be filed. This amount is also known as the "Exemption Equivalent" and currently equals \$600,000.00. The amount so set apart shall be a pecuniary amount and shall not participate in any appreciation or depreciation in the value of Donor's estate during the administration thereof. To the extent other property is available, this share shall not be reduced by the payment of debts, taxes and administrative expenses applicable to and payable from, or by, Donor's estate.

3.01.b. Share Number Two shall be an amount equal to the remaining assets of Donor's estate, which may also be referred to as the rest residue and remainder of the assets in the hands of my Executor/Trustee. However, this subsection shall not be applicable to any property which passes to or becomes a part of Share Number Three pursuant to a disclaimer or renunciation.

3.01.c. Share Number Three shall be those assets for which a proper disclaimer or renunciation has been executed pursuant to Kentucky law and/or the Internal Revenue Code.

The court agreed with the IRS that the insurance plus the exemption equivalent was taxable. The planning point is clear: have the insurance paid to a marital trust if it is included in the estate.

2. **OTIP Regulations: Effect of Estate Expenses.** Proposed regulations on the effect of administration expenses on the marital deduction were issued, REG-114663-97 (December 15, 1998), and final regulations were issued in T.D. 8846 (December 2, 1999). The regulations distinguish 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 final regulations are substantially like the proposed regulations with one notable exception:

Many of the comments concerned the special rule of section 20.2056(b)-4(e)(2)(ii) of the proposed regulations. Under the special rule, the value of the deductible property interest is not increased as a result of the decrease in the federal estate tax liability that is attributable to the deduction of estate management expenses as expenses of administration under section 2053 on the federal estate tax return. A similar rule would have applied for purposes of the estate tax charitable deduction.

Several of these commentators argued that the special rule is inconsistent with sections 2056(a) and 2055(c), because the value of the property passing to the surviving spouse or charity should be reduced only by the estate taxes actually paid. Thus, an estate should be permitted the full benefit of deducting management expenses on the federal estate tax return, including an increase to the marital or charitable deduction based on the resultant decrease in tax payable

from the marital or charitable share.

Conversely, other commentators asserted that the special rule does not conform with section 2056(b)(9). Section 2056(b)(9) provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent. These commentators pointed out that if estate management expenses paid from the marital or charitable share are deducted on the federal estate tax return, and no reduction is made to the allowable amount of the marital or charitable deduction, then the same property interest is deducted twice in violation of section 2056(b)(9).

After considering these comments, the Treasury and the IRS have eliminated the special rule of the proposed regulations. The final regulations provide that estate management expenses attributable to, and payable from, the property interest passing to the surviving spouse or charity do not reduce the value of the property interest. However, pursuant to section 2056(b)(9), the allowable amount of the marital or charitable deduction is reduced by the amount of these management expenses if they are deducted on the Federal estate tax return.

The regulations provide as follows:

(d) Effect of administration expenses -- (1) Definitions -- (i) Management expenses. Estate management expenses are expenses that are incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration. Examples of these expenses could include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

(ii) Transmission expenses. Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense. Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees 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.

(iii) Marital share. The marital share is the property or interest in property that passed from the decedent for which a deduction is allowable under section 2056(a). The marital share includes the income produced by the property or interest in property during the period of administration if the income, under the terms of the governing instrument or applicable local law, is payable to the surviving spouse or is to be added to the principal of the property interest passing to, or for the benefit of, the surviving spouse.

(2) Effect of transmission expenses. For purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate transmission expenses paid from the marital share.

(3) Effect of management expenses attributable to the marital share. For purposes of determining the marital deduction, the value of the marital share shall not be reduced by the amount of the estate management expenses attributable to and paid from the marital share. Pursuant to section 2056(b)(9), however, the amount of the allowable marital deduction shall be reduced by the amount of any such management expenses that are deducted under section 2053 on the decedent's Federal estate tax return.

(4) Effect of management expenses not attributable to the marital share. For purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate management expenses paid from the marital share but attributable to a property interest not included in the marital share.

(5) Examples. The following examples illustrate the application of this paragraph (d):

Example 1. The decedent dies after 2006 having made no lifetime gifts. The decedent makes a bequest of shares of ABC Corporation stock to the decedent's child. The bequest provides that the child is to receive the income from the shares from the date of the decedent's death. The value of the bequeathed shares on the decedent's date of death is \$3,000,000. The residue of the estate is bequeathed to a trust for which the executor properly makes an election under section 2056(b)(7) to treat as qualified terminable interest property. The value of the residue on the decedent's date of death, before the payment of administration expenses and Federal and State estate taxes, is \$6,000,000. Under applicable local law, the executor has the discretion to pay administration expenses from the income or principal of the residuary estate. All estate taxes are to be paid from the residue. The State estate tax equals the State death tax credit available under section 2011. During the period of administration, the estate incurs estate transmission expenses of \$400,000, which the executor charges to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the Federal and State estate taxes and by the estate transmission expenses. If the transmission expenses are deducted on the Federal estate tax return, the marital deduction is \$3,500,000 (\$6,000,000 minus \$400,000 transmission expenses and minus \$2,100,000 Federal and State estate taxes). If the transmission expenses are deducted on the estate's Federal income tax return rather than on the estate tax return, the marital deduction is \$3,011,111 (\$6,000,000 minus \$400,000 transmission expenses and minus \$2,588,889 Federal and State estate taxes).

Example 2. The facts are the same as in Example 1, except that, instead of incurring estate transmission expenses, the estate incurs estate management expenses of \$400,000 in connection with the residue property passing for the benefit of the spouse. The executor charges these management expenses to the residue. In determining the value of the residue passing to the spouse for marital deduction purposes, a reduction is made for Federal and State estate taxes payable from the residue but no reduction is made for the estate management expenses. If the management expenses are deducted on the estate's income tax return, the net value of the property passing to the spouse is \$3,900,000 (\$6,000,000 minus \$2,100,000 Federal and State estate taxes). A marital deduction is claimed for that amount, and the taxable estate is \$5,100,000.

Example 3. The facts are the same as in Example 1, except that the estate management expenses of \$400,000 are incurred in connection with the bequest of ABC Corporation stock to the decedent's child. The executor charges these management expenses to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the Federal and State estate taxes and by the management expenses. The management expenses reduce the value of the residue because they are charged to the property passing to the spouse even though they were incurred with respect to stock passing to the child. If the management expenses are deducted on the estate's Federal income tax return, the marital deduction is \$3,011,111 (\$6,000,000 minus \$400,000 management expenses and minus \$2,588,889 Federal and State estate taxes). If the management expenses are deducted on the estate's Federal estate tax return, rather than on the estate's Federal income tax return, the marital deduction is

\$3,500,000 (\$6,000,000 minus \$400,000 management expenses and minus \$2,100,000 in Federal and State estate taxes).

Example 4. The decedent, who dies in 2000, has a gross estate of \$3,000,000. Included in the gross estate are proceeds of \$150,000 from a policy insuring the decedent's life and payable to the decedent's child as beneficiary. The applicable credit amount against the tax was fully consumed by the decedent's lifetime gifts. Applicable State law requires the child to pay any estate taxes attributable to the life insurance policy. Pursuant to the decedent's will, the rest of the decedent's estate passes outright to the surviving spouse. During the period of administration, the estate incurs estate management expenses of \$150,000 in connection with the property passing to the spouse. The value of the property passing to the spouse is \$2,850,000 (\$3,000,000 less the insurance proceeds of \$150,000 passing to the child). For purposes of determining the marital deduction, if the management expenses are deducted on the estate's income tax return, the marital deduction is \$2,850,000 (\$3,000,000 less \$150,000) and there is a resulting taxable estate of \$150,000 (\$3,000,000 less a marital deduction of \$2,850,000). Suppose, instead, the management expenses of \$150,000 are deducted on the estate's estate tax return under section 2053 as expenses of administration. In such a situation, claiming a marital deduction of \$2,850,000 would be taking a deduction for the same \$150,000 in property under both sections 2053 and 2056 and would shield from estate taxes the \$150,000 in insurance proceeds passing to the decedent's child. Therefore, in accordance with section 2056(b)(9), the marital deduction is limited to \$2,700,000, and the resulting taxable estate is \$150,000.

Example 5. The decedent dies after 2006 having made no lifetime gifts. The value of the decedent's residuary estate on the decedent's date of death is \$3,000,000, before the payment of administration expenses and Federal and State estate taxes. The decedent's will provides a formula for dividing the decedent's residuary estate between two trusts to reduce the estate's Federal estate taxes to zero. Under the formula, one trust, for the benefit of the decedent's child, is to be funded with that amount of property equal in value to so much of the applicable exclusion amount under section 2010 that would reduce the estate's Federal estate tax to zero. The other trust, for the benefit of the surviving spouse, satisfies the requirements of section 2056(b)(7) and is to be funded with the remaining property in the estate. The State estate tax equals the State death tax credit available under section 2011. During the period of administration, the estate incurs transmission expenses of \$200,000. The transmission expenses of \$200,000 reduce the value of the residue to \$2,800,000. If the transmission expenses are deducted on the Federal estate tax return, then the formula divides the residue so that the value of the property passing to the child's trust is \$1,000,000 and the value of the property passing to the marital trust is \$1,800,000. The allowable marital deduction is \$1,800,000. The applicable exclusion amount shields from Federal estate tax the entire \$1,000,000 passing to the child's trust so that the amount of Federal and State estate taxes is zero. Alternatively, if the transmission expenses are deducted on the estate's Federal income tax return, the formula divides the residue so that the value of the property passing to the child's trust is \$800,000 and the value of the property passing to the marital trust is \$2,000,000. The allowable marital deduction remains \$1,800,000. The applicable exclusion amount shields from Federal estate tax the entire \$800,000 passing to the child's trust and \$200,000 of the \$2,000,000 passing to the marital trust so that the amount of Federal and State estate taxes remains zero.

Example 6. The facts are the same as in Example 5, except that the decedent's will provides that the child's trust is to be funded with that amount of property

equal in value to the applicable exclusion amount under section 2010 allowable to the decedent's estate. The residue of the estate, after the payment of any debts, expenses, and Federal and State estate taxes, is to pass to the marital trust. The applicable exclusion amount in this case is \$1,000,000, so the value of the property passing to the child's trust is \$1,000,000. After deducting the \$200,000 of transmission expenses, the residue of the estate is \$1,800,000 less any estate taxes. If the transmission expenses are deducted on the Federal estate tax return, the allowable marital deduction is \$1,800,000, the taxable estate is zero, and the Federal and State estate taxes are zero. Alternatively, if the transmission expenses are deducted on the estate's Federal income tax return, the net value of the property passing to the spouse is \$1,657,874 (\$1,800,000 minus \$142,106 estate taxes). A marital deduction is claimed for that amount, the taxable estate is \$1,342,106, and the Federal and State estate taxes total \$142,106.

Example 7. The decedent, who dies in 2000, makes an outright pecuniary bequest of \$3,000,000 to the decedent's surviving spouse, and the residue of the estate, after the payment of all debts, expenses, and Federal and State estate taxes, passes to the decedent's child. Under the terms of the applicable local law, a beneficiary of a pecuniary bequest is not entitled to any income on the bequest. During the period of administration, the estate pays estate transmission expenses from the income earned by the property that will be distributed to the surviving spouse in satisfaction of the pecuniary bequest. The income earned on this property is not part of the marital share. Therefore, the allowable marital deduction is \$3,000,000, unreduced by the amount of the estate transmission expenses.

The effective date is for decedents dying after December 3, 1999.

3. **Savings Clause.** The IRS determined in 199932001 that a general marital deduction savings clause "trumped" a provision cutting off distributions to the surviving spouse if such distributions would make the spouse ineligible for government benefits. The Service noted that a savings clause is not decisive but is helpful in ascertaining a decedent's intent. Here, the spouses's rights were described as follows:

My Trustees shall pay the entire net income therefrom to my wife [Spouse] for so long as she lives, in quarter annual or more frequent intervals as my Trustees determine in their absolute discretion. In addition, my Trustees may pay to or apply for the benefit of my wife, for so long as she lives, so much (even to the extent of the whole) of the principal of this trust as my Trustees shall deem advisable, in their sole and absolute discretion. However, any authorization, direction, or other provision contained in this trust which would prevent my wife from being eligible for or result in the loss of government benefits or assistance shall be void to the extent that such authorization, direction or other provision would have such adverse result. I intend that the trust assets be used to supplement, not supplant, impair or diminish, any benefits or assistance of any federal, state, county, city, or other governmental entity for which my wife may otherwise be eligible or which my wife may be receiving.

4. **Minority Interest Passing to Spouse.** Problems arise when a decedent owns a majority interest in a closely-held business at death but a minority interest passes to the surviving spouse. Such were the facts in Estate of Frank M. DiSanto, et al. v. Commissioner, T.C. Memo. 1999-421. The decedent owned 53.5% of Morganton Dyeing & Finishing Corp. The decedent's wife disclaimed a portion of the stock with the result that she received a minority interest. The court found that a share was worth \$23.50 per share as a majority interest and \$13.00 per share as a minority interest. The opinion states:

Petitioners contend that we must base the marital deduction on the value of Mr.

DiSanto's controlling interest in MD&F stock. We disagree. An estate may deduct "an amount equal to the value of * * * property which passes or has passed from the decedent to his surviving spouse". Sec. 2056(a). The value of the marital deduction for a devised interest in stock of a closely held corporation equals the value of the interest that passes to the surviving spouse. See sec. 2056(b)(4); sec. 20.2056(b)-4(a), Estate Tax Regs.; Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1588- 1589 (1987). Thus, the marital deduction for Mr. DiSanto's estate is based on the value of the interest that passed from Mr. DiSanto's estate to Mrs. DiSanto.

Mrs. DiSanto's disclaimer reduced the value of her interest in Mr. DiSanto's estate, and reduced the amount of the marital deduction for Mr. DiSanto's estate. See sec. 2518(a). We have decided that the fair market value of each share of MD&F stock that Mrs. DiSanto was entitled to receive from Mr. DiSanto's estate after she made the disclaimer was \$13 per share when she died. See paragraph B-3, above. Mr. DiSanto's estate may claim a marital deduction based on that per share stock value.

Petitioners contend that we should disregard Mrs. DiSanto's disclaimer in deciding the amount of the marital deduction for Mr. DiSanto's estate just as we disregard postdeath fluctuations in the values of assets in estates in deciding marital deduction amounts. We disagree. Petitioners cite Rev. Rul. 90-3, 1990-1 C.B. 174. In Rev. Rul. 90-3, 1990-1 C.B. 174, respondent ruled that the value of a residuary bequest to a surviving spouse does not change even if the value of estate assets fluctuates after the decedent dies. Mrs. DiSanto's disclaimer of \$1,325,000 worth of Mr. DiSanto's MD&F stock is not a postdeath fluctuation in the value of his stock. Thus, Rev. Rul. 90-3, 1990-1 C.B. 174, does not apply here.

Petitioners contend that, if a surviving spouse executes a disclaimer, the marital deduction is merely reduced by the disclaimed amount, citing Estate of Nix v. Commissioner, T.C. Memo. 1996-109. We disagree. In Estate of Nix, we held that the disclaimer reduced the surviving spouse's interest in the decedent's estate by the value of disclaimed property. Unlike the facts in Estate of Nix, here the qualified disclaimer reduces Mrs. DiSanto's interest in Mr. DiSanto's stock in MD&F from a controlling interest to a minority interest.

Petitioners cite Estate of Jameson v. Commissioner, T.C. Memo. 1999-43, for the proposition that respondent may not use one value for including the MD&F stock in Mr. DiSanto's estate and a lower value for calculating the marital deduction. We disagree. The decedent in Estate of Jameson bequeathed an amount to his children and the residuary to his wife. We held that his estate may not use a lower per share value of closely held stock to increase the number of shares to compute the bequest to his children and a higher per share value of the same stock to compute the marital deduction. Estate of Jameson v. Commissioner, supra, is distinguishable because the decedent's wife did not disclaim part of her interest as Mrs. DiSanto did here.

The disclaimer was apparently entered into because Mrs. DiSanto was in ill health and it was thought desirable for her to be in a minority position. The opinion does not discuss the application of the tax clause. Where should the estate tax due on the gap between the estate value and the marital deduction value fall? In general, state law may "protect" a marital bequest from paying tax if the bequest generates no tax but such is not the case here. If it is not protected, the marital deduction would be reduced further.

5. **Nonqualified Disclaimer of QTIP Income Interest.** PLR 200022031 involves interesting facts. Spouse died leaving assets in a QTIP trust with remainder in part to a private foundation and in part to charitable remainder trusts, one for each of three children. Taxpayer -- the surviving spouse -- proposed to execute a

nonqualified disclaimer of his interest in the QTIP trust, with any gift tax being paid by the recipients of the disclaimed property as provided in section 2207A. The ruling states:

In the present case, because Taxpayer's disclaimer is not a qualified disclaimer under section 2518, Taxpayer's relinquishment of the income interest is a gift by Taxpayer of the value of that interest under section 2511. Under section 2502(c), the payment of the tax is the liability of the Taxpayer. However, a condition of the Taxpayer's transfer is the agreement that the gift tax will be paid by the trustees of the Trust. Consequently, under section 2512(b), the value of the gift of Taxpayer's income interest is measured by the fair market value of the income interest minus the amount of gift tax to be paid.

In addition, Taxpayer's relinquishment of his income interest constitutes a disposition of Taxpayer's income interest under section 2519. The amount of the gift made by the Taxpayer under section 2519 will be the value of the corpus of Trust less the value of Taxpayer's qualifying income interest, reduced by the amount of the gift tax paid by the person receiving the property under section 2207A.

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

1. **Gift Tax Disclosure Regulations.** REG. 106177-98 set forth proposed regulations relating to the gift tax statute of limitations which became final regulations in T.D. 8845 (December 2, 1999). The 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. With respect to the finality issue, the explanation to the regulations states:

Under the proposed regulations, if a transfer is adequately disclosed on the gift tax return, and the period for assessment of gift tax has expired, then the IRS is foreclosed from adjusting the value of the gift under section 2504(c) (for purposes of determining the current gift tax liability) and under section 2001(f) (for purposes of determining the estate tax liability). However, the IRS is not precluded from making adjustments involving legal issues, even if the gift was adequately disclosed. This position was based on longstanding regulations applying section 2504(c) and relevant case law.

Comments suggested that this rule is contrary to Congressional intent in enacting section 2001(f) and amending section 2504(c) to provide a greater degree of finality with respect to the gift and estate tax statutory scheme. In response to these comments, the final regulations preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift.

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)(2) if the return (or a statement attached to the return) provides the following information --

- (i) A description of the transferred property and any consideration received by the transferor;
- (ii) The identity of, and relationship between, the transferor and each transferee;
- (iii) If the property is transferred in trust, the trust's tax identification number

and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

(iv) Except as provided in section 301.6501-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, 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 a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph (f)(2)(iv). In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided 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 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. 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)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest; and

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer (see section 601.601(d)(2) of this chapter).

Appraisals will satisfy these rules in certain circumstances:

Submission of appraisals in lieu of the information required under paragraph (f)(2)(iv) of this section. The requirements of paragraph (f)(2)(iv) of this section will be satisfied if the donor submits an appraisal of the transferred property that meets the following requirements --

(i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:

(A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

(B) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.

(C) The appraiser is not the donor or the donee of the property or a member of

the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

(ii) The appraisal contains all of the following:

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Transactions that are non-gifts were handled in the following way, after much criticism of the proposed regulations:

Under the proposed regulations, a completed transfer that did not constitute a gift would be considered adequately disclosed if the taxpayer submitted the information required for adequate disclosure and an explanation describing why the transfer was not subject to the gift tax. One commentator suggested that the adequate disclosure requirement should be waived if the taxpayer reasonably, in good faith, believes the transfer is not a gift (for example, a salary payment made to a child employed in a family business). Another commentator noted that the standard for adequate disclosure is higher for a "non-gift" than it is for a gift transaction since, in the non-gift situation, the donor must provide all the information required by the regulation and a statement why the transaction is not a gift. Another comment requested more guidance for reporting non-gift business transactions. In response to the comments, the final regulations limit the information required in a non-gift situation. In addition, the final regulations provide that completed transfers to members of the transferor's family (as defined in section 2032A(e)(2)) in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax return, if the item is properly reported by all parties for income tax purposes. For example, in the case of a salary payment made to a child of the donor employed in the donor's business, the transaction will be treated as adequately disclosed for gift tax purposes if the salary payment is properly reported by the business and the child on their income tax returns. This exception only applies to transactions conducted in the ordinary course of operating a business. It does not apply, for example, in the case of a sale of property (including a business) by a parent to a child.

Another major issue that arose in response to the proposed regulations was the effective date of the

regulations. The explanation states:

One comment requested clarification of the effective date of section 6501(c)(9), as amended. The Taxpayer Relief Act of 1997 provides that the amendments to section 6501(c)(9) (commencing the running of the period of limitations only if the gift is adequately disclosed) apply to gifts made in calendar years ending after August 5, 1997 (that is, all gifts made in calendar year 1997 and thereafter). However, the underlying legislative history indicates that the amendment to section 6501(c)(9) applies "to gifts made in calendar years after the date of enactment [August 5, 1997]". H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 408 (1997). Notwithstanding this statement in the legislative history, the statutory language is clear that the section as amended applies to all gifts made during the 1997 calendar year, and thereafter. In the final regulations, the statutory effective date language is restated in a manner that makes it clear that section 6501(c)(9) as amended applies to all gifts made after December 31, 1996.

Another comment suggested clarification of the application of the adequate disclosure rules and the interaction between sections 2504(c) and 6501(c)(9) with respect to gifts made between January 1, 1997, and August 6, 1997, since section 2504(c) as amended applies only to gifts made after August 5, 1997, but section 6501(c)(9) as amended applies to all gifts made in 1997. In response to this comment, an example has been added under section 25.2504-2(c) involving a situation where a gift is made prior to August 6, 1997, that is not adequately disclosed on the return filed for 1997. The example clarifies that the period for assessment with respect to the pre-August 6, 1997 gift does not commence to run because the gift is not adequately disclosed. Accordingly, a gift tax may be assessed with respect to the gift at any time, and notwithstanding the effective date for section 2504(c), that 1997 gift can be adjusted as a part of prior taxable gifts in determining subsequent gift tax liability. Further, the 1997 gift can be adjusted as part of taxable gifts under section 2001 in determining estate tax liability.

Finally, in response to another comment, an example has been added illustrating the application of the effective date rules in a similar fact pattern, where the gifts are made in a calendar year prior to 1997. The example illustrates that the IRS may not revalue the gifts, for purposes of determining prior taxable gifts for gift tax purposes, if a gift tax was paid and assessed with respect to the calendar year, and the period for assessment has expired. Since the gifts were made prior to 1997, the rules of section 2504(c) and section 6501 prior to amendment apply. However, the IRS may adjust the gifts for purposes of determining adjusted taxable gifts for estate tax purposes.

2. **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.'" The Seventh Circuit affirmed, at 85 AFTR2d ¶ 2000-690. 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).

3. **Prepaid Tuition Payments.** In TAM 199941013 the National Office dealt with whether prepaid tuition payments by a decedent on behalf of two grandchildren to an educational institution would be qualified

transfers under section 2503(e). The transfers were made beginning in 1994 and continuing through 1996 and were intended to fund tuition through the year 2004. The ruling notes that the payments were not subject to refund and would be forfeited if the decedent's grandchildren ceased to attend the school and thus the payments could only be described as being made directly to an educational organization to be used exclusively for the payment as specified tuition costs for designated individuals. By contrast, Example 2 of Treas. Reg. §25.2503-6(c) determined that the unlimited exclusion under §2503(e) would not apply where a donor transferred assets to a trust which required the trustee to use the trust funds to pay tuition expenses for the donor's grandchildren. The transfers must be to the educational institution itself.

4. **Stock Options.** PLR 199927002 provides as follows:

In the present case, Taxpayer proposes to transfer options that he received as an employee of Company, to one or more of his children, or to a trust for the benefit of one or more of his children. The exercise of the options will not be conditioned on continued future employment of Taxpayer at the time of transfer. The transferees may exercise the options and purchase the stock at their discretion after the price appreciation thresholds have been met.

After the transfers to the individuals or the trust, Taxpayer will retain no interest or reversion in the options or the stock upon exercise and has no right to alter, amend, or revoke the transfer of the options or stock. In addition, Taxpayer holds no general power of appointment over the options or the stock.

Based on the information submitted, we rule as follows:

1. The transfer of the stock options to the transferee will not cause the recognition of taxable income or gain to Taxpayer
2. If the transferee subsequently exercises the stock options, Taxpayer (or, if Taxpayer is not then living, Taxpayer's estate) will be deemed to receive taxable compensation under section 83 of the Code, and Company will receive a corresponding deduction under section 162 of the Code.
3. If the transferee exercises the stock options, the transferee's basis in the stock so acquired will be its fair market value on the date of exercise which consists of the consideration paid by the transferee and income taxed to Taxpayer (or Taxpayer's estate) under section 83 of the Code.
4. Taxpayer's transfers of his Plan A options and Plan B options to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511 of the Code, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gift incomplete.
5. he proposed transfers of the stock options granted under Plan A and Plan B from Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children will not be subject to sections 2701 and 2703 of the Code.
6. After the transfer of the options by Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children, neither the options nor the shares obtained upon the exercise of the options will be includable in Taxpayer's gross estate.

PLR 199952012 dealt with the transfer of vested stock options. Rev. Rul. 98-21, 1998-18 IRB 7, provides that a complete gift cannot be made of options that are conditioned on the performance of future services. The

ruling states:

Because the option cannot be exercised if A fails to perform the services, Rev. Rul. 98-21 provides that, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B, one of A's children, for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. Rev. Rul. 98-21 concludes that the transfer of a nonstatutory stock option by A, the optionee, to B, a family member, for no consideration is a completed gift under section 2511 on the later of (i) the date of the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.

The ruling distinguished these, vested, options:

In the present case, Taxpayer, an employee of Company, holds options to purchase Company common stock under both Plan A and Plan B. Taxpayer is under age fifty and has been employed by Company for less than thirteen years. At the time of this ruling, the options received under Plan A met all of the price appreciation thresholds required by Plan A; however, only a portion of the options received under Plan A satisfied the holding period requirements for vesting. Further, at the time of this ruling, the options received under Plan B had not met all of the price appreciation thresholds required by Plan B, and only a portion of the option received under Plan B satisfied the holding period requirements for vesting.

Although all of the stock price appreciation requirements for the option issued to Taxpayer under Plan A have been met, the option owned by Taxpayer under Plan A is not completely vested. Further, the option owned by Taxpayer under Plan B has not met all of the stock appreciation thresholds, nor is the option owned by Taxpayer under Plan B completely vested. Taxpayer proposes to transfer only the portions of the options granted under Plan A and Plan B that are both vested and exercisable. After the proposed transfers, Taxpayer will have no power or right to determine when the transferred portion of the option is exercised. Because Taxpayer proposes to transfer only portions of the Plan A and Plan B options that are vested and exercisable, we conclude that his proposed transfers of the portions of his Plan A and Plan B options that are vested and exercisable to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gifts incomplete.

The relevance of the "price appreciation requirements" being met or unmet is unclear. The issue was not part of Rev. Rul. 98-21.

Section 83 governs the income taxation of the options:

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, the excess of (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having a beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if

any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Pursuant to section 83(h) of the Code, there is allowed a deduction under section 162 of the Code, to the person for whom were performed the services in connection with which the property was transferred, an amount equal to the amount included under section 83 in the gross income of the person who performed the services. The deduction will be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed the services. Section 1.83-6(a)(3) of the Income Tax Regulations provides an exception to the rule of section 83(h) concerning what taxable year the service recipient is allowed the deduction. There, it is provided that, if property is substantially vested upon transfer, the deduction will be allowed in accordance with the service recipient's method of accounting.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value at the time the option is granted. If section 83(a) does not apply to the grant of the option because it does not have a readily ascertainable fair market value at the time of the grant, section 83 will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under section 83(a). If the option is sold or otherwise disposed of in an arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as section 83 would apply to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the tests to be applied in determining whether an option has a readily ascertainable fair market value.

Section 1.83-4(b) of the regulations provides in part that, if property to which section 83 applies is acquired by any person (including a person who acquires such property in a subsequent transfer which is not at arm's length), while such property is still substantially nonvested, such person's basis in the property should reflect any amount paid for the property and any amount includible in the gross income of the person who performed the services.

Here, Section 83 will not apply until the options are exercised. The ruling holds:

1. The transfer of the stock options to the transferee will not cause the recognition of taxable income or gain to Taxpayer.
2. If the transferee subsequently exercises the stock options, Taxpayer (or, if Taxpayer is not then living, Taxpayer's estate) will be deemed to receive taxable compensation under section 83 of the Code, and Company will receive a corresponding deduction under section 162 of the Code.
3. If the transferee exercises the stock options, the transferee's basis in the stock so acquired will be its fair market value on the date of exercise which consists of

the consideration paid by the transferee and income taxed to Taxpayer (or Taxpayer's estate) under section 83 of the Code.

The Service also determined that sections 2701 and 2703 would not apply to the options and the decedent would have no retained interests.

5. **Reciprocal Gifts.** Gifts by siblings to their own children and their nieces and nephews were collapsed by the Tax Court in Larry L. Sather, et al. v. Commissioner, T.C. Memo. 1999-309. The court found that the inclusion of a childless sibling in the scheme did not save it from the reciprocal trust doctrine. The court stated:

Section 2501(a) imposes a tax "on the transfer of property by gift", and section 2511(a) provides that "the tax imposed by section 2501 shall apply * * * whether the gift is direct or indirect". Section 2503(b) excludes from the definition of "taxable gifts" the first \$10,000 of gifts to any person during the year. The simultaneous, circuitous transfers of identical property to the various nieces and nephews constitute gifts by the transferors to their own children. See, e.g., Furst v. Commissioner, T.C. Memo. 1962-221. Petitioners' attempt to manufacture exclusions under a taxing statute that reaches both direct and indirect gifts is unavailing.

We are led to the inescapable conclusion that the form in which the transfers were cast, i.e., gifts to the nieces and nephews, had no purpose aside from the tax benefits petitioners sought by way of inflating their exclusion amounts. The substance and purpose of the series of transfers was for each married couple to give to their own children their Sathers stock. After the transfers, each child was left in the same economic position as he or she would have been in had the parents given the stock directly to him or her. Each niece and nephew received an identical amount of stock from his or her aunts and uncles and was left in the same economic position in relation to the others. This was not a coincidence but rather was the result of a plan among the donors to give gifts to their own children in a form that would avoid taxes. We hold the number of exclusions under section 2503 is limited by the number of children in each petitioner's family.

Our conclusion is supported by the doctrine of economic substance as embodied in the reciprocal trust doctrine. In United States v. Estate of Grace, 395 U.S. 316 (1969), the decedent created a trust for the benefit of his wife and, at the same time, his wife created a trust of equal value for his benefit. The trusts had identical terms granting the other spouse a life estate with the remainder to their children. The Supreme Court applied the reciprocal trust doctrine which requires that where two settlors simultaneously create trusts with the same provisions and with similar property for the benefit of each other, each settlor will be considered the creator of the trust that is in form created by the other. See *id.* The Supreme Court clarified that subjective intent of the settlors is irrelevant and held the doctrine applies if the two trusts: (1) Are interrelated, and (2) leave the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as beneficiaries. See *id.*; Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977).

This Court and other courts have applied the principles of the reciprocal trust doctrine to gift tax cases under facts similar to those of this case, see, e.g., Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Furst v. Commissioner, *supra*, and we apply those principles herein. The gifts to the nieces and nephews are interrelated. They are identical in type and amount and were executed at the same time. Indeed, the gifts were all part of a plan designed and carried out by petitioners as a group. It is clear that the purpose of the plan was for each married couple to benefit their own children. It is also clear that the gifts in trust

left each beneficiary (the nieces and nephews), to the extent of mutual value, in the same position as they would have been in had their parents given the property directly to them. In relation to one another, the nieces and nephews all were left in the same economic position. The fact that petitioners routed the gifts to their own children through their nieces and nephews is immaterial, and we ignore that routing for tax purposes. We sustain respondent's determinations of gift tax for 1993 relating to Larry, Kathy, John, and Sandra. For the same reasons, we also agree with respondent that Kathy, Sandra, and Diane are each entitled to only three exclusion amounts under section 2503 on their respective gift tax returns for 1992.

Petitioners argue that the entire series of transactions should be respected for tax purposes because Rodney gave property on the same dates in 1992 and 1993, and he received nothing in return. Petitioners argue that application of the step-transaction doctrine mandates this result. That doctrine requires that interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. See *Commissioner v. Clark*, 489 U.S. 726, 738 (1989). When the step-transaction doctrine is applied, separate steps of a transaction are collapsed into one taxable event if the steps of the series are really prearranged parts of a single transaction. See *id.*; *Penrod v. Commissioner*, 88 T.C. 1415, 1429 (1987). As we understand it, petitioners' argument is that all transfers by Larry, Kathy, John, Sandra, Duane, Diane, and Rodney, in each year, were really separate steps of a single transaction. Therefore, petitioners argue, the transaction must be viewed and taxed as a "whole", and Rodney's participation destroys the reciprocal nature of the entire transaction because he received nothing in return for his gifts.

To the extent petitioners suggest that Rodney's unilateral gift giving somehow validates the entire transaction and destroys the reciprocal nature of the gifts, we disagree. Rodney is a separate taxpayer whose gifts have not been challenged. That his gifts may have passed scrutiny does not dictate the result as to the other taxpayers. Rodney's participation in the gift giving in no way lends economic reality to the form in which the other donors structured the transfers, and his participation does not immunize the questioned transfers from application of the doctrine of economic substance or the reciprocal trust doctrine.

6. **Use of Unified Credit.** TAM 199930002 deals with simple, but interesting, facts:

Taxpayer died on Date. During Taxpayer's lifetime, Taxpayer made gifts in Year 2 of Amount 1 that were reported on a timely filed gift tax return. No gift tax was due after application of the unified credit under section 2505. The transfers in Year 2 utilized almost the entire amount of the unified credit available to Taxpayer. The statute of limitations for assessment of tax on the Year 2 gifts has expired. During the course of the estate tax examination, it was discovered that in Year 1, Taxpayer entered into a transaction with his children pursuant to which Taxpayer purportedly sold real estate valued at Amount 2 to his children for adequate consideration in money or money's worth. No gift tax return was filed reporting the transaction in Year 1. It is contended that this transaction is properly characterized as a gift subject to gift tax in Year 1. See, *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2d Cir. 1993); Rev. Rul. 77-299, 1977-2 C.B. 343. Taxpayer has not agreed with this characterization.

The Service determined:

In the instant case, under the statutory scheme, Taxpayer is not entitled to a total unified credit for lifetime transfers in excess of the amount provided by section 2505. Provided it is determined, either by a court or as a result of the

administrative process, that the Year 1 transaction constituted a gift subject to gift tax in Year 1, /1/ Taxpayer was obligated to report the gift and to utilize the unified credit in Year 1. By claiming the unified credit with respect to the Year 2 gifts, Taxpayer represented that Taxpayer had not made any prior gifts and that Taxpayer still had his entire unified credit available. The Service relied on this representation in allowing the use of the unified credit for the Year 2 gifts, with respect to which the statute of limitations has now expired. In allowing the application of the unified credit in Year 2, the Commissioner was not provided with any facts or information by Taxpayer that would disclose the Year 1 transaction. The Commissioner may rely on the correctness of a return or report by Taxpayer that is given to the Commissioner under penalty of perjury. Assuming that it is determined, by a court or otherwise, that Taxpayer made a gift in Year 1, the determination would constitute a contrary representation regarding the Year 2 transaction. Taxpayer is precluded from contradicting the previous representation and it is not necessary that there be a finding of intentional misrepresentation by Taxpayer. Accordingly, Taxpayer would be estopped from now arguing that Taxpayer has available the entire unified credit allowable for application against the Year 1 gift tax liability. Any other result would conflict with the clear statutory intent of section 2505(a), limiting to \$192,800, the total available unified credit that can be claimed with respect to lifetime transfers.

7. **Gift of Estate Income.** The failure to require payment of income may be a gift. In Estate of Ona E. Hendrickson v. Commissioner, T.C. Memo. 1999-357, the estate of the decedent's deceased husband received about \$2 million in investment income from the period 1979 to 1993 of which the decedent, Ona Hendrickson, was entitled to approximately \$913,000. The decedent never took the income. The Estate argued that the income was used to maintain the farm, but the Tax Court determined that the needs of the farm did not exceed approximately \$239,000 and the decedent's spouse's share of that expense would have been not more than \$120,000. That result was a significant gift by the decedent's spouse.

8. **Excess Trustee Fees as Gifts.** In TAM 200014004 the IRS assumed that trustee fees paid in a QTIP trust to a widow's children were excessive under sections 162 and 212. The issue was whether the fees were, therefore, gifts from the widow to the children. The TAM states:

In Estate of Hendrickson v. Commissioner, TCM 1999-357, the surviving spouse was bequeathed a substantial portion of the decedent's estate. The estate was subject to a prolonged period of administration during which the court determined the spouse was entitled to receive approximately \$913,000 in estate income. However, most of this income was diverted to, or expended for the benefit of the other beneficiaries of the estate (the spouse's children.) The court held that the spouse's conduct as personal representative of the estate and her acquiescence in the expenditure of estate income that she was otherwise entitled to receive for the benefit of her children, constituted a gift for gift tax purposes.

In the present case, we believe that the fees, to the extent they were excessive, constitute gifts by Spouse to C and D. The trustees' fees were paid by agreement of Spouse, to her two children, the natural objects of her bounty. There is no evidence of any arm's length bargaining regarding the setting of the fees, and little evidence of a good faith effort to determine the appropriate fee amount, at least on an ongoing basis. The income tax examiner has determined that there is a substantial disparity between the fees paid and that which would constitute a reasonable fee. Thus, there is no indication that the setting of the trustees' fees and the subsequent payment should be viewed as a transaction in the ordinary course of business. Spouse is the income beneficiary of Trust B. As was the case

in Estate of Hendrickson, cited above, Spouse's agreement to, and acquiescence in, the payment of excessive fees effectively diverted to her children trust income she was otherwise entitled to receive. We believe the facts (including the substantial disparity between a reasonable fee and the fees actually paid) support the conclusion that the excessive fees were intended by all the parties involved to facilitate Spouse's estate plan by transferring assets that would otherwise be subject to estate tax in Spouse's gross estate to Spouse's children without the payment of transfer tax.

9. **Redemption for Less Than Fair Market Value Creates a Gift.** The Estate of Mary D. Maggos v. Commissioner, T.C.M. 2000-129, can be read very simply: if a shareholder allows his or her stock to be redeemed for less than fair market value then the shareholder has made a gift to the other shareholders. But the facts are much more interesting.

The decedent owned 56.7% of Pepsi-Cola Alton Bottling, Inc. ("PCAB") which, in 1987, she allowed to be redeemed for a \$3,000,000 note, interest only for 10 years at 8%. As a result the decedent's son, Nikita, owned all of the company. The opinion described the transaction:

Decedent was represented by independent and experienced counsel in the transaction. The redemption transaction was designed to be an "estate freeze". The purpose of an estate freeze, to minimize estate taxes, was explained to decedent by her counsel before the redemption. The redemption price of \$3 million was determined in part because Nikita Maggos' attorney believed they could support such a valuation for gift tax purposes. In part, the price was determined by the amount Nikita Maggos thought he could afford. Decedent and Nikita Maggos did not negotiate the redemption price. Neither Nikita Maggos nor decedent sought a formal valuation of the company prior to the redemption. However, in January 1987, Nikita Maggos' accountants wrote to Robert T. Shircliff & Associates, Inc. (Shircliff & Associates), requesting that Shircliff & Associates review the draft financial results of PCAB to October 31, 1986, so that they could advise Nikita on the value of PCAB. The purpose of obtaining the valuation was for estate planning. Shircliff & Associates were in the business of consulting with Pepsi bottlers and acting as business brokers in the purchase and sale of Pepsi bottling franchises. Shircliff & Associates prepared a preliminary valuation of PCAB's business based in part on a complete valuation of the business that Shircliff & Associates had conducted in 1983 and on the recent draft financial information that had been provided. Shircliff & Associates formed the view that the business as a whole could be sold for between \$9,764,144 and \$13,169,366.

Things changed, as they often do in families:

In 1994, after receiving advice from her daughter, Catherine Adkins, decedent ceased her association with Robert Hite, her attorney of many years, and retained new counsel.

Subsequent to retaining new counsel on May 31, 1994, decedent disinherited her son, Nikita Maggos. Based on advice from new counsel, on August 23, 1994, decedent commenced suit in the U.S. District Court for the District of Hawaii against Nikita Maggos and PCAB (Civil No. 94-00649ACK) (the District Court litigation). On August 17, 1995, decedent commenced suit in the Circuit Court of the First Circuit of Hawaii against Helm, Huber, Ring, Helm & Co., Bezman, and Katten Muchin & Zavis (Civ. No. 95-2973-08). The circuit court litigation was removed to the Federal District Court in Hawaii (Civil No. 95-00784 SPK) and was ultimately consolidated with the District Court litigation. In the District Court litigation, decedent sought both damages and the rescission of the redemption transaction based on a number of claims asserted against Nikita

Maggos and PCAB, including common law fraud, breach of fiduciary duty (against Nikita in his capacity as a fiduciary being the president and a director of PCAB and the decedent's son), and breach of the Illinois Business Corporation Act. Decedent also asserted similar claims, as well as professional malpractice claims, against Helm, Huber, Ring, Helm & Co. (her former accountants), Bezman, and Katten Muchin & Zavis (Nikita's, and PCAB's attorneys)

Petitioner's attorneys requested Coopers & Lybrand to determine the fair market value of a 100-percent and a 56.7-percent interest in PCAB. Coopers and Lybrand prepared an expert report for the District Court litigation in support of petitioner's contention that decedent had been defrauded by Nikita Maggos. Coopers & Lybrand concluded that on May 1, 1987, a 100-percent interest in PCAB was worth between \$14 million and \$18 million and a 56.7-percent interest was worth between \$7,144,200 and \$9,185,400. That study determined that the appropriate "marketability discount" that should be applied to the value of a 56.7-percent interest was 10 percent. Petitioner filed the Coopers & Lybrand report in the District Court litigation on or about December 10, 1996, in support of decedent's assertion that her interest in PCAB was worth substantially in excess of what she received in the May 1, 1987, redemption. The District Court litigation was settled out of court in early 1998.

Nikita paid \$1,400,000 plus real estate of unstated value to his mother's estate.

The taxpayer's estate argued first that she did not really own the redeemed stock (it had been held in a trust) but the court summarily rejected that argument because she had filed the civil action. The taxpayer next argued she was defrauded, also rejected by the court:

In May 1987, decedent and her son, Nikita Maggos, entered into a transaction designed to minimize estate taxes and achieve decedent's testamentary goals. Both decedent and Nikita Maggos were represented by independent and qualified attorneys in the transaction. Nikita was represented by Mr. Bezman. Decedent's attorney at the time of the redemption transaction was Robert Hite. We found Mr. Hite to be a credible, truthful, and disinterested witness. Mr. Hite testified that the purpose of the transaction was an "estate freeze", a legitimate estate planning technique to move an appreciating asset out of decedent's estate. /16/ He further testified that Nikita Maggos' attorney, Victor Brezman, had planned the transaction. Mr. Hite did not question the redemption price that decedent and her son, Nikita Maggos, had agreed upon because it satisfied decedent's testamentary plan. /17/ Mr. Hite testified that decedent "had promised to leave him [Nikita Maggos] the shares when she died." /18/ The conclusion that the redemption transaction was part of an estate plan is corroborated by the fact that as part of the redemption transaction plan, Nikita Maggos' and PCAB's attorneys contacted decedent's attorney and recommended that decedent should be convinced to make a gift to decedent's daughter in 1987 so that the statute of limitations for assessing gift tax would start to run. We find that decedent and her son entered into the redemption transaction to fulfill decedent's estate planning goals and for no other reasons. Decedent was not concerned with and did not negotiate or authorize her attorney to negotiate for the fair market value of her interest in PCAB. The price received was the price that satisfied decedent's needs while she was alive, was the greatest amount her son believed he could pay, and was the lowest price Nikita's lawyers thought could be defended for gift tax purposes. So long as the transaction could be defended for Federal gift tax purposes, the fair market value of the PCAB shares that were redeemed was not of material concern to decedent.

We further find that decedent, after having received competent independent legal advice, gave a fully informed consent to the redemption transaction as an estate planning technique. On the record before us, given the intended nature of

the redemption transaction, we can find no credible evidence that would support a finding that decedent was defrauded of her interest in PCAB or that there was any breach of fiduciary duty by Nikita Maggos which was owed to decedent, thus entitling decedent to rescind the transaction. We therefore reject petitioner's "incomplete gift argument", and for the same reasons, we also reject petitioner's "bad business bargain" or "unilateral mistake" arguments.

O. **SECTION 2518 - DISCLAIMERS**

1. **Reasonable Time.** In PLR 199934011 the Service allowed a disclaimer in an unusual situation. Father created a trust for the benefit of son, son's descendants, and son's wife. Son died and son's wife became aware of her interest and wanted to disclaim it. The ruling states

As discussed above, section 25.2511-1(c)(2) governs the effectiveness of a disclaimer with respect to an interest created in a "taxable transfer" prior to 1977. In the instant case, under the terms of Trust, Taxpayer was a contingent beneficiary of Trust, in the event she survived Son. Under Jewett and Ordway, the "taxable transfer" creating Taxpayer's interest in Trust occurred on Date 3, when Decedent died. Therefore, section 25.2511-1(c)(2) applied in determining the effectiveness of Taxpayer's disclaimer for federal transfer tax purposes.

As discussed above, under section 25.2511-1(c)(2), the disclaimer will not be subject to the gift tax if it is made within a reasonable time after the disclaimant obtains knowledge of the transfer creating the interest. The question of what constitutes a reasonable time is dependent on federal, rather than state, criteria and is generally dependent on the facts and circumstances presented.

We note that a disclaimer made within nine months of the disclaimant learning of the existence of the transfer creating the interest would generally satisfy the reasonable time requirement of the regulations, in the absence of facts indicating a contrary result is warranted. Accordingly, Taxpayer's disclaimer within nine months of learning of the existence of Trust would be timely for purposes of section 25.2511-1(c)(2). We express or imply no opinion as to when Taxpayer first obtained the requisite knowledge of the transfer creating the interest.

Presumably there would have been a different result for a post 1976 power.

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.

Example 4 of the new proposed GST regulations deals with this issue (see P-7 below) in a slightly different way:

Example 4. Change in trust situs. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2000, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

2. **Effective Date Rule.** The Eighth Circuit has issued a very important opinion in John M. Simpson, et al. v. United States, 84 AFTR2d Par. 99-5089. The facts were simple. Grover Simpson died in 1966 and creates a general power of appointment marital trust. Mary dies in 1993 having exercised the power of appointment in favor of her grandchildren. Does the GST apply to the assets passing to the grandchildren?

The court has no trouble answering the questions -- the GST does not apply:

The parties discuss at some length what the purpose of the special effective-date provision could have been. The effective date of September 25, 1985, is the date on which the staff of the Joint Committee on Internal Revenue Taxation issued a summary of proposals for a revision of the then-existing GST tax. (The tax had first been enacted, in a different form, in 1976.) The premise of such provisions, in general, is that taxpayers, at least those with a lot at stake, follow closely proposals pending in Congress to amend the tax laws. Once the taxpayer has notice of a proposal, it is fair to subject him or her to the tax, even when the tax may be enacted some months or even years later. (Congress has power, within broad limits, to make taxing statutes retroactive, but it frequently chooses not to exercise this power.) So the provision was obviously intended to protect taxpayers who had, before September 25, 1985, taken certain irrevocable action in reliance upon the state of the tax law existing at the time of the action. What is the relevant action in the present case? The government argues that the relevant action was the exercise of the power of appointment by Mrs. Bryan, an exercise which became effective only upon her death, approximately eight years after September 25, 1985. The taxpayer argues, to the contrary, that the relevant action is the date of the creation of the trust, which occurred when Mr. Simpson died in 1966. When Mr. Simpson created the trust, there was no GST tax, and he thus had no reason to anticipate that his wife's exercise of her general testamentary power of appointment would trigger any kind of a tax over and

above the ordinary estate tax consequent upon her possession of a general power, see 26 U.S.C. section 2041.

Which side is right about the purpose of the statute? The issue is easily resolved, we think, by consulting the most important evidence of a statute's purpose -- that is, its words. Recall the relevant clause: "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985." The government wants us to read the words, in effect, as though "which" modified "transfer." This is not a meaning that the words will bear. The antecedent of "which" is "trust," not "transfer." The relevant action which has to take place before September 25, 1985, is the creation of the trust, or rather its becoming irrevocable, not the occurrence of the generation-skipping transfer. We see no escape from the logic of this reasoning. In the present case, the trust became irrevocable before September 25, 1985. The transfer was made possible by the trust. The transfer was "under" the trust. The fact that the transfer occurred after September 25, 1985, and, indeed, that Mrs. Bryan, the transferor, could have avoided the GST tax by giving the property to someone other than her grandchildren, is not relevant. The point is that when the trust was created and became irrevocable Mrs. Bryan was given the authority, under the law as it then existed, to exercise her general power of appointment in favor of anyone at all, and to do so without subjecting the transfer to a GST tax, such a tax then being far in the future. This is the sort of reliance that the effective-date provision protects.

The IRS thought the issue had been addressed previously in E. Norman Peterson Marital Trust v. Commissioner, 78 F.3d 795 (2d Cir. 1996). The facts there, as recited by the Simpson court were:

In that case, the original settlor, E. Norman Peterson, died in 1974. His will created a trust for the benefit of his wife, Eleanor Peterson. Mrs. Peterson was given a general testamentary power of appointment over the corpus of the trust. If the power was not exercised, the corpus was to be set aside for the Petersons' grandchildren. Mrs. Peterson died in 1987. Because she had a general power of appointment, the remaining value of the trust was then included in her gross estate under 26 U.S.C. section 2041. But in her will, Mrs. Peterson specifically stated that she was not exercising the power, except to the extent necessary to pay the estate tax attributable to the inclusion of the trust property in her estate. The power therefore lapsed, and the property remaining in the trust after payment of the estate taxes was transferred to the grandchildren.

The court distinguished Peterson:

The distinction between Peterson and the present case is obvious. Here, when the power was exercised, it was exercised with respect to the entire remaining corpus. There was no portion of the trust remaining after the exercise. Nor did the power lapse to any extent. There is therefore no way to argue, and the government in fact does not argue, that the transfer at issue here is subject to the GST tax because it was made out of corpus added to the trust after September 25, 1985. Nor is there any regulation, temporary or permanent, that applies to the particular sort of transfer made here -- a transfer of the entire corpus of the trust remaining at the time of the exercise of the power. We have no quarrel with the holding of Peterson, but we cannot agree with the government that it compels or even supports the result contended for in the present case.

Clearly the court was puzzled over why there was any dispute at all:

The entire concept of written law, indeed of all verbal communication, depends on the idea that words have SOME meaning. It is true that the ingenuity of lawyers can usually scrape up some tag end of ambiguity on which to hang a policy hat. But judges are obliged, unless there is a substantial uncertainty as to the meaning of the words of a statute, to apply the statute as written, unless the

words are simply nonsense, or self-contradictory, or something of that kind. This is not such a case. The words of Section 1433(b)(2)(A) are clear, at least to us, and we see no reason not to apply them. The words make it clear that Congress intended to protect the reliance of creators of trusts on the law as it existed at the time the trusts became irrevocable. That Congress could, consistently with the Constitution and with fairness, have selected another effective-date regime is not relevant. We hold that the transfer at issue in this case took place under a trust which was irrevocable on September 25, 1985. The GST tax therefore does not apply.

The new proposed regulations attempt to reverse the result in Simpson (see P - 7 below).

3. Proposed Regulations Dealing With Changes to Exempt Trusts and the Effective Date Rule.

On November 18, 1999 the IRS published proposed regulations, REG- 103841-99, dealing with the effect of modifications of exempt trust on that status and the application of effective date provisions to exempt trusts. The proposed regulations would be effective as November 18, 1999.

The explanation of the modifications provision states as follows:

The proposed regulations provide guidance regarding the types of modifications, constructions, and settlements of controversies that will not cause a trust to lose its exempt status. However, the rules contained in these proposed regulations apply only for GST tax purposes. Thus, the rules do not apply in determining, for example, whether a modification will result in a gift for gift tax purposes, or may cause inclusion of the trust assets in the gross estate, or may result in the realization of gain for purposes of section 1001 of the Code.

Under the proposed regulations, a court order in a construction proceeding that resolves an ambiguity in the terms of a trust instrument will not cause the trust to lose its exempt status. The judicial action, however, must involve a bona fide issue and the court's decision must be consistent with applicable state law that would be applied by the highest court of the state. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Construction proceedings determine a settlor's intent as of the date the instrument became effective, and thus, a court order construing an instrument that satisfies these requirements does not alter or modify the terms of the instrument.

Similarly, under the proposed regulations, a court- approved settlement of a bona fide controversy relating to the administration of a trust or the construction of terms of the governing instrument of a trust will not cause a trust to lose its exempt status. This will be the case, however, only if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. See *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981); *Estate of Suzuki v. Commissioner*, T.C. Memo. 1991-624. For example, A and B are the sole remainder beneficiaries of a trust established by their parent. They disagree as to the portion of the remainder each is entitled to under the terms of the trust when the trust terminates. A settlement dividing the corpus equally among A, B, and C, B's child and the grandchild of the parent who established the trust, would not be considered within the range of reasonable outcomes because C is not a potential remainderman under any construction of the trust agreement.

The proposed regulations also address the situation in which a trustee distributes trust principal to a new trust for the benefit of succeeding generations. In some cases, the governing instrument grants the trustee broad discretionary powers to distribute principal to or for the benefit of the trust beneficiaries, outright or in

trust. Under these circumstances, distributions by the trustee to trusts for the benefit of trust beneficiaries will not cause the original trust or the new trusts to lose exempt status provided the vesting of trust principal is not postponed beyond the perpetuities period applicable to the original trust.

Finally, under the proposed regulations, a trust may be modified and remain exempt for GST purposes. The modification, however, must not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification and must not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Do the proposed regulations accomplish the IRS objective of reducing the number of rulings? At most only in part. The failure of parallel regulations on the income tax issues creates the need for a significant number of rulings. In addition, a great many modifications are not covered by the proposed regulations, including, for instance, modification of an income only payout trust to a unitrust payout trust (does that shift interests to a lower generation, arguably it does, but is that what the IRS is concerned about? Does it matter what the unitrust payout is?).

The proposed regulations also attempt to reverse Simpson. The explanation states the IRS's purpose and reasoning:

In Simpson v. United States, 183 F.3d 812 (8th Cir. 1999), the decedent exercised a testamentary general power of appointment granted under a marital trust that was created in 1966. Pursuant to the decedent's exercise of the general power of appointment, the property passed to her grandchildren who were skip persons under section 2612. The court concluded that the transfer to the grandchildren was exempt from the GST tax under section 1433(b)(2)(A) of the TRA, because the transfer was "under a trust" that was irrevocable on September 25, 1985.

The facts in Simpson are similar to those presented in Peterson Marital Trust v. Commissioner, 78 F.3d 795 (2nd Cir. 1996). In Peterson, the decedent had a testamentary general power to appoint property in a pre-September 25, 1985 marital trust created under her husband's will. Rather than appointing the property outright, the taxpayer allowed the power to lapse and the property passed to her husband's grandchildren, who were skip persons under section 2612. The court concluded that the transfer was subject to the GST tax. The court noted that the effective date provisions in section 1433(b)(2) of the TRA were "designed . . . to protect those taxpayers who, on the basis of pre-existing rules, made arrangements from which they could not reasonably escape and which, in retrospect, had become singularly undesirable." Peterson Marital Trust, at 801 (footnote omitted). The court concluded that there was no basis to apply the protection provided in section 1433(b)(2) to the marital trust because the arrangement could have been changed to avoid the GST tax through the exercise of the decedent's general power of appointment.

Treasury and the IRS believe that there is no substantive difference between the situation in Simpson where property passed pursuant to the exercise of a general power of appointment and the situation in Peterson Marital Trust where property passed pursuant to a lapse of a general power of appointment. An individual who has a general power of appointment has the equivalent of outright ownership in the property. Estate of Kruz v. Commissioner, 101 T.C. 44, 50-51, 59-60 (1993). The value of the property subject to the general power is includible in the power holder's gross estate at death under section 2041(a). In either case, the power holder can avoid the consequences of the GST tax by appointing the property to nonskip persons. Therefore, as the court noted in Peterson Marital Trust, there is no basis for exempting such dispositions from

the GST tax under the TRA effective date provisions.

Accordingly, the proposed regulations clarify that the transfer of property pursuant to the exercise, release, or lapse of a general power of appointment created in a pre-September 25, 1985 trust is not a transfer under the trust, but rather is a transfer by the power holder occurring when the exercise, release, or lapse of the power becomes effective, for purposes of section 1433(b)(2)(A) of the TRA.

The IRS is correct that there is no substantive difference between the facts of Simpson and Petersen. However, the Eighth Circuit in Simpson appeared to be interpreting the statute, not the regulations, in its holding despite the language distinguishing Petersen and referring to the regulation. It should be more difficult for the IRS to reverse a Circuit Court interpretation of the statute itself.

The effect of a new Kentucky statute should be considered as well. The statute is attached as an Appendix.

Q. SECTIONS 2701-2704 - SPECIAL VALUATION RULES

1. **Application to Family Limited Partnerships.** In Blaine P. Kerr, et ux. v. Commissioner, 113 T.C. No. 30 (1999), the Tax Court considered the application of the statute to the transfer of interests in a family partnership to GRATs, KFLP was created under the Texas Revised Limited Partnership Act (TRLPA). The court described the taxpayer's position:

Petitioners contend that section 2704(b) does not apply to the KFLP interests that they transferred to the GRAT's trustees because those interests were merely assignee interests under State law. TRLPA section 7.02(a)(2) provides that an assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or exercise the rights or powers of a partner. TRLPA section 7.02(a)(3) and (4) provides that an assignee is allocated the income, gain, loss, deduction, or credit to which the assignor was entitled, and, until the assignee becomes a partner, the assignor continues to be a partner and to have the power to exercise any rights or powers of a partner. TRLPA section 7.04(a) provides that an assignee of a partnership interest may become a limited partner if and to the extent that the partnership agreement provides for such a transition or on the consent of all partners. Relying on the definition of an applicable restriction contained in section 25.2704-2(b), Gift Tax Regs., petitioners maintain that an assignee's inability to force KFLP to liquidate under the KFLP partnership agreement imposes no greater restriction than those imposed upon assignees under TRLPA.

Petitioners' contention that the partnership interests they transferred to the GRAT's trustees were assignee interests as opposed to limited partnership interests is based on a strict construction of the KFLP partnership agreement. In particular, although petitioners made the transfers to themselves as GRAT's trustees, petitioners nonetheless maintain that their children, as KFLP general partners, had to consent to the admission of the GRAT's trustees as limited partners pursuant to section 3.06 of the KFLP partnership agreement.

The taxpayer's argument was rejected because the court found that the interests transferred were limited partnership interests not assignee interests. The opinion states:

Read as a whole, the language used in the "Assignment of Partnership Interest" establishes that petitioners transferred limited partnership interests to themselves as the GRAT's trustees. Although the documents refer to the GRAT's trustees as assignees, the description of the assigned interests contained in Schedule I clearly states that the assignees will hold class B limited partnership interests in KFLP.

Equally important, the "Assignment of Partnership Interest" states that petitioners had obtained all necessary consents to effect the conveyance. Because the GRAT's trustees qualified as permitted assignees within the meaning of section 8.03 of the partnership agreement, and petitioners were not required to obtain any consents to transfer an assignee interest to a permitted assignee, the inclusion of the statement that all necessary consents had been obtained also indicates that petitioners were transferring limited partnership interests to the GRAT's trustees. Further, the statement that all necessary consents had been obtained contradicts the testimony of the Kerr children that petitioners never requested that they consent to the transfers to the GRAT's trustees.

C. OBJECTIVE ECONOMIC ANALYSIS

The objective economic realities underlying the transfers to the GRAT's trustees do not support petitioners' position that the transferred interests should be considered assignee interests. First, and perhaps most importantly, there were no significant differences under the KFLP partnership agreement between the rights of limited partners and assignees. Petitioners were vested with managerial responsibilities for KFLP; neither limited partners nor assignees had any managerial rights. In addition, limited partners and assignees enjoyed equivalent rights to information concerning the partnership's business affairs, and they shared the same interests in the partnership's distributable cash. Finally, while limited partners were permitted to put or sell their interests to the partnership under section 9.02 of the partnership agreement, assignees were given a substantially equivalent right to offer their interests to the partnership under sections 8.04 and 8.21 of the partnership agreement.

The only relevant difference between the rights of limited partners and assignees relates to a limited partner's right to vote on major decisions - a right not extended to assignees. However, given the rare and extraordinary nature of the matters qualifying as a major decision, such as the filing of a bankruptcy petition or approving an act in contravention of the partnership agreement, we do not consider a limited partner's right to vote on such matters to be significant for purposes of deciding the question presented.

We further note that petitioners retained the right to vote the limited partnership interests and petitioners and the Kerr children had the ability to convert the purported assignee interests to full limited partnership interests or liquidate the partnership at will. To characterize the interests that petitioners transferred to the GRAT's trustees as assignee interests ignores the objective economic reality that there was no meaningful difference between the transfer of an assignee interest as opposed to a limited partnership interest.

D. TAX MOTIVATION

The record shows that Eastland structured petitioners' transfers to the GRAT's trustees primarily to avoid the special valuation rules set forth in section 2704(b). Eastland's writings on the subject of family limited partnerships disclose his belief that the transfer of an assignee interest from one family member to another would serve to circumvent section 2704(b). Accepting petitioner's testimony that he did not consider whether he was transferring a limited partnership interest as opposed to an assignee interest to his GRAT's, it appears that Eastland made a

conscious decision not to raise the subject with his clients.

Consistent with the foregoing, we conclude that petitioners transferred limited partnership interests to the GRAT's trustees in substance as in form.

Having decided that partnership interests were transferred the court determined that section 2704 did not apply:

Section 2704(b)(2)(A) broadly defines an applicable restriction as "any restriction which effectively limits the ability of the corporation or partnership to liquidate". However, section 2704(b)(3)(B) excepts from the definition of an applicable restriction "any restriction on liquidation imposed, or required to be imposed, by any Federal or State law".

In what we view as an expansion of the exception contained in section 2704(b)(3)(B), the Secretary promulgated section 25.2704-2(b), Gift Tax Regs., which states in pertinent part: "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Thus, the question arises whether the partnership agreements involved herein impose greater restrictions on the liquidation of KFLP and KILP than the limitations that generally would apply to the partnerships under State law.

Section 10.01 of the partnership agreements states in pertinent part that the partnerships shall dissolve and liquidate upon the earlier of December 31, 2043, or by agreement of all the partners. Petitioners direct our attention to TRLPA section 8.01, which provides that a Texas limited partnership shall be dissolved on the earlier of: (1) The occurrence of events specified in the partnership agreement to cause dissolution; (2) the written consent of all partners to dissolution; (3) the withdrawal of a general partner; or (4) entry of a decree of judicial dissolution. TRLPA section 8.04 provides that, following the dissolution of a limited partnership, the partnership's affairs shall be wound up (including the liquidation of partnership assets) as soon as reasonably practicable.

On the basis of a comparison of section 10.01 of the partnership agreements and TRLPA section 8.01, we conclude that section 10.01 of the partnership agreements does not contain restrictions on liquidation that constitute applicable restrictions within the meaning of section 2704(b). We reach this conclusion because Texas law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in section 10.01 of the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under Texas law. Consequently, these provisions are excepted from the definition of an applicable restriction pursuant to section 2704(b)(3)(B) and section 25.2704-2(b), Gift Tax Regs.

The Federal District Court for San Antonio has upheld a death-bed family limited partnership involving very difficult facts for the taxpayer. The case of Elsie J. Church v. United States, 85 A.F.T.R.2d 2000-804 (W.D. Tex., 2000) is attached as an appendix. The Court rejected the application of sections 2703 and 2704.

In Estate of Reichardt v. Commissioner, 114 T.C. _____ (2000), the Court disregarded a death-bed partnership because, the Court found, the decedent had retained, by implied agreement, use of the partnership units he had given away. The Court determined that the form of the partnership was not respected by the parties. In particular, he continued to live rent-free in a house owned by the partnership and opened no partnership bank accounts.

2. **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.

Borrowing can have negative income tax consequences. In TAMs 200010010, 200010011, and 200011005, the Service considered GRATs which borrowed money from another trust to pay the annuity. The remainder beneficiaries of both the GRAT (Trust 2) and the lender trust (Trust 3) were the annuitant's nephews. The TAMs conclude that when the GRAT's status as a grantor trust terminated the annuitant/grantor recognized gain. The Service states:

Section 1.1001-2(a) of the Income Tax Regulations provides that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property."

In Rev. Rul. 85-13, 1985-1 C.B. 184, an individual, A created an irrevocable trust, T, and funded T with 100 shares of stock in Corporation Z in 1980. A's basis in the shares was \$20x. On December 27, 1981, when the fair market value of the Corporation Z shares was \$40x, W, as trustee, transferred the 100 shares to A in exchange for A's unsecured promissory note with a face amount of \$40x, bearing an adequate rate of interest. On January 20, 1984, A sold the 100 shares to an unrelated party for \$50x. The Revenue Ruling concludes that A's acquisition of the entire corpus of T in exchange for an unsecured note was, in substance, the economic equivalent of borrowing trust corpus, and therefore A is

treated as the owner of the trust under section 675(3), and is considered to be the owner of the trust assets for federal income tax purposes. Furthermore, the ruling concludes that the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets.

Under section 1.1001-2(c) Ex. 5, C, an individual creates T, a grantor trust. C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. When C renounces the powers that initially resulted in T being classified as a grantor trust, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. Since prior to the renunciation, C was the owner of the entire trust, C was considered the owner of all the trust property for federal income tax purposes and C was considered to be the partner in P during the time T was a grantor trust. When T no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity. At that time C's share of P's liabilities is \$11,000. On the transfer, C's share of partnership liabilities is considered as money received.

Similarly, in the present case, X has created a grantor trust and is treated as the owner of the entire trust and the owner of all the trust property. Thus, although X has nominally transferred a shares of Company stock to Trust 2, X remains the owner of the trust property for federal income tax purposes. Therefore, when Trust 2 terminates and transfers a shares of Company stock to the remainder trusts for C and D, X is considered to have disposed of the Company stock to the remainder trusts, along with the associated liability assumed by the remainder trusts, and X's amount realized includes the amount of liabilities from which X is discharged as a result of the disposition.

X argues that this case is distinguishable from Example 5 in 1.1001-2(c) because, in that example, T purchased an interest in P and C deducted the distributive share of partnership losses attributable to the partnership interest held by T, while, in the present case X did not deduct losses attributable to debt incurred by Trust 2. Therefore, X argues that X should not be considered the owner of all the trust property for federal income tax purposes, and X should not be considered to have transferred ownership of the stock, subject to the liability, to the remainder trusts. X argues that instead, Trust 2 should be treated as the owner of the stock, and Trust 2 should be treated as the transferor of the stock, subject to the liability, to the remainder trusts. In addition, X argues that the debt is incurred by reason of Trust 2's acquisition of the stock, and since under Rev. Rul. 85-13, the amount of the debt did not increase Trust 2's basis in the stock, the liability should not be included in Trust 2's amount realized under section 1.1001-2(a)(3).

However, although X did not deduct losses attributable to debt incurred by Trust 2, X received an annuity payment from Trust 2 that was not includible in X's income, and thus, X benefitted from the debt incurred by Trust 2. Therefore, we conclude that the present case is not distinguishable from Example 5 of section 1.1001-2(c). Because X was considered the owner of the stock for federal income tax purposes, the exception in section 1.1001-2(a)(3) does not apply to the present case. X, not Trust 2, is the transferor of the stock on termination of Trust 2 and X did not incur the indebtedness in order to acquire the stock within the meaning of section 1.1001-2(a)(3).

In addition, X argues that the language of section 1.1001-2(a)(3) does not require that the debt be incurred by reason of the transferor's acquisition of the property, but merely be incurred by reason of any acquisition of the property.

Therefore, X states that regardless of whether X or Trust 2 is treated as the transferor of the stock to the remainder trusts, the amount of the liability should not be included in X's amount realized because the debt was incurred by reason of Trust 2's acquisition of Company stock. Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property." We believe this language can only be reasonably read to refer to the transferor's acquisition of the property. We believe this case is substantially identical to Example 5 in section 1.1001-2(c).

3. **Commutation of GRIT.** TAM 199935003 determined that the commutation of a grantor retained income trust would not remove assets from the grantor's estate. The GRIT was created in 1988 and the trustee could commute the GRIT by giving the grantor and the remainderman their respective actuarial interests. The commutation at issue was as follows:

On Date 1, in 1995, the decedent was admitted to the hospital. The Decedent had been diagnosed with terminal cancer.

Eight days later, on Date 2, the trustee wrote the three remaindermen and informed the remaindermen that if Decedent died during the ten-year trust term, then the entire value of the trust would be included in Decedent's gross estate. The letter further stated that, by commuting the Decedent's interest, and, thus avoiding inclusion of the entire trust corpus in the gross estate, a significant amount of estate tax could be saved. The letter then requested the beneficiaries' recommendation regarding commutation. The three remaindermen recommended commutation.

Eleven days later on Date 3, the trust was valued at \$6,159,479.05. The trustee distributed \$2,247,981.95 to a separate account for the Decedent. The balance of the trust, \$3,911,497.20, was distributed to the three remainder beneficiaries (pursuant to authority contained in Article TENTH). The amount distributed to the Decedent was the actuarial value of Decedent's interest on the date of the distribution, determined based on the actuarial tables contained in the regulations.

The Decedent died the following day on Date 4.

The IRS argued that the grantor's death may have been imminent so the actuarial tables would not apply. However, its primary argument was under section 2035:

In *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961), the settlor created an irrevocable trust reserving an income interest for her life in a portion of the trust. Subsequently, the settlor sold her income interest in the trust to her son in exchange for an amount equal to the actuarial value of the income interest. The estate acknowledged that if the decedent had gratuitously transferred her income interest in the trust, the trust corpus would be includable under section 811(c)(1)(A) of the 1939 Code, the predecessor to section 2035 /1/. However, because the settlor received adequate consideration for the transfer of the income interest, the estate argued that section 811(c)(1)(A) did not apply. The court concluded that in order to remove the trust, property from a decedent's gross estate under the bona fide sale exception to section 811(c)(1)(A), the consideration received for the sale had to be at least equal to the value of the property that would have been included in the gross estate if the interest had been retained. In *Allen*, since the settlor had reserved an income interest in part of the trust corpus, the portion of the trust associated with the reserved income interest would have been included in the settlor's gross estate upon the settlor's

death. Thus, payment equal to the value of the income interest was not adequate and full consideration for purposes of the statute, because the value of the income interest was less than the value of the trust portion that would otherwise be included in the settlor's gross estate if the income interest had been retained until death.

* * *

There is little distinction between the sale considered by the court in *United States v. Allen* and the commutation involved in the instant case. In *Allen*, the decedent transferred her interest to her son in exchange for cash. In this case, the commutation effectuated a transfer of the decedent's interest to the trust (or the trust remaindermen) in exchange for cash. The amount received by the Decedent for the transfer of her income interest did not constitute adequate and full consideration for purposes of the "bona fide sale" exception contained in section 2035, since the amount received was only a fraction of the value of the trust corpus subject to inclusion under section 2036. Further, it is questionable whether the commutation transaction could be characterized as a sale, but in any event, it would clearly not constitute a "bona fide" sale. As the facts indicate, the intra-family transaction was consummated shortly before Decedent's death. The amount received by the Decedent, considering the state of Decedent's health, was wholly inadequate, in view of the right of Decedent's revocable trust to receive the entire trust corpus in the event Decedent died prior to the expiration of the 10 year trust term. The parties were clearly not dealing at arm's length. Accordingly, as was the case in *Allen*, the entire trust corpus (less the payment received for the income interest) should be included in the gross estate under section 2035.

Taxpayer argues that sections 2035(a) and 2035(d)(2) do not apply to the transaction, because the Decedent did not "transfer" the retained interest. Rather the term "transfer" implies a volitional act. Here taxpayer was required to relinquish her interest pursuant to the terms of the trust authorizing the trustee to commute her interest. However, in this case, the Trustee's actions effectuated a transfer of Decedent's retained interest in the trust for a cash payment. Although the trustee may have initiated the transaction, nonetheless, the transaction resulted in a transfer by the Decedent of her retained interest for purposes of section 2035(d)(2). The Decedent authorized the commutation clause in the trust with the intent and expectation that the trustee would exercise the power in appropriate circumstances, such as a situation where the Decedent's death was imminent. Thus, although the Decedent did not formally initiate the commutation, the exercise of the power by the trustee was consistent with Decedent's intent and was authorized, if not implicitly directed, by the Decedent. Further, the transaction was entirely intra-family between the Decedent and her children, and was consummated solely to reduce the impending estate tax liability. Thus, even assuming that statute requires that an intra-family transaction must be initiated or consented to by the decedent, it is difficult to characterize the transaction in this case as other than a "transfer" within the purview of section 2035, by the Decedent. As the court noted in *United States v. Allen*, "It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates."

4. **Change of Interest Rate in Buy-Sell Does Not Violate Sections 2703 or 2704.** PLR 200015012 confirms that a change in a pre-October 8, 1990 partnership agreement to change the interest rate paid on repurchases of partnership interests from 5% to the greater of 5% or the section 1274 long-term rate will not violate sections 2703 or 2704.

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

No Developments.

S. **TAX ADMINISTRATION**

1. **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). The Supreme Court upheld at 84 AFTR2d ¶ 99-5563. The Court stated:

The Eighth Circuit, with fidelity to the relevant Code provisions and our case law, determined first what rights state law accorded Drye in his mother's estate. It is beyond debate, the Court of Appeals observed, that under Arkansas law Drye had, at his mother's death, a valuable, transferable, legally protected right to the property at issue. See 152 F.3d, at 895 (although Code does not define "property" or "rights to property," appellate courts read those terms to encompass "state-law rights or interests that have pecuniary value and are transferable"). The court noted, for example, that a prospective heir may effectively assign his expectancy in an estate under Arkansas law, and the assignment will be enforced when the expectancy ripens into a present estate. See *id.*, at 895-896 (citing several Arkansas Supreme Court decisions, including: *Clark v. Rutherford*, 227 Ark. 270, 270-271, 298 S.W. 2d 327, 330 (1957); *Bradley Lumber Co. of Ark. v. Burbridge*, 213 Ark. 165, 172, 210 S.W.2d 284, 288 (1948); *Leggett v. Martin*, 203 Ark. 88, 94, 156 S.W.2d 71, 74-75 (1941)).

Drye emphasizes his undoubted right under Arkansas law to disclaim the inheritance, see Ark. Code Ann. section 28-2-101 (1987), a right that is indeed personal and not marketable. See Brief for Petitioners 13 (right to disclaim is not transferable and has no pecuniary value). But Arkansas law primarily gave Drye a right of considerable value -- the right either to inherit or to channel the inheritance to a close family member (the next lineal descendant). That right simply cannot be written off as a mere "personal right . . . to accept or reject [a] gift." Brief for Petitioners 13.

In pressing the analogy to a rejected gift, Drye overlooks this crucial distinction. A donee who declines an inter vivos gift generally restores the status quo ante, leaving the donor to do with the gift what she will. The disclaiming heir or devisee, in contrast, does not restore the status quo, for the decedent cannot be revived. Thus the heir inevitably exercises dominion over the property. He determines who will receive the property -- himself if he does not disclaim, a known other if he does. See Hirsch, *The Problem of the Insolvent Heir*, 74 Cornell L. Rev. 587, 607-608 (1989). This power to channel the estate's assets warrants the conclusion that Drye held "property" or a "right to property" subject to the Government's liens.

* * *

In sum, in determining whether a federal taxpayer's state-law rights constitute "property" or "rights to property," "[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property." Morgan, 309 U.S., at 83. Drye had the unqualified right to receive the entire value of his mother's estate (less administrative expenses), see *National Bank of Commerce*, 472 U.S., at 725 (confirming that unqualified "right to receive property is itself a property right" subject to the tax collector's levy), or to channel that value to his

daughter. The control rein he held under state law, we hold, rendered the inheritance "property" or "rights to property" belonging to him within the meaning of section 6321, and hence subject to the federal tax liens that sparked this controversy.

2. **Recalculation of State Death Tax Credit.** In TAM 199940005 the National Office held that where a state imposed an estate tax for the amount attributable to the recapture tax under section 2032A(c) the state death tax credit would be redetermined. Presumably, the result will be the same with respect to a recapture tax under section 2057.

3. **Reopening Audit After Erroneous Closing Letter.** In Estate of Eileen K. Brocato v. Commissioner, T.C. Memo. 1999-424, the court allowed the IRS to reopen an audit after a closing letter had been sent by mistake. While the IRS was hiring an appraiser the estate filed a supplemental estate tax return to claim an additional interest deduction. A clerk at the Ogden, Utah Service Center issued the closing letter. The opinion states:

Petitioner argues that respondent should be estopped from assessing additional estate taxes on two grounds: (1) Respondent's closing letter constituted affirmative misconduct on which petitioner relied to its detriment; and (2) respondent failed to follow the procedures for reopening a case outlined in the Internal Revenue Manual (the Manual) and closing letter.

There is no doubt that the Ogden Service Center's closing letter was erroneous. It, however, appears from the sparse record on this point that the error occurred because an Ogden Service Center employee neglected to check the estate's transcript which indicated an examination was underway before issuing the closing letter. Respondent never affirmatively concealed the mistake. Once the mistake was discovered, respondent immediately notified petitioner that the audit was still underway. Petitioner has failed to demonstrate how this isolated and careless act amounts to affirmative misconduct going beyond mere negligence.

As for petitioner's second argument, we do not believe that respondent violated the Manual procedures or the closing letter's description of the circumstances for reopening petitioners' case. Under section 4023.2(1) of the Manual, there are three criteria for reopening an audit. The third criterion is that an audit may be reopened where "other circumstances exist which indicate failure to reopen would be a serious administrative omission." 1 Audit, Internal Revenue Manual (CCH), sec. 4023.2(1) at 7063-4. Under section 4023.5 of the Manual, a "serious administrative omission" is defined as a closed case where failure to reopen the case could "result in serious criticism of the Service's administration of the tax laws". 1 Audit, Internal Revenue Manual (CCH), sec. 4023.5 at 7065. The closing letter stated: "we will not reopen this return unless * * * other circumstances exist which indicate that a failure to reopen would result in a serious administrative omission." The reopening letter stated that the audit was being reopened because a "serious administrative omission" had occurred and failure to reopen the case "would result in criticism, undesirable precedent, or inconsistent treatment."

Failure to reopen the audit, herein, would mean that a potential \$1,373,797 of estate tax could go uncollected. The loss of such revenue could result in criticism of the IRS' administration of the tax laws and inconsistent treatment among taxpayers. We believe that respondent complied with the Manual's procedures and the closing letter's description of circumstances for reopening an audit. Further, this Court has stated numerous times that procedural rules of this

sort are "merely directory, not mandatory, 'and compliance with them is not essential to the validity of a notice of deficiency.'" Collins v. Commissioner, 61 T.C. 693, 701 (1974)(quoting Luhring v. Glotzbach, 304 F.2d 560, 563 (4th Cir. 1962)).

We are also not convinced that the traditional elements of equitable estoppel are satisfied. We doubt whether petitioner's reliance on the closing letter was reasonable. On October 10, 1995, Mr. Samuelson notified petitioner's counsel that the IRS intended to hire an appraiser to value the properties which would take at least 3 months, and Mr. Samuelson would contact petitioners' counsel when the expert was hired. On December 14, 1995, the Ogden Service Center issued the closing letter. Neither petitioner's counsel nor a representative of petitioner contacted Mr. Samuelson to discuss the issuance of the closing letter and the inconsistencies between its issuance and the conversation between petitioner's counsel and Mr. Samuelson just 2 months earlier. We believe that a reasonable and prudent person would have inquired about these inconsistencies.

Additionally, we are skeptical as to petitioner's claim of detriment in this case. Petitioner claims that it wanted to know the precise amount of estate tax owed before formulating its plan to dispose of the Brocato properties and it relied on the closing letter in determining that amount. If petitioner had not received the closing letter, petitioner contends that it would have exercised its section 6166 election and would have waited to sell 2360 Chestnut after the property appreciated.

It is not disputed that petitioner had a valid section 6166 election and could have deferred payment of its estate tax. We, however, question whether petitioner would have actually exercised its section 6166 election. Petitioner paid its estate tax liability on May 22, 1996, approximately 3 years before it was required to pay under section 6166. It is speculative whether petitioner would have continued to take advantage of the section 6166 election had it been told of the increased estate tax liability.

Petitioner also claims that the Chestnut property appreciated in value after its premature sale, and petitioner would have been able to sell it for a higher sum but for the issuance of the closing letter. Again, this involves conjecture. Petitioner has failed to demonstrate that it suffered a detriment as a result of its reliance on the closing letter.

4. **Fiduciary Liability for Unpaid Income Taxes.** William D. Little v. Commissioner, 113 T.C. No. 31, deals with a fiduciary's liability for unpaid income taxes when the fiduciary relies on an attorney's advice that no taxes were owed. The opinion states:

Respondent argues that under 31 U.S.C. section 3713(b), petitioner is personally liable for the estate's unpaid income tax liabilities. Title 31 U.S.C. section 3713 provides:

Section 3713. Priority of Government claims

(a)(1) A claim of the United States Government shall be paid first when --

* * * * *

(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

* * * * *

(b) A representative of a person or an estate * * * paying any

part of the debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

This section appears to impose strict liability on a fiduciary who makes a disbursement which leaves the estate with insufficient funds with which to pay a debt owed to the United States. However, courts have long departed from such a rigid interpretation. "[I]t has long been held that a fiduciary is liable only if it had notice of the claim of the United States before making the distribution." *Want v. Commissioner*, 280 F.2d 777, 783 (2d Cir. 1960); see also *Leigh v. Commissioner*, 72 T.C. 1105, 1109 (1979). Whether the fiduciary had notice is determined by whether the executor knew or was chargeable with knowledge of the debt. "The knowledge requirement of 31 U.S.C. sec. 192 [now 31 U.S.C. sec. 3713] may be satisfied by either actual knowledge of the liability or notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States." *Leigh v. Commissioner*, supra at 1110 (citing *Irving Trust Co. v. Commissioner*, 36 B.T.A. 146 (1937); *Livingston v. Becker*, 40 F.2d 673 (E.D. Mo. 1929)). To be chargeable with knowledge of such a debt, the executor must be in possession of such facts as to "put him on inquiry." *New v. Commissioner*, 48 T.C. 671, 676 (1967). "It is this knowing disregard of the debts due to the United States that imposes liability on the fiduciary". *Leigh v. Commissioner*, supra at 1109-1110 (citing *United States v. Crocker*, 313 F.2d 946 (9th Cir. 1963)).

It is clear that petitioner had no actual knowledge of the estate's income tax liabilities at the time that he made disbursements and distributions from the estate. However, respondent argues that petitioner's receipt of Forms W-2 and 1099 and subsequent notices would have put a reasonably prudent person in petitioner's position on inquiry as to the existence of the debts due to the United States for unpaid income taxes.

We agree that the receipt of the tax information forms in January 1990 and 1991 was sufficient to put petitioner on inquiry. However, petitioner, having been put on inquiry, acted in a prudent and reasonable manner consistent with his fiduciary duties. Petitioner forwarded the forms to the estate's attorney, Mr. Lahr, and sought his advice. Mr. Lahr informed petitioner that because of the estate's size, the estate had no income tax liabilities. Mr. Lahr's legal advice was wrong.

Petitioner continued to receive the same advice from Mr. Lahr after giving him other notices from respondent that indicated there might be unpaid income taxes for which the estate might be liable. It was not until the summer of 1993 when Mr. Dilg was brought in and prepared and filed delinquent returns that the tax liabilities in issue were discovered by Mr. Lahr. But almost all the estate's assets had already been distributed by then. As a result, on November 30, 1993, petitioner submitted an Offer in Compromise and sent a check for \$17,586.07, the balance of the estate's assets, to respondent. The offer was not accepted, and several months later respondent returned the check to petitioner without explanation. Petitioner immediately informed Mr. Lahr. Thereafter, Mr. Lahr and Mr. Dilg met with representatives of respondent and erroneously concluded that respondent would drop the tax claims against the estate. They informed petitioner of this, and Mr. Lahr advised petitioner to make the final disbursements and to close the estate. Relying on the advice of the estate's attorney and the certified public accountant, petitioner closed the estate.

5. **Post-Death Events Relevant to Whether Failure to Pay Estate Tax Was Reasonable.** The Fifth Circuit has held in Estate of Willie Mae Sowell v. United States, 84 AFTR2d Par. 99-5583 (1999), that post-death events are relevant. The opinion states:

The Estate argues that since "reasonable cause" and "willful neglect" are determined as of the date the taxes are due, any events subsequent to that date are irrelevant and unduly prejudicial. /4/ We disagree. The post-due date evidence was introduced by the government to rebut the Estate's argument that it used "ordinary care and prudence" in attempting to pay the tax before it was due. /5/ For example, the fact that the Estate did not attempt to obtain a loan for the entire four-year period following the due date is certainly relevant to whether its failure to arrange for a loan before the due date was "reasonable." Further, the Estate's failure to appeal the IRS's denial of its request for an extension clearly affects whether the Estate's overall failure to pay on time was "reasonable." Such information is more than merely relevant, it is quite probative of "reasonableness", and outweighs any unduly prejudicial effect it may have had on the estate.

Under the Estate's rationale, evidence that an executor used estate funds to purchase a fleet of luxury cars and an island in the South Pacific after the date the taxes were due would be inadmissible to prove that the executor's failure to pay the estate taxes on time was unreasonable. This is plainly wrong. Accordingly, the district court did not abuse its discretion in allowing introduction of the post-due date evidence as admissible to prove that the Estate was unreasonable in failing to pay its taxes on the due date.

The court also found that the trial court could exclude expert testimony on whether the estate acted reasonably.

T. **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.

Section 2206 gives the executor a right of reimbursement against the beneficiary of life insurance, unless the decedent otherwise directs in his Will. The meaning of "otherwise directs" was before the Supreme Court of Georgia in Emmertz v. Cherry, 271 Ga. 458 (1999). The opinion states:

The will in issue here in the first sentence of Item IV directs the payment of "all Estate, inheritance, succession or death taxes" from the residuum, but it does not contain language specifically providing for the payment of taxes on the life insurance proceeds from the residual estate. The third sentence of Item IV reflects the testator's knowledge of the estate tax consequences of nonprobate property and his express

exclusion from the initial "pay all taxes" provision of those taxes his estate could incur from two specific types of nonprobate property, i.e., QTIP and power of appointment property, pursuant to IRC ss 2207 and 2207A.

We agree with the probate court that there existed adequate proof of the testator's intention in Item IV to include the taxes on the life insurance proceeds in the "pay all taxes" provision in the first sentence by reading that sentence together with the third sentence. In this regard, the third sentence indicated that the testator knew he owned nonprobate property on which taxes would be due and also indicated that the testator believed that the first sentence would encompass taxes on such nonprobate property unless he expressly exempted that property from the "pay all taxes" provision. The testator accomplished this exemption in the third sentence as to QTIP and power of assignment property but deliberately declined to include the life insurance proceeds within the exemption. Accordingly, by omitting life insurance proceeds among those nonprobate properties the taxes on which the executor was specifically instructed in the third sentence to recover, the testator thus indicated that he intended for the taxes on the life insurance proceeds to be included in the "pay all taxes" provision of the first sentence. We thus reject the executor's argument that because the will does not expressly direct the executor not to recover the pro rata share of estate taxes paid on the life insurance policies proceeds, the testator did not "direct[] otherwise" pursuant to s 2206.

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.

U. **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. Barks, 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. **Effect of Six Month Claims Statute on Claims After Divorce.** The facts before the Kentucky Court of Appeals in Underwood v. Underwood, 999 S.W.2d (1999), were:

The appellant, Agnes D. Underwood (Agnes), was divorced from the decedent, John Thomas Underwood, III (John), by a decree entered in Oldham Circuit Court on October 13, 1988, and amended by order dated July 3, 1992. Among other things, the decree directed that Agnes would receive maintenance payments of \$1,350,000 per month from John for her lifetime. In addition, the court ordered that Agnes would receive thirty-five percent (35%) of John's National Guard pension, and fifty percent (50%) of his pension from Chevron.

John died testate in Franklin County on December 2, 1996, on December 16, 1996, John's second wife, Marilyn J. Underwood was appointed the executrix of his estate. Agnes filed a verified complaint against the estate on December 11, 1997. She alleges that the maintenance payments and the National Guard pension payments to her ceased following John's death. Apparently, John failed to take the appropriate steps to arrange for Agnes to receive survivor benefits from his National Guard retirement account. Agnes sought a judgment against the estate for lifetime maintenance payments and for an amount equal to thirty-five percent (35%) of John's National Guard retirement account continuing until her death.

The court held:

Although the requirement for presentation of claims to the personal representative and the statute of limitations are separate grounds, they are related under the circumstances of this case. In Batson v. Clark, Ky. App., 980 S.W.2d 566 (1998), this court explained that claims which arise after the death of the decedent are not subject to the presentation requirements of KRS 396.035 and 396.015, or the statute of limitations contained in KRS 396.011, generally refers

to “debts or demands against the decedent which might have been enforced against him during his lifetime.” *Id.* at 570 (quoting 31 Am.Jur.2d *Executors and Administrators* § 603 (1989)). If the decedent took no action during his lifetime which could have prompted litigation, then the claim cannot be said to have arisen during the decedent’s lifetime.

In the present case, Agnes alleges that John failed to take the necessary steps for Agnes to receive this national Guard survivor benefits. Agnes also alleges (although the record does not confirm this fact) that the Oldham Circuit Court issued a qualified domestic relations order (QDRO) to enforce her rights to receive a portion of John’s military retirement. Clearly, any breach of duty by John occurred prior to his death, when he could have been directed to make the necessary arrangements for Agnes to receive his survivor benefits. Therefore, this claim arose prior to his death and was subject to both the presentation requirement in KRS 396.015 and the six (6) month statute of limitations in KRS 396.011.

However, Agnes’s claim for maintenance is a different issue. The Oldham Circuit Court directed that, under certain circumstances, her maintenance would continue after John’s death. If the cessation of maintenance occurred after John died, as Agnes alleges, then the claim did not arise out of any action taken by John during his life. Rather, Agnes has stated a claim for actions taken (or not taken) by the personal representative. Since Agnes’s claim for continuation of maintenance arose after John’s death, it is not subject to the six (6) month statute of limitations in KRS 396.011 or to the presentation of claims requirement in KRS 396.035 and 396.015. Batson, 980 S.W.2d at 570-572. Consequently, the trial court erred in dismissing Agnes’s claim for maintenance.

5. Transfer of Stock. The Kentucky Court of Appeals has held in Meshew v. Whitlock, Ky. App., 9 S.W.3d 581 (1999) that where the owner of closely held stock changed the face of a stock certificate to create a survivorship interest that was sufficient despite the fact that the certificate was not endorsed.

6. What is a Lapsed Legacy in Kentucky? KRS 394.400 provides as follows:

If a devisee or legatee dies before the testator, or is dead at the making of the will, leaving issue who survive the testator, such issue shall take the estate devised or bequeathed, as the devisee or legatee would have done if he had survived the testator, unless a different disposition thereof is made or required by the will.

At issue in Blevins v. Moran, Ky. App., 12 S.W.2d 698 (2000), was the meaning of “unless a different disposition is made or required by the will.” The decedent made a number of specific bequests, none of which were specifically conditioned on survivorship, and several named beneficiaries predeceased the decedent. The residuary clause stated:

All the rest, residue and remainder of my estate, both real and personal, wherever situated and of whatever nature, kind and description that I own at my death, including legacies and devises, if any, which may lapse or fail for any reason, I give, devise and bequeath to my nephews, Donald W. Blevins and Barkley L. Blevins in fee simple in equal shares.

The court reviewed cases from other jurisdictions, the Uniform Probate Court, and commentary on the lapse issue. The court concluded that Kentucky has a very strong presumption against lapses and that a general clause would not be sufficient to overcome the application of the statute. The opinion states:

The appellants summarize the matter succinctly as a dispute over the meaning of the phrase “lapsed” legacy. Under the common law, they note, a legacy

"lapsed" if, among other reasons, an individual donee pre-deceased the testator. Typically, lapsed gifts passed according to the residuary clause, if there was one, or according to the laws of intestacy, if there was not. The anti-lapse statute, they argue, does not alter this meaning of "lapse," which still applies to any legacy the beneficiary of which pre-deceases the testator. The statute merely alters the consequences of lapse in certain circumstances. The residuary clause's reference to "lapsed" legacies or devises, therefore, encompasses the gifts at issue here and preempts KRS 394.400.

The trial court, on the other hand, understood KRS 394.400 as preventing the "lapse" of the contested gifts in the first place, thus rendering the will's residuary clause inapplicable to them. The residuary clause, according to the trial court, was intended merely to ensure that any gifts that lapsed or failed under the current law of wills--including the anti-lapse statute--would not pass by the law of intestacy. It did not manifest an intention to avoid the anti-lapse statute.

The appellants rely on four cases from foreign jurisdictions that support their position in this semantic argument. *Estate of Salisbury*, 76 Cal.App.3d 635, 143 Cal.Rptr. 81 (1978); *In re Phelps' Estate*, 147 Iowa 323, 126 N.W. 328 (1910); *In re Neydorff*, 193 A.D. 531, 184 N.Y.S. 551 (1920); and *Jensen v. Nelson*, 236 Iowa 569, 19 N.W.2d 596 (1945). In each of these cases, a reference in the residuary clause to "lapsed legacies," such as the reference in Dr. Peterson's will, was understood as implying the testator's intention to avoid the effect of the anti-lapse statute. Indeed, the Court in *In re Neydorff*, referring to the following language from the will: "All the rest, residue and remainder of my estate, ... including lapsed legacies, I give and devise to my niece." opined that "it must be obvious that the testator referred to 'lapsed legacies' as those legacies which were defeated by the prior death of the beneficiaries." *Id.* at 553. And the California Court in *Estate of Salisbury* was likewise certain that "the testatrix's reference to failed and lapsed gifts in the residuary clause can only be interpreted as indicating her intent to substitute the residuary beneficiaries in place of her brother should he predecease her." *Id.* at 85.

The trial court took pains to distinguish these cases from the present one. The court noted, for example, that the California statute at issue in *Estate of Salisbury* recalls expressly the common-law rule of lapse and merely provides for an exception to it:

If a devisee or legatee dies during the lifetime of the testator, the testamentary disposition to him fails, unless an intention appears to substitute another in his place; except that when any estate is devised or bequeathed to any kindred of the testator, and the devisee or legatee dies before the testator, having lineal descendants, or is dead at the time the will is executed, but leaves lineal descendants surviving the testator, such descendants take the estate so given by the will in the same manner as the devisee or legatee would have done had he survived the testator.

KRS 394.400, on the other hand, provides that the lineal descendants of a deceased beneficiary "shall take" that beneficiary's gift unless a contrary intention appears in the will. Kentucky's presumption against lapse is thus far stronger than California's. Even to the extent that the appellants' foreign authorities are not obviously distinguishable, the trial court (citing *Chenault's Guardian v. Chenault's Estate*, 10 Ky.L.Rptr.840, 9 S.W. 775 (1888) and *Nance's Executors v. Akers*, 165 Ky. 461, 177 S.W. 235 (1915)) regarded them and the appellants' use of them as inconsistent with KRS 394.400's pronounced anti-lapse intent and spirit. Our anti-lapse statute effects a greater departure from the common law than is reflected in the appellants' cases, the trial court

wrote, "by preventing a lapse from occurring ... unless the testator clearly expresses a different disposition of that person's gift. ... This requires the testator to state, affirmatively, that another person is to take a particular gift should the primary named legatee predecease the testator." (Emphasis in the original). Pointing again to the cases cited above, however, and insisting upon their understanding of the word "lapse," the appellants maintain that the provision for lapsed gifts in the residuary clause of Dr. Peterson's will is, in fact, an affirmative statement to that effect. We disagree.

The court concluded:

In sum, although in other jurisdictions the result would perhaps be different, we are persuaded that the recital in a will's residuary clause that the residue is to include lapsed and failed gifts is not by itself sufficient evidence of a testator's contrary intent to overcome the strong presumption against lapse provided by KRS 394.400. Such clauses are to be construed, like all other will clauses, in light of the entire document, and are only to be given preclusive effect when such clearly was the testator's intent. No such clear intent appearing in this case, we affirm the October 30, 1998, judgment of Fayette Circuit Court.

7. **Ability of Attorney in Fact to Make Gifts.** May an attorney in fact make gifts to himself or herself without express authority in the power of attorney document? In Wabner v. Black, Ky. 7 S.W.3rd 379 (2000), the Kentucky Supreme Court answered yes, so long as the attorney in fact acted with the "utmost good faith." The facts before the court were as follows:

On March 11, 1994, elderly George Tapp executed a durable power of attorney in favor of his niece, Nancy Wabner. He had recently relocated from Evansville, Indiana, to Poole, Kentucky, where he lived with his sister, Leona Poole. According to Ms. Wabner, after her uncle executed the power of attorney (in the presence of Leona Poole and Jimmy Vaughn of Poole Deposit Bank), her uncle instructed her to collect his Evansville bank accounts and certificates of deposit into a local bank account naming her as joint owner with right of survivorship. Leona Poole confirmed that these were Tapp's instructions to Wabner.

Tapp's will, drafted in 1986, expressly provided that any such accounts existing at the time of his death would become the property of the joint owner. His will also passed the family farm to Wabner (whose father had once owned a one-half interest in the farm) and made one-quarter residuary bequests to the Garvinwood Baptist Church, the General Baptist Foundation, Poole, and Wabner.

Pursuant to the power of attorney and allegedly complying with oral instructions from her uncle, who purportedly maintained his mental faculties until his death, Wabner collected assets valued at over \$200,000 into joint bank accounts. George Tapp died on April 21, 1994 at the age of 94. At that time, Wabner had collected into the accounts approximately 80% of her uncle's assets other than the farm.

The opinion relies on Deaton v. Hale, Ky., 592 S.W.2d 127 (1979):

In Deaton, the attorney in fact (second wife of her principal) was alleged to have made gifts to herself from her principal's estate and to have maintained her principal's cash estate in a joint checking account. This Court refused to adopt a per se restoration rule and instead announced an "utmost good faith" standard by which to judge the transactions made by the attorney in fact. In so holding, the Court stated:

An attorney-in-fact, one acting under a Power of Attorney, must

account for any and all property, real or personal, that is received by him from or for his principal. The accounting must be for all property that is received by him while acting in his official capacity or otherwise. We do not mean to say, and we do not hold, that an agent operating in a fiduciary capacity, such as in the instant case, is liable for restoration or reimbursement for all properties received by him from the principal or from whatever source. What we are saying is that the agent does have the responsibility of explaining to the satisfaction of the Court what disposition was made of the properties. The agent is required to go forward with an explanation when proof is introduced showing that the property was in the hands of the agent. The burden of going forward with the proof so as to explain the disposition of any and all properties received by the agent is then with him. The issue thereby presented is one of fact to be decided by the court or by a jury, as the case may be.

The court concluded:

The power of attorney executed by Tapp was unambiguous. It expressly provided in writing that Wabner was to have the full power "to cash any certificates of deposits which I own or to change and redesignate the ownership thereof in his [her] sole discretion." When Wabner changed her uncle's accounts to joint accounts, she did what was expressly authorized by the power of attorney. The only question then was whether Wabner's exercise of the express authority granted by the power of attorney was attended by the utmost good faith. This was a question of fact for the jury.


* * *

The "flat rule" announced by the Court of Appeals has the advantage that every per se rule has in that it allows certainty and predictability. We do not believe, however, that this rule of law should be adopted here in light of Deaton and the clear language of the power of attorney authorizing Wabner to make the disputed transactions. The better approach, consistent with firmly established law, is to allow the court or the jury, as it may be, to determine as a matter of fact the propriety of the transactions. Although this Court may not agree with the verdict reached by the jury here, it is not the place of an appellate tribunal to substitute its judgment for that of a fact-finding body. Thus, the jury's verdict must stand.

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS,
SAN ANTONIO DIVISION

FILED

JAN 18 2000

CLERK, U.S. DISTRICT COURT
WESTERN DISTRICT OF TEXAS
BY  DEPUTY CLERK

ELSIE J. CHURCH, DECEASED,
MARSHALL B. MILLER, JR., and
MARY ELSIE NEWTON, Independent
Co-Executors,

§
§
§
§
§
§
§
§
§
§

Plaintiffs,

v.

CAUSE NO. SA-97-CA-0774-OG

UNITED STATES OF AMERICA,
Defendant.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Following trial on the merits and submission of post-trial briefs (docket nos. 60, 63, 64, and 67), and pursuant to the February 17, 1999 agreement of the parties to withdraw this case from the jury and submit it to the Court for decision, the Court enters its findings of fact and conclusions of law. FED. R. Civ. P. 52. To the extent any finding of fact is made in the Conclusions of Law section, or vice versa, the section headings will be disregarded.

Jurisdiction and Venue

1. This court has jurisdiction over this matter pursuant to 28 U.S.C. § 1346(a)(1) because this suit arose under the Internal Revenue laws of the United States for a refund of estate taxes that were allegedly erroneously assessed and collected.
2. Venue for this action properly lies in the Western District of Texas pursuant to 28 U.S.C. § 1391(e).

Findings of Fact

1. Elsie S. Church ("Mrs. Church") died on October 24, 1993, at the age of about 72. (Tr. 166, 223).

2. Mrs. Church was the mother of plaintiffs Marshall B. Miller, Jr. and Mary Elsie Newton. (Tr. 110).
3. On October 22, 1993, Mrs. Church, Marshall B. Miller, Jr., and Mary Elsie Newton signed an agreement entitled, "Agreement of Stumberg Ranch Partners, Ltd." ("Partnership Agreement"). (Tr. 131, 409, PX 1). The execution of this document resulted in the formation of a Texas limited partnership ("the Partnership"), subject only to substantial compliance with the Texas Revised Limited Partnership Act then in effect. TEX. REV. CIV. STAT. ANN. art. 6132a-1, and the Texas Uniform Partnership Act. TEX. REV. CIV. STAT. ANN. art. 6132b.
4. The purpose of the Partnership was twofold. Most importantly, the partners wished to consolidate their undivided interests in a family ranch known as the W.R. Stumberg Ranch ("the Ranch") to provide for centralized management of their interests and preserve the Ranch as an on-going enterprise for future generations. (Tr. 121-22, 126-27, 141, 148, 225-27). In addition, as she aged, Mrs. Church became concerned about protection of her substantial assets from judgment creditors in the event of a catastrophic tort claim against her. (Tr. 128-29).
5. The Ranch, located in West Texas, consists of approximately 23,000 acres. (Tr. 114). The ranch supports grazing of cattle, sheep, and goats. (Tr. 112, 115-17). Since about 1979, the Ranch has been leased for grazing and hunting. (Tr. 115-17, 126). There is currently an oil and gas lease on the Ranch. (Tr. 121).
6. Mrs. Church was a limited partner in the Partnership. (PX 1). While she had actively managed the Ranch on behalf of all of the owners in years past under an informal

agreement, she had largely relinquished this role to her two children after her remarriage to William Church in 1984. (Tr. 118, 121, 124-25). The other undivided interest owners in the Drake family had never been active in the management of the Ranch. (Tr 118, 137).

7. Miller and Newton were also limited partners in the Partnership. Stumberg Ranch, L.C. was designated as the general partner, and was to be owned 50-50 by Miller and Newton to reflect their active roles in managing the Ranch. (Tr. 136, PX 1). This corporation, however, had not yet been formed when Marshall Miller signed the Partnership Agreement on its behalf on October 22, 1993. (PX 1 at 17, PX 5, PX 6).
8. The capital contributions to the Partnership consisted of each limited partner's undivided interest in the Ranch. In addition, Mrs. Church contributed approximately \$1 million in securities inherited from her mother and from her husband Bill Church that were held in street name in an account at Paine Webber. (Tr. 131-32, 139, 192, PX 1 at 2, Ex. A, PX 11). At this time, the limited partners owned 57% of the Ranch while members of the Drake family owned the remaining 43%. Of the 57% interest owned by the Partnership, Mrs. Church owned 62% in her individual capacity, and Miller and Newton each owned 18%. Mrs. Church owned the remaining 2% as a trustee. (Tr. 123, 136, PX 1 at 3). The undisputed market value of the interest in the Ranch contributed by Mrs. Church was \$380,038, while the value of her children's interests was \$232,927. (Tr. 131-32, 154, PX 1, PX 9 at Ex. B).
9. The Agreement allocated profit or loss from Ranch operations in proportion to the interests contributed by the limited partners. Ninety-nine percent of the taxable income from the securities contributed by Mrs. Church was specially allocated to her after

expenses. (Tr. 133, 136, 187, PX 1 at 2-3). Mrs. Church also received 62% of the income attributable to the operation of the Ranch. (Tr. 136). The result was that the Partnership was a pro rata partnership in the sense that profits, losses, and income were allocated in proportion to each partner's capital contribution, and no partner experienced an economic benefit from the contribution of another.

10. The limited partners conveyed their interest in the Ranch to the Partnership in a Special Warranty Deed signed on October 22, 1993. (PX 4). On the same day, Miller signed an Assignment Separate from Certificate conveying Mrs. Church's securities to the Partnership. (PX 3). He did so under a power of attorney Mrs. Church had given him in July of 1992. (PX 7).
11. Two days after these transactions, on October 24, 1993, Mrs. Church died suddenly and unexpectedly of cardiopulmonary collapse. (PX 8).
12. At the time she died, Mrs. Church had breast cancer. She had first been treated for this condition by Dr. Stephen Cohen in July of 1990. (Tr. 165). Dr. Cohen is an eminently qualified oncologist. (Tr. 163-65). Although the Court finds the cause and timing of Mrs. Church's death is largely irrelevant to this case, the Court accepts as true the testimony of Dr. Cohen that Mrs. Church's death was unexpected and unrelated to her cancer. (Tr. 169-70). After diagnosis and initial treatment, Dr. Cohen initially treated Mrs. Church with chemotherapy that was very debilitating but successful in destroying signs of the disease. (Tr. 165-66). After 1½ years, the cancer recurred and Mrs. Church was again treated with chemotherapy that had to be stopped because of the side effects. (Tr. 166) This course of treatment nevertheless was successful in the sense that Mrs. Church went

into clinical remission for the last six months of her life. (Tr. 171-72).

13. Notwithstanding her cancer, Mrs. Church was living a normal life at the time of her death. She had her own apartment where she lived without assistance, drove a car, visited family and friends, and did not exhibit any signs of a belief that she would die soon. Indeed, she had purchased new clothing shortly before her death, which is not the act of one on her deathbed. (Tr. 146-47, 167, 223-24). I thus accept as true the conclusion of Dr. Cohen that Mrs. Church had no reason to believe that she would soon die. Moreover, there were many available treatments for Mrs. Church's breast cancer that she had not yet undergone because she did not need them. Any estimate of how long she could or would have lived with her cancer would be a guess, with no factual support or probative value. (Tr. 173).
14. While the Partnership was formed on October 22, 1993, the organization of its affairs was not completed prior to Mrs. Church's death. The Certificate of Limited Partnership was not filed in the Office of the Texas Secretary of State until October 26, 1993. (PX 2). This Certificate states it was signed and executed on July 1, 1993 by Marshall B. Miller, Jr. Miller indicated at trial that this was incorrect, and that he probably signed it on October 22 with the other Partnership documents. He attributed this mistake to the fact that the Partnership Agreement, while not signed until October 22, has an effective date of July 1, 1993. Since the date on the Certificate was typed, I find that this was a clerical error that Miller did not notice when he signed the Certificate. Miller made no effort to conceal this mistake, and it is immaterial when the Certificate was signed.
15. The corporate general partner of the Partnership was not actually organized until March

of 1994. (PX 5, 6). The Paine Webber account in the name of Elsie Church was not changed to a Partnership account until the same month. To the limited extent that a determination of relevance involves findings of fact, common experience tells us that it is not unusual that all of the paperwork associated with the formation of a business entity was not completed in a single day, or in the short interval of two days between execution of the Partnership Agreement and Mrs. Church's death. Indeed, the failure to complete the paperwork on Friday, October 22, 1993 lends credence to the testimony that the state of Mrs. Church's health and her possible death were not motivating factors in the decision to form the Partnership. After Mrs. Church's death, it was obviously immaterial whether paperwork was completed in a day or a month. The legal consequences, if any, arising from the failure to complete the paperwork prior to death were fixed.

16. I find that the primary purpose of the partners in forming the Partnership was a desire to preserve the family ranching enterprise for themselves and their descendants. Both Miller and Newton testified to, and I accept as true, their feelings that their and their mother's association with a working ranch was an important and beneficial influence on their otherwise urban lives that would also benefit their descendants. Bringing organization to the Ranch would remove it from the control of one or more fractional, undivided-interest owners who could use the property at will, interfere with operations, and ultimately force a partition or sale of the Ranch. (Tr. 120-122, 126-27, 141-45, 148, 225-27).
17. The evidence of this motivation is concrete and persuasive. In the first instance, Mrs. Church and her children had already experienced the consequences of undivided ownership in a real-estate-based business enterprise. Prior to formation of the Partnership,

Mrs. Church's nephew, Rod Drake, had exercised his rights as an undivided owner by moving onto the Ranch, interfering with operations, threatening legal action, and almost driving off the grazing lessee who was the major source of the Ranch's income. (Tr. 122).

Mrs. Church, her two children, and their cousin had to solve this threat by borrowing money to purchase the nephew's interest. (Tr. 122, 225). Moreover, they knew this nephew would likely inherit additional interest in the Ranch through his father and would likely have to be bought out again. (Tr. 123). This in fact occurred after formation of the Partnership. The securities contributed to the Partnership by Mrs. Church provided the \$200,000 in capital necessary for this second buy-out that increased the Partnership's interest in the Ranch from 57% to its present 75%. It also was, and is, the intention of the Partnership to purchase the outstanding 25% undivided interest of Whit Drake when, and if, the Partnership has accumulated sufficient capital to do so. (Tr. 144-45).

18. The Partnership was also formed with an eye towards the possibility of actively engaging in raising cattle. The Ranch was in the midst of a prolonged and continuing drought. The grazing lease expired in 1994, and there was a question whether it would be renewed. The Partnership was prepared, if necessary, to replace this lost income through active operations. (Tr. 184-85). Working capital over and above income from the Ranch would have been necessary to engage in this activity.
19. The Government contends that while the formation of the Partnership took the form of a bona fide business transaction, the transaction had no substance and was entered into for no purpose other than to reduce the taxation of Mrs. Church's estate. I do not find this to be the case. The character of the interests owning a majority of the Ranch changed

dramatically as a result of the Partnership. Prior to its formation, Plaintiffs and their descendants would have owned undivided interests in the Ranch, with each interest carrying the right to use and enjoy the property, or force a partition or possible sale. The Partnership eliminated these individual rights and placed ownership of a majority of the Ranch in a Partnership that was not controlled by any single person.

20. I find as a matter of fact that the Partnership had bona fide business purposes and was not a sham as that term is used in estate taxation.
21. I also find that the Partnership was not formed solely to reduce estate taxes.
22. Mrs. Church intended to, and did, convey her interest in the securities held by Paine Webber on October 22, 1993. This intent to relinquish her interest is explicitly expressed in the Partnership Agreement she signed on that date
23. There is no ambiguity in the Partnership Agreement with respect to the power to amend it, and no claim of ambiguity has been brought to the attention of the Court. Even if such a claim had been made, no extrinsic evidence was offered to explain any claimed ambiguity.
24. Mrs. Church did not have the unilateral right to alter, amend, revoke, or terminate the Partnership Agreement. Section 29 of the Partnership Agreement provides that it may be amended "only upon the written agreement of the Partners then entitled to eighty percent (80%) or more of the Partnership interests in profits from operations." The reference to "profits from operations" can logically refer only to Ranch operations, and therefore Mrs. Church was entitled to only 62% of those profits. Nor could Mrs. Church dissolve the Partnership through the use of her amendment power, even if she could cast more than

80% of the vote to do so. As Texas partnership law provides, no act in contravention of the agreement (such as dissolution) may be done without the consent of all the partners. TEX. REV. CIV. STAT. ANN. art. 6132b § 18(h). Such a unilateral act would also contravene sections 15(a) and 22 of the Partnership Agreement.

25. There was no expressed or implied agreement between the partners in the Partnership that Mrs. Church could continue to use, possess, or enjoy partnership property, or retain the right to income from Partnership property, within the meaning of I.R.C. § 2036.

26. To the extent that the safe harbor exceptions to application of I.R.C. § 2703 involve issues of fact, I find that the Partnership was a bona fide business arrangement, and not a device to transfer property to members of Mrs. Church's family for less than full and

adequate consideration in money or money's worth. I also accept as true the uncontradicted testimony of Charles Hornberger that the terms and restrictions in the Partnership Agreement were comparable to similar arrangements entered into by persons in arms-length transactions. With respect to the issue of consideration, I reject the Government's contention that the difference in value between the Partnership interest Mrs. Church received on formation and the value of the assignee interest transferred upon her death is the appropriate measure of the consideration she received for her contribution of assets to the Partnership. These are two different interests that are not comparable. My finding that she received full and adequate consideration is premised upon the fact that whatever the value of her Partnership interest on the date of formation, it was directly proportionate to the contributions and Partnership interests of the other partners to a Partnership that had a bona fide business purpose.

27. The fair market value of the assets contributed by Mrs. Church to the Partnership, as of the date of her death or the alternate valuation date of April 24, 1994, was \$1,467,748 (Tr. 410). Of this figure, the value of the Ranch accounted for \$380,038, and the value of the cash and securities contributed by Mrs. Church was \$1,087,710.
28. The fair market value of Mrs. Church's limited partnership interest in the Partnership, as of the date of her death or the alternate valuation date of April 24, 1994, was \$617,591. (PX 13 at i). While this is precisely the estimate of Plaintiffs' valuation expert, Mr. Bruce Johnson, and presumably could have been challenged given that the valuation of such interests are ultimately a matter of opinion, the Government chose not to present any valuation evidence of its own. Since the Court must find facts based on the record before it, it accepts Mr. Johnson's uncontradicted estimate.
29. On July 25, 1994, the Estate of Elsie Church timely filed a Form 706, United States Estate Tax Return. (Tr. 410).
30. On February 16, 1996, the Internal Revenue Service served a Notice of Deficiency proposing to assess against the estate a deficiency of \$212,503 plus interest. (Tr. 410).
31. After adjustments, the estate made full payment of the deficiency on April 8, 1996 in the amount of \$230,100, representing the principal sum of \$197,221 and statutory interest of \$32,879. (Tr. 410).
32. On October 9, 1996, Plaintiffs filed a claim for refund that the IRS denied. (Tr. 411).
33. On March 3, 1997, the IRS refunded \$14,631.65 to the estate. This refund was attributable to additional deductible attorney's fees of \$43,769 and appraisal fees of \$5,594 incurred in connection with this matter and necessary in the administration of the

estate. (Tr. 411).

34. This lawsuit was filed on June 26, 1997. (Tr. 411).
35. Since March 3, 1997, Plaintiffs have actually and necessarily incurred the sum of \$101,442.71 in additional attorney's fees and expenses in seeking a refund through this suit. I find that these attorney's fees and expenses were necessary in the administration of the estate because they were actually incurred in the collection of assets within the meaning of Treas. Reg. 20.2053-3. This sum is accordingly an additional deduction from the federal estate tax heretofore paid.
36. Plaintiffs are entitled to a refund based on the proper valuation of Mrs. Church's Partnership in the amount of \$617,591. In accordance with the parties' stipulation, the Government shall calculate the refund and submit its calculation to Plaintiffs for approval within thirty (30) days of this decision. Any dispute thereafter as to the amount of the refund shall be submitted to the Court, which shall include the dollar amount of the refund in its final judgment.

Conclusions of Law

1. For the reasons stated in its order on the Government's motion in limine (docket no. 44), the Court concludes that the formation of Stumberg Ranch Partners, Ltd. was in substantial compliance in good faith with the Texas Revised Limited Partnership Act, and TEX. REV. CIV. STAT. ANN. art. 6132a-1, and the Texas Uniform Partnership Act. TEX. REV. CIV. STAT. ANN. art. 6132b.
2. Accordingly, the Partnership was a valid Texas limited partnership as of October 22, 1993, and Mrs. Church's limited partnership interest must be taxed as such under I.R.C.

§§ 2033 and 7701(a)(2).

3. The Government contends that prior to her death, Mrs. Church did not effectively convey to the partnership legal title to the securities in her Paine Webber account. Based on the undisputed facts, the Court concludes this contention is without merit. Mrs Church did not hold legal title to these securities; hers was an equitable beneficial interest and legal title was held by Paine Webber. It would make no difference even if this were not the case because neither Texas law nor the federal law of estate taxation concern themselves with legal title in determining ownership of partnership property. Under well-established principles of Texas law, ownership of property intended to be a partnership property is not determined by legal title, but rather by the intention of the parties. Logan v. Logan, 156 S.W.2d 507, 512 (Tex. 1941); Foust v. Old Am. County Mut. Fire Ins. Co., 977 S.W.2d 783, 786 (Tex App.-- Fort Worth 1998, no writ). Mrs. Church's intention to relinquish her beneficial interest in the securities held by Paine Webber was clearly expressed by her executions of the Partnership Agreement in which these securities are specifically described. This intention governs without regard to legal title to the securities and the securities were the property and assets of the Partnership.
4. If Mrs. Church effectively conveyed the securities in her Paine Webber account to the Partnership, as the Court has concluded, the Government next contends that there was a taxable gift on formation of the Partnership. The taxable value of this gift is represented to be the difference between the \$1,467,748 in assets contributed by Mrs. Church to the Partnership, and what the Government claims was the value of the Partnership interest she received in return. This latter sum is the \$617,591 estimated market value of Mrs.

Church's interest in the Partnership at death.

5. Initially, the Government's contention confuses the market value of the assignee interest passing at death with the value of the Partnership interest Mrs. Church received in return for her contribution. The two interests are not comparable. More importantly, the Government ignores the fact that this was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner. Implicit in the Government's argument is the notion that since the value of Mrs. Church's Partnership interest was less than the assets she contributed, someone must have received a gratuitous transfer of the difference. This was not the case, and never could be in the formation of a business entity in which each investor's interest is proportional to the capital contributed.
6. A gift can be made in many guises, and it is the intention of I.R.C. § 2501, et. seq. to tax them whatever their form. Nevertheless, a taxable gift must involve a gratuitous transfer, which by definition requires a donee. Dickman v. Commissioner, 465 U. S. 330, 334, 104 S.Ct. 1086 (1984). There was none in this case. Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982) and the other cases cited by the Government reinforce this point rather than contradict it. Each involved an attempt to donatively pass property to others through the formation of business entities in which the donor did not receive an interest proportionate to his or her capital contribution.
7. I.R.C. §§ 2036 and 2038 likewise require a "transfer" as a predicate to their application. Shafer v. Commissioner, 749 F.2d 1216, 1221 (6th Cir. 1984); Estate of Harrison v Commissioner, 52 T.C.M. (CCH) 1306, 1309 (1987). Since the gift and estate taxes are considered *in pari materia*, Wheeler v United States, 116 F.3d 749, 761 (5th Cir. 1997),

the term "transfer" must be given the same meaning in construing sections 2036 and 2038 as it is in the taxation of gifts. Having previously concluded that there was no gratuitous donative transfer in the formation of Stumberg Ranch Partners, Ltd. in connection with the Government's contention of a gift on formation, I likewise conclude that sections 2036 and 2038 do not apply to the transaction in issue. Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306, 1309 (1987); Estate of Michelson v. Commissioner, 37 T.C.M. (CCH) 1534, 1538 (1978).

8. The Government makes two contentions with respect to the application of I.R.C. § 2703 to this case. It first suggests that the term "property" refers to the assets Mrs. Church contributed to the Partnership prior to death, rather than her Partnership interest. There is no statutory basis for this contention. Mrs. Church did not own the assets she contributed to the Partnership on the date of her death; she owned a Partnership interest. The estate tax is imposed on that which a decedent transfers at death without regard to the nature of the property interest before or after death. I.R.C. § 2033; Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981) (en banc). I.R.C. § 2033 provides that the gross estate shall include any partnership interest owned by a decedent as defined by I.R.C. § 7701 (a)(2). Lusthaus v Commissioner, 327 U.S. 293, 66 S.Ct. 539 (1946); Estate of Winkler v. Commissioner, 73 T.C.M. (CCH) 1657 (1997). I.R.C. § 2703 does not define the term "property" in any matter inconsistent with these provisions, or indeed at all, and cannot have a meaning attributed to it without Congressional authorization that would make it unique in the estate tax provisions of the Code.
9. The Government alternatively contends that if I.R.C. § 2703 does require taxation of Mrs.

Church's Partnership interest, it may nonetheless disregard the term restriction, and restrictions on sale in the Partnership Agreement that serve to reduce its market value. No case supports the Government's position, and nothing in the legislative history, or the regulations adopted by the IRS itself, convince this Court to read into Section 2703 something that is not there. By its very nature, a partnership is voluntary association of those who wish to engage in business together, and upon whom the law imposes fiduciary duties. Term restrictions, or those on the sale or assignment of a partnership interest that preclude partnership status for a buyer, are part and parcel of the property interest created by state law. These are not the agreements or restrictions Congress intended to reach in passing I.R.C. § 2703. Reviewing the legislative history, and construing I.R.C. § 2703 with its companion statute, I.R.C. § 2704, it is clear that the former was intended to deal with below-market buy-sell agreements and options that artificially depress the fair market value of property subject to tax, and are not inherent components of the property interest itself.

10. The Court concludes that Plaintiffs have carried their burden of proof and are entitled to the refund prayed for in the amount set out in the findings of fact.
11. Interest on the Court's judgment shall run in accordance with the provisions of 28 U.S.C. § 2411.

SIGNED and ENTERED this 18th day of January, 2000.


ORLANDO L. GARCIA
UNITED STATES DISTRICT JUDGE

GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

2000 REGULAR SESSION

SENATE BILL NO. 309

FRIDAY, MARCH 10, 2000

AN ACT relating to trusts.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

SECTION 1. A NEW SECTION OF KRS CHAPTER 287 IS CREATED TO READ AS FOLLOWS:

As used in Section 2 and Section 3 of this Act:

- (1) "Life beneficiary" means a beneficiary who is a current permissible or mandatory recipient of income or principal from the trust, or, if more than one (1), the beneficiary or beneficiaries of the oldest generation;*
- (2) "Remainder beneficiary" means a beneficiary who would have received the trust property in fee but for the continuation of the trust by the corporate trustee;*
- (3) "A portion or all of the trust" means a portion, including all, of any remainder beneficiary's share of the trust to which the remainder beneficiary would be entitled in fee following the death of the life beneficiary. The portion of each of the remainder beneficiary's share that is continued shall be held as a separate trust;*
- (4) "Trust" has the same meaning as set forth in KRS 386.800; and*
- (5) "Corporate trustee" means a trust company or a bank empowered as a fiduciary.*

SECTION 2. A NEW SECTION OF KRS CHAPTER 287 IS CREATED TO READ AS FOLLOWS:

- (1) A corporate trustee administering a trust may continue the term of a portion of the trust so long as the period of the continuation does not extend beyond the term of the Rule Against Perpetuities, as set forth in KRS 381.215, that is applicable to the trust.*
- (2) Subject to KRS 381.215, the portion of the trust continued by the corporate trustee shall continue for the life of the remainder beneficiary of the trust, upon the same terms and conditions as provided in the trust, for the term preceding the life beneficiary's death. In addition, commencing with the death of the life beneficiary, the remainder beneficiary may withdraw that portion of the trust that has been continued by giving written notice to the corporate trustee. However, each year five percent (5%) of the remainder beneficiary's right of withdrawal shall lapse on December 31, and the lapses shall be*

cumulative.

(3) The corporate trustee's authority granted in subsection (1) of this section shall not apply to any portion of a trust which:

(a) Continues by its terms after the death of the life beneficiary; or

(b) Has been pledged to secure a debt.

(4) This section shall apply to any trust that was irrevocable on January 1, 1976.

Section 3. KRS 287.220 is amended to read as follows:

- (1) When acting as a fiduciary or in any other capacity in which the duties, powers, liabilities, rights, and compensation are regulated by law, or under the control or supervision of the court, banks and trust companies shall, except as provided in subsection (2) and subsection (3) of this section, be subject to the same duties and responsibilities, have the same rights and powers, and receive the same compensation as is allowed the individual holding or exercising similar offices or trusts.
- (2) Upon all bonds required to be executed by such corporation before any court, the capital stock shall be the only security required for the faithful performance of its duties, unless the court or officer before whom the bond is executed, or some party in interest demands additional security.
- (3) A bank or trust company serving as a trustee of multiple trusts having one (1) or more common beneficiaries or remainder beneficiaries, need not obtain court approval for performance or execution of its duties, and it shall not be considered a conflict of interest solely because all beneficiaries or remainder beneficiaries of the trusts are not identical.

NON-TAX CONSIDERATIONS

FOR THE ESTATE PLAN

**Turney P. Berry
Ogden Newell & Welch
Louisville, Kentucky**

**Edward Jay Beckwith
Baker & Hostetler LLP
Washington, D.C.**

**Kathleen C. Thompson
Stock Yards Bank & Trust Company
Louisville, Kentucky**

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and Kathleen Thompson

SECTION B



Panel Discussion
Non-Tax Considerations for the Estate Plan

Use of Trusts for Beneficiaries.

Should beneficiaries receive assets outright or should they remain in trust? If the latter, who or what should be the trustee? What kind of control should beneficiaries have over a trustee? Are advisors appropriate, and, if so, who are appropriate advisors?

Consider the following situation. Mom and Dad have well beyond a taxable estate and three children. It is a first marriage and the children are 3, 7 and 12 years old. Mom and Dad want to protect the children, should both of them die, until the kids are a reasonable age and then "turn the money over to them." The recommended plan is as follows:

*Separate trusts for each child with a corporate trustee serving initially. Each trust is for the health, education, maintenance and support of the child, and the child's descendants, and the child has a broad special power of appointment over the trust assets and a general power of appointment over assets subject to the generation skipping tax.

*An advisory committee consisting of Mom's father (and mother as replacement), Dad's brother (and sister as replacement), and Mom and Dad's accountant. The AC has the power to recommend investments, direct distributions, and remove the trustee and select another corporate trustee.

*At age 25 a child will become a member of the advisory committee. At age 30 child will become the sole member of the advisory committee. At age 35 child may serve as sole trustee of the trust and may select individuals or corporate trustees to serve thereafter.

Good plan? Bad plan? Is this the equivalent of turning the money over to the children? Are there advantages or disadvantages?

Uses of Special Powers of Appointment.

It is Mom's first marriage and Dad's second. Mom and Dad each have taxable estates of about the same size. It is unclear how much "really" once belonged to whom. Mom and Dad have been married for 10 years and have two children together, one 8 and the other 6. Dad also has two children, one 24 and the other 27 (who is married to a wonderful person and they are likely to have children soon). Mom and Dad state that their joint goal is to treat all four children equally. Dad is 50 and Mom is 44.

Dad is going to create a Crummey trust for Mom and his descendants. Mom is going to create a GRAT and fund it with stock in a high-tech start-up that her family is involved in. Each of them will create a QPRT. They desire to have as much flexibility as they reasonably can. Should Mom and Dad give each other broad special powers of appointment or should they be limited, and if the latter, how?

Mom and Dad also like the kind of plan recommended in Situation 1. They want to ensure, though, that the spouses of children are included if appropriate should Mom and Dad die and a child die. What is the best way to do that?

While they are on the subject Mom and Dad ask whether they should include spouses as beneficiaries of the Crummey trust and give them withdrawal rights?

Family Partnerships Have Independent Significance.

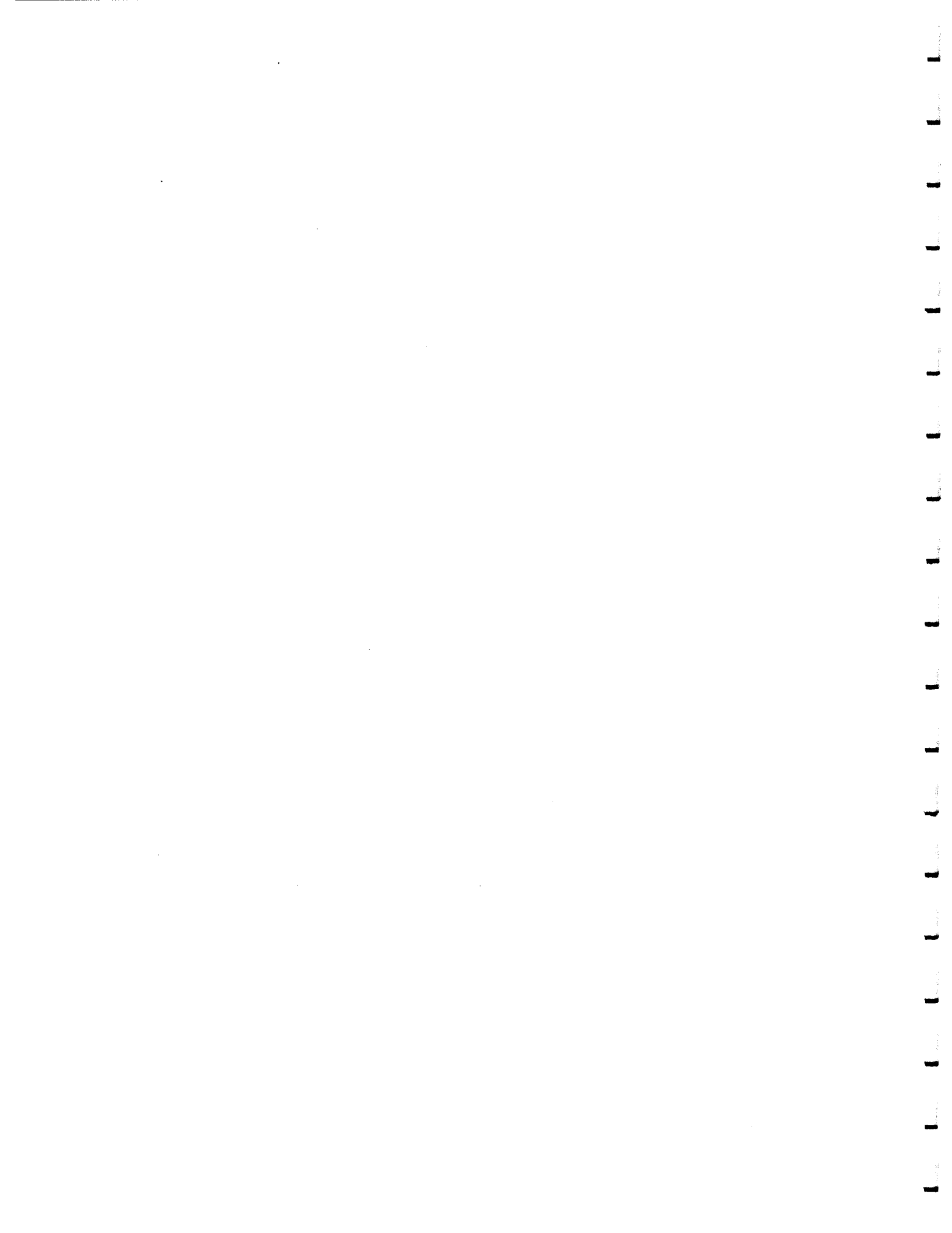
When creating family limited partnerships who gets control? How is the control passed from one generation to the next? We all know that what is "supposed" to happen is for the partnership to be dissolved "down the line" but will that really happen and what if it does not? What rights do limited partners really have and does that matter?

Mom is a billion years old. She has one surviving child and a deceased child with four living children. The family – Mom, child, and grandchildren – all agree that Mom should form a family partnership and should give or sell control to the next generation. Actually, Mom doesn't agree because she is incapacitated and has been for years, but she would agree if she could. Today child handles Mom's affairs.

Who should be the general partner when the partnership is formed? Can everyone's rights be protected and, if so, how?

**DEATH TAX IMPLICATIONS
OF POWER IN A TRUSTEE**

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DEATH TAX IMPLICATIONS OF POWERS IN A TRUSTEE

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1. INTRODUCTION.

The first question often asked to clients when discussing estate planning is "assuming that taxes were not an issue to who and how would you like your assets to pass?" Often the answer is in trust for my spouse then in trust for my children and grandchildren. The client desires to use trusts for creditor and predator protections. However, the client desires to balance these protections with the reality that if their loved ones want or need money, they should have access to it. In other words, they want to have their cake and eat it too.

Thus, as drafters of language we would like to provide to the client the greatest amount of flexibility both during life and after death. Powers of Appointment provide that type of flexibility. This distribution flexibility is often granted in two circumstances: (i) to a trust beneficiary as a power of appointment among other trust beneficiaries; or (ii) to a trustee to make distributions or withdrawals when appropriate. Powers of appointment properly drafted allow other to exercise the same judgment that the grantor could have if they still controlled the property.

However, because estate, gift and income tax consequences of the transaction are at stake, extreme care must be exercised to avoid breaching numerous tax rules with the establishment of trusts whether inter vivos irrevocable trusts, or trusts under Wills. This outline will address the types of powers of appointments, the tax ramifications, and post-death planning opportunities.

2. TYPES OF POWERS OF APPOINTMENT.

Powers of appointment are not specifically defined in the Internal Revenue Code of 1986, as amended (the "Code"). However, in sections 2041(b)(1)(A) and 2514(c)(1) of the Code, the power to "consume, invade or appropriate property" from taxation was exempt from estate and gift taxation under the ascertainable standard exception. The Treasury Regulations define powers of appointment to include "all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations."¹

Property subject to a general power of appointment is included in a decedent's gross estate by reason of section 2041 of the Code. Similarly, an inter vivos exercise or release of a general power of appointment is a transfer of property subject to gift tax by reason of section 2514 of the Code. In determining the estate, gift and income tax consequences of any power of appointment, it is necessary to first ascertain whether the interest is a general or nongeneral power.

¹ Treas. Reg. §20.2041-1(b)(1) and Treas. Reg. §25.2514-1(b).

2.1 General Power of Appointment.

A general power of appointment is a power exercisable in favor of the power holder, his estate, his creditors or the creditors of his estate.² The power to appoint in favor of any of the four will be considered a general power of appointment.³ But take note that the determination regarding whether a holder of a power may, in fact, exercise the same in favor of himself, his estate or the creditors of either of those, is to be made in accordance with local substantive law. However, where the state law nomenclature attached to a given right or power differs from the reality of the situation giving due regard to the intent and objective of the federal tax law, the state law must give way to the federal tax interpretation.⁴ The Treasury Regulations expand upon the definition provided in the Code of general power of appointment.⁵

(a) The Powers of Appointment Act of 1951.⁶ The 1951 Act was enacted in response to criticism of the extensive taxation of powers of appointment under the Revenue Act of 1942.⁷ The 1951 Act was made retroactive to 1942, as if it had been part of the 1942 Act.

²Sections 2041(b)(1) and 2514(c) of the Code. *See also Peterson v. Comr.*, 31 T.C.M. 269 (1972) (spouse had life estate and general power of appointment over the community property where she had received the life estate in the property and the right to use, occupy, enjoy, convey, and expend the property as she desired during her lifetime.)

³*Estate of Edelman v. Comr.*, 38 T.C. 972 (1962); *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970), cert. denied, 400 U.S. 829 (1970); and PLR 9110054 (beneficiary's power to appoint in favor of his creditors is a general power).

⁴*See i.e., Martin v. U.S.*, 780 F.2d 1147 (4th Cir. 1986). The decedent/trust beneficiary had, at the time of death, a power to appoint trust assets to anyone of her choosing, and only in the absence of the exercise of the power, would the trust assets be paid to her estate. Such a power was construed under Maryland law not to include the power to appoint to one's self, estate or creditors, unless such terms were clearly set forth. The lower court held that, under Maryland law, the power was not technically a general power of appointment because she could not appoint property in a way triggering section 2041. However, the 4th Circuit held that the decedent had general power of appointment at death, since the choice not to exercise the power resulted in her estate receiving the assets.

⁵Treas. Regs. §§20.2041-1(c)(1) and 20.2514-1(c).

⁶Pub. L. No. 82-58, 65 Stat. 91, 91-95.

⁷John G. Steinkamp, Estate and Gift Taxation of Powers of Appointment Limited by Ascertainable Standards, 79 Marquette Law Review 195, 202 (Fall 1995).

(b) The taxation of property subject to powers of appointment depends upon the date of a power's creation and the nature of the power.

(1) In pre-October 22, 1942 general power of appointment, if the decedent did not exercise the power, there is no estate tax liability as a result of the existence of the power. Additionally, a failure to exercise a pre-October 22, 1942 power is not deemed an exercise of the power.⁸

(2) In a pre-October 22, 1942 general power of appointment, if the decedent exercised the power, his gross estate includes the value of the appointed property under sections 2035 and 2038 of the Code. However, for decedents dying after December 31, 1981, section 2035(a) of the Code does not apply except for specified types of transfers. Thus, gifts made within three years of death generally are not included in a decedent's gross estate.⁹

(3) In a post-October 21, 1942 general power of appointment, will be included in the decedent's gross estate.

(4) In a pre-October 22, 1942 nongeneral power of appointment, the decedent's gross estate under sections 2041 or 2514 of the Code does not include the value of the property.

(5) Post-October 21, 1942 nongeneral power of appointment, are generally not taxed under sections 2041 or 2514 of the Code.

2.2 Nongeneral Power of Appointment.

Powers that are not general powers are nongeneral either by default or because they fall within a specific statutory exception.

(a) Certain powers of appointment are considered nongeneral because they fall outside the statutory definition of general powers. A specific statutory exception is not needed because the holder of the power does not have the power to appoint the property to himself, his estate, or creditors of either. For example, an independent trustee discretionary power to distribute principal to the children of Settlor is a nongeneral power.

(b) However, certain power of appointment are considered nongeneral

⁸Treas. Regs. §20.2041-2(c), Ex. 4.

⁹Section 2035(d)(1) of the Code.

only because Congress has specifically excepted them when it defined general powers.

(1) Perhaps the most important exception is for powers to consume, invade or appropriate property for one's own benefit which are "limited by an ascertainable standard relating to the health, education, support or maintenance" of the holder.¹⁰ Generally, property subject to a decedent's general power of appointment must be included in his gross estate under section 2041 of the Code, and the lifetime exercise or release of a general power of appointment (in favor of another person) is treated as a taxable gift under section 2514(b) of the Code. However, where such power is subject to an ascertainable standard relating to the health, education, support, or maintenance of the powerholder, it is specifically excluded from treatment as a general power of appointment. The rationale for excluding powers limited by an ascertainable standard from the definition of a general power of appointment is because the holder no longer has unfettered discretion over the assets. Go to Paragraph 4 for further discussion on Ascertainable Standards.

(2) If a power is exercisable only in conjunction with the power's creator it is not considered a general power of appointment. The rationale for this rule is based on the transfer tax consequences to the creator of the power. For gift tax purposes, such creation of a joint power with the creator may make the gift incomplete. Whether the gift is completed will turn on the character of the joint power holder. If they are considered adverse, the gift will be complete. If they are not, the gift will be incomplete. You can make an incomplete gift complete via a subsequent release, lapse or exercise of the power in favor of someone other than the creator. Congress reasoned that two persons should not be subject to transfer tax with respect to the same property.¹¹ Go to Paragraph 3.1 for further discussion on Gift Tax.

(3) The final statutory exception is for post-October 21, 1942 powers exercisable only in conjunction with a "person having a substantial interest in the property, subject to the power, which is adverse to the exercise of the power in favor of the decedent."¹² The person's adverse interest must be in the trust property.¹³ According to the regulations, an interest is adverse to the exercise of power if its value in relation to the total value of the property subject to the power is not insignificant.¹⁴

¹⁰Sections 2041(b)(1)(A) and 2514(c)(1) of the Code.

¹¹Steinkamp, 79 Marq. L. Rev. at 207.

¹²Sections 2041(b)(1)(B) and 2514(c)(2) of the Code.

¹³Sections 2041(b)(1)(C)(ii) and 2514(c)(3)(B) of the Code; Treas. Reg. §20.2041-3(c); and Miller v. U.S., 387 F. 2d 866, 870 (3rd Cir. 1968).

¹⁴Treas. Reg. §20.2031-1.

Thus, cotrustees, institutional or individual, who possess no beneficial interest in the trust, will not cause a power of appointment to be considered a nongeneral power within this exception.¹⁵ A co-holder of a joint power who is either designated as a beneficiary or can appoint the trust property to himself, his estate or creditors has an adverse interest. For further discussion on Adverse Co-Trustee see Paragraph 5.

(A) In Rev. Rul. 79-63¹⁶, the decedent's spouse created a testamentary trust which the decedent was given the life income and a testamentary special power of appointment. If the testamentary special power of appointment was not exercised, the remainder was payable equally to decedent's children. The decedent also had a general power of appointment during her lifetime to appoint trust assets with the consent of A, one of decedent's children. The IRS stated that this was still a general power of appointment because A was simply a permissible appointee under the lifetime power, but was not vested. Therefore, A's interest was not substantially adverse. Had A held a vested remainder, he would have had an interest substantially adverse to the exercise of the decedent's lifetime power of appointment.

(B) Similarly in PRL 9030032, the surviving spouse and one of her four children were the co-trustees of the decedent's testamentary trust. The trustees could invade corpus for the surviving spouse's "support and comfort." At the surviving spouse's death, the remaining corpus is payable to her surviving children. Although the standard was not considered ascertainable, the surviving spouse did not have a general power of appointment because the power was exercisable only in conjunction with a child, who was an adverse party.

3. ESTATE AND GIFT TAXATION OF POWERS OF APPOINTMENT.

3.1 Gift Tax Consequences of Powers of Appointment.

(a) Inter vivos Transfers. Generally, a completed gift occurs when the transferor has (for less than full consideration) parted with dominion and control over property.¹⁷ However, a gift is incomplete to the extent that the transferor has reserved the right to modify the interest of the donee(s), unless such power is a fiduciary power limited by a fixed or ascertainable standard.

The ascertainable standard requirement under the gift tax Regulations is conceptually

¹⁵Miller, 387 F. 2d at 870; see also Estate of Vissering v. Cmm'r, 96 T.C. 749, 754 (1991), *rev'd on other grounds*, 990 F. 2d 578 (10th Cir. 1993).

¹⁶ 1971-1 CB 302

¹⁷Treas. Reg. §25.2511-2(b).

identical to the judicially imposed ascertainable standard exception under sections 2036(a) and 2038 of the code.¹⁸ Clearly, a reserved power which is fixed (e.g. \$5,000 per year) is ascertainable for the purposes of application of the standard. However, by its own terms the exception applies only where the power is exercisable in a fiduciary capacity.

Example: G transfers \$1,000,000 into trust for the benefit of B1 and B2, and all trust income is distributed equally to B1 and B2 annually. However, as trustee, G has the power to make special distributions of income to B3 to maintain her accustomed standard of living. G's transfer is a completed gift because of his continuing power over the property is constrained by a fiduciary power subject to judicial determination and enforcement in the future. If G's power to distribute trust income to B3 was exercisable either (i) not in a fiduciary capacity or (ii) without proper and sufficient restraint as to amount, the income portion of the transfer would be treated as an uncompleted gift.

Additionally, under the Regulations, a gift is incomplete when the donor reserves the power to revest beneficial title to the transferred property in himself.¹⁹ Although not addressed directly by the Code or the Regulations, a trust transfer where the grantor reserves only a fiduciary power limited by an ascertainable standard to distribute income, principal, or both to himself would be treated as a completed gift to the extent that the transfer exceeds the ascertainable value of such power.²⁰

Example: G transfers \$1,000,000 in trust for the equal benefit of B1 and B2, but retains, as trustee, the right to distribute \$5,000 per year to himself. the grantor has made a completed gift in the amount of \$1,000,000 less the value (the discounted present value) of the power to take \$5,000 per year for the duration of the trust.

¹⁸Treas. Reg. §25.2511-1(g)(2). The following examples are cited as properly limited powers:

- the distribution of corpus for the education, support, maintenance or health;
- for his reasonable support and comfort;
- to enable him to maintain his accustomed standard of living;
- to meet an emergency.

¹⁹Treas. Reg. §25.2511-2(c).

²⁰It is clear that a grantor's transfer of property to himself as trustee will not be a wholly completed gift unless he retains no beneficial interest in the trust property. Yet, the situation where the grantor may distribute to himself under an ascertainable standard is not mentioned. *See also*, Richard W. Harris, Ascertainable Standard Restrictions of Trust Powers under the Estate, Gift and Income Tax, 50 Tax Law. 489, 501 (Spring 1997).

One must always be aware of the special valuation rules under section 2702 of the Code when a grantor makes a transfer in trust for the benefit of family members and retains an interest in the trust. When section 2702 of the Code applies, the valuation of the gift is generally the fair market value of the entire transfer without reduction for the retained non-qualified interest of the transfer. However, where the power is such as to make the entire transfer incomplete, the special rules of section 2702 of the Code do not apply. Thus, where the grantor has a retained interest in the trust (for the benefit of family members) either as trustee with the ascertainable standard power to distribute trust property to himself, or merely to enforce such power in favor of himself, the retained power will be treated as a retained interest under section 2702, and valued at zero accordingly.

(b) Release. The release of a general power is treated as the same as an exercise and is considered a transfer for gift tax purposes.²¹ The rationale for this rule is that the holder of power could have exercised the power in his own favor and then transferred the property by gift. The general power holder control the property and its release caused the property to pass to another.

(1) A complete release of a pre-October 22, 1942 power is not considered an exercise of a general power. A partial release of a pre-October 22, 1942 general power of appointment followed by an exercise of the partially released power may be treated as the exercise of the nongeneral power.

(2) A post-October 21, 1942 power released by a donee is subject to gift tax.²²

For example, in Revenue Ruling 86-39²³, the Service ruled that the life beneficiary's release agreeing not to challenge the trustee's actions in a recapitalization of the trust assets which resulted in a decreased amount of remaining interests over which the life beneficiary had a general power of appointment was a taxable release. However, in the *Estate of Robinson v. Com'r.*²⁴, the Tax Court held that the agreement entered into by the surviving spouse and the remainder children terminating the trust and distributing the assets outright to the surviving spouse was not taxable under the decedent's lifetime under section 2514 of the Code. The Court held that the agreement converted the general power of appointment into an inter vivos power of appointment which the spouse exercised in favor of herself. Since the property was transferred to herself and not another person, the court held that no gift could occur.

²¹Section 2514(b) of the Code.

²²Section 2514(b) of the Code.

²³1986-1 C.B. 301.

²⁴101 T.C. 103 (1993).

(c) Lapse. Under section 2514(b) of the Code, the lapse of a general power of appointment is to be treated as a release of that power and is a transfer for gift tax purposes. However, a lapse is treated as a release only to the extent that the value of the property which could have been appointed exceeds the greater of \$5,000 or 5% of the value of the property out of which the power could have been satisfied.²⁵ This power is commonly known as the “five-and-five” power.

(1) If a donee allows a pre-October 22, 1942 power to lapse, there is no taxable gift.²⁶

In general, a lapse of a post-October 21, 1942 power is treated like a release and subject to gift tax just as a release would be.²⁷ However, there are two main exceptions to this rule: (i) when the holder of such power is incompetent and (ii) the “five and five power”.

(A) Incompetent Holder. When the holder of a general power of appointment is incapable of exercising the power by reason of incompetency, minority or otherwise, there is no gift tax liability.²⁸ This result is nonconforming with the estate tax result that the holder of a power of appointment is deemed to possess the power regardless of whether or not the holder has the legal power to exercise the power.

Query: What if donor created a trust for beneficiary with income payable to beneficiary for life. Beneficiary is given an inter vivos power to appoint corpus until age 60. Upon age 60, any property remaining in the trust is to be held until beneficiary dies with the remainder going to the remaindermen. Assume at age 40 beneficiary is adjudicated incompetent and guardian may not exercise the beneficiary power. Has the beneficiary’s power lapsed upon the adjudication resulting in no taxable gift? Not upon the adjudication, because the beneficiary has not attained age 60. What then if the beneficiary attains age 60 and is still incompetent? One answer is that it is a lapse and subject to gift tax. This is harsh to the taxpayer. The other answer is that there is no lapse and gift tax

²⁵Section 2514(e) of the Code.

²⁶Sections 2514(a) and (e) of the Code and Treas. Regs. 25.2514-2(c).

²⁷Treas. Reg. §25.2514-3(c)(4). *See also* Rev. Proc. 94-44, 1994-2 C.B. 683 (IRS stated that it will not recognize the effectiveness for federal transfer tax purposes of state legislation purporting to retroactively change an individual’s property rights or powers after the federal tax consequences have attached. In the Rev. Proc. a Florida statute attempted to preclude trustees from exercising fiduciary powers to make discretionary distributions to or for their own benefit other than to provide for their health, education, maintenance or support.)

²⁸Treas. Reg. §25.2514-3(c)(4).

due and the remaindermen would take the corpus at beneficiary's death. This would unreasonably favor the taxpayer. The result is not settled however.

(B) "Five and Five Power." A lapse during any calendar year is considered a release subject to gift tax only to the extent that the property which could have been appointed by the exercise of the lapsed power of appointment exceeds the greater of (1) \$5,000 or (2) 5% of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.²⁹

Example: Grantor establishes gift trust with value of \$200,000. Donee has a noncumulative right to withdraw \$10,000 a year from the principal of the trust. In year one, Donee fails to exercise this right. This is not a gift since the withdraw right (\$10,000) is not greater than the greater of (i) \$5,000 or (ii) 5% of the value of the trust (\$200,000 times 5% equals \$10,000). Assume that, at the end of year two, the value of the trust decreased to \$80,000. Donee once again does not exercise his rights. In year two, a gift occurs to the extent that the amount of the withdrawal right (\$10,000) exceeds the greater of \$5,000 or 5%(\$80,000 times 5% equals \$4,000). Therefore, the gift will be \$5,000 (\$10,000 minus \$5,000).³⁰

However, the Service has stated³¹ that it will not issue rulings regarding the "five and five" power protection of a beneficiary in a section 2514(e) of the Code situation which the beneficiary allows a lapse in a trust where (a) the corpus is substantially composed of life insurance; (b) the trustee may pay premiums on the life insurance policy from corpus; (c) the trustee has the power to loan assets to the donor's estate or purchase assets from the grantor's estate; (d) the beneficiaries can withdraw on demand any additional transfers to the trust; and (e) the trust is a grantor trust.

(d) The release, lapse or possession at death of a nongeneral power of appointment generally has no gift tax consequences. The exercise of a nongeneral power of appointment can have gift tax consequences in two situations.³²

(1) If a nongeneral power is exercised during life to create a new

²⁹Treas. Reg. §25.2514-3(c)(4). See also TAM 8901004.

³⁰Treas. Reg. §25.2514-3(c)(4).

³¹Rev. Proc. 99-3, 1999-1 C.B. 103.

³²The exercise of nongeneral powers in several other situations can have gift tax consequences under section 2511 of the Code.

power of appointment that can be validly exercised under applicable state law without reference to the date of creation of the first power, exercise will result in taxation of the power as if it were a general power.³³ This is often referred to as the “Delaware Tax Trap” because in Delaware the perpetuities period is computed from the time a power is exercised, rather than the time it was created. The result is that you could avoid estate and gift tax forever through the creation and exercise of successive nongeneral powers of appointment.

(2) When the holder possesses both general and nongeneral powers of appointment over the same property, exercise of the nongeneral power in favor of another will be considered a release or exercise of the general power.³⁴ The release or exercise will be considered a transfer of the property for gift tax purposes.

3.2 Estate Tax Consequences of Powers of Appointment.

Section 2041 of the Code provides different estate tax consequences for general powers of appointment created on or before October 21, 1942 and those created after.

(a) General Powers Exercised or Unexercised.

(1) Pre-October 22, 1942 Powers. If a decedent exercised such power, his gross estate would include the value of the appointed property. If a decedent did not exercise a pre-October 22, 1942 power, there is no estate tax liability as a result of the existence of the power. Furthermore, the failure to exercise such a power is not deemed an exercise of the power.³⁵

(2) Post-October 21, 1942 Powers. Mere possession of a post October 21, 1942 power will result in inclusion in the holder’s gross estate under section 2031(a)(2) of the Code. The fact that the decedent failed to exercise the power is irrelevant for the purposes of estate tax inclusion. Inclusion may also be required even if the power of appointment was not possessed at death. For example, if a general power of appointment was exercised and released during life, the property previously subject to the power will be included in the holder’s estate if the power was exercised in a manner that, had it been a transfer of the property owned by the decedent, it would have been included in the holder’s gross estate under sections 2035, 2036, 2037, or 2038 of the Code.³⁶

³³Section 2514(d) of the Code; Treas. Reg. §25.2514-3(d); and Steinkamp, 79 Marq. L. Rev. 210.

³⁴Treas. Reg. §25.2514-1(d), and Treas. Reg. §25.2514-1(b)(2).

³⁵Section 2041 of the Code.

³⁶Section 2041(a)(2) of the Code. *See also* Steinkamp, 79 Marq. L. Rev. at 209.

Further, often overlooked in estate tax inclusion is the holding of a "five-and-five" power. The lapse of this power will not cause transfer tax consequence as discussed above. However, if the power for the year of the power holder's death is exercisable as of death, then it is includible in the holder's estate for estate tax purposes and characterized as a general power of appointment. In PLR 8951049, the IRS ruled that a decedent's "five and five" power over both the QTIP and non-QTIP portions of a residuary trust is a section 2041 general power as to both portions of the trust subject to the power and, at its lapse, both the QTIP and the non-QTIP assets subject to the power are includible in the estate. The Tax Court in *Estate of Kurz* ruled that the 5% portion of an otherwise excluded trust was includible in the decedent's gross estate.³⁷

(A) Physical of Mental Capability to Exercise. Until 1975 physical or mental capabilities were immaterial as to estate tax inclusion of a general power of appointment. Mere *possession* was the test. However, from 1975 to 1980 a number of court cases held that the lack of mental capacity barred inclusion of an otherwise general power of appointment.³⁸ However, during this period the Service maintained their position that legal incapacity does not render a general power a nongeneral power.³⁹ After all, if the Service did not maintain this position a creative taxpayer could avoid taxation in both estates.

Example: Husband and Wife are married. They have Wills that mirror each other creating both Marital and non-Marital Trusts. At Husband's death, the IRS allows the Marital deduction in his estate to "zero-out" the tax. However, if this Trust was to avoid taxation at the subsequent death of the wife because she was deemed to be incompetent, the Marital Trust would avoid estate taxation at her death. If the statute of limitations passes after husbands death, taxation would be avoided.

However, by 1993, at least seven circuits have upheld the Service's position. The *Boeving* and *Williams* cases were directly reversed and similar results were obtained in other cases. After the reversal the aforementioned cases, there appears to be little, if any, vitality to the argument espoused.

(B) Exercise. Applicable state law determines whether a power has been exercised. There is no exercise unless the decedent takes the appropriate steps under applicable state law to make a valid exercise. Regardless of state law, a power of appointment is considered exercised in favor of the taker in default of appointment, and

³⁷ *Estate of Kurz*, 101 T.C. 3 (1993).

³⁸ *Boeving v. U.S.*, 493 F. Supp. 665 (D. Mo. 1980), *rev'd*, 650 F.2d 493 (8th Cir. 1981); *Finley v. U.S.*, 404 F. Supp. 200 (S.D. Fla. 1975) *rev'd on other grounds*, 612 F. 2d 166 (5th Cir. 1980); and *Williams v. U.S.*, 78-2 USTC ¶13,246 (W.D. Tex. 1978), *rev'd*, 634 F.2d 894 (5th Cir. 1981).

³⁹ Rev. Rul. 75-350, 1975-2 C.B. 368.

irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment.⁴⁰

(b) Release.

(1) Pre-October 22, 1942 Power.

(A) Complete Release. A complete release of a pre-October 22, 1942 power is not considered an exercise of a general power.⁴¹ Hence, such a power can be released without causing estate tax inclusion. This is consistent with the rule that only an exercise of a pre-October 22, 1942 power will result in estate tax. A power holder may release all or a portion of the property subject to such power. If the decedent completely relinquishes all powers over one-half of the property subject to the power, the power is completely released as to that half.⁴²

(B) Partial Release. A Partial Release occurring before November 1, 1951, may under certain conditions, not be deemed to be an exercise of a general power, but rather an exercise of a nongeneral power. While a partial release after November 1, 1951, may be included in a decedent's estate under section 2041 of the Code.

(2) Post-October 21, 1942 Power. The release by a decedent of such a power at his death is subject to estate tax. Under the Regulations 20.2041-3(d)(2), a post-October 21, 1942 power is not included in a decedent's estate if (1) the power has been completely released by the decedent during his lifetime; (2) the decedent did not retain any interest or control over the property subject to the power which would have caused the property to be included in his gross estate under sections 2036 through 2038 of the Code if the property had been transferred; and (3) the release was not made in contemplation of death within the meaning of section 2035 of the Code.

(c) Power disclaimed or renounced.

A pre-October 22, 1942 power that is disclaimed or renounced is not included in the decedent's gross estate under section 2041 of the Code. A post-October 21, 1942 general power created before January 1, 1977 is not considered a release of the power and thus not includible in

⁴⁰ Treas. Regs. §20.2041-1(d); *Guaranty Trust Co. of New York v. Johnson*, 165 F. 2d 298 (2nd Cir. 1948); *Wilson v. Kraemer*, 190 F.2d 341 (2nd Cir. 1951); *Estate of Kerr*, 174 F.2d 555 (3rd Cir. 1949); and 825 BNA at A-31.

⁴¹ Section 2041(a)(1) of the Code.

⁴² Treas. Regs. §20.2041-2(d); *U.S. v Hubner*, 285 F.2d 29 (9th Cir. 1960).

the taxable estate.⁴³ A release of a general power created after January 1, 1977 is also not considered a release if the requirements of section 2518 of the Code have been met.

An attempt to disclaim a general power of appointment by limiting it to a special power of appointment exercisable in favor of persons other than the takers in default will not be recognized by the Service as a valid disclaimer. For example in PLR 8149009, the Service ruled that such an attempt is an exercise of dominion and control by the power holder over the disposition resulting in the acceptance of the power. Further in *Goudy v U.S.*⁴⁴, the court held that a decedent's partial disclaimer of the general power of appointment, which caused it to be a nongeneral power, was not valid because the decedent has, in effect, redirected the disclaimed property to persons other than the takers in default.

Under Treasury Regulation section 25.2518-2(c)(3), rules are provided for determining the timeliness of a disclaimer. In the case of a general power of appointment, the holder must disclaim within nine months after the creation of the power. A person to whom an interest passes by reason of the exercise or lapse of a general power may disclaim such interest within nine months after the exercise or lapse. The holder of a nongeneral power of appointment, permissible appointees, or takers in default, must disclaim within nine months after the original taxable transfer that created or authorized the creation of the power.

(d) Lapse.

If a decedent possessed a pre-October 22, 1942 power that lapsed during his lifetime, under section 2041 of the Code there is no estate tax liability. In PLR 9318020, the Service followed this position.

Generally, the lapse of a post-October 21, 1942 power will be deemed to be a release. Therefore, if the lapse occurs at the time of the decedent's death, it will be subject to estate tax. This will also be true if the lapse was due to a transfer of property which would have been included in the decedent's gross estate under sections 2035 through 2038 of the Code. If a decedent's post-October 21, 1942 power to appoint is limited to a certain amount each year and consecutive, rather than one-time, lapses of the power occur, each lapse must be treated as a separate release.

A lapse of the power annually under which the decedent is permitted to appoint the greater of \$5,000 or 5% of the corpus, is not treated as a general power and escaped tax under section 2041 of the Code.

⁴³ Treas. Regs. §20.2041-3(d)(6)(ii). *See also*, PLR 9046035 (disclaimer of an interest in a pre-1977 trust made soon after the power holder reached the age of majority is not a release of the general power of appointment).

⁴⁴ 86-2 USTC ¶13,690 (D. Ore. 1986), *rev'd in unpub. opin.* (9th Cir.1988).

Example: Donor transfers \$200,000 worth of securities to a trust which provides income to Donee for life, remainder to his issue. Donee has a noncumulative right, which he never exercises to withdraw \$10,000 a year from the trust. Assuming that the value of the trust remains constant, Donee's failure to exercise his withdrawal power in the year before his death results in no estate taxation. However, at Donee's death, his gross estate will include the \$10,000 which he was entitled to withdraw for the year of death.

If Donee had the right to withdraw \$15,000 instead of \$10,000, the failure to exercise such power in any year would be treated as a release to the extent of the excess of the amount subject to withdrawal over 5% of the trust fund - here \$5,000 [\$15,000 minus \$10,000 (\$200,000 time 5%)]. This value is includible in the Donee's estate.

4. ASCERTAINABLE STANDARDS EXCEPTION.

A trust is subject to federal estate tax in the beneficiary's estate if the beneficiary holds a general power of appointment over the trust.⁴⁵ A general power of appointment is a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Such a power is not deemed to be a general power of appointment if it is limited by an ascertainable standard relating to the health, education, support or maintenance of the power holder.⁴⁶ The regulations further provide that a power is limited by the requisite ascertainable standard "if the extent of the [holder's] duty to exercise and not to exercise the power is reasonably measured in terms of his needs for health, education or support (or any combination of them)."⁴⁷ Whether the exception applies is determined as of the moment the power is created, not later, considering how the holder actually exercises the power.⁴⁸ The regulations provide a list of limitations which meet the statutorily proscribed ascertainable standard exception.

- "support;"
- "support in reasonable comfort;"
- "maintenance in health and reasonable comfort;"
- "support in his accustomed manner of living;"
- "education, including college and professional education;"
- "health;"
- "medical, dental, hospital and nursing expenses and expenses of invalidism."⁴⁹

Finally, ascertainable standards have been found to be imposed by state law, when not expressly incorporated by the document. However, on the other hand, at times a standard for invasion that appears to be ascertainable within sections 2041 and 2514 of the Code has been

⁴⁵ Section 2041(b)(1)(A) of the Code.

⁴⁶ Sections 2041(b)(1)(A) and 2514(c)(1) of the Code.

⁴⁷ Treas. Regs. §§20.2041-1(c)(2), 25.2514-1(c)(2).

⁴⁸ *Jenkins v. U.S.*, 428 F.2d 538(5th Cir. 1970) cert. Denied, 400 U.S. 829 (1970).

⁴⁹ *Id.*

rendered unlimited by state law. For example, in Revenue Rule 76-547⁵⁰, a trust was created for Donee, as sole trustee. The Donee standard was not an ascertainable standard as defined in the Code and hence the Donee was deemed could invade the trust for health, care maintenance and enjoyment. Under state law, such a to have a general power of appointment. Nonetheless, state law, because for federal tax purposes, state law controls in determining the extent and nature of the powers and rights of a decedent⁵¹, generally is favorable for the taxpayer in establishing an ascertainable standard.⁵²

4.1 Different Standards of the Exception.

The governing instrument is not required to use the statutorily proscribed terms. The inquiry under current law is whether the particular language used establishes a standard that, under local law, is both ascertainable and related to one or more of the statutory purposes. However, the results of the decisions are less predictable when the trust terms departs from the statutory "safe harbors."

(a) Support and Maintenance. The Code specifically provides that a power of invasion related to the holder's "support" or "maintenance" fits within the ascertainable standard exception. The words are synonymous and their meaning is not limited to the bare necessities of life.⁵³ As long as support or maintenance is in the standard, modifying language will not jeopardize the exception. For example, "support in reasonable care" or "maintenance in health and reasonable comfort" are permissible standards. The test is whether the terms broaden the purpose for which invasions can be made. For example, in *Hunter v U.S.*⁵⁴, the IRS conceded that a power of invasion for the holder's "comfortable support and maintenance" fit within the exception.⁵⁵

(b) Accustomed standard of living. These words provide a measuring stick against which the court can determine the permissibility of distributions. The purpose of the exception is to allow the court to determine if a power is limited to certain events, these terms

⁵⁰ Rev. Rul. 76-547, 1976 C.B. 302.

⁵¹ *Morgan v. Com'r*, 309 U.S. 78 (1940).

⁵² See *i.e.*, *Estate of Vissering*, 990 F.2d 578 (10th Cir. 1993), *rev'g* 96 T.C. 749 (1991).

The Tenth Circuit reversed the Tax Court and held that the term "comfort" under Florida law imposes an ascertainable standard when used in context of the decedent holding the power to invade corpus as "required for the continued comfort, support, maintenance, or education" of the decedent.

⁵³ Treas. Regs. §§20.2041-1(c)(2) and 20.2514-1(c)(2).

⁵⁴ 597 F. Supp. 1293 (W.D. Pa. 1984).

⁵⁵ See *also*, TAM 7836008 (a power for "reasonable health, education, support and maintenance needs consistent with a high standard and quality of living" was within the exception because it did not broaden the invasion purposes).

allow the court to be able to determine if a distribution was appropriately made. For example, the court can easily determine if a distribution of a Porsche to a beneficiary meets the ascertainable standard exception.

In *Estate of Strauss*⁵⁶, the Tax Court held that the discretion to use principal for “care and comfort, considering his standard of living as of the date of my death and considering his income, right to income and other property he may have . . .” was a power limited to an ascertainable standard. The term “comfort” referred to someone’s station in life to which that person is accustomed and, since that person’s station in life is known, the standard is measurable and hence ascertainable.

However, in *Independence Bank of Waukesha v U.S.*⁵⁷, the decedent was appointed trustee of a testamentary trust created by her husband. The standards in the trust was for “her own proper maintenance in the stations of life to which she and I have been accustomed” and further provided that the decedent “shall use her own discretion as to how much of my property she will use for her own maintenance. . . and I specifically direct that she may use so much of my property as she desires for her own use and for whatever purpose she desires to use the same, without court approval.” The court concluded that the husband’s will created a general power of appointment in favor of his will because the wife’s power was not limited to an ascertainable standard because of the terms “whatever purposes she desires.” However, the court concluded that under Wisconsin law to use the trust assets “for her own proper maintenance in the station of life to which she was accustomed” would be limited by an ascertainable standard.

Further in Revenue Ruling 77-60⁵⁸, the necessity to follow the proscribed regulations for consistent results is exemplified. In the ruling, the power “to continue the donee’s accustomed standard of living” was not sufficient to fall within the ascertainable standard exception. Further limitation was needed for predictability and measurability. The standard of living may include customary travel, entertainment, luxury items or other items that are not required to meet the donee’s needs for health, education or support. Although the power was limited by an ascertainable standard, it was not a standard related to a statutory purpose.⁵⁹ However, in *Strauss*, above, the Tax Court held that a standard designed to maintain one in his station of life related to a statutory purpose under the regulations.⁶⁰

In TAM 89101006, the deceased income beneficiary had the power “to use as much or all of said property as may be necessary for her sickness, hospitalization, doctor’s care, medication, support, maintenance, welfare and general comfort in keeping with the manner and mode of living

⁵⁶ T.C. Memo 1995-248.

⁵⁷ 761 F.2d 442 (7th Cir. 1985).

⁵⁸ Rev. Rul. 77-60, 1977-1 C.B. 282.

⁵⁹ Steinkamp, 79 Marq. L. Rev. at 247; see also, *Estate of Little*, 87 T.C. 599 (1986).

⁶⁰ cf. PLR 7914036 (Donee had the power to invade to “maintain a standard of living,” was a nongeneral power).

to which she has been accustomed.” The Service stated that the donee had a general power of appointment because “welfare,” “comfort,” and “accustomed standard of living” took the power outside the ascertainable standard exception.

In conclusion, if the trust limits the invasions for one of the statutory purposes, the fact that those purposes are modified by an accustomed standard of living language will not cause the power to be a general power of appointment. However, if invasions are not limited by one of the four statutory purposes, accustomed standard of living language will not cause the power to fit within the ascertainable standard exception.⁶¹

(c) Benefit. The author has not been able to locate a case in which the power to invade for one’s own benefit was held to meet the ascertainable standard exception. Further, the IRS has concluded in Letter Rulings that the power to invade for one’s benefit was not statutorily limited. In TAM 8642006, the power to invade for the holder’s “benefit” was not limited by the requisite ascertainable standard.

In *Strite v McGinnes*⁶², the decedent held a power to consume that was exercisable at any time necessary or advisable in order to provide for the reasonable needs and proper expenses or the benefit or comfort of the decedent. “Benefit” was held to be much broader than support and included anything that worked to the advantage or gain of the recipient.⁶³

Further in *De Oliveira v. U.S.*⁶⁴, the beneficiary’s “power to consume, invade or appropriate property was limited only by the requirement that it be exercised for her ‘benefit.’” The beneficiary was deemed to have a general power of appointment.

(d) Business Purpose. The seminal case in interpreting this standard is *Penner v. Commissioner*⁶⁵, the decedent had a life estate in certain trust properties. The decedent had the power to invade corpus up to a maximum of \$50,000 for a “business purpose.” Under state law, the decedent’s power to invade was not limited or restricted to matters relating to her maintenance or support. The Tax Court held that the decedent died possessing a general power of appointment because her power of invasion was for purposes unrelated to those specified in section 2041 of the Code.

(e) Care. Most cases that have been decided where the term “care” was in

⁶¹ TAM 9344004; TAM 8901006; and PLR 8239004.

⁶² 330 F.2d 234 (3rd Cir. 1964), *cert. denied*, 379 U.S. 836 (1964), *reh’g denied*, 379 U.S. 910 (1964).

⁶³ *See also, Estate of Lanigan*, 45 T.C. 247 (1965)(the Tax Court held that a power to distribute principal for one’s own “use or benefit” as one deems advisable was not limited by the requisite ascertainable standard under state law.

⁶⁴ 767 F.2d 1344 (9th Cir. 1985).

⁶⁵ 67 T.C. 864 (1977).

the distribution standard were decided on other terms in the standard. There have been a few decisions that held that powers of invasion that included "care" were sufficiently limited to fit within the exception.

In Private Letter Ruling 9148036, the Service held that the power to use property for one's own care was limited by the requisite standard. The trustee could make distributions for the beneficiary's "support, maintenance and care." Support and maintenance were acceptable standards, as they are found in the statute. The IRS had to rule on whether "care" fell within the statutory exception. State law was silent on the use of care as an ascertainable standard. The Service ruled that the power to consume for care was limited by the more restrictive standards of maintenance and support and thus within the ascertainable standard exception.

However, this Private Letter Ruling should not be relied on. It was wrongly decided for a variety of reasons. A power to invade for one's own care should not be considered limited by an ascertainable standard related to health, education, support or maintenance. No court cases have directly addressed the term and the Private Letter Ruling is unreliable. If the term "care" must be used, it should be done in conjunction with an otherwise ascertainable standard and does not expand the power beyond the statutory purpose.

(f) Comfort. The term "comfort" has by far been the most litigated term regarding ascertainable standards. Treasury Regulations distinguish between use of the term "comfort" as a standard and as a term modifying an other ascertainable standard. "Comfort" alone is not an ascertainable standard.⁶⁶ While the converse, using "comfort" to modify an ascertainable standard, is sufficient to fit the power within the ascertainable standard exception.

In *Miller v U.S.*⁶⁷, the Third Circuit held that a trustee's power to distribute principal for "proper maintenance, support, medical care, hospitalization, or expenses incidental to her comfort and well-being" constituted a general power of appointment. Comfort when combined with well-being went further than the statutory exception of health, education and support.

When "comfort" is used in a power to determine whether the power is limited by ascertainable standard the issue will turn on whether it is used as a standard or to modify an otherwise sufficient standard. If it is used alone, it should be held to be a nonascertainable standard because it is not limited to a statutory purpose. If it is used to modify an otherwise ascertainable standard, it will not effect qualification.

(g) Emergency. Although this term is often found in the limitations, it is not a statutorily proscribed term. Most emergencies relate to one's health, support or maintenance and thus are covered in the other statutorily proscribed options. In fact, in *Hunter v*

⁶⁶ Treas. Reg. §§20.2041-1(c)(2) and 20.2514-1(c)(2).

⁶⁷ 387 F.2d 866 (3rd Cir. 1968).

U.S.⁶⁸, the court stated that it could “envision no emergency which would not be reasonably measurable in terms of health or to support a beneficiary’s standard of living.” An emergency is a circumstance that calls for immediate action. However, it is not always related to health, support or maintenance. There might be emergencies regarding the need for extra collateral due to a drop in market conditions. Yet, this is not an emergency related to maintenance.⁶⁹

In TAM 9044081, the decedent’s surviving spouse had a power to invade principal for her medical needs, support, maintenance and any other emergency conditions. The surviving spouse was deemed to have a general power of appointment.

The IRS’ position in cases of emergency is that the power to invade in the event of an emergency does not satisfy the ascertainable standard exception.

(h) Happiness. The Treasury Regulations expressly provide that the power to use property for one’s happiness falls outside the ascertainable standard exception.⁷⁰ This term clearly falls outside of the scope of the statute. Nonetheless, it has been the subject of numerous decisions.

In *Brantingham v U.S.*⁷¹, the decedent was the income beneficiary of a trust. The decedent had the power to invade the corpus as she deemed necessary for her “maintenance, support and happiness.” Under Massachusetts law, the decedent’s power was limited to an ascertainable standard. However, in Revenue Ruling 82-63⁷², the Service announced that it will not follow the authority of *Brantingham*. According to the Service, the court incorrectly extended previous authority, *Dana v. Gring*⁷³, to situations in which a nonfiduciary beneficiary has the power to invade corpus for “happiness.” In *Dana*, the trustee had fiduciary obligations, as discussed later, to preserve the corpus for the benefit of remaindermen. While in *Brantingham*, there was no such limitation.

In *Estate of Little*⁷⁴, the Tax Court accepted the IRS’ position in Revenue Ruling 82-63. In *Little*, the decedent was the beneficiary and sole trustee of the trust. Decedent had the power

⁶⁸ 597 F.Supp. 1293 (W.D. Pa. 1984).

⁶⁹ See *i.e.*, *Sowell v. Com’r*, 74 T.C. 1001 (1980), *rev’d*, 708 F.2d 1564 (10th Cir. 1983)(deceased income beneficiary had a power to invade trust principal in case of emergency or illness. Donee deemed to have a nongeneral power). *But see*, PLR 7841006(same language creating a general power).

⁷⁰ Treas. Reg. §§20.2041-1(b)(c)(2) and 20.2514-1(c)(2).

⁷¹ 631 F.2d 542 (7th Cir. 1980).

⁷² 1982-1 C.B. 135.

⁷³ 374 Mass. 109, 371 N.E.2d 755 (1977)(the beneficiary had the power to invade for “reasonable welfare or happiness;” the court concluded that happiness meant standard of living at the time she became a trust beneficiary).

⁷⁴ 87 T.C. 599 (1986).

to invade income and corpus for support, maintenance, welfare, health and general happiness in the manner to which he was accustomed at the time of his spouse's death. Under California law, the standard was ascertainable, but the "happiness" element was incompatible with the support or maintenance limitation. The power was thus a general power of appointment.

In *Jenkins v. U.S.*⁷⁵, the decedent possessed a power to use trust property in his absolute discretion for his happiness. However, in fact the decedent was frugal and never used any trust property. Nevertheless, the mere possession of such power caused inclusion in his gross estate. Reminding us that the relevant inquiry is not what the decedent did, but what they were empowered to do.

In summary, powers to invade for happiness fail the two part test: they are neither limited by an ascertainable standard, nor is the standard related to the holder's health, education, support or maintenance.

(i) Miscellaneous Cases.

In *Franz v. U.S.*⁷⁶, the decedent held a life estate in certain trust properties. Under the instrument, the decedent could invade the corpus for "the care, maintenance, and welfare [of the lifetime beneficiary]." Under Kentucky law, decedent's power to invade corpus was not limited by an ascertainable standard. Therefore, the corpus was included in the decedent's gross estate.

5. JOINT POWERS EXCLUSION.

A power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, and is not limited by an ascertainable standard, may still be classified as a nongeneral power if it is held jointly with another individual and if certain other requirements are met.⁷⁷ In a pre-October 22, 1942 power, the power will be treated as nongeneral if it is exercisable only in conjunction with another person. The identity of the other person or his interest in the trust property is irrelevant. However, that is not true with post-October 21, 1942 powers. In post-October 21, 1942 power, the relationship of the joint power holder with the property is determinative of whether the power is classified as general or nongeneral.

5.1 *Exercisable with the Creator.*

If the power is exercisable only in conjunction with the creator or donor of the property it is treated as a nongeneral power.⁷⁸ The creator need not have a retained interest in the property for the power to be treated as nongeneral. All that is important is that the power must be

⁷⁵ 428 F.2d 538 (5th Cir, 1970); *See also* TAM 8642006.

⁷⁶ 77-1 USTC ¶13,182 (E.D. Ky. 1977).

⁷⁷ Sections 2041(b)(1)(B), (C) and 2514(c)(2), (3) of the Code.

⁷⁸ Sections 2041(b)(1)(C)(i) and 2514(c)(3)(A) of the Code.

exercised with the creator. If the creator of the power dies and no person having a substantial adverse interest to the exercise of the power succeeds to the creator's position, then the donee would have a general power.

5.2 Substantial Adverse Interest.

If the power is exercisable only in conjunction with a person having a substantial adverse interest in the property, the power will be considered as nongeneral.⁷⁹ Under the Code, if any person who, after the decedent's death, may possess a power of appointment with respect to the property subject to the decedent's power, which he, the survivor, may exercise in his favor, that person is deemed to have an interest in the property and the interest is deemed adverse to the exercise of the power.⁸⁰

For example, if Donee and Third Party had a right to appoint property in favor of Donee during his lifetime, Donee would be considered to have a general power of appointment. The co-trustee is not the creator nor a substantial adverse party. If donee dies it is included in his gross estate or if donee disclaims, it is a taxable gift. However, if Donee's son was the co-trustee, Donee would have a nongeneral power of appointment (assuming Donee's son was the beneficiary of the trust).

But beware of the facts and approach each situation carefully. For example, assume that Life Tenant and Remainderman-1 are co-trustees. The income is to be paid to Life Tenant for life. Life Tenant and Remainderman-1, as co-trustees, can designate jointly whether corpus is to be distributed to Remainderman-1 or Remainderman-2 after Life Tenant's death. Remainderman-1 has a general power of appointment since Life Tenant's interest is not adverse to an exercise of the power in favor of Remainderman-1.⁸¹

The regulations provide in part that an interest adverse to the exercise of a power is considered substantial if its value in relation to the total value of the property subject to the power is not insignificant.⁸²

5.3 Exercisable with Nonadverse Person.

If the joint power holder is nonadverse, the power will be treated as a general power of appointment. This is the worst situation for the beneficiary. For he can not access the property without cooperation of the joint power holder, but the property is included in his gross estate as if he had unlimited access. This issue comes into play often with banks as co-trustees.

⁷⁹ Sections 2041(b)(1)(C)(ii) and 2514(c)(3)(B) of the Code.

⁸⁰ *Id.*

⁸¹ Treas. Regs. §§20.2041-3(c)(2), *Ex. 3*; 25.2514-3(b)(2), *Ex. 3*.

⁸² Treas. Regs. §§20.2041-3(c)(2) and 25.2514-3(b)(2).

In *Estate of Towle*⁸³, the decedent had two powers. The first was a noncumulative power to withdraw \$13,500 per year from corpus, and second was to withdraw at any time all of the corpus with the consent of the bank who was trustee. The Tax Court stated that generally a nonbeneficiary trustee is neither substantial nor adverse. The bank obviously was not a beneficiary of the trust. The bank merely had the usual fiduciary powers to guard against the capricious exhaustion of corpus. The Court found that the nonfiduciary co-trustee must have a present or future chance to obtain personal benefit from the property itself to have a substantial adverse interest.

Further a corporate trustee is not considered to have substantial adverse interest in trust property as a result of its right to compensation for serving as trustee, even if such compensation is tied to corpus.⁸⁴ Also in this vein, the Court is not considered a person with substantial adverse interest. If court order is needed before selling or conveying property, the beneficiary would continue to have a general power of appointment.⁸⁵

Always be mindful that if the person in conjunction with whom the power is exercisable predeceases the decedent and no other person who has a substantial adverse interest succeeds to the power holder's position, the decedent will be vested with a general power of appointment.

5.4 Fractional Interest.

If a jointly held power is exercisable in favor of whom the power is held, the power is deemed a general power of appointment only to the extent of the fractional part of the property subject to the power.⁸⁶ The decedent is treated as though he was a joint owner of the property with the other holders who are permissible appointees. The value of the each share is determined by dividing the value of the entire property by the total number of persons in favor of whom the power is exercisable.⁸⁷

6. EXAMPLE.

Under the Will of Decedent, his "residuary estate" was divided into two shares. One share, "Share A," was a fractional marital bequest and one share, "Share B," was the unified credit trust. The Share B trust is held in trust for decedent's spouse for life with remainder to the issue of decedent and decedent's spouse living at decedent's spouse's death. There is no testamentary special power of appointment over the Share B trust. Decedent's spouse is entitled to net income of the Share B trust, and the corpus may be distributed to her by the trustee under certain

⁸³ 54 T.C. 368 (1970).

⁸⁴ *Miller v U.S.*, 387 F.2d 866 (3rd Cir. 1968).

⁸⁵ *Picciano v. U.S.*, 532 F. Supp. 246 (S.D. Ohio 1981).

⁸⁶ Sections 2041(b)(1)(C)(iii) and 2514(c)(3)(C).

⁸⁷ Sections 2041(B)(1)(C)(iii) and 2514 (c)(3)(C) and Treas. Regs. §§20.2041-3(c)(3) and 25.2514-3(b)(3).

standards. The standards are as follows:

“The trustee shall distribute corpus to my spouse because of illness or any extraordinary or unforeseen circumstances or in order for her to maintain the same standard of living to which she was accustomed to as my spouse, without regard to income she may be entitled to receive from any other trust created hereunder.”

Under the terms of the Will, decedent’s spouse and decedent’s son are named as co-trustees of any trust established hereunder. However, the co-trustee shall serve alone if the other co-trustee shall die or fail to cease to serve thereas.

A trust is subject to federal estate tax in the beneficiary’s estate if the beneficiary holds a “general power of appointment” over the trust. A general power of appointment is a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except where the power is limited by ascertainable standards.

According to the IRS regulations, a power is limited by an ascertainable standard if the extent of the donee’s duty to exercise and not to exercise the power is reasonably measured in terms of the donee’s needs for health, education, or support or any combination of them. A power vested in a donee to consume, invade or appropriate property, even though for his or her own benefit, is not deemed a general power of appointment if it is limited by an ascertainable standard relating to the health, education, support or maintenance of the power holder.

ASCERTAINABLE STANDARDS.

In the above example four reasons are enumerated, none of them expressly listed in the Code, for distributions:

- (1) Illness; or
- (2) Any extraordinary circumstances; or
- (3) Any unforeseen circumstances; or
- (4) To maintain her same standard of living to which she was accustomed as my spouse.

1. Illness - This term appears analogous to the ascertainable standard of “health” as set forth in the regulation. Therefore, it should be considered an ascertainable standard under the Code and alone would not create a general power of appointment. *See Sowell v. Commissioner*, 708 F.2d 1564 (10th Cir. 1983)(held to be an ascertainable standard when donee had the power to invade trust principal in case or emergency or illness); *Barritt v. Tomlinson*, 129 F. Supp. 642 (S.D. Fla. 1955)(held the phrase “proper maintenance, support, medical care, hospitalization” establishes an appropriate ascertainable standard); TAM 8901006 (deceased income beneficiary given the power “to use as much or all of said property as may be necessary for her sickness, hospitalization, doctor’s care, medication, support, maintenance, welfare and general comfort in keeping with the manner and mode of living to which she has come accustomed;” the terms

“welfare,” “comfort” and “accustomed standard of living” take the power outside an ascertainable standard); *cf. Doyle v. U.S.*, 358 F. Supp. 300 (D.C. Pa. 1973) (Court found no ascertainable standard under the standard of “necessary for the comfort, maintenance and support of the donee, or in the event of illness or emergency as the result of which there may be a need).

2. Any extraordinary circumstances or any unforeseen circumstances. There is not direct authority on these terms. However, they appear to be analogous to the term “emergency.” Perhaps the most important decision in interpreting the term “emergency” was *Sowell v. Commissioner*⁸⁸. The Tenth Circuit held that a power to invade corpus in the case of an “emergency” was a power limited by an ascertainable standard relating to health, education, support or maintenance. The Tax Court, whose decision was reversed by the Tenth Circuit, had held that the term “emergency” related to the timing of the invasion and not to any particular source of need. The Tenth Circuit stated that an “emergency” is a special sudden event that calls for immediate action. The Tenth Circuit continued to hold that “emergency” should not be read so expansively as to include other uses than those permitted under the regulations.

However, the Service has attempted to limit this case. For example in PLR 9044081, the standard was (1) support and maintenance; (2) medical needs; and (3) any other emergency condition of any exigencies which might make the trust income insufficient for the decedent’s reasonable needs. The Service said that the language was broader than *Sowell* and thus not an ascertainable standard. They stated that the emergency power was not limited to health, maintenance and support situations.

In the example at hand, the terms “any extraordinary circumstances” or “any unforeseen circumstances” do not appear to limit the trustees’ discretion. What constitutes extraordinary circumstances? What are unforeseen circumstances? The terms go beyond the standard as set forth in the regulations of health, education, support or maintenance. Absent the Tenth Circuit opinion regarding emergency, there is the weight of authority that these terms cannot constitute an ascertainable standard. *See i.e.*, Treas. Reg. §20.2041-1(c)(2)(standard should be “clearly measurable” and under which donee is “legally accountable”); *Holmes v. U.S.*, 90-2 CCH ¶60,029 (D.C. Minn. 1990)(held under Kentucky law, general power of appointment existed regarding the language “in any way which she may deem proper”); PLR 8601003(held no ascertainable standard for “any special need to maintain herself in the status she enjoyed” or “for any special needs she may have”). The term is not tied to an ascertainable standard term, except maybe illness. This does not appear to be sufficient. In fact, the standard of “illness or emergency as the result of which there may be a need,” was considered to not be an ascertainable standard.⁸⁹

If necessary, one could argue that the terms “extraordinary” or “unforeseen” relate to illness and thus are part of an ascertainable standard. The key would be to state that the terms

⁸⁸ 708 F.2d (10th Cir. 1983).

⁸⁹ *Doyle v. U.S.*, 358 F. Supp. 300 (D.C. Pa. 1973).

“extraordinary” and “unforeseen” modify the phrase “illness.”⁹⁰ If you cannot or if illness is not considered an ascertainable standard, then the terms would go beyond the statutory standard and create a general power of appointment.

3. To maintain her same standard of living to which she was accustomed as my spouse.

In Revenue Ruling 77-60⁹¹, the decedent held a life estate in certain properties, with the remainder to other named beneficiaries. Under the trust instrument, decedent has a power to invade corpus as desired “to continue [his] accustomed standard of living.” Under state law, the Service construed this power of invasion as not imposing an objective limitation. A standard of living may include customary travel, entertainment, luxury items or other expenses not required for meeting the donee’s needs for health, education or support.

However, in *Strauss v. U.S.*⁹², the standard of “care and comfort, considering his standard of living as of the date of [the donor’s] death and considering his income, right to income and other property he may have . . . ,” was considered an ascertainable standard. The Tax Court found that under Illinois law, “comfort” refers to maintaining someone in the same station in life to which that person has become accustomed. Therefore, the power was deemed to be a general power of appointment limited by an ascertainable standard.

But beware, as discussed *supra*, the term standing alone rarely is an ascertainable standard. It must modify existing standards. That is why *Strauss* was decided in the manner it was. Once “comfort” was an ascertainable standard all the term did was modify this standard to give guidance on the extent of the power.

SUBSTANTIALLY ADVERSE INTEREST.

A general power of appointment which is exercisable by the donee only with the consent or joinder of another person is not regarded as general if the other person either: (1) is the donor of the power; or (2) has with respect to the appointive property a *substantial interest adverse* to any exercise in favor of the donee, his estate, his creditors, or the creditors of his estate.⁹³ A co-holder of a joint power who is either designated as a beneficiary or can appoint the trust property to himself, his estate or creditors has an adverse interest. The co-trustee must have a vested interest in the remainder. According to the regulations, an interest is adverse to the exercise of the power if its value in relation to the total value of the property subject to the power is not insignificant.

⁹⁰ *Wahfeld v. U.S.*, 47 AFTR 2d, 81-1565 (C.D. Ill. 1981) (“accident, illness or unusual circumstances ‘an ascertainable standard,’ ‘unusual circumstances’ were related to accident or illness”).

⁹¹ Rev. Rul. 77-60, 1977-1 C.B. 282.

⁹² T.C. Memo 1995-248 (1995).

⁹³ Section 2041(b)(1)(C) of the Code.

In Revenue Ruling 79-63⁹⁴, the decedent's spouse created a testamentary trust which the decedent was given the life income and a testamentary special power of appointment. If the testamentary special power of appointment was not exercised, the remainder was payable equally to the decedent's children. The decedent also had a general power of appointment during her lifetime to appoint trust assets with the consent of A, one of the decedent's children. The Service stated that this was still a general power of appointment because A was simply a permissible appointee under the lifetime power, but was not vested. Therefore, A's interest was not substantially adverse. Had A held a vested remainder, he would have had an interest substantially adverse to the exercise of the decedent's limited power of appointment.

Similarly in PLR 9030032, the surviving spouse and one of her four children were the co-trustees of the decedent's testamentary trust. The trustees could invade corpus for the surviving spouse's "support and comfort." At the surviving spouse's death, the remaining corpus is payable to her surviving children. Although the standard was not considered ascertainable, the surviving spouse did not have a general power of appointment because the power was exercisable only in conjunction with a child, who was an adverse party.

In the case at hand, given the lack of a testamentary special power of appointment by decedent's spouse, the co-trustee/beneficiary would have an interest substantially adverse. The co-trustee/beneficiary is a vested remainderman. His self-interest is to protect the trust corpus, to save it for himself and the other remainder beneficiaries. Thus, as long as he continues to be a co-trustee, the surviving spouse will not have a general power of appointment.

EXISTING CO-TRUSTEE FAILS OR CEASES TO SERVE.

If the current co-trustee fails or ceases to serve thereas, according to the trust, surviving spouse would serve alone. She would then be the sole trustee of a trust with no ascertainable standards without a co-trustee whose interest is substantially adverse to hers. Thus, she would be vested with a corpus withdrawal power over the Share B trust which is a general power of appointment for estate tax purposes.

⁹⁴ Rev. Rul. 76-63, 1971-1 C.B. 302.

SALES TO GRANTOR TRUSTS

**A Review of the Basics
-- The Benefits and the Pitfalls --**

**Edward Jay Beckwith
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Washington, D.C.**



27TH ANNUAL MIDWEST/MIDSOUTH
ESTATE PLANNING INSTITUTE

JULY 14, 2000

"SALES TO GRANTOR TRUSTS: A
REVIEW OF THE BASICS - THE
BENEFITS AND THE PITFALLS"

by
Edward Jay Beckwith, Esq.

TAX ADVANTAGED LIFETIME
TRANSFERS

- Net Gift – Good
- Gift – Better
- Grantor Retained Annuity Trust ("GRAT") -
- Even Better
- Installment Sale To A Grantor Trust –
Best?

ANATOMY OF AN INSTALLMENT
SALE TO A GRANTOR TRUST

- Identify Appreciating Income-Producing
Asset To Be Transferred – Strong
Preference For Pass-Through Entities
("Asset")
- Create Trust Which -
 - Will Not Be Included In The Grantor's Estate
But
 - Will Be Treated As A Grantor Trust With
Respect To The Grantor For Income Tax
Purposes ("Trust")

- Grantor Makes A Cash Gift To The Trust ("Gift")
- Report The Cash Gift (And Invoke The Generation-Skipping Transfer Tax Exemption If The Trust Is Dynastic)
- Establish Fair Market Value Of The Asset

- Grantor Sells The Asset To The Trust ("Sale") For Fair Value In Exchange For A Down-Payment And An Installment Note ("Note")

- THE TRUST -- AVOIDING ESTATE TAX INCLUSION (PART I)**
- Grantor As Mandatory Beneficiary Would Cause Inclusion
 - Grantor As Discretionary Beneficiary -- Beware!
 - Section 2037 Should Not Apply
 - Section 2036 Also Should Not Apply But
 - Rights Of Grantor's Creditors Under State Law Can Cause Inclusion Under Sections 2036 and 2038
 - Lesson: Best To Avoid Naming Grantor As A Beneficiary

THE TRUST -- AVOIDING ESTATE TAX INCLUSION (PART II)

- Grantor As Trustee
 - General Administrative Powers Should Not Cause Inclusion
 - Power to Distribute Limited By "Ascertainable" Standards Should Not Cause Inclusion
 - Again Beware Of Creditors' Rights Under State Law
- Lesson: Why Risk It?

SECURING GRANTOR TRUST STATUS

- The Code Provides Multiple Ways To Create A Grantor Trust
 - The Grantor (Or Anyone Else) Is Granted The Power (In a Non-Fiduciary Capacity) To Reacquire Trust Corpus By Substituting Other Property Of Equivalent Value -- Section 675(4)(C)
 - The Grantor Or The Grantor's Spouse Has The Power To Borrow Trust Income Or Corpus
 - Without Adequate Security -- Section 675(3) and 672(e).

- Actually Borrow From The Trust When The Spouse Or A Related Or Subordinate Person Is Trustee -- Section 675(3)
- Would Power To Borrow Cause Estate Tax Inclusion?
- Any Person Has The Power To Add Beneficiaries To The Trust --
 - If Held By Grantor May Cause Estate Tax Inclusion
 - See Regulations 1.674(b)-1(b)(5)(iii)

• Lesson: Combine A Power To Reacquire With A Power To Add Beneficiaries And Confer The Power On Someone Other Than The Grantor

CONSEQUENCES OF GRANTOR TRUST STATUS

- The Trust Is Disregarded For Income Tax Purposes
- All Items Of Trust Income, Deductions And Credits Are Reported By The Grantor
- Transactions Between The Grantor And The Trust Have No Income Tax Consequences -- Rev. Rul. 85-13

ESTABLISHING THE FAIR MARKET VALUE OF THE ASSET

- General Definition Of Fair Market Value
- Asset May Be Difficult To Value
- Undervaluation May Create A Gift Element To The Sale
- Providing For A Price Adjustment Based On IRS Values Will Not Eliminate The Risk Of Gift Tax Exposure

- Exposure May Be Reduced By Adjustment Based Upon Independent Appraisal -- Rev. Rul. 86-41
- An Alternative Seeks To "Peg" The Value Of What Is Transferred Rather Than Adjustment After The Fact
- Lesson: Adjustments Are Problematic; Attention To Proper Valuation Is Key

MATCHING THE "VALUE" OF THE NOTE TO THE VALUE OF THE ASSET

- The Note Alone Is Not Sufficient -- Section 2036
- "Coverage" Of Ten Percent Has Become The Rule Of Thumb
- Service Relies On Section 7872 To Determine Proper Interest Rate

- Section 7872 Incorporates The 1274 Rule
 - Federal Mid-Term Rate If Note Term Is Over 3 But Less Than 9 Years
 - Federal Long-Term Rate If Note Term Is Over 9 Years
 - Both Are Less Than 120% Of The Mid-Term Rate Under 7520
- If Adequate Stated Interest, Principal May Be Paid As A Balloon

**WHAT HAPPENS IF THE GRANTOR
DIES BEFORE THE NOTE IS
SATISFIED?**

- One School Of Thought Is That Loss Of Grantor Trust Status Results In A Taxable Sale At That Point
 - If The Sale Is Deemed To Occur Before Death, Gain Would Equal The Difference Between The Grantor's Basis In The Asset And The Outstanding Balance On The Note Or Would Be Calculated On The Basis Of A Reconstructed Installment Sale

- If Sale Is Deemed To Occur After Death, Asset Would Be Deemed Owned By Grantor
 - Step-up Should Off-Set Gain And
 - Assets Might Acquire A Stepped-Up Basis
- Some Have Argued There Is No Tax Consequence
- Recent Private Rulings From The Service
- Lesson: Pay Off Note Prior To Death Even If A Portion Of The Asset Is Used To Do So

Illustrated Sale of Asset to a Grantor Trust Assumptions

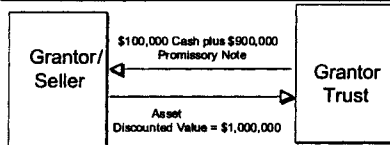
Undiscounted Value: 1,500,000
Discounted Value: 1,000,000 (at 33-1/3% Discount)
First Year Taxable Income: 200,000
Income Tax Rate: 40.0%
Initial Gift: 100,000
Initial Note Balance: 900,000
Note Interest Rate: 7.0%

Sale to a Grantor Trust -- Initial Steps



- (1) Grantor executes Trust for the benefit of children and/or grandchildren
- (2) Grantor gifts \$100,000 cash to Trust
- (3) Grantor utilizes remaining balance of \$675,000 applicable exclusion amount--if the extent gift exceeds exclusion amount, federal gift tax would be payable
- (4) If desired, Grantor could allocate \$100,000 of Donor's \$1,030,000 GST exemption to Trust

Sale to a Grantor Trust Sale of Asset with Promissory Note



- (5) Trust uses \$100,000 Cash and \$900,000 Promissory Note to purchase Asset for \$1,000,000, pledging interest in Asset as security
 - Documentation includes purchase agreement, promissory note and pledge agreement
 - See illustration of loan repayments
- (6) Net result is that "future value" of Asset (for example, if net income grows to \$580,000, illustration projects a discounted value of about \$2,900,000) is transferred for a taxable gift of only \$100,000

The Numbers Based on the Assumptions

Year	Grantor Trust Assets/Income			Net Value in Grantor's Estate	
	Starting Value	Pre-Tax Income	Ending Value	Annual Tax Paid	Note Balance
1	1,000,000	200,000	1,000,000	(80,000)	850,000
2	1,000,000	220,000	1,100,000	(88,000)	852,810
3	1,100,000	240,000	1,200,000	(96,000)	820,787
4	1,200,000	260,000	1,300,000	(104,000)	774,242
5	1,300,000	280,000	1,400,000	(112,000)	716,438
6	1,400,000	300,000	1,500,000	(120,000)	646,588
7	1,500,000	320,000	1,600,000	(128,000)	563,851
8	1,600,000	340,000	1,700,000	(136,000)	467,320
9	1,700,000	360,000	1,800,000	(144,000)	356,033
10	1,800,000	380,000	1,900,000	(152,000)	228,955
11	1,900,000	400,000	2,000,000	(160,000)	84,982
12	2,000,000	420,000	2,100,000	(168,000)	(77,070)
13	2,100,000	440,000	2,200,000	(176,000)	(259,464)
14	2,200,000	460,000	2,300,000	(184,000)	(460,557)
15	2,300,000	480,000	2,400,000	(192,000)	(684,798)
16	2,400,000	500,000	2,500,000	(200,000)	(932,732)
17	2,500,000	520,000	2,600,000	(208,000)	(1,205,023)
18	2,600,000	540,000	2,700,000	(216,000)	(1,506,444)
19	2,700,000	560,000	2,800,000	(224,000)	(1,835,896)
20	2,800,000	580,000	2,900,000	(232,000)	(2,196,408)

Potential Net Estate Tax Savings
(even on the basis of discounted value)

Discounted Asset Value:	2,900,000
Plus Tax Cost Borne by Grantor:	2,196,408 (After Note is Paid Off)
Value Out of Grantor's Estate:	5,096,408
Less Taxable Gift:	(100,000)
Net Reduction in Taxable Estate:	4,996,408
Potential Estate Tax Savings:	2,748,025

**EFFECTIVE HANDLING OF RETIREMENT BENEFITS
AND IRAS**

Pre-Death and Post Mortem

**Andrew R. Jacobs
Stites & Harbison
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EFFECTIVE HANDLING OF RETIREMENT BENEFITS AND IRAs

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EFFECTIVE HANDLING OF RETIREMENT BENEFITS AND IRAS: PRE-DEATH AND POST-MORTEM

I. INTRODUCTION

Because of the booming stock market of the last 17 years and the rise in popularity of defined contribution retirement plans (such as 401(k) plans), many individuals with otherwise modest assets have amassed large sums of monies in their Qualified Plans and Individual Retirement Accounts ("IRA"). Not surprisingly, retirement assets often represent a very large portion of an individual's overall net worth. This raises many interesting and complex challenges for effective estate planning. The purpose of this paper is (i) to set forth and explain the important concepts that must be understood before even attempting planning with respect to Qualified Plans and IRAs and (ii) to explore various estate planning strategies.

IRA and Qualified Plan account balances are generally includible in an individual's gross estate for federal estate tax purposes. In addition, the benefits are subject to federal and state income tax when actually paid to the beneficiary. Thus, these benefits may be subject to both estate and income taxation which generally makes such assets less than ideal for use in meeting the credit shelter exemption. Nevertheless, where an individual does not have sufficient non-retirement assets to fully utilize the credit shelter exemption, it may be necessary to use retirement assets for this purpose.

Much of the discussion in this paper focuses on how to leave monies in the Qualified Plan or IRA as long as possible so as to defer income taxation to the extent possible and maximize the tax free accumulation of benefits. It should be noted that this does not mean that the participant owner or beneficiary is required to defer taxation by electing to receive only the Minimum Required Distribution from the IRA or Qualified Plan. The beneficiary is always free to withdraw monies at a faster rate than what is required by law. Indeed, the IRS welcomes the early withdrawal of account balances so it can immediately tax the benefits.

Finally, throughout this paper the term "participant" shall be used to refer to the individual who is the subject of the estate planning and is the original owner of the IRA or Qualified Plan benefit.

II. WHAT ARE QUALIFIED PLANS AND IRAS?

A. QUALIFIED PLAN

For purposes of this paper, Qualified Plan means an employer sponsored retirement plan which is intended to meet the requirements of Internal Revenue Code ("Code") § 401(a). The primary advantage of a Qualified Plan is it permits the participant to defer taxation until retirement benefits are actually paid to the participant but the employer receives a current deduction on contributions to the plan. In order to obtain this favorable tax treatment, a Qualified Plan must satisfy

the detailed and complex requirements of Code § 401(a), such as the nondiscrimination, vesting, and minimum required distribution rules.

There are two types of Qualified Plans: defined contribution and defined benefit.

1. Defined Contribution Plan - means a Qualified Plan in which each participant has his or her own individual account for bookkeeping purposes. In many plans, the participant is able to select the specific investment options for his or her account. Any amounts contributed to the plan by the participant or employer on the participant's behalf are allocated to the participant's separate account where it is then invested and grows tax free until paid out to the participant at a later date, such as retirement or separation from service.

The most common forms of a defined contribution plan are 401(k) plans, profit sharing plans, and money purchase pension plans. Often times, 401(k) and profit sharing plans are combined into one plan. The 401(k) portion represents the amounts that the participant elects to have withheld from his or her salary on a pre-tax dollar basis and the profit sharing portion consists of employer discretionary contributions on behalf of the participant. Under a money purchase pension plan, the employer is required to make a contribution each year in accordance with a formula set forth in the plan (e.g., 5% of participant compensation), whereas in a profit sharing plan, contributions are generally discretionary each year.

In a defined contribution plan, the participant's retirement benefit is simply the value of the participant's account balance at the time the participant elects to withdraw his or her benefit from the plan. Once the employer contributes money to the plan and those monies are allocated to participant accounts, the employer has no further funding obligations.

2. Defined Benefit Plan - means a qualified plan in which the participant's retirement benefit is defined by a set formula in the plan document and not by the participant's individual account balance. In a defined benefit plan, individual accounts are not maintained. A common example of a defined benefit plan benefit formula would be that upon reaching age 65 the participant shall receive a monthly annuity payment for life equal to 2% of the participant's average monthly compensation (over his or her last five years of employment) multiplied by the participant's years of service. Under this example, if the participant was employed for 25 years, they would receive a monthly benefit beginning at age 65 and extending for the remainder of his or her life equal to 50% of the participant's average monthly compensation over his or her last five years of employment. The employer is then responsible to fund the plan so that the plan has sufficient funds to pay all benefits over the period of the participant's retirement. This means that the employer and not the employee bears the risk of any poor investment decisions made by the plan, and the employer may have

variable and uncertain future funding obligations extending for many years.

Defined benefit plans also allow participants to receive monthly benefits over the joint life expectancy of the participant and the participant's spouse and where the participant predeceases his or her spouse, benefit payments will continue to the surviving spouse for the surviving spouse's lifetime. In addition, some defined benefit plans allow participants to receive lump sum distributions of their benefits which are determined to be actuarially equivalent to the lifetime monthly annuity based on mortality and interest rate assumptions.

3. Trend Toward Defined Contribution Plans. Over the last 20 years, many employers have terminated their defined benefit plans and established defined contribution plans, especially 401(k) profit sharing plans. The primary reasons for this switchover are the greater administrative costs associated with defined benefit plans and the uncertain and potentially huge future funding obligations associated with defined benefit plans. The movement toward defined contribution plans in which the participant has an individual investment account (which have typically been invested in mutual funds) in combination with the booming stock market of the last 17 years has resulted in many participants having retirement account balances over \$1 million even though the participant may not have ever earned a large salary.

B. INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)

IRA means an account which may be established on an individual's behalf for purposes of saving for retirement pursuant to Code § 408. Individuals are generally limited to contributing no more than \$2,000 per year to their IRA. However, IRA account balances can reach very large levels because many individuals roll over their benefits from a Qualified Plan to an IRA at retirement or separation from service. Unlike a Qualified Plan, an IRA is not maintained or established by an employer. Typically, banks and brokerage firms act as the custodian of the IRA.

III. NECESSARY RULES TO UNDERSTAND FOR ESTATE PLANNING WITH RESPECT TO QUALIFIED PLANS AND IRAs

As briefly mentioned above, Qualified Plans are subject to many complex and technical rules under Code § 401(a). For the most part, these rules are well beyond the scope of this outline and an understanding of these rules is not necessary for effective estate planning. However, certain of these rules must be understood before engaging in estate planning. Discussed below are the rules which are essential for effective estate planning.

A. SPOUSAL RIGHTS

1. Code § 401(a)(11).

Spousal rights under a Qualified Plan should always be considered in the estate planning process because they may limit planning options. Code § 401(a)(11) requires many Qualified Plans to pay the participant's accrued vested benefit, if married, upon death in the form of a qualified pre-retirement survivor annuity ("QPSA") and to pay the accrued benefit of a vested married participant who elects to begin receiving retirement benefits in the form of a qualified joint and survivor annuity ("QJSA") (see also Code § 417).

A QJSA is an annuity for the life of the participant with a survivor annuity payable to the participant's surviving spouse in an amount equal to at least 50% but not exceeding 100% of the annuity amount payable to the participant during the participant's life (Code § 417(b)). A QPSA means a survivor annuity for the life of the surviving spouse for purposes of a defined benefit plan (Code § 417(c)(1)), and with respect to a defined contribution plan, a QPSA means an annuity for the life of the surviving spouse in an amount not less than 50% of the participant's plan benefit. If the plan permits, the surviving spouse may receive the QPSA in the form of a lump sum (Code § 417(c)(2)).

The participant's spouse may waive his or her rights to a QJSA and QPSA but only during certain waiver periods. The spouse's consent must designate a nonspouse beneficiary which generally may not be changed without the spouse's further consent (Reg. § 1.401(a)-20, Q&A-31(a) and (b)). However, a "general consent" permits the participant to waive a QPSA or QJSA (with spousal consent) and change the designated beneficiary without any requirement of further spousal consent. To be effective, a general consent must acknowledge that the spouse has the right to limit consent to a specific beneficiary and that the spouse voluntarily elects to relinquish this right (Reg. § 1.401(c)-20, Q&A-31(c)). Moreover, if the designated beneficiary is a trust, the spouse need only consent to the designation of the trust and need not consent to the designation of trust beneficiaries or any changes of trust beneficiaries (Reg. § 1.401(a)-20, Q&A-31(a)). A general consent, however, is not permitted unless the Qualified Plan permits such a consent.

Waiver of the QJSA may only be made during the 90-day period ending on the first day of the period for which the first payment is to be made. The QPSA can generally only be waived on or after the first day of the plan year in which the participant attains age 35 (Code § 417(a)(6)(B)). A plan may provide for an earlier waiver provided a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th

birthday occurs (Reg. § 1.401(a)-20, Q&A-33(b)). If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death.

In addition, the foregoing consent to a waiver of the QJSA and QPSA must be made while the spouse was married to the participant. An IRS regulation provides that an agreement entered into prior to marriage does not satisfy the consent requirements, even if the agreement is executed with the applicable election period (Reg. § 1.401(a)-20, Q&A-28). Although many federal courts have upheld this position, the Sixth Circuit Court of Appeals has indicated in at least one case that it may be willing to allow premarital consents. Callahan v. Hutsell, 1993 U.S. App. LEXIS 34005 (6th Cir. 1993), remanding 813 F. Supp. 541 (W.D. Ky. 1992).

2. Spousal Rights Not Applicable to IRAs and Certain Defined Contribution Qualified Plans.

IRAs are not subject to the qualified survivor annuity rules (Reg. § 1.401(a)-20, Q&A-3(d)).

In addition, a defined contribution plan, other than a money purchase pension plan, is not subject to the qualified survivor annuity rules if (1) such plan provides that the participant's nonforfeitable accrued benefit is payable in full, on the death of the participant to the participant's surviving spouse (or, if there is no surviving spouse or the surviving spouse consents in the manner required under § 417(a)(2), to a designated beneficiary); (2) the participant does not elect a payment of benefits in the form of a life annuity; and (3) with respect to the participant, such plan is not a direct or indirect transferee of a plan which is subject to the qualified survivor annuity rules (e.g., a money purchase pension plan). This third requirement shall apply only with respect to the transferred assets if the plan separately accounts for such assets in any income therefrom (Code § 401(a)(11)(B)(iii)). If the qualified survivor annuity rules are not applicable, the spouse can waive his or her right to the death benefit at any time after the marriage.

While money purchase pension and defined benefit plans are always subject to the qualified survivor annuity rules, profit sharing plans may fall under the above exception and not be subject to the rules. Thus, if the individual for whom you are performing estate planning has a profit sharing plan benefit, as a first step, you should determine whether the individual is subject to the qualified survivor annuity rules.

Finally, if the participant spouse is asked to waive either the QPSA or QJSA or death benefit under a plan subject to the QPSA and QJSA requirement, counsel should advise the spouse to seek independent counsel.

B. MINIMUM REQUIRED DISTRIBUTIONS

The Code requires that Qualified Plan and IRA benefits be subject to certain Minimum Required Distribution rules so that participants and beneficiaries cannot leave monies in a plan indefinitely to accumulate tax free. Simply put, because the Code provides special tax advantages to Qualified Plans and IRAs, the government wants to be able to set certain limits on how long assets may escape taxation by remaining in the Qualified Plan or IRA. Minimum Required Distributions refers to those distributions which are required to be taken from a Qualified Plan or IRA.

1. Minimum Required Distributions.

Code §§ 401(a)(9) and 408(a)(6) require that the participant begin withdrawing certain minimum amounts (i.e., Minimum Required Distributions) each year from his or her Qualified Plan or IRA no later than the participant's Required Beginning Date. Minimum Required Distributions must be calculated so that the participant's entire interest is distributed over a period no longer than the life of the participant or the joint life expectancy of the participant and designated beneficiary. It is important to note that Code § 401(a)(9) merely sets forth the minimum amount the participant or beneficiary must take out each year, but the participant or beneficiary is always free to withdraw a larger amount or the entire balance in any given year, provided the Qualified Plan permits, and thereby pay more income tax. For purposes of this paper, we will assume that the participant has sufficient other assets to maintain his or her standard of living and does not want to withdrawal any assets from a Qualified Plan or IRA unless required.

2. Required Beginning Date.

The Required Beginning Date is the date by which a participant must begin withdrawing monies from his or her Qualified Plan or IRA. For a Qualified Plan, the Required Beginning Date is the April 1 of the calendar year following the latter of: (1) the calendar year in which the employee attains age 70 1/2 or (2) the calendar year in which the employee retires (Code § 401(a)(9)(C); Prop. Reg. § 1.401(a)(9)-1, Q&A-B-2(a)). However, in the case of a 5% owner, the Required Beginning Date shall be the April 1 following the year in which the owner reaches age 70 1/2 regardless of whether the owner is still employed. For purposes of an IRA, the Required Beginning Date is simply the April 1 following the calendar year in which the individual attains age 70 1/2.

3. Calculating Minimum Required Distributions.

The Minimum Required Distribution, in any given year, is determined by dividing the participant's benefit by the applicable life expectancy (Code § 401(a)(9)(A); Prop. Reg. § 1.401(a)(9)-1, Q&A-F-1(a)). As a general rule, distributions made prior to the Required Beginning Date shall not be used as credits against any future required distributions. The calendar year in which the Required Beginning Date occurs may have two required distributions--one for the calendar year in which the participant reached age 70 1/2 and a second for the calendar year in which the Required Beginning Date occurs (Prop. Reg. § 1.401(a)(9)-1, Q&A-F-1(b) and (c)). The expected return multiples in Tables V and VI of Reg. § 1.72-9 are used to determine life expectancies (Prop. Reg. § 1.401(a)(9)-1, Q&A-E-3 and E-4).

4. Annual Recalculation.

In calculating life expectancies for purposes of calculating Minimum Required Distributions each year, the general rule is to recalculate the participant and, if applicable, the beneficiary's life expectancy each year. This is called annual recalculation. A participant may, however, elect not to recalculate life expectancy annually and this election can apply to both the participant and beneficiary or to just one or the other. The advantage of recalculating annually is that if the participant and beneficiary do not have premature deaths, they will have greater life expectancies each year that they live which will lead to smaller Minimum Required Distributions. However, under the annual recalculation method, a participant and designated beneficiary have a life expectancy of zero for purposes of calculating Minimum Required Distributions in the year following their respective deaths, whereas if the owner opts out of annual recalculation, the participant's and designated beneficiary's life expectancies as of the Required Beginning Date remain fixed (Code § 401(a)(9)(D); Prop. Reg. § 1.401(a)(9)-1, Q&A-E-7). The participant's election regarding annual recalculation becomes irrevocable at the participant's Required Beginning Date.

The following examples demonstrate the advantage of not recalculating annually:

Example 1: An IRA owner and spousal designated beneficiary fail to opt out of recalculating annually. As of the Required Beginning Date, the owner, age 70, and spouse, age 68, have a joint life expectancy of 21.5 years. The owner dies the following year at age 71 and the spouse dies two years later, also at age 71. Because the owner had failed to opt out of recalculating annually with respect to both the owner and designated beneficiary, the owner's and the spouse's respective life expectancies in the years following their deaths is zero. Thus, the entire

IRA balance would have to be distributed to their heirs no later than December 31 of the year following the spouse's death.

Example 2: Assume the facts as above, except the IRA owner elected to opt out of recalculating annually with respect to the owner's and beneficiary's lives. Accordingly, the IRA owner and spouse's life expectancies would have been fixed as of the Required Beginning Date and, notwithstanding their premature death, their heirs could elect to have the IRA account balance distributed over the 21.5 year joint life expectancy of the owner and surviving spouse as of the Required Beginning Date.

5. Minimum Distribution Incidental Benefit Rule.

The Minimum Distribution Incidental Benefit Rule generally requires that for purposes of computing the joint and survivor life expectancy of a participant and his non-spouse designated beneficiary during the participant's lifetime for purposes of calculating Minimum Required Distributions, the designated beneficiary is deemed to be no more than 10 years younger than the participant (Code § 401(a)(9)(G); Prop. Reg. § 1.401(a)(9)-2, Q&A-A-1). Thus, this limits somewhat the effectiveness of designating a child as beneficiary as opposed to a spouse for purposes of extending the payout period and reducing Minimum Required Distributions.

6. Multiple Beneficiaries.

If more than one beneficiary is selected, then the designated beneficiary with the shortest life expectancy shall be used for purposes of calculating Minimum Required Distributions unless each beneficiary is a beneficiary of a separate account or separate share (Prop. Reg. § 1.401(a)(9)-1, Q&A-E-5(a) and H-2(b)).

If, as of the participant's Required Beginning Date or as of the IRA owner's date of death, if earlier, a beneficiary is named for each separate account in the IRA or Qualified Plan, the Required Minimum Distribution rules may be applied separately to each separate account. Thus, the life expectancy of the beneficiary of each separate account will be used with respect to the separate account (Prop. Reg. § 1.401(a)(9)-1, Q&A-H-2A(a) and H-2(b)). The separate accounts rule is probably the most overlooked estate planning technique.

7. Minimum Required Distributions After Participant's Death Where Participant Dies On or After Required Beginning Date.

If the participant dies on or after his or her Required Beginning Date, the remainder of the benefit must be distributed at least as rapidly as the method of distribution in effect at the date of the decedent's death (Code

§ 401(a)(9)(B)(i)). If benefits are being paid out over the joint lives of participant and a designated beneficiary; the beneficiary whose life expectancy is being used must be the person entitled to the remaining benefits (Prop. Regs. § 1.401(a)(9)-1, Q&As-B-4 and E-5).

8. Special Spousal Rollover Rights.

An exception to the rule of section 7 is the special rights of a surviving spouse beneficiary with respect to a participant's Qualified Plan or IRA benefit. The surviving spouse may rollover the participant's Qualified Plan benefit into the spouse's own IRA. If the surviving spouse is the beneficiary of the participant's IRA, the spouse may make an election to treat the decedent's IRA as his or her own or roll it over into the spouse's IRA (Code § 402(c)(9); Prop. Reg. § 1.408-8; Q&A-A-4). By electing to treat the IRA as his or her own or rolling the decedent's IRA or Qualified Plan benefit into his or her own IRA, the surviving spouse may designate a new beneficiary and delay any distributions or further distributions until the spouse's own Required Beginning Date which is the April 1 of the calendar year following the calendar year in which he or she reaches age 70 1/2 (Code § 408(d)(3)(C)(ii); Prop. Regs. § 1.408-8; Q&A-A-4(b)). The surviving spouse must designate a new beneficiary before the later of the spouse's Required Beginning Date (i.e., April 1 of the year after the calendar year in which he or she reaches age 70 1/2) or December 31 of the year following the first spouse's death. According to IRS Private Letter Ruling ("PLR") 9711032, any future distributions can then be minimized by electing to receive them over the joint life expectancy of the surviving spouse and new beneficiary. Another advantage to this approach, according to PLR 9711032, is that it allows the surviving spouse to make a new election with respect to annual recalculation of life expectancies and not be bound by the participant's prior election. This avoids early distribution of the full account balance after the surviving spouse's death if the decedent had elected annual recalculation. These options are available to the surviving spouse even if the decedent and surviving spouse were both age 70 1/2 or over at the time of the decedent's death (PLR 9711032). One disadvantage however to this approach is that if the surviving spouse has not yet reached age 70 1/2 and begins to make withdrawals from his or her own IRA, the withdrawals will be subject to the 10% excise tax of Code § 72(t), unless some exception applies.

9. Minimum Required Distributions After Participant's Death Where Participant Dies Before Required Beginning Date.

If the participant dies before his or her Required Beginning Date, then a decedent's entire interest must be distributed by December 31 of the calendar year which contains the 5th anniversary of the participant's death (Code § 401(a)(9)(B)(ii); Prop. Reg. § 1.401(a)(9)-1, Q&A-C-2).

However, there are two exceptions to this rule. First, if payments to a nonspouse beneficiary begin not later than December 31 of the calendar year after the calendar year in which the participant dies, the payments may be paid over the life of the designated beneficiary or over a period not extending beyond the life expectancy of the beneficiary, subject to the terms of the plan (Prop. Reg. § 1.401(a)(9)-1, Q&A-C-3). Second, if the designated beneficiary is a surviving spouse, the surviving spouse could wait until the decedent would have reached age 70 1/2 before being required to take a Minimum Required Distribution and to make withdrawals at such time over the surviving spouse's life expectancy (Prop. Regs. § 1.409(a)(9)-1, Q&A-C-3).

If the surviving spouse beneficiary dies after the participant but before distributions to the spouse have begun, the five year rule and the exceptions to the five year rule apply as if the spouse were the participant (Prop. Regs. § 1.401(a)(9)-1, Q&A C-5).

The rules for determining whether either of these two exceptions applies are as follows. If the plan does not specify whether the exception applies and the surviving spouse is the designated beneficiary, the spousal exception will apply but the exception for nonspousal beneficiaries will not apply. For the nonspousal exception to apply, the plan must specifically provide for such exception (Prop. Reg. 1.401(a)(9)-1, Q&A-C-4).

10. Designated Beneficiary.

For purposes of calculating Minimum Required Distributions, the proposed regulations provide certain limitations on who or what will be treated as a designated beneficiary with a life expectancy. A beneficiary's failure to qualify as a designated beneficiary under the proposed regulations does not affect the beneficiary's legal right to the Qualified Plan or IRA benefit, it simply means that the beneficiary will not be eligible to take advantage of either exception to the five-year distribution rule and the beneficiary will have a life expectancy of zero for purposes of calculating Minimum Required Distributions. Generally, only individuals and individual beneficiaries of certain trusts may be treated as designated beneficiaries for purposes of the Minimum Required Distribution rule (Prop. Regs. § 1.401(a)(9)-1, Q&A-E-5(e)). Estates, trusts not meeting specific requirements, and charitable organizations will not be treated as designated beneficiaries (Prop. Regs. § 1.401(a)(9)-1, Q&A-D-2A(a)).

The individual beneficiaries of a trust will be treated as designated beneficiaries for purposes of the Minimum Required Distribution rule if the trust meets the following four requirements: (1) the trust is valid under state law or would be but for the fact that there is no corpus; (2) the trust is irrevocable, or will become irrevocable by its terms upon death of the

participant; (3) the trust beneficiaries are identifiable from the trust instrument; and (4) the plan administrator has either been provided with a copy of the trust instrument or with a list of the trust beneficiaries, including contingent and remainder beneficiaries (Prop. Regs. § 1.401(a)(9)-1, Q&A-D-5 and D-6).

Significantly, if a person other than an individual is designated as a beneficiary, the participant will be treated as not having a designated beneficiary for purposes of the Minimum Required Distribution rule even if there are also individuals designated as beneficiaries (Prop. Regs. § 1.401(a)(9)-1, Q&A-E-5(a)). If a beneficiary's entitlement to a participant's benefit is contingent on the death of a prior beneficiary, such contingent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy or whether a beneficiary who is not an individual is a beneficiary (Prop. Regs. § 1.401(a)(9)-1, Q&A-E-5(e)).

11. Consequences of Not Designating a Beneficiary.

The consequences of not designating a beneficiary or having a beneficiary who cannot be treated as a beneficiary for purposes of the Minimum Required Distribution rules could be significant. If the participant dies before his or her Required Beginning Date and has not designated a beneficiary, then all distributions from the IRA or Qualified Plan must be completed within five years (Reg. § 1.401(a)(9)-1, Q&A-C-4(a)(2) and Q&A-D-4(a)). If the participant dies after his Required Beginning Date and did not elect out of recalculating annually, then the entire IRA or Qualified Plan balance must be distributed no later than December 31 of the calendar year following participant's death. But if the owner elected out of recalculating life expectancies annually, the Qualified Plan or IRA can be distributed to the owner's estate over the life expectancy of the owner calculated as of his or her Required Beginning Date.

IV. EXAMINE DOCUMENTS

Before attempting any serious estate planning, the first step is to carefully examine the documents governing the individual's Qualified Plan and/or IRA. In the case of a Qualified Plan, the actual plan document should be examined in addition to the summary plan description ("SPD") because inconsistencies between the plan document and SPD often exist. In the event of an inconsistency, the plan document generally prevails over the SPD. In a Qualified Plan, the death benefits, distribution options and rollover provisions among others, of the plan document as well as the available beneficiary designation forms should be examined.

A Qualified Plan may be more restrictive than an IRA in terms of distribution options. Some Qualified Plans only permit lump sum distributions or offer a limited number of distribution options. Other Qualified Plans may not permit lump sum distributions. In

addition, the spouse of a participant in many Qualified Plans must consent to the designation of a nonspouse as the primary beneficiary of the plan's death benefit (Code § 401(a)(11)).

Furthermore, we generally see no real advantage in leaving a benefit in a Qualified Plan after the participant retires as opposed to rolling it over into an IRA. In most cases, an IRA will provide greater flexibility in terms of distribution options and, perhaps, investment options. Under federal law, Qualified Plan benefits receive greater protection from creditors than IRA benefits. But in Kentucky, IRA assets also appear to have similar protection from creditors (see KRS 427.150). Thus, at least in Kentucky, there does not appear to be any reason not to rollover benefits from a Qualified Plan to an IRA when permitted and, indeed, there may be certain advantages.

V. BENEFICIARY DESIGNATION ALTERNATIVES

The most common beneficiary designations with respect to Qualified Plans and IRAs are the following: (1) spouse; (2) marital deduction trust; (3) credit shelter trust; (4) children; and (5) charitable organization. In determining the appropriate beneficiary or beneficiaries, most individuals focus on the following objectives: (1) need to provide financial security to the surviving spouse; (2) minimization of federal estate tax by utilizing the unified credit exemption; and (3) maximizing the income tax deferral of Qualified Plan or IRA assets by delaying distributions to the extent permitted by the Minimum Distribution rules.

A. SPOUSE AS DESIGNATED BENEFICIARY

In many cases the surviving spouse will be the appropriate designated beneficiary of the participant's Qualified Plan and/or IRA. The surviving spouse receives significant tax advantages. First, the marital deduction for federal estate tax purposes will apply if the Qualified Plan or IRA benefit is payable to the spouse (Regs. § 20.20556(b)-5(f)(6)). However, although the marital deduction allows the avoidance of federal estate tax upon passage of these benefits to the surviving spouse, the surviving spouse will incur income tax on any distributions. The surviving spouse has several planning options to minimize these income taxes and, in particular, the surviving spouse has the unique ability to rollover the decedent's Qualified Plan or IRA assets into the surviving spouse's own IRA or the surviving spouse can claim the decedent's IRA as his or her own.

1. Rollover/Claim as Own Option.

First, if permitted under the Qualified Plan, the surviving spouse will be able to consider rolling over the benefit into the spouse's own IRA. If the surviving spouse is the beneficiary of the decedent's IRA, the spouse can consider making an election to treat the decedent's IRA as his or her own or rolling it over into the spouse's IRA (Code § 402(c)(9); Regs. § 1.408-8, Q&A-A-4). While electing to treat the IRA as his or her own or rolling the decedent's IRA or Qualified Plan benefit into his or her own IRA, the

surviving spouse may designate a new beneficiary and delay any distributions or further distributions until the spouse's Required Beginning Date which is the April 1 of the calendar year following the calendar year in which he or she reaches age 70 1/2 (Code § 408(d)(3)(C)(ii); Prop. Regs. § 1.408-8, Q&A-A-4(b)). According to PLR 9711032, any future distributions can then be minimized by electing to receive them over the joint life expectancy of the surviving spouse and new beneficiary, which may be a child, under the Minimum Required Distribution rule. The surviving spouse must designate a new beneficiary before the later of the spouse's Required Beginning Date (i.e., April 1 of the year after the calendar year in which he/she reaches age 70 1/2) or December 31 of the year following the first spouse's death. Another advantage to this approach, according to PLR 9711032, is that it allows the surviving spouse to make a new election with respect to annual recalculation of life expectancies and not be bound by the participant's prior election. This avoids early distribution of the full account balance after the surviving spouse's death if the decedent has elected annual recalculation. This option is available to the surviving spouse even if the decedent and surviving spouse were both age 70 1/2 or over at the time of decedent's death (PLR 9711032). One disadvantage to this approach, however, is that if the surviving spouse has not reached age 59 1/2 and begins to make withdrawals from the IRA, the withdrawals would be subject to the 10% excise tax of Code § 72(b) unless some exception applies.

2. No Rollover/Claim as Own.

A second alternative would be for the surviving spouse to leave the benefits in the decedent's Qualified Plan or not elect to make the decedent's IRA his or her own by rollover or election. Under this approach, the surviving spouse would have to begin receiving Minimum Required Distributions by the end of the year in which the participant would have reached age 70 1/2 if permitted by the governing document (Code § 401(a)(9)(B)(iv)(I)). But the 10% excise tax of § 72 would not be applicable to any withdrawals even if the surviving spouse has not reached age 59 1/2.

While it will generally be beneficial for a surviving spouse to claim the decedent's IRA as his or her own or to roll the decedent's IRA or Qualified Plan over into his or her own IRA, it may be advantageous to leave the benefit in the decedent's Qualified Plan or IRA if the decedent was considerably younger than the surviving spouse and the decedent has not reached age 70 1/2. The surviving spouse could then wait until the decedent would have reached age 70 1/2 before being required to take a Minimum Required Distribution and could make withdrawals at such time over the surviving spouse's life expectancy. If the surviving spouse were to die before payments began, the surviving spouse may designate a new beneficiary.

3. Lump Sum Treatment.

Another alternative for the surviving spouse to consider is whether to elect a lump sum distribution of the Qualified Plan benefit, if permitted by the plan document. If the participant reached age 50 before 1986 and age 59 1/2 before death, 10 year averaging and capital gains treatment may be available for a lump sum by a surviving spouse taken from a Qualified Plan (Code § 402(d)).

4. Disclaimer.

Finally, the surviving spouse may consider disclaiming some or all of these benefits, especially if the marital deduction is overfunded, with the benefits then passing to a credit shelter trust or directly to alternative beneficiaries of the IRA or Qualified Plan.

5. Objectives.

In terms of meeting the three above-mentioned objectives, designation of the surviving spouse as beneficiary best meets the objective of providing financial security to the surviving spouse and accomplishes some income tax deferral under the Minimum Required Distribution rule, albeit not as much as with a child designated beneficiary. Designation of the spouse as beneficiary will come up short in terms of minimizing estate taxes unless there are other assets available to fund a credit shelter trust.

B. NONSPOUSE DESIGNATED BENEFICIARY

1. Generally.

Obviously, the marital deduction will not apply with a nonspouse beneficiary. Thus, any benefits payable to a nonspouse will be subject to estate tax, unless they fall within the credit shelter exemption. A nonspouse beneficiary's options are more limited than a spouse for purposes of minimizing income taxes on the benefit. Unlike a surviving spouse, a nonspouse beneficiary cannot claim the decedent's IRA as his or her own or roll it over into his or her own IRA (Code § 402(c)(9); Prop. Regs. § 1.408-8, Q&A-A-4)). Moreover, the Minimum Distribution Incidental Benefit rule restricts the benefit for the participant to name a nonspouse beneficiary because no matter how young the nonspouse beneficiary for purposes of calculating participant's Minimum Required Distribution amount, the nonspouse beneficiary must be treated as no more than 10 years younger than the participant.

If the participant dies on or after his or her Required Beginning Date, the remainder of the benefit must be distributed to a nonspouse beneficiary at least as rapidly as the method of distribution in effect at the date of the

decedent's death (Code § 401(a)(9)(B)(i)). If the decedent dies before his or her Required Beginning Date, then the decedent's entire interest must be distributed to the nonspouse beneficiary by December 31 of the calendar year containing the fifth anniversary of the decedent's death (Code § 401(a)(9)(B)(ii); Prop. Reg. § 1.401(a)(9)-1, Q&A-C-2). But if payments to a nonspouse beneficiary begin not later than December 31 of the calendar year after the calendar year in which the participant died, the payments may be paid over the life of the designated beneficiary or over a period not extending beyond the life expectancy of the beneficiary, subject to the terms of the Qualified Plan or IRA (Prop. Regs. § 1.401(a)(9)-1, Q&A-C-4).

2. Lump Sum.

Moreover, if the participant reached age 50 before 1986 and age 59 1/2 before death, 10 year averaging and capital gains treatment may be available for a lump sum received by a nonspouse beneficiary from a Qualified Plan (Code § 402(d)).

3. Objectives.

Designation of a nonspouse beneficiary, such as a child, will likely maximize the deferral of income taxes under the Minimum Required Distribution rule and will help reduce estate taxes to the extent Qualified Plan and IRA assets must be used to fund the credit shelter exemption. In the absence of sufficient other assets in the estate, however, designation of a nonspouse beneficiary will defeat the objective of providing financial security to the surviving spouse.

C. MARITAL TRUST BENEFICIARY.

1. Generally.

A marital trust may be the designated beneficiary of an IRA or Qualified Plan. However, in order for the individual beneficiaries of a trust to be treated as designated beneficiaries for purposes of the Minimum Required Distribution requirements, the trust must meet the following requirements at the later of the date the trust is named as beneficiary or the participant's Required Beginning Date: (1) the trust is valid under state law, or would be but for the fact that there is no corpus; (2) the trust is irrevocable or will become irrevocable by its terms upon the death of the employee; (3) the trust beneficiaries are identifiable from the trust instrument; and (4) the plan administrator has either been provided with a copy of the trust instrument or with a list of the trust beneficiaries, including contingent and remainder beneficiaries.

Where there are multiple beneficiaries, the beneficiary with the shortest life expectancy will be used for purposes of calculating Minimum Required Distributions. In most cases, this will be the surviving spouse.

A life income/general power of appointment trust would be the simplest trust for purposes of qualifying for the marital deduction. But a life income/general power of appointment trust may not allow the participant to retain the desired control over the trust assets after the participant's death. If the participant wishes to provide for his or her surviving spouse, defer payment of estate taxes until the surviving spouse dies, and retain control over the disposition of any remaining Qualified Plan or IRA benefit at the surviving spouse's death, then a qualified terminable interest property (QTIP) trust may be the appropriate option.

2. QTIP Trust.

In order for a QTIP trust to qualify for the marital deduction, the following three requirements must be met: (1) no payments from the trust can be made to anyone other than the surviving spouse during his or her lifetime; (2) the decedent's executor must elect QTIP treatment by listing the assets on Schedule M of the estate tax return (Form 706); and (3) the surviving spouse must be entitled during his or her lifetime to all of the income from the assets payable at least annually. It is the third requirement -- that the surviving spouse be entitled to all income from the trust during his or her life -- which can be problematic. This income distribution requirement may require that IRA or Qualified Plan assets be paid out faster than the Minimum Required Distribution rules would otherwise require. For example, in a QTIP trust, the surviving spouse would begin to receive income distributions upon the participant's death. However, if the surviving spouse was simply the designated beneficiary of the participant's IRA or Qualified Plan, the surviving spouse could roll the benefit over into his or her own IRA and delay distributions until the surviving spouse reaches age 70 1/2. In addition, depending upon the surviving spouse's age, the Minimum Required Distribution amount each year may be less than the income. Thus, to insure that the QTIP trust qualifies for the marital deduction, the trust should provide that the Qualified Plan or IRA paid to the QTIP trust each year the greater of the income generated by the assets representing the accrued benefit in the Qualified Plan or IRA or the Minimum Required Distribution amount as determined under § 401(a)(9).

3. Disclaimer/Lump Sum.

If a marital trust is the beneficiary, rollover treatment is generally foreclosed unless the spouse has the right to revoke the trust or has a lifetime power to withdraw assets from the trust. The surviving spouse may want to consider the use of a disclaimer to help fund a credit shelter

trust or pass monies directly to other beneficiaries. Similarly, the executor could also consider a partial QTIP election. Moreover, if the trust were to elect a lump sum distribution from a Qualified Plan, 10 year averaging and capital gains treatment may be available if the participant reached age 50 before 1986 and age 59 1/2 before death.

4. Objectives.

A marital trust beneficiary will provide financial security to the surviving spouse, but it will do nothing to reduce estate taxes because in the absence of other available assets, the credit shelter exemptions may go unused. A marital trust beneficiary will also not maximize the deferral of income taxes under the Minimum Required Distribution rule because (i) the beneficiary for purposes of measuring life expectancy will likely be the spouse and not a child and (ii) rollover treatment is not available from the trust which eliminates the ability of the surviving spouse to rollover the benefit to his or her own IRA and effectively reset the clock for purposes of Minimum Required Distributions.

D. CREDIT SHELTER TRUST BENEFICIARY

1. Generally.

A credit shelter trust may be named as beneficiary of a Qualified Plan or IRA benefit. It is generally preferable, however, to use assets other than Qualified Plan or IRA assets to fund a credit shelter trust because the trust or children will pay income tax on the distributions. It would be better for the surviving spouse to pay this income tax and thereby reduce the size of his or her estate rather than reducing the amount that passes free of estate tax through the credit shelter trust. In many cases, however, Qualified Plan or IRA assets will need to be used to fund the credit shelter trust because the participant does not have sufficient other assets.

2. Rollover/Lump Sums.

To the extent benefits are payable to a credit shelter trust, a marital deduction and rollover treatment will not be available. If the participant reached age 50 before 1986 and age 59 1/2 at death, 10 year averaging and capital gains treatment may be available for the trust if the distribution qualifies as a lump sum distribution under Code § 402(d)(4).

3. Objectives.

Although use of Qualified Plan or IRA assets is not the most effective way of funding the credit shelter exemption, in the absence of sufficient other assets, it may be the only alternative to meet the objective of reducing estate taxes. The credit shelter trust can be structured to provide some financial security to the surviving spouse. As with the marital trust,

discussed above, the credit shelter does not maximize the deferral of income under the Minimum Required Distribution rules.

E. CHARITABLE ORGANIZATION BENEFICIARY

1. Generally.

If a person is charitably inclined, a charitable organization may be a very appropriate beneficiary for purposes of an IRA or Qualified Plan. The advantages of a charitable beneficiary designation are that (1) the value of the Qualified Plan or IRA is deductible for federal estate practices and (2) if the charitable organization is exempt from federal and state income taxes, then distribution of the Qualified Plan or IRA assets to the charitable organization will escape federal and state income taxes unlike distributions to nontax-exempt beneficiaries. Qualified Plan and IRA benefits constitute income in respect of a decedent and thus the beneficiary must treat these benefits in the same manner as the owner would have.

IRA or Qualified Plan assets should not be used to satisfy a pecuniary bequest to a charity because the estate will recognize current income on the amount of the bequest because the estate is treated as receiving a distribution from the IRA or Qualified Plan and then using it to satisfy its obligation to pay pecuniary bequests.

It is important to note, however, that a charitable organization is not a designated beneficiary for purposes of the Minimum Required Distribution rules. Accordingly, a charitable organization is treated as having no life expectancy and, therefore, the participant owner cannot receive the benefit of a second life expectancy and further delaying distributions under the Minimum Required Distribution rule.

Caution should also be exercised in naming a charitable organization as a beneficiary of a trust along with a spouse or children. If any of the multiple noncontingent beneficiaries is not a designated beneficiary for purposes of the Minimum Required Distribution rules, then the IRA or Qualified Plan will be treated as not having a designated beneficiary.

2. Objectives.

Designation of a charitable organization as beneficiary certainly reduces estate taxes but it fails the test of providing financial security to the spouse. Charitable organization beneficiaries do not maximum the deferral of income tax because under the Minimum Required Distribution rules only the participant's life expectancy may be used because the charitable organization is deemed not to have a life expectancy.

F. NO BENEFICIARY DESIGNATION

Perhaps the biggest planning mistake that can be made is for an IRA or Qualified Plan owner to not have a designated beneficiary. In the absence of a designated beneficiary, there will be no life expectancy of a beneficiary for purposes of stretching the minimum distributions out over a longer period of time. If the participant dies before his Required Beginning Date and has not designated a beneficiary, then all distributions must be completed within five years (Reg. § 1.401(a)(9)-1, Q&A-C-4(a)(2) and Q&A-D-4(a). If the participant dies after his Required Beginning Date, did not designate a beneficiary, and did not elect out of recalculating annually, then the entire Qualified Plan or IRA balance must be distributed no later than December 31 of the year following the IRA or Qualified Plan owner's death. But if the owner elected to opt out of recalculating life expectancies annually, then the IRA or Qualified Plan balance can be distributed to the owner's estate over the life expectancy of the owner calculated as of his or her Required Beginning Date.

VI. POSTMORTEM PLANNING

As set forth above, it is often advisable to designate a surviving spouse as the beneficiary of a Qualified Plan or IRA because of the significant tax advantages afforded a surviving spouse. The surviving spouse is first eligible for the marital deduction which allows the avoidance of estate taxes until his or her death and second has greater flexibility to defer payment of income taxes. Nevertheless, a decedent will for various reasons designate a beneficiary other than his or her spouse, such as an estate, trust or child. After the decedent's death, the parties involved may wish instead to have these benefits paid to the surviving spouse if the spouse could roll the benefits into his or her IRA.

If this is the case, the following options should be explored to allow the spouse to receive the benefits and roll them over to an IRA: disclaimer, exercise of an elective share, intestacy, or a distribution from the Qualified Plan or IRA. The IRS has generally held that if a decedent's Qualified Plan or IRA benefits pass through a third party to the spouse, such as an estate or trust, the spouse will be treated as receiving the benefits for a third party and will not be eligible for rollover treatment (PLR 9416045). However, the IRS has made various exceptions to this rule in numerous situations (PLRs 9524020, 9047065, 9609052, 9615043, 9623064, 9626049, 9515041, 9450042, and 9402023).

In contrast, many estate planners name the surviving spouse as the designated beneficiary of the Qualified Plan or IRA with the expectation that the surviving spouse will disclaim to the extent necessary to fund a credit shelter trust (PLRs 9442032 and 9320015).



LIVING WITH LIVING WILLS

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SECTION F

LIVING WITH LIVING WILLS

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LIVING WITH LIVING WILLS

Whoever no longer wishes to live shall state his reasons to the Senate, and after having received permission shall abandon life. If your existence is hateful to you, die; if you are overwhelmed by fate, drink the hemlock. If you are bowed with grief, abandon life. Let the unhappy man recount his misfortune, let the magistrate supply him with the remedy, and his wretchedness will come to an end.¹

I. Social and Religious Perspectives – Attorney Perspectives

A. Social Perspectives

We may think that no one gave thought to end of life decisions prior to the 1970's, but that is far from true. The Greeks embraced the concept of euthanasia, meaning well (eu) death (thanatos). There is some evidence that in Ceos there was an ancient custom requiring people over sixty to commit suicide. In the Republic, Plato condemned the physician Hero ditus, teacher of Hippocrates, for "educating diseases . . . and inventing lingering death".² He goes on to say: "Being a trainer, and himself of a sickly constitution, by a combination of training and doctoring [he] found out a way of torturing first and chiefly himself, and secondly the rest of the world."³

In Rome, suicide was punishable only if it was irrational. Anyone who killed himself without cause was looked down on, because "whoever does not spare himself would much less spare another." Suicide, however, brought on by "impatience of pain and sickness" was perfectly acceptable, as was that induced by "weariness of life . . . lunacy, or fear of dishonor."⁴ To the Romans, living nobly meant dying nobly.

Roman attitudes toward suicide as a release from unendurable suffering reflect a synthesis of the Stoic, Pythagorean, Platonic, Aristotelian, and Epicurean influences. Seneca the Stoic wrote:

It makes a great deal of difference whether a man is lengthening his life or his death. But if the body is useless for service, why should one not free the struggling soul? Perhaps one ought to do this a little before the debt is due, lest, when it falls due, he may be unable to perform the act.⁵

In the second and third centuries, Stoicism was undermined by the growing influence of Christianity. Suicide was denounced. Anyone who took his own life was denied a Christian

burial. Civil legislation was influenced as well. Not only were the victim's goods and property confiscated by civil authorities; the body received an ignominious burial on the highway, impaled by a stake. There were no exceptions – not even for those who had endured prolonged suffering due to an incurable illness.⁶ Every suicide was branded a *felo de se* (self-murder).

By the fifth century, St. Augustine decried suicide as a "detestable and damnable weakness." His arguments were: First, taking one's own life defied the Sixth Commandment, "Thou shall not kill." By committing suicide, a man was usurping the function of church and state. Finally, Augustine held that life and its sufferings are divinely ordained by God and must be borne accordingly.⁷

During the Renaissance with the reawakened interest in individualism, philosophers tended to restate Stoic ideas, tempered by Christianity. Montaigne wrote, "Death is a most assured haven, never to be feared, and often to be sought." And later he said: "All comes to one period, whether man makes an end for himself, or whether he endure it."⁸

By the eighteenth century, a few members of the medical community began to stress the importance of a natural and humane way of dying. For instance, in his "Oratio de Euthanasia" of 1794, Paradys, a physician recommended an "easy death" for a patient, especially one who is incurable and suffering.⁹ Like others, he saw medical progress as a double edged sword, with the patient sometimes the victim.

From the nineteenth century until 1940, in both America and Europe, the subject of euthanasia was becoming less academic and more a matter of what should be done – not only by physicians, but by the law and governing bodies. Bills began to be proposed in both England and the United States. The first proposed in the U.S. was proposed in 1906 to the Ohio legislature. However, though bills were introduced, none were passed. Nonetheless, the introduction of the bills caused much debate between physicians, churchmen and legislatures. Equally important in fueling the debate was the growing number of cases in England and America since 1920 that revolved around mercy killings, assisted suicide, and suicide due to terminal illness. No two results were the same.

At the end of the nineteenth century and the beginning of the twentieth century people were increasingly becoming concerned with the quality of life, the impact of sophisticated medical techniques, and the ability to control the environment. However, in England and the U.S. no legislation was passed.

In Germany, the concept was very different than in England and the U.S. The concept of *lebensunwerten Leben* – "life not worthy of life" – had surfaced as early as 1920 and appeared in German medical and legal literature through the 1920s and 1930s. This was similar to literature in England and America, but in Germany the notion gained government approval. As a result, *lebensunwerten Leben* provided the rationale for the Nazi practice of senselessly murdering thousands and thousands of people. Labeled euthanasia, such practice will forever affect the meaning of the word and cause us to view the concept totally differently than the Greeks and Romans understood it.

The experience of Nazi Germany should forever effect our opinions on all end of life legislation. Laurence McCullough, a post doctoral fellow who took part in the 1976 conference on "Biomedical Ethics and the Shadow of Nazism" said:

Our slippery slope might yet be analogous to Nazi Germany's in a more abstract way. If we consider the rationale which gives social utility or economic returns precedence over individual freedom, then we might see how our society could approach the kind of thinking that underlay the Nazi experience. There, racism overrode personal autonomy; here it might be economic rationale – the attitude that we won't spend so much per year to keep somebody alive on the slim chance of recovery. The slippery slope then is not the precipitating act; it is the context in which it takes place.¹⁰

During the 1940s and 50s, there was little tolerance for any consideration for the idea of "merciful dying" or to allow legislatures to pass any law which dictated judgements on medical questions in order to make them serve political ends.

During the 50s and 60s, the debates continued. As medical science continued to advance, the argument was advanced that if only God decides when life should end, it is equally immoral to lengthen life through medical advances. To the argument that suffering is part of God's plan, then the response became then should we withhold all medical relief that alleviates suffering. Slowly the debate was becoming one about passive and active euthanasia and ordinary versus extraordinary means.

In the 1960s, as spectacular breakthroughs in medicine took on a new urgency, circumstances surrounding death and dying had to be reevaluated. Unanticipated dilemmas accompanied the progress. In a decade when many traditional values were being examined, additional questions arose. What were the ethics of transplants? Did medical advances prolong

dying as well as living? Why keep a brain dead person alive indefinitely on a life-support system? What constitutes the precise moment of death? How did the dying feel about dying? Should doctors tell terminally ill patients the truth?

Books and articles were written and debated. Physicians began to look at the emotional needs of the dying, committees were set up to draft a more strict definition of death, and the first Advance Directive was prepared by an attorney for his client.

In the early 1970s, the first American hospice opened in New Haven, Connecticut. Elizabeth Küber-Ross's book, On Death and Dying was on the best-seller list. Medical schools began teaching classes on how to deal with dying patients and their families. Life Magazine published an article in 1972, titled "When Do We Have the Right to Die?" The subtitle was "There are times when keeping someone alive may be crueler than death."

In 1975, Karen Ann Qurnlin took some drugs with alcohol and stopped breathing, was resuscitated and remained in a coma. By the end of 1975, bills had been introduced in fifteen states regarding Living Wills. In October 1976, the first was signed into law in California

The way we die has changed drastically in the last fifty years. Just as my generation was the first routinely born in hospitals, my grandparents' generation was the first to routinely die in hospitals or nursing homes. Dr. Sherwin B. Nuland, a physician who has regularly dealt with death describes this phenomenon as follows:

We have created the method of modern dying. Modern dying takes place in the modern hospital, where it can be hidden, cleansed of its organic blight, and finally packaged for modern burial. We can now deny the power not only of death but of nature itself. We hide our faces from its face¹¹

The average life expectancy in 1900 was 49 years; in 1950, 68.2 years; and today 76 years. By 2010 the average person is expected to live for 77.9 years.¹² Along with the increased life expectancy has come an unrealistic expectation that given enough time all disease will be eradicated and more personally, that we all can be cured. Along with this unrealistic view of our own mortality – that we aren't mortal - is the baby boomer expectation that we not only will not die, but we will not even age. Therefore, for a time, the mind set seemed to be, life at any cost and in any form. Because of that mind set, we face the issues I am going to raise today. The question has become for many, "is death with dignity more important than lingering life?"¹³

Given the financial and emotional expense of maintaining life in a near death state, can and should life be preserved at all cost?

Out of approximately two million people who die in the United States each year, 80% die in hospitals. Of those who die in hospitals, 70% die after a decision has been made not to pursue life-sustaining treatment.¹⁴ The role of the hospital in near death treatment has been significant. It has contributed to a change in the location and style of death, from a personal and symbolic transition from life to an impersonal foreign, and often protracted failed rescue of the human organism.¹⁵

Death has been dissected, cut to bits by a series of little steps which finally make it impossible to know which step was the real death, the one in which consciousness was lost, or the one in which breathing stopped. All these little silent deaths have replaced and erased the great dramatic act of death, and no one any longer has the strength or patience to wait over a period of weeks for a moment which lost a part of its meaning.¹⁶

The changes have contributed to the paradox of the nature of the modern death – while death is to be avoided in modern society, it has become a more protracted and larger part of the life cycle. People are likely to meet their end "in a sedated or comatose state; be tubed nasally, abdominally and intravenously, and far more like manipulated objects than like moral subjects."

B. Religious Perspectives

One of the primary questions which has occurred to me and which I have been asked over the years is how do various religions instruct followers on these end of life issues.

First, it must be noted that this outline makes use of the terms "passive euthanasia" and "active euthanasia." For our purposes, the term "passive euthanasia" is used only to describe the removal of certain life sustaining measures and is not intended to invoke any other political implications.

Most Christian groups do not oppose passive euthanasia, and although they are less specific about it, neither do most Eastern religions. Allowing a hopelessly ill person to die by not imposing extraordinary measures is widely accepted today by the churches as being part of God's will. Only Mormons, Evangelicals, and other strict gospel denominations are opposed to passive euthanasia in the West, while Islam is opposed in the East. Religious public policy making in this area has almost entirely followed the Karen Ann Quinlin case in 1976.

But active voluntary euthanasia, taking one's life or helping another to die – is a different matter. No church hierarchy has endorsed the practice. Sometimes, however, denominations differ on the definition of “active” or “passive” euthanasia.

The Roman Catholic Church has never avoided the issues of euthanasia. Its position – acceptance of passive but rejection of active – is the most clearly articulated of any faith, especially since the Vatican's 1980 Declaration of Euthanasia.

The Jewish position is that passive euthanasia can, under carefully scrutinized conditions, be allowed. Jewish theologians speak of "indirect euthanasia," wherein the patient's death is merely the unpremeditated result of some medication given only to relieve pain or is a consequence of the withdrawal of treatment.

Because there is no possibility of repentance for self destruction, Judaism considers suicide a sin worse than murder; therefore active euthanasia, voluntary or involuntary, is forbidden.

Most churches find it easy to accept passive euthanasia because it is natural, but cannot accept active because it is suicide and taboo. In fact, our own informal survey indicated that many churches encourage their members to have advance directives in place and organize living will seminars for their congregation to attend. At the seminar, the church leaders provide their spiritual position, a lawyer from the congregation provides some legal guidance and a doctor from the congregation provides some medical guidance. Afterward, living wills and other health care surrogate forms are generally available for execution.

However, it must also be noted that among the Christian denominations, we found some differences in the way passive euthanasia and active euthanasia are defined. Principally, the disparity exists in the way people view artificial nutrition and hydration.¹⁷ Some denominations view artificially provided nutrition and hydration as a medical procedure which can be removed as part of passive euthanasia. Other denominations view nutrition and hydration as a natural phenomenon, regardless of how it is provided, which can not be removed under the definition of passive euthanasia.¹⁸ Therefore, for those who believe that artificially provided nutrition and hydration is not a medical procedure, the removal of such will be seen as active euthanasia.

The following is a chart which I found in the book, The Right to Die, by Derek Humphry and Ann Wickett. I also conducted my own informal survey of ministers and others in various church positions and my findings were consistent with those presented on the chart. I would add that I

believe the book, when referring to Baptists, is not referring to Southern Baptists. I was told by many people that though a convention of Baptists may approve or disapprove anything, it is not binding on any individual Baptist. Most Baptists would resent the unwarranted intrusion into their private lives.

Beliefs About Euthanasia^{19*}

Religion	Passive	Active
Assemblies of God	individual decision	individual decision
The Baha'is	individual decision	oppose
Baptist	accept	oppose
Buddhism	accept	oppose
Christian Church (Disciples of Christ)	individual decision	individual decision
Christian & Missionary Alliance Church	oppose	oppose
Christian Scientist**	individual decision	individual decision
Church of the Brethren**	accept	oppose
Church of Christ (Christian)	oppose	oppose
Church of the Nazarene	oppose	oppose
Episcopal** (Anglican)	accept	individual decision
Evangelical	oppose	oppose
Greek Orthodox	accept	oppose
Hindu**	individual decision	individual decision
Humanists	accept	accept
Islam**	oppose	oppose
Jehovah's Witnesses	accept	oppose
Judaism**	accept	oppose
Krishna**	accept	oppose
Lutheran	accept	oppose
Mannonite	accept	accept
Mormon	oppose	oppose
Moravian	accept	oppose
Quaker Religious Society	accept	individual decision
Reformed Church of America	oppose	oppose
Roman Catholic	accept	oppose
Russian Orthodox	accept	oppose
Seventh-Day Adventist**	accept	oppose
Sikh Dharma**	individual decision	individual decision
Swedenborgianism	accept	oppose
Theosophical Society	individual decision	individual decision
Unitarian Universalist	accept	individual decision
United Church of Christ	accept	individual decision
United Methodist	accept	individual decision
United Presbyterian	individual decision	individual decision

*Where churches have no stated official position on this topic, it is assumed that the decision is one of individual choice. Individual decision usually implies a matter of concern between patient, family, and doctor.

**"No official statement": In such cases, spokespersons form their conclusions based on religious rationale and opinion.

We tend to forget that not all history is Western. Our culture is not the only one which has dealt with end of life issues.

When an Aymara Indian of Bolivia becomes terminally ill, he summons friends and relatives to his home to keep a death vigil. If death is slow, the ill person may ask for help. The family will withhold food and drink until the dying person slips into unconsciousness and dies.

In some Eskimo cultures, an old sick Eskimo tells his family he is ready to die and the family will immediately comply by abandoning the aged person to the ravages of nature or by killing him.

There are stories of old men of northern tribes who jumped into the sea from overhanging rocks. Aged Ethiopians allowed themselves to be tied to wild bulls. Natives of Amboyna ate their failing relatives out of charity, and the Congolese jumped on the tired and old until they were dead. The Formosans choked the sick and aged with strong drink, while the Hottentots gave a lavish feast in honor of the ailing senior citizen before abandoning him in a hut in the wilderness.

Indeed, in more primitive societies, death – as a result of illness, injury, or old age – was treated more realistically than perhaps we treat it today. Aiding death was often done out of respect for an ill person.

Today, many of the end of life issues we are facing in the West are not issues at all in other parts of the world. In many countries, medical care is not available to all, transplants, open heart surgery, respirators, and artificially provided nutrition and hydration are alien concepts.

C. Attorney Perspectives

Kentucky has become much more diverse than the Kentucky of my youth. There are many people of Japanese ancestry here because of jobs at Toyota and related plants. Just among the children who are in my house regularly are children from Saudi Arabia, Vietnam, China, and Bosnia. In Margaret's fifth grade class there were children from India, Cuba, Bosnia, China and the Sudan. We should be aware there may be cultural differences as well as religious differences

in how our clients feel about the idea of advance directives, the designation of health care surrogates and organ donation.

Certainly, it is our responsibility as attorneys to provide our clients with a properly drafted living will or health care surrogate and see that it is correctly executed. But it is also our responsibility to assure that our clients give thoughtful consideration to the import of the document they are signing. When a client comes in to sign a living will or health care POA, often as part of a total estate plan, he or she may not previously have given full attention to the documents.²⁰ First, the client needs to understand the language of the advance directive or the powers which he or she is granting to a surrogate. Next, the client needs to chose a surrogate. Has the client really thought through the responsibility which may befall his or her surrogate? Is a spouse, parent or child who is named as a surrogate going to be emotionally equipped to carry out the duties of a surrogate. Truly, the best candidate for an Executor/Trustee position is not necessarily the best candidate to serve as health care surrogate. Lastly, the client must be satisfied that their decisions are spiritually sound. Like it or not, when a client executes a living will, he or she will likely require guidance not only on the legal aspect, but also the medical and spiritual aspects of the document.

While we must be diligent in providing counsel, we must also be careful not to impose our religious or cultural views on our clients. The way in which a living will is presented to a client could very well influence the decisions the client make's regarding life sustaining treatment or organ donation. One of the greatest advantages of the advance directive is to get people to discuss the issues involved before the necessity of making decisions. It is okay to admit we don't have all the answers and to counsel clients to discuss the issues with their family, their clergy and their physicians.

II. Constitutional and Legal Analysis

A. Introduction

When we present a living will to clients along with other estate planning documents we usually receive a number of questions (what does it do? Is it ok with my church?). The initial question we generally receive is "why do I need a living will?" As attorneys we know that a living will is an important tool in the complement of estate planning documents but we may not always be able to articulate its importance to the client. This section of the outline is intended to

review some of the legal vagaries which make it necessary for clients to have living wills and other health care documents. The first topic to be covered is a brief review of the legal standards healthcare decision makers may be forced to apply in the absence of any clearly expressed intent by the patient. The other item is brief overview of the three well known cases, all dealing with patients in a persistent vegetative state, which have shaped the public consciousness about end of life issues and the legal framework in which we currently operate.

B. Substituted Judgement and Best Interests

In the absence of a living will or other advance directive, or when the items contained in the living will do not speak to a certain situation, what process must a surrogate decision maker go through in making the decision to end life-prolonging treatment? Ultimately, the answer will depend on the facts of each situation. However, the process can be broadly divided between two standards: substituted judgement and best interests.

Substituted judgement is a subjective standard used by a surrogate decision maker to place the surrogate in the shoes of the patient and try to determine what the patient would decide, if competent to do so, under the circumstances at hand.²¹ In this context, the role of the surrogate decision maker is not to determine what is best for the patient. Rather, it is to carry out the will of the patient where it can be clearly ascertained.

Sometimes ascertaining the patient's wishes is as easy as reading a previously executed living will. Other times, a patient's wishes are not clearly expressed. Perhaps the patient made some general statements while competent such as "I wouldn't want to live like a vegetable" or "I can't believe they are keeping her alive on those machines." In these situations, it is up to the surrogate to determine whether those statements, when combined other information, apply to the present circumstances. It is in these situations that evidentiary concerns arise and hospitals get nervous.

What if the patient expressed nothing relevant to the issue while competent? At this point it will be difficult for the surrogate to continue using substituted judgement. If it is to be applied, the surrogate must try to put herself in the patient's position and, based on the surrogate's intimate knowledge of the patient, make the best judgement possible about what the patient would have chosen. In some cases, the surrogate will resort to considering the patient's values and religious beliefs as far as they are known to the surrogate.

Rather than applying the substituted judgement standard in the extreme, or possibly not at all, the law may require a surrogate to apply the best interests standard. Best interests is an objective standard in which the surrogate decision maker attempts to determine what the reasonable person would want done.²² Put another way, in order for treatment to be withdrawn using the objective best interest standard, the burdens of continued life must outweigh the benefits.²³

There are even instances where a combination of the two standards has been applied to reach a "limited objective" standard:

Thus, if some trustworthy evidence existed that the individual would have wanted to terminate treatment, but not enough to clearly establish a person's wishes for purposes of the subjective standard, and the burden of a prolonged life form the experience of pain and suffering markedly outweighs its satisfactions, treatment could be terminated under a "limited-objective" standard.²⁴

Obviously, both standards are fraught with peril because, ultimately, they both involve a quality of life (life worth living) determination which runs the risk of being tainted by the surrogate decision maker's own conscious and sub-conscious feelings on the subject.

Unfortunately, it appears that there are some inconsistencies under Kentucky law as to whether substituted judgement or best interests is the appropriate standard. By affirming the trial court's decision that a patient's guardian had proven by clear and convincing evidence that Sue DeGrella, who was in a Persistent Vegetative State, did not want to receive artificially provided nutrition, the Kentucky Supreme Court approved of the substituted judgement standard.²⁵ However, the Kentucky Living Will Act seems to mandate an application of best interests in certain situations.²⁶ Perhaps Kentucky has joined the numerous other states who seem to apply the standard which best fits the circumstances or, a combination of both. From a client's perspective, it's surely better to have his or her wishes clearly expressed in a living will.

C. Case Law

The cases of Karen Quinlan, Nancy Cruzan and Sue DeGrella all illustrate the negative effects that modern technology has had on the natural process of dying. These are the horror stories which are publicized and in the forefront of our clients' concerns. None of these young ladies had living wills.

Certainly, the public consciousness of this issue was first aroused by the tragic situation of Karen Ann Quinlan. In 1975, at the age of 22 Karen Quinlan lay in a hospital bed in New Jersey in a Persistent Vegetative State (PVS) being kept alive by a respirator with no reasonable hope of recovery. Karen's father, as guardian, attempted to have Karen's respirator removed but the hospital refused without court approval. The case went to the Supreme Court of New Jersey who found that Karen had a constitutional privacy right, even when incompetent, to decide whether to permit her vegetative existence to terminate.²⁷ The Court further found that Karen's right to privacy was greater than New Jersey's interest in the preservation of human life.²⁸

After the decision in Quinlan, most courts based their decisions on the constitutional right to privacy which must be balanced against the state's interest in protecting human life. In 1990, however, the Supreme Court handed down the Cruzan decision which based its decision in the Fourteenth Amendment.²⁹ The Court held that a competent person has a constitutionally protected liberty interest in refusing unwanted medical treatment, which upon a showing of clear and convincing evidence, outweighed the State's interest in the protection and preservation of human life.³⁰

Lastly, in 1993, the Supreme Court of Kentucky took up this sensitive issue in the case of Martha Sue DeGrella.³¹ In DeGrella, the court found that Kentucky's living will statute (which has now been amended) did not preclude the removal of a feeding tube even though such a situation was not specifically contemplated by the statute. The court found the statute's to be remedial rather than exclusive. As with the two cases discussed above, the court relied on statements made by Sue DeGrella while competent that she would not like her life artificially prolonged if she were in a vegetative state. After noting that the trial court had found that the evidence of Sue Degrella's wishes was clear and convincing, the court held that her constitutional rights were unaffected by the Kentucky Living Will Act and that they further outweighed the state's interest in preserving human life.

III. Kentucky Living Will Directive Act

A. Introduction - In 1994, the Kentucky State Legislature enacted a new Kentucky Living Will Directive Act which had the effect of repealing and replacing prior legislation. The Act was further amended in 1998 to add additional provisions including the allowance of

statements in living wills regarding the giving of body parts for any general purpose or for certain specified purposes.³²

B. Definitions - The Definitions contained in the Act are important to an understanding of the function of the Living Will Statute for several reasons; most notably of which is that the definitions themselves seem to require further definition. For purposes of this outline, many of the more critical terms and definitions are set out below.³³

1. Advanced Directive – Means a Living Will Directive made in accordance with KRS 311.621-311.643, a Living Will or designation of healthcare surrogate executed prior to July 15, 1994, and *any other document that provides directions relative to healthcare to be provided to the person executing the document*³⁴. Clearly, it is this later definition of advance directive, because it brings into the purview of every type of document that contains health care directions such as a power of attorney, which gives an attorney-in-fact the power to make health care decisions for the principal.

2. Artificially-Provided Nutrition and Hydration – Means sustenance or fluids that are artificially or technologically administered.³⁵ The most common example of this is the feeding tube. .

3. Decisional Capacity – Means the ability to make and communicate a healthcare decision.³⁶ This appears to be one of the more vague definitions in the Act. Conspicuously absent from the definition are any objective criteria for determining "decisional capacity" along with any reference to a time frame. Taken literally, this definition could apply to someone just recovering from minor surgery but still under the effects of anesthesia, or someone who is competent but must use pain relieving medication.

4. Health Care Facility – Means any institution, place, building, agency, or portion thereof, public or private, whether organized for profit or not, used, operated, or designed to provide medical diagnosis, treatment, nursing, rehabilitative, or preventative care, and licensed pursuant to KRS Chapter 216B.³⁷

5. Healthcare Provider – Means any healthcare facility or provider of healthcare services, including but not limited to, those licensed, certified, or regulated under the provisions of KRS Chapter 211, 216, 311, 312, 313, or 314.³⁸

6. Life Prolonging Treatment – Means any medical procedure, treatment, or intervention which:

a. Utilizes mechanical or other artificial means to sustain, prolong, restore, or supplant a spontaneous vital function ; and

b. When administered to a patient would serve only to prolong the dying process. "Life Prolonging Treatment" shall not include the administration of medication or the performance of any medical procedure deemed necessary to alleviate pain.³⁹

7. Permanently Unconscious – Means a condition which to a reasonable degree of medical probability as determined solely by the patient's attending physician and one (1) other physician on clinical examination is characterized by an absence of cerebral cortical functions indicative of consciousness or behavioral interaction with the environment.⁴⁰

8. Terminal Condition – Means a condition caused by injury, disease, or illness which to a reasonable degree of medical probability, as determined solely by the patient's attending physician and one (1) other physician, is incurable and irreversible and will result in death within a relatively short time, and where the application of life prolonging treatment would serve only to artificially prolong the dying process.⁴¹

C. Eligible Persons-Scope-Effect-Do Not Resuscitate Orders

1. Any person at least eighteen years of age with "decisional capacity" may make a written Living Will Directive that directs the withholding or withdrawal of "life prolonging treatment"; or directs the withholding or withdrawal of "artificially provided nutrition or hydration" or designates one (1) or more adults as a surrogate or successor surrogate to make healthcare decisions on behalf of the grantor. Furthermore, during any period in which two or more surrogates are serving, all decisions must be made by unanimous consent of the acting surrogates unless the advance directive provides otherwise. Added by the legislature in 1998, the Living Will may also direct the giving of all or any part of an adult's body upon death for any purpose specified in KRS 311.185 which are set out below:

a. Any hospital, surgeon, or physician, for medical or dental education, research, advancement of medical or dental science, therapy, or transplantation; or

b. Any accredited medical or dental school, college or university for education, research, advancement of medical or dental science, or therapy; or

c. Any bank or storage facility, for medical or dental education, research, advancement of medical or dental science, therapy, or transplantation; or

d. Any specified individual for therapy or transplantation needed by him.

2. In general, a Living Will Directive made pursuant to the Act must be honored by a grantor's family, regular family physician or attending physician, and any healthcare facility in which the grantor is a patient. However, there are exceptions, discussed herein, for a refusal on moral, religious, or professional grounds.⁴²

3. Do Not Resuscitate Orders -

a. While a Living Will Directive is designed to carry out a patient's wishes once they have already been diagnosed as terminal or as being permanently unconscious, it is important for the client to understand that a Living Will (or any other advanced directive) does not address or control a desire not to be resuscitated. Added to the Living Will Act is a statement that, for purposes of the Act, notification to any emergency medical responder or any paramedic of a person's wish not to be resuscitated shall be recognized only if on a standard form or identification approved by the Kentucky Board of Medical Licensure, in consultation with the Cabinet for Health Services.

b. The Cabinet for Health Services approved a standard DNR form and it is available on their web page. EMT's and paramedics are required to attempt CPR, defibrillation, or other forms of resuscitation when medically indicated unless the approved DNR form is physically present on or with the patient. The DNR order is composed of two sections. The first section explains the nature of the DNR form as follows: (1) if my heart stops beating or if I stop breathing, no medical procedure to restart either, such as electric shocking of the heart or CPR will be started by EMS personnel; (2) the order will not prevent EMS from providing other medical care; (3) the DNR order is revocable; and (4) the DNR form or bracelet must be shown to EMS to be effective.

c. The second part of the order consists of a portion which can be completed and inserted into a standard hospital bracelet.

d. It must be noted that the DNR order applies only to resuscitation attempts in a pre-hospital setting such as paramedic treatment, in patients homes, in long term care facility, during transport, or in other locations outside acute care hospitals.

D. Court Appointed Fiduciary vs. Healthcare Surrogate

This section provides that if, following the execution of an Advance Directive under the Act, a court of the grantor's principal domicile appoints a fiduciary charged with the care and protection of the grantor's person, the fiduciary shall be bound by the terms of the grantor's Advance Directive. However, should the Advance Directive designate a surrogate to make healthcare decisions for the grantor, the surrogate may continue to act.⁴³ This section places the previously nominated healthcare surrogate in a superior position to that of the court appointed guardian for purposes of healthcare decision making. This would serve to protect a grantor's decision in nominating a healthcare surrogate who is likely to be someone whom the grantor has chosen because he or she believes that the nominated surrogate will be able to act in an objective capacity. This objective surrogate could very well be someone other than a likely candidate to be the grantor's court appointed guardian. It must also be noted that under the Act, the "Advance Directive" can be anything from a Living Will to a Power of Attorney which gives the Attorney-in-fact the power to make health care decisions.

E. Form Of The Living Will-The 1994 Act As Amended In 1998

1. This section provides that a Living Will Directive made pursuant to the Act must be substantially in a form consistent with that which is set forth in the statute. However, the form may also include other specific directions which are in accordance with accepted medical practice and not specifically prohibited by any other statute. Furthermore, should any specific directions contained in the directive be held by a court to be invalid, such invalidity will not affect the entire directive. A copy of the approved Living Will form is included as an appendix to this outline. As previously stated, the statutory form essentially allows for the removal of "life prolonging treatment, and artificially provided food, water, or other nourishment or fluids." The Act also allows the giving of all or any part of a patient's body upon death. Again, a "Living Will" must be distinguished from an "Advanced Directive" for purposes of this section. A Living Will is simply one type of Advanced Directive. The Statute does not mandate the form of all Advance Directives. What sets the Living Will apart is that the Grantor is making pre-need decisions about specific types of treatment in specific sets of circumstances.⁴⁴

2. Proper Execution – Because of the tenuous nature of the laws surrounding Advance Directives and the dramatic results which can follow, it is essential that the Advance

Directive be executed in the exact manner which is dictated by Kentucky Statute. An Advance Directive must be in writing, dated and signed by the grantor, or at the grantor's direction, and **either** witnessed by two (2) or more adults in the presence of the grantor and in the presence of each other, **or** acknowledged before a notary public or other person authorized to administer oaths. The statute also provides a list of persons who may not be a witness or serve as a notary in regard to any Advance Directive made according to the Act:

- a. A blood relative of the grantor;
- b. A beneficiary of the grantor under descent and distribution statutes of the Commonwealth;
- c. An employee of a healthcare facility in which the grantor is a patient, unless the employee serves as a notary public;
- d. An attending physician of the grantor; or
- e. Any person directly financially responsible for the grantor's healthcare.⁴⁵

Clearly, this is a pitfall for the attorney who is unaware of these prohibitions. Because of the private nature of a Living Will Directive or other Advance Directive and the circumstances which often surround their execution, (i.e. in a nursing home, hospital) it may be assumed that the family members will be witnessing the Advance Directive. In the alternative, an employee of a hospital or nursing home may be close at hand who could also easily serve as a witness. Obviously, this would be a direct violation of the statute and could cause the failure of the Advance Directive. Probably the best course of action is to arrange for a notary to be present upon the signing of an Advance Directive.

- f. Also regarding who may serve as a surrogate, the Act states that an employee, owner, director, or officer of a healthcare facility where the grantor is a resident or patient may not be designated or act as surrogate unless related to the grantor within the fourth degree of consanguinity or affinity or a member of the same religious order.⁴⁶

F. Powers Of Health Care Surrogate

1. The General - A surrogate designated pursuant to any of the forms allowed under the definition of "Advanced Directive" can make health care decisions for the grantor which the grantor could make individually if he or she had "decisional capacity", as long as all the decisions are consistent with the desires of the grantor as expressed in the Advance Directive.

Furthermore the surrogate shall not make any health care decisions for the grantor without considering the recommendations of the attending physician. Lastly, the surrogate may not make a health care decision in any situation in which the grantor's attending physician has determined in good faith that the grantor has decisional capacity.⁴⁷ This language is also interesting because it is the only section in the statute which elaborates on who could determine when a grantor lacks decisional capacity. The definitions are silent as to who might have the authority to determine the existence of decisional capacity and the definition of decisional capacity is conspicuously brief and void of reference to incompetency.

2. The Specific - When executing a Living Will with a client, we are often asked to elaborate on the situations in which a health care surrogate may authorize the withdrawal or withholding of artificially provided nutrition and hydration. Essentially, the Act sets out four scenarios which would invoke the directions provided in a Living Will or the powers invested in a health care surrogate:

a. When inevitable death is eminent which for the purposes of the Act mean when death is expected, by reasonable medical judgement, within a few days (While the act defines "permanently unconscious" and "terminal condition" as something which must be determined by the attending physician and one (1) other doctor. However in the definitions which cover "eminent, inevitable death." Therefore, it would follow that the requirement of two physicians reading the same conclusion is not necessary in this instance.); or

b. When a patient is in a permanently unconscious state if the grantor has executed an Advance Directive authorizing the withholding or withdrawal of artificially-provided nutrition and hydration; or

c. When the provision of artificial nutrition cannot be physically assimilated by the person; or

d. When the burden of the provision of artificial nutrition and hydration itself shall outweigh its benefit.⁴⁸ This is the catch all provision which, in a previous form, was also the subject of some discussion by the Supreme Court of Kentucky in the DeGrella case.⁴⁹

Notwithstanding the above, artificially provided nutrition and hydration shall not be withheld or withdrawn if it is needed for comfort or for the relief of pain.⁵⁰

3. Notwithstanding the execution of an Advance Directive, a pregnant woman shall continue to receive life sustaining treatment and artificially provided nutrition and hydration if it is determined that the procedures will maintain the woman in a way to permit the continuing development and live birth of the unborn child unless the procedure will be physically harmful to the woman or prolong severe pain which cannot be alleviated by medication.⁵¹

G. Other Parties Authorized To Make Health Care Decisions

1. This section was not part of Kentucky's original Living Will Act, but was added in 1994 to cover situations in which a patient has not executed an Advance Directive or to the extent the Advance Directive does not address a situation (and one would presume does not nominate a surrogate to make decisions).

2. In the event that an adult patient, who does not have decisional capacity, has not executed an Advance Directive or to the extent the Advance Directive does not address a decision that must be made, any one (1) of the following responsible parties, in the following order of priority if no individual in a prior class is reasonably available, willing, and competent to act, shall be authorized to make health care decisions on behalf of the patient:

- a. The judicially-appointed guardian of the patient, if the guardian has been adopted and if medical decisions are within the scope of the guardianship;
- b. The spouse of the patient;
- c. An adult child of the patient, or if the patient has more than one (1) child the majority of the adult children who are reasonably available for consultation;
- d. The parents of the patient;
- e. The nearest living relative of the patient, or if more than one (1) relative of the same relationship is reasonably available for consultation, majority of the nearest living relatives.⁵²

3. All of the individuals listed above have the authority to make health care decisions for the patient including the withdrawal or withholding of artificially provided nutrition and hydration pursuant to the circumstances outlined above. It is also interesting to note that the section provides that any individual authorized to consent for another under the section shall act in good faith, in accordance with any Advance Directive executed by the individual who lacks decisional capacity, and in the "best interest" of the individual who does not have decisional capacity.

4. It is interesting to note the legislature's use of the phrase "best interest" in this context. In this area, "best interest" is considered a legal standard by which health care decisions are made. However, the phrase "substituted judgement" is also used to describe a method of making health care decisions. In fact, the opinion in the DeGrella decision would seem to indicate an acceptance of the "substituted judgement" method where the patient's wishes are known.

H. Notice And The Effects Of Refusal To Apply

1. The last four sections of the Act seem to be devoted to providing for physician and health care facility refusals to comply with Living Wills, exemptions from criminal and civil liability and declarations that adherence to the Act does not constitute suicide or negate health care coverage. However, one of the most important provisions in the Act is contained in KRS 311.633, which states that it is the responsibility of the grantor or the responsible party of the grantor to provide notification to the grantor's attending physician and health care facility where the grantor is a patient that an Advance Directive has been made. If the grantor is comatose, and incompetent, or otherwise mentally or physically incapable, any other person may notify the attending physician of the existence of an Advance Directive. An attending physician who is notified shall promptly make the Living Will Directive or a copy of the Advance Directive a part of the grantor's medical records. It is clear, then, that the responsibility of making the grantor's wishes known to any health care providers rests on the grantor, his or her surrogate and the rest of the friends and family. This proactive responsibility was the subject of a recent article which appeared in the *Lexington Herald-Leader* on May 29, 2000. In that story, two nieces were entrusted with health care power of attorney but did not understand their role as health care surrogates.

2. Any attending physician or health care facility which refuses to comply with an Advance Directive of a patient or decision made by a surrogate or responsible party must immediately inform the patient or the patient's responsible party of the refusal. Thereafter, at the discretion of the patient or surrogate, the transfer of the patient to a physician or health care facility which will comply with the Advance Directive can proceed without impediment.

3. While it is the responsibility of all involved parties to abide by the directions of a properly executed Advance Directive or the surrogate, the Act does allow for refusal to comply with Advance Directives on moral, religious, or professional grounds. The Act

further states that any person refusing to comply with an Advance Directive or surrogate instruction based on these grounds shall not be held liable for their refusal. In fact, the Act makes it unlawful for any person to impose penalties or take disciplinary action or deny or limit licenses, certifications, degrees, or other approvals or documents or qualification to any physician, nurse, staff member, or employee who refuses to comply with the Advance Directive of a patient or health care decision by a responsible party under the Act.

¹ Libanius, quoted in Emile Durkheim, *Suicide: A Study in Sociology*, trans. John A. Spalding and George Simpson (New York Free Press, 1951), 330.

² Plato, *Republic*, III: 295

³ *Ibid*

⁴ Quoted by Helen Silving, "Suicide and the Law" in *Clues to Suicide*, ed. Edwin S. Shneidman and Norman L. Farberow (New York: McGraw Hill, 1957), 80-1.

⁵ Seneca, *Epistulae Morales*, trans. Richard M. Gummere (London: William Heinemann, 1917) I, lvii, 32-6: 407-9.

⁶ A. Frenay, *The Suicide Problem in the United States* (Boston: Gorham, 1926), 66.

⁷ Alvarez, *Savage God*, 68.

⁸ Montaigne, "A Custom of the Isle of Crea," *Essays*, (London: J.M. Dent and sons 1938), II:27.

⁹ Wilson, *Death by Decision*, 26.

¹⁰ McManners, *Death and the Enlightenment*, 414-15.

¹¹ Sherwin B. Nuland, *How We Die: Reflections on Life's Final Chapter*, at xv (1994).

¹² Lawrence A. Frolik & Abson P. Barnes, An Aging Population: A Challenge to the Law, 42 *Hastings L.J.* 683 (1991).

¹³ Steven I. Freeland, *The Health Care Proxy and The Narrative of Death*, *The Journal of Law and Health*, p. 98.

¹⁴ *Id.*, p. 99.

¹⁵ *Id.*, p. 116.

¹⁶ Philippe Aries, *Western Attitudes Towards Death: From the Middle Ages to the Present* (1974).

¹⁷ The Kentucky Supreme Court has also addressed this issue and indirectly stated that, for the purposes of legal analysis, artificially provided nutrition and hydration are forms of medical treatment. In discussing the removal of Sue DeGrella's feeding tube the Court stated that "...the advances of medical technology have made it possible to sustain existence when life has ended except for the natural process of dying. This is not an objective inquiry into the quality of life, but a subjective inquiry into whether the patient wishes the continuation of medical procedures to interdict the natural process of dying." *DeGrella v. Elston*, Ky., 858 S.W.2d 698 (1993).

¹⁸ Authors' interview with a member of the leadership of Southeast Christian Church, Louisville, Kentucky.

¹⁹ Derek Humphry and Ann Wickett, The Right to Die, (1986) p. 295.

²⁰ Of course, executing a living will in the office of your attorney will still lend itself to more thoughtful consideration than executing a living will, along with a number of other forms, as part of the check in process in the emergency room of the hospital. Unfortunately, this is the first place most people encounter living wills.

²¹ Strasser, *Incompetents and the right to die: In search of consistent meaningful standards*, 83 Kentucky Law Journal 4 (1994-95).

²² Strasser, Supra at 771.

²³ Strasser, Supra at 771

²⁴ Cruzan v. Director, Missouri Department of Health, 497 U.S. 261 (1990).

²⁵ DeGrella v. Elston, Ky., 858 S.W.2d 698 (1993)

²⁶ See, KRS § 311.629(3)(d) "When the burden of the provision of artificial nutrition and hydration itself outweigh its benefit." See also, KRS § 311.631(3) "An individual authorized to consent for another under this section shall act in good faith, in accordance with any advance directive executed by the individual who lacks decisional capacity, and in the best interests of the individual who does not have decisional capacity."

²⁷ In the Matter of Karen Qunilan, 355 A.2d 647 (1976).

²⁸ Id.

²⁹ Cruzan, Supra, note 24.

³⁰ Cruzan, Supra, note 24.

³¹ DeGrella, Supra, note 25.

³² See, KRS §311.621-311.643

³³ KRS § 311.621

³⁴ Id.

³⁵ Id.

³⁶ Id.

³⁷ Id.

³⁸ Id.

³⁹ Id.

⁴⁰ Id.

⁴¹ Id.

⁴² KRS § 311.623

⁴³ KRS § 311.6231

⁴⁴ KRS § 311.625

⁴⁵ Id.

⁴⁶ Id.

⁴⁷ KRS § 311.629

⁴⁸ Id.

⁴⁹ DeGrella v. Elston, Ky., 858 S.W.2d 698 (1993).

⁵⁰ KRS § 311.629

⁵¹ Id.

⁵² KRS § 311.631

LIVING WILL DIRECTIVE

My wishes regarding life-prolonging treatment and artificially provided nutrition and hydration to be provided to me if I no longer have decisional capacity, have a terminal condition, or become permanently unconscious have been indicated by checking and initialing the appropriate lines below. By checking and initialing the appropriate lines, I specifically:

_____ Designate _____ as my health care surrogates to make health care decisions for me in accordance with this directive when I no longer have decisional capacity. If either of _____ is unable or unwilling to act as my health care surrogate, then the other may act alone. If both _____ are unable or unwilling to act as my health care surrogate, I designate _____, as my health care surrogate. Any prior designation is revoked.

If I do not have a surrogate who is willing or able to serve, the following are my directions to my attending physician. If either of my designated surrogates is willing and able to serve, my surrogate shall comply with my wishes as indicated below:

_____ Direct that treatment be withheld or withdrawn, and that I be permitted to die naturally with only the administration of medication or the performance of any medical treatment deemed necessary to alleviate pain.

_____ **DO NOT** authorize that life-prolonging treatment be withheld or withdrawn.

_____ Authorize the withholding or withdrawal of artificially provided food, water, or other artificially provided nourishment or fluids.

_____ **DO NOT** authorize the withholding or withdrawal of artificially provided food, water, or other artificially provided nourishment or fluids.

_____ Authorize my surrogate, designated above, to withhold or withdraw artificially provided nourishment or fluids, or other treatment if the surrogate determines that withholding or withdrawing is in my best interest; but I do not mandate that withholding or withdrawing.

_____ Authorize the giving of all or any part of my body upon death for any purpose specified in KRS 311.185.

_____ Authorize the giving of all or any part of my body upon death for the specific purposes specified below:

_____ Any hospital, surgeon or physician, for medical or dental education, research, advancement of medical or dental science, therapy or transplantation;

_____ Any accredited medical or dental school, college or university for education, research, advancement of medical or dental science or therapy;

_____ Any bank or storage facility, for medical or dental education, research, advancement of medical or dental science, therapy or transplantation;

_____ Any specified individual for therapy or transplantation needed by him.

_____ **DO NOT** authorize the giving of all or any part of my body upon death.

In the absence of my ability to give directions regarding the use of life-prolonging treatment and artificially provided nutrition and hydration, it is my intention that this directive shall be honored by my attending physician, my family, and any surrogate designated pursuant to this directive as the final expression of my legal right to refuse medical or surgical treatment and I accept the consequences of the refusal.

I understand the full import of this directive and I am emotionally and mentally competent to make this directive.

Signed this _____ day of _____, 2000.

In our joint presence, _____, who is of sound mind and eighteen years of age, or older, voluntarily dated and signed this writing or directed it to be dated and signed on his behalf.

Witness
Address: _____

Date: _____

Witness

Address: _____

Date: _____

COMMONWEALTH OF KENTUCKY)

) SS

COUNTY OF JEFFERSON)

Before me, the undersigned authority, came _____ who is of sound mind and eighteen (18) years of age, or older, and acknowledged that he voluntarily dated and signed this writing or directed it to be signed and dated as above.

Done this _____ day of _____, 2000.

My commission expires: _____.

NOTARY PUBLIC, STATE AT LARGE, KY



POST MORTEM TAX PLANNING

**Melony J. Lane
Ogden Newell & Welch PLLC
Louisville, Kentucky**

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POST MORTEM TAX PLANNING

Melony J. Lane
Ogden Newell & Welch PLLC

I. Decedent's Final Income Tax Return(s).

- A. The Decedent's final income tax return is due on the date it would normally be due had the Decedent lived for the entire taxable year. (Treas. Reg. §1.6072-1(b).) Thus, for a calendar year taxpayer, the taxpayer's final return is due on April 15 of the year following the year of the taxpayer's death.
- B. The Executor or Administrator of the Decedent's estate must file the Decedent's final income tax return. (IRC §6012(b)(1).)
- C. If a taxpayer dies prior to filing his or her income tax return for the preceding year, the fiduciary must file the return on his or her behalf for 2 years. Example: X, a calendar year taxpayer, died on February 14, 2000, prior to filing X's 1999 income tax return. X's Executor is required to file X's 1999 income tax return which is due on April 15, 2000.
- D. Separate or Joint Return?
 - 1. Benefit of Joint Return - The primary benefit of filing a joint return is that the income reported on the return is subject to more advantageous tax rates.
 - 2. Disadvantage of Joint Return - The estate becomes jointly and severally liable with the surviving spouse for the entire income tax liability for the tax year.
 - 3. Pursuant to IRC §6013, the Decedent's Executor may file a joint return if:
 - (a) the Decedent was married at the date of death;
 - (b) the surviving spouse has not remarried during the remainder of the taxable year;
 - (c) neither the Decedent nor the surviving spouse was a nonresident alien at any time during the taxable year; and
 - (d) the surviving spouse consents to the joint return.
 - 4. The surviving spouse may unilaterally file a joint return if an executor has not been appointed by the due date of the return. However, the election may be revoked by a subsequently appointed executor by filing a separate return for the decedent within 1 year from the due date of the return, including extensions. (IRC §6013(a)(3).)

E. Series E and EE Bond Interest.

1. Accrued income on Series E and EE bonds is not taxable until the bond is redeemed or matures. Thus, cash-basis taxpayers are not required to report the accrued interest (which is evidenced by the increase in redemption price) as taxable income each year.
2. A taxpayer may elect to report all previously unreported Series E or EE accrued interest as income in any year. Thereafter, the taxpayer must report all interest as it accrues. (IRC §454(a).)
3. The Executor may, on behalf of the Decedent, make the election to report the previously unreported Series E or EE bond interest on the Decedent's final income tax return. (Rev. Rul. 68-145, 1968-1 C.B. 203; Rev. Rul. 79-409, 1979-2 C.B. 208.)
4. Making the election on the Decedent's final income tax return produces an estate tax deduction equal to the amount of income tax generated by the election.
5. If the election is made, the election must:
 - (a) be made on a timely filed return; and
 - (b) be made with respect to all bonds owned by the Decedent.
6. If the election is not made, the interest that accrued prior to death is considered IRD ("income in respect of a decedent") which is taxable to the estate or beneficiary when the income is received. (IRC §691(a).) However, such income is subject to an income tax deduction for the federal estate taxes that were attributable to the unreported interest. (IRC §691(c).)

F. Medical Expenses.

1. The Executor may elect to deduct medical expenses incurred prior to death but paid after death on either the Decedent's income tax return filed for the year in which the expenses were incurred or the estate tax return. (IRC §213(c).)

2. In order to deduct medical expenses on the final income tax return, the expenses:
 - (a) must exceed 7.5% of adjusted gross income (IRC §213(a)); and
 - (b) must have been paid within 1 year after the decedent's death (IRC §213(c)).
3. The medical expense deduction will generally be more advantageous on the final income tax return if the Decedent has a non-taxable estate. In order to claim the deduction on the income tax return, the Executor must file a statement, in duplicate, stating that the medical expenses have not been allowed as an estate tax deduction under IRC §2053 and waiving the right to have the medical expenses allowed as a deduction under IRC §2053.
4. If the Decedent's estate is a taxable estate, the deduction is generally more advantageous on the estate tax return:
 - (a) estate tax brackets are generally higher than the Decedent's personal income tax brackets; and
 - (b) the increased income tax is deductible on the estate tax return.

G. Partnership and S-Corporation Income.

1. For partnership tax years ending after December 31, 1997, the partnership's tax year closes with respect to a partner whose entire partnership terminates because of death. The Decedent's final income tax return includes the flow through items for the short tax year ending on the Decedent's date of death. (See IRC §706(c)(2)(A) and the regulations thereunder.)
2. For an S-corporation shareholder, the Decedent's final income tax return includes the Decedent's pro rata share of the S-corporation's income from the beginning of the tax year until the Decedent's date of death, allocated based on the number of days the Decedent lived in the tax year.

H. Request for Prompt Assessment.

1. IRC §6501(a) provides that the IRS must make an assessment for deficiency for federal income tax within 3 years after the return is filed. However, an Executor may request prompt assessment of any deficiency which must be made within 18 months. (IRC §6501(d).)

2. The request must be:
 - (a) in writing;
 - (b) filed after the return in question was filed; and
 - (c) filed with the district director for the IRS district in which the return was filed.(See Treas. Reg. §301.6501(d)-1(b).)
3. Use IRS Form 4810 to make the request for prompt assessment.
4. **Caution:** Request for prompt assessment may increase your audit risk.

I. Request for Discharge from Personal Liability.

1. An Executor may request release from personal liability for the Decedent's income taxes. (IRC §6905(a).)
2. The request must be:
 - (a) in writing;
 - (b) filed after the return in question was filed;
 - (c) filed with the IRS office where the estate tax return is required to be filed; or, if no estate tax return is required, in the office where the Decedent's final income tax return is required to be filed.(See Treas. Reg. §301.6905-1(a).)
3. Discharge under IRC §6905 only relieves the Executor of personal liability and does not apply to the Executor's liability in a fiduciary capacity to the extent of the estate's assets that remain in the Executor's control.

Use IRS Form 5495 to make the request for discharge from personal liability.
4. **Caution:** Request for discharge from personal liability may increase your audit risk.

II. **Fiduciary Income Tax Returns.**

- A. Fiscal Year. The Executor may select a calendar year or a fiscal year for the estate.
1. A selected fiscal year must not exceed 12 months and must end on the last day of the month. (IRC §441(e).)

Example: Mr. X died on October 20, 1999. The Executor of Mr. X's estate may choose a fiscal year ending on September 30, 2000, or on the last day of any month prior to September 2000.

2. A fiscal year end is elected on the first fiduciary income tax return. In addition, the election must be made by the statutory due date of the return without regard to extensions. (Temp. Reg. §1.441-1T(b)(2).) Further, if a fiscal year is not elected by the due date of the first return, the estate must use a calendar year end. (Temp. Reg. §1.441-1T(d).)

- B. Income Deferral. Careful selection of a fiscal year may allow beneficiaries to defer reporting income received by the beneficiary from the estate. Beneficiaries report income received from an estate in the beneficiary's calendar year in which the estate's fiscal year ends.

Example: An estate's fiscal year ends on February 28, 2000. All income distributed to estate beneficiaries during the fiscal year are deemed distributed on February 28, 2000, and are reportable on the beneficiaries' 2000 calendar year returns, even if the distributions were made during 1999.

- C. 65-Day Rule. The Taxpayer Relief Act of 1997 extended the application of the "65-day rule" to estates. Thus, an executor may elect to treat distributions made within 65 days of the close of the tax year as if such distributions were made on the last day of the tax year. (IRC §663(b).)

1. Applies to tax years beginning after August 5, 1997.
2. The election must be made on a timely filed Form 1041 (including extensions). Once made, the election is irrevocable. (Treas. Reg. §1.663(b)-2(a).)

- D. Treating Revocable Trust as Part of an Estate for Income Tax Purposes. The Taxpayer Relief Act of 1997 introduced IRC §645 (originally IRC §646) which permits an executor and a trustee of a "qualified revocable trust" to treat the trust as part of the estate for income tax purposes.

1. IRC §645 is effective for estates of decedents dying after August 5, 1997.
2. The definition of "qualified revocable trust" includes any trust for which all or a portion was treated under IRC §676 as owned by the decedent by reason of a power retained or held by the decedent/grantor, and determined without regard to IRC §672(e). (IRC §645(b)(1).)

3. The election must be made by the due date of the estate's first income tax return, determined without regard to extensions. (IRC §645(c).)
4. If the election is made, the trust is treated and taxed as part of the estate for all taxable years ending after the decedent's date of death until:
 - (a) 2 years after the decedent's date of death if no federal estate tax return is required; or
 - (b) 6 months after the final determination of federal estate tax liability if a federal estate tax return is required.

(IRC §645(a) and 645(b)(2).)

5. The procedures and requirements for making the IRC §645 election are contained in Rev. Proc. 98-13, 1998-4 IRB 1:
 - (a) The Executor must attach a statement to the estate's 1041 for the first taxable year. The Trustee must also attach a copy of the statement to the trust's 1041 for its first taxable year ending after the decedent's death.
 - (b) The statement must include the following:
 - (i) identify the election as an IRC §645 election;
 - (ii) identify the decedent's name, address, date of death, and taxpayer identification number (i.e.- social security number);
 - (iii) identify the trust's name, address, and taxpayer identification number;
 - (iv) identify the estate's name, address, and taxpayer identification number;
 - (v) represent the trust as one that was treated under IRC §675 as owned by the decedent due to the decedent's power to revoke the trust; and
 - (vi) be signed and dated by both the executor and the trustee.
 - (c) If the election is made, all of the trust's income and deductions accruing after the decedent's date of death are excluded from the trust's 1041 and are reported on the estate's 1041. (See item 4 above for determination of when the election ends.)

III. **Gift Tax Planning.**

A. Filing Requirements.

1. Late Returns. The Executor is required to file gift tax returns for any taxable gifts where the Executor is aware no gift tax returns were filed. (Treas. Reg. §25.6019-1(g).)
2. Gifts Made in Year of Death. For gifts made in the year of the Decedent's death, the gift tax return is due on the earlier of April 15 of the year following the year of the gifts or the due date of the federal estate tax return. (IRC §6075(b)(3).)

B. Gift Splitting.

1. IRC §2513(a)(1) permits spouses to treat gifts made to third persons as if the gifts were made one-half by each spouse. The requirements for gift splitting are as follows:
 - (a) the spouses must have been married to each other at the time of the gifts;
 - (b) both spouses must be either U.S. citizens or residents at the time of the gifts; and
 - (c) neither spouse may have remarried during the remainder of the calendar year involved.
2. After the death of a spouse, the Executor of the Decedent's estate and the surviving spouse may elect gift splitting with respect to gifts made during the year of the Decedent's death by either the Decedent or the surviving spouse. (Treas. Reg. §25.2513-2(c).)
3. Consent signified by the Decedent's Executor is not effective for gifts made by the surviving spouse after the Decedent's date of death. (Treas. Reg. §25.2513-1(b)(1).)
4. Only gift taxes attributable to gifts made by the Decedent are deductible as a debt on the Decedent's estate tax return. (Treas. Reg. §20.2053-6(d).)

IV. Estate Tax Planning.

A. Alternate Valuation - IRC §2032.

1. **General Rule.** Estate assets are generally valued on the date of the Decedent's death.
2. **Alternate Valuation.** IRC §2032 permits estates to elect to value assets on the date 6 months after the Decedent's date of death if both the value of the gross estate and the amount of estate tax payable is reduced as a result of the alternate valuation.
 - (a) Assets which are sold, distributed, exchanged, or otherwise disposed of during the 6 month period are valued on the date of the sale, distribution, exchange, or other disposition. (IRC §2032(a)(1).)
 - (b) Any changes in asset value which are merely a result of the passage of time are disregarded. (IRC §2032(a)(3).) Examples of assets the value of which changes due to the passage of time include life estates, remainder interests, and patents. (See Treas. Reg. §20.2032-1(f) for further discussion.)
3. If alternate valuation is elected, all estate assets must be valued under the provisions of IRC §2032. The executor may not "pick and choose" the assets to be valued under the alternate valuation rules. (Treas. Reg. §20.2032-1(b)(2).)
4. The election is made by the executor on the estate tax return. Once made, the election is irrevocable. (IRC §2032(d)(1).)
5. The election may not be made on a return that is filed more than 1 year after the due date, including extensions. (IRC §2032(d)(2).)

B. Special Use Valuation - IRC §2032A

1. Under IRC §2032A, certain real estate that is used for farming or in a trade or business may be valued for estate tax purposes at its value in that "qualified use" rather than at its "highest and best use" value.
2. In order to qualify for special use valuation, the decedent must have been either a U.S. citizen or resident at the decedent's date of death. (IRC §2032A(a)(1)(A).)

3. For decedents dying in 2000, the aggregate reduction in value from special use valuation may not exceed \$770,000, which reflects the inflation adjustment from the original \$750,000 provided in IRC §2032A(a)(2). (See also Rev. Proc. 99-42, 1999-46 IRB 1.) The inflation adjustment amount is rounded down to the nearest \$10,000 multiple. (IRC §2032A(a)(3).)
4. "Qualified Use" refers to property devoted to farming or used in a trade or business other than farming. (IRC §2032A(b)(2).)
5. The technical requirements which must be met in order to qualify for special use valuation are contained in IRC §2032A(b) and are very complicated:
 - (a) 50% or more of the value of the adjusted gross estate must consist of the value of real or personal property which was being used for a qualified use on the decedent's date of death by either the decedent or a member of the decedent's family and such property must pass to a qualified heir of the decedent.
 - (b) 25% or more of the value of the adjusted gross estate must consist of the adjusted value of real property which was acquired from or passed from the decedent to a qualified heir and meets the requirements set forth in (c).
 - (c) The property must have been owned by the decedent or a member of the decedent's family for 5 out of the last 8 years immediately preceding the decedent's death and there must have been material participation by the decedent or a member of the decedent's family in the qualifying use.
 - (d) All persons receiving an interest in the property must enter into a recapture agreement.
6. If within 10 years after the decedent's death and before the qualified heir's death the property is disposed of to someone outside of the qualified heir's family or ceases being used for a qualified use, then the heir is subject to recapture tax. (IRC §2032A(c)(1).) The recapture tax is due within 6 months following the applicable transfer or cessation of qualified use. (IRC §2032A(c)(4).)

7. If special use valuation is elected, the property is valued as follows:
 - (a) farm land may be valued by a capitalization of rents method as specified in IRC §2032A(e)(7) or a 5-factor method specified in IRC §2032A(e)(8); and
 - (b) property used in a trade or business other than farming is valued using the 5-factor method outlined in IRC §2032A(e)(8).
8. Disadvantages of Special Use Valuation:
 - (a) Reduced Income Tax Basis. If special use valuation is elected, the income tax basis of the property is the special use value established for federal estate tax purposes.
 - (b) Beneficiaries are burdened with the requirements of IRC §2032A for 10 years.

C. Qualified Family Owned Business Interest Deduction - IRC §2057

1. Under IRC §2057, a deduction is allowed for certain “qualified family owned business interests,” which are often referred to as “QFOBI,” and the principal place of business of which is located in the United States.
2. QFOBI means:
 - (a) an interest as a proprietor in a trade or business operated as a proprietorship, or
 - (b) an interest in an entity operating a trade or business if at least:
 - (i) 50% of the entity is owned by the decedent or members of the decedent’s family;
 - (ii) 70% of the entity is owned by members of 2 families and the decedent and the decedent’s family owns at least 30%; or
 - (iii) 90% of the entity is owned by members of 3 families and the decedent and the decedent’s family owns at least 30%.

(IRC §2057(e)(1).)

3. Again, the technical requirements set forth in IRC §2057(b)(1) are very complicated:
 - (a) The decedent must have been a U.S. citizen or resident;
 - (b) The executor must affirmatively make the election for the QFOBI deduction and the heirs must enter into a recapture agreement;
 - (c) The QFOBI interests owned by the decedent at the time of the decedent's death plus those interests which were given to members of the decedent's family during the decedent's lifetime must exceed 50% of the decedent's adjusted gross estate; and
 - (d) The QFOBI interests must have been owned by the decedent or a member of the decedent's family for 5 of the last 8 years immediately preceding the decedent's death and either the decedent or a member of the decedent's family must have materially participated in the business during such time period.
4. If the requirements are met, the value of the taxable estate is determined by deducting the value of the adjusted QFOBI interests, not to exceed \$675,000, from the value of the gross estate. (IRC §2057(a).)
5. If the QFOBI election is made, the applicable exemption amount with respect to the estate is limited to \$625,000, regardless of the year in which the decedent died. However, there is a dollar-for-dollar increase in the exemption amount, up to the maximum exemption for the year in which the decedent died, for every dollar the QFOBI deduction is less than the \$675,000 maximum. (IRC §2057(a)(3).) Thus, the total applicable exemption amount and QFOBI deduction is capped at \$1,300,000.
6. IRC §2057(f) provides recapture provisions which apply if any of the following occur within 10 years of the decedent's death and prior to the qualified heir's death:
 - (a) the material participation requirements are not met or cease to be met;
 - (b) the qualified heir disposes of the QFOBI interest to someone other than a member of the qualified heir's family or through a qualified conservation contribution under IRC §170(h);
 - (c) the qualified heir loses U.S. citizenship; or

- (d) the principal place of business ceases to be in the U.S.
- 7. 100% of the tax is recaptured if the disqualifying event occurs in years 1 through 6; 80% in year 7; 60% in year 8; 40% in year 9; and 20% in year 10. (IRC §2057(f)(2)(B).)
- 8. The IRC §2057 QFOBI deduction is separate from the special use valuation provisions of IRC §2032, and the two may be used together where the requirements for both are met.

D. Marital Deduction Planning: Qualified Terminable Interest Property.

- 1. IRC §2056(b)(7) provides the marital deduction for qualifying lifetime interests passing to the surviving spouse who is a U.S. citizen.
- 2. Qualified Terminable Interest Property is defined in 2056(b)(7)(B) as property which:
 - (a) passes from the decedent,
 - (b) in which the surviving spouse has a qualifying income interest for life, and
 - (c) to which a QTIP election is made pursuant to IRC §2056(b)(7).(IRC §2056(b)(7)(B)(i).)
- 3. In order for a lifetime income interest to be a qualifying income interest, the following criteria must be met:
 - (a) the surviving spouse must be entitled to all income from the property and the income must be payable to the spouse in annual or more frequent installments, and
 - (b) no person may have a power to appoint the principal or any part thereof to anyone other than the surviving spouse during the surviving spouse's lifetime.(IRC §2056(b)(7)(B)(ii).)
- 4. The election is made by designating the property to which the election applies on Schedule M of the decedent's federal estate tax return. Once made, the election is irrevocable.

5. If the QTIP election is made under IRC §2056(b)(7), the marital deduction applies in the immediate decedent's estate and the property subject thereto is included in the surviving spouse's taxable estate at its value on the surviving spouse's date of death. Thus, the QTIP marital deduction operates as a tax deferral device.
6. Partial QTIP elections are permitted if the partial election regards a fractional or percentage share of the property such that the portion to which the election applies reflects its proportionate share of any increases or decreases in value. In addition, the partial election may be defined by a formula. (Treas. Reg. §20.2056(b)-7(b)(2)(i).)
7. If a partial QTIP election is made, and if the trust document or local law permits, the trust may be divided into separate trusts to reflect the partial election. Such division must be done on a fractional or percentage basis, but the separate trusts do not have to be funded with a pro rata share of each asset held by the original, undivided trust. (Treas. Reg. §20-2056(b)-7(b)(2)(ii).)
8. Taking the maximum marital deduction is not always advantageous. Sometimes such an election would result in the loss of all or a portion of the decedent's applicable exemption amount.

Example: D died leaving the residue of his estate to a trust for the sole benefit of S, D's surviving spouse. The terms of the trust provide that the income is distributable to S on a quarterly basis and that the trustee may encroach on the trust principal for S's health, maintenance, and support. The trust qualifies under the provisions of IRC §2056(b)(7) for the QTIP marital deduction. However, if the QTIP election is made for 100% of the trust, D's applicable exemption amount would be wasted.

In such situations, a fractional election, which anticipates changes in value on audit of the estate tax return, is preferable:

Example: Executor hereby elects the QTIP marital deduction for a fraction of the trust, the numerator of which equals the value of the trust as finally determined for federal estate tax purposes less the applicable exemption amount available to the decedent's estate; and the denominator of which equals the value of the trust as finally determined for federal estate tax purposes.

9. In addition, maximum estate tax deferral is not always advantageous.

(a) Time Value of Money. Professor and noted speaker Jeffrey Pennell has often stated that the time value of money argument in favor of maximum deferral is a misnomer and that the estate is ultimately better off if taxes are paid up front and the remaining property is left to grow tax free. (See Jeffrey N. Pennell and R. Mark Williamson, "The Economics of Prepaying Wealth Transfer Tax," Trusts & Estates, June 1997, at p. 49, July 1997, at p. 40, and August 1997, at p. 52.)

(b) Previously Taxed Property Credit. If the surviving spouse dies within 10 years after the decedent's death, the actuarial value of any portion of the marital trust for which the marital deduction was not elected will qualify for the previously taxed property credit under IRC §2013, even though such property is not included in the surviving spouse's estate.

Tip: Request a 6-month extension to file the federal estate tax return when analyzing the appropriateness of taking less than the maximum marital deduction. If the surviving spouse dies during that time period, the previously taxed property credit is preserved.

(c) Manipulation of Estate Tax Brackets. Taking less than the maximum QTIP marital deduction may also be advantageous to "manipulate" the estate tax brackets of the decedent and the surviving spouse. Making a partial QTIP election allows each estate to receive the benefit of "running up the brackets" before reaching the maximum estate tax bracket. However, once the maximum bracket is reached, there is nominal advantage to foregoing the marital deduction unless use of the previously taxed property credit is anticipated.

E. Non-Citizen Surviving Spouses.

1. Generally, the marital deduction is not available to non-citizen surviving spouses.

2. There are 2 exceptions to the general rule:

(a) The surviving spouse resided in the U.S. at all times after the decedent's death and becomes a U.S. citizen before the estate tax return is filed (IRC §2056(d)(4)); or

- (b) The property passes to a Qualified Domestic Trust (QDOT). (IRC §2056(d)(2). The property may pass directly from the decedent to a QDOT trust or may pass to the surviving spouse and the surviving spouse may voluntarily place the property in a QDOT created by the surviving spouse. (IRC §2056(d)(2)(B).)
3. The QDOT requirements are set forth in IRC §2056A. In summary, QDOTs have the following requirements in addition to the basic requirements of 2056(b)(7):
 - (a) At least 1 trustee of the trust must be either an individual who is a U.S. citizen or a domestic corporation;
 - (b) The trust must provide that no principal distributions may be made unless the qualifying trustee has the right to withhold from the distribution the tax imposed thereon;
 - (c) The trust must comply with the requirements set forth in any regulations which are designed to ensure the collection of the tax; and
 - (d) The QDOT marital deduction must be elected on the federal estate tax return to be effective.
 4. If the QDOT marital deduction is elected, a tax is imposed on any principal distributions made during the surviving spouse's lifetime. In addition, the balance of the trust property remaining in the trust at the surviving spouse's death is included in the surviving spouse's taxable estate. (IRC §2056A(b)(1).) The amount of the tax is determined by the tax that would have been applied had the distribution not qualified for the marital deduction, and previous taxable distributions are taken into consideration in making this determination. (IRC §2056A(b)(2).)
 5. No estate tax is imposed on income distributions made from a QDOT trust. (IRC §2056A(b)(3).)
 6. Once made, the election is irrevocable. Further, the election may not be made on a return that is filed more than 1 year after the due date of the return, including extensions. (IRC §2056A(d).)

Note: Some commentators suggest that the penalty for late filing may be worth incurring to avoid the QDOT rules if it is likely that the surviving spouse will become a U.S. citizen shortly after the due date

(including extensions). (See BNA portfolio 843, "Estate Tax Marital Deduction", VI(G)(1).)

F. Generation Skipping Transfer Tax - Reverse QTIP Election.

1. In general, the surviving spouse is treated as the transferor for GST purposes of QTIP property that is included in the surviving spouse's estate. (IRC §2652(a)(1).) Thus, under this general rule, use of the maximum QTIP deduction may prevent the decedent from fully utilizing the decedent's GST exemption.
2. IRC §2652(a)(3) provides a special election that may be made with respect to QTIP trusts which allows the decedent to treat the QTIP trust for GST purposes as if the decedent is the transferor; thus allowing the decedent to allocate part or all of the decedent's GST exemption to the QTIP trust. Such election is known as a "reverse QTIP election" because the decedent is electing for GST purposes to treat the property as if the QTIP election had not been made.
3. The reverse QTIP election is made on the federal estate tax return upon which the QTIP election is made. Once made, the election is irrevocable. (Treas. Reg. §26.2652-2.)
4. The reverse QTIP election cannot be used with respect to IRC §2056(b)(5) general power of appointment marital trusts.

Estate Planning Tip:

Do not use general power of appointment marital trusts or marital bequests in fee where the assets of such trust or bequest will be needed in order to fully utilize the decedent's GST exemption.

G. Disclaimers.

1. "Qualified Disclaimers," as defined in IRC §2518(b), can be an effective post mortem tax planning device. In essence, a disclaimer is a refusal to accept property to which one would otherwise be entitled. If the disclaimer is a qualified disclaimer, the property is treated as if it had never been transferred to the disclaimant.

2. A qualified disclaimer is an irrevocable and unqualified refusal to accept property that meets the following requirements:
- (a) is in writing;
 - (b) is received by the transferor, his legal representative, or the holder of the legal title to the property;
 - (c) is received not later than 9 months after the later of:
 - (i) the date on which the transfer creating the interest in the disclaimant is made; or
 - (ii) the day on which the donee attains age 21;
 - (d) the disclaimant has not accepted the disclaimed property nor any of its benefits; and
 - (e) as a result of the disclaimer, the property passes without direction on the disclaimant's part to:
 - (i) the decedent's surviving spouse; or
 - (ii) to a person other than the disclaimant.

(IRC §2518(b).)

3. If a qualified disclaimer is made with respect to a transfer of property, the disclaimed interest is treated as if it had never been transferred to the disclaimant and is instead treated as if it passed directly from the transferor to the person entitled to receive the property as a result of the disclaimer. Thus, the disclaimant has not made a gift with respect to the property subject to the disclaimer. (Treas. Reg. §25.2518-1(a)(3).)
4. 9-month time limit. The time period for making the disclaimer is determined with regard to the transfer creating the interest in the disclaimant. (Treas. Reg. §25.2518-2(c)(3).) Common examples:
- (a) inter-vivos gifts - disclaimer period begins running on the date of the gift.
 - (b) testamentary transfers - disclaimer period begins running on the date of the decedent's death.

- (c) transfers which become irrevocable at the transferor's death - disclaimer period begins on the transferor's date of death. E.g. - Revocable Trusts.
- (d) **Caution** - With respect to an interest that is created during the transferor's lifetime and is later included in the transferor's estate for federal estate tax purposes, the disclaimer period is determined with reference to the initial transfer creating the interest. E.g. - Grantor Retained Annuity Trusts or Qualified Personal Residence Trusts created during the transferor's lifetime but for which the transferor did not outlive the estate tax inclusion period.
- (e) If a person who is entitled to receive property as a result of a qualified disclaimer wishes to disclaim the property interest, such person's successive disclaimer must be made within the original 9 month disclaimer period.
- (f) With respect to transfers of a life interest with a separate remainder interest, including QTIP transfers, any disclaimers with regard to a remainder interest must be made within the 9 month period following the original transfer that created the remainder interest.

5. Disclaimer of Survivorship Interest in Real Property. The interest to which a joint owner succeeds by right of survivorship may be disclaimed within 9 months of the death of the deceased joint owner. Such interest is generally deemed to be a one-half interest, regardless of portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent's gross estate under IRC §2040. (Treas. Reg. §25.2518-2(c)(4)(i).)

Example: D purchased property in joint name with right of survivorship with D's spouse, S. D furnished 100% of the consideration. Upon S's death, D may disclaim the 50% interest in the property to which D would otherwise be entitled by right of survivorship.

This provision can be very helpful where the first spouse to die does not have sufficient assets in such spouse's individual name to fully utilize such spouse's applicable exemption amount. Such a disclaimer is particularly beneficial where the disclaimed interest passes to a credit shelter trust for the benefit of the surviving spouse.

6. Special Rule for Joint Bank, Brokerage, and Other Investment Accounts. Transfers to a joint bank, brokerage, or other investment account for which the transferor may unilaterally withdraw the property without the consent of the other joint tenants is not a completed gift and the transfer creating the survivor's interest in the deceased transferor's share of the account occurs at the death of a transferor. Therefore, a surviving co-tenant may disclaim the survivorship interest within 9 months of the death of a transferor. The survivorship interest is determined using a contribution test. Thus, a surviving co-tenant may not disclaim any portion of the account for which the surviving co-tenant supplied the consideration. (Treas. Reg. §25.2518-2(c)(4)(iii).)
7. No Acceptance of Benefits. A donee may not disclaim property for which the donee has accepted any benefits. Acceptance is shown by an affirmative act which is indicative of ownership, such as the use or occupation of real property, receipt of rents or dividends, etc. Nevertheless, a surviving co-owner of real property is not deemed to have accepted the survivorship interest merely by continuing to occupy the real property after the co-owner's death. (Treas. Reg. §25.2518-2(d)(1).)
8. Beneficiaries Who Are Also Fiduciaries. Actions taken in a fiduciary capacity to preserve or maintain disclaimed property are not deemed to be an acceptance by the beneficiary who happens to be the fiduciary. Nevertheless, the beneficiary may not retain wholly discretionary fiduciary powers to direct the enjoyment of the disclaimed property – to do so would violate the requirement that the disclaimed property pass without direction by the disclaimant. (Treas. Reg. §25.2518(d)(2).)

Example: S disclaims a 50% survivorship interest in real estate which passes as a result of the disclaimer to a credit shelter trust of which S is the trustee and which is administered for the benefit of S and S's descendants. S must also disclaim any general OR special power of appointment concerning the trust property in order for the disclaimer of the 50% survivorship interest to be a qualified disclaimer.

Note: Powers which are subject to an ascertainable standard may be retained.

9. Passage Without Direction on the Part of the Disclaimant. The disclaimed property must pass to the next recipient without any direction from the disclaimant. Any powers to redirect the distribution of the property, including general and special powers of appointment and encroachment

powers which are not limited by an ascertainable standard, will disqualify the disclaimer even if such powers are retained in a fiduciary capacity. (Treas. Reg. §25.2518-2(e).)

Note that powers of appointment are considered separate property interests which may be disclaimed independent from other interests.

Caution: Verify that the dispositive provisions will achieve the desired transfer results.

10. Surviving Spouse's Disclaimer. A surviving spouse is the only person who may disclaim an interest in property which will pass to a trust that benefits the surviving spouse. However, the surviving spouse may not retain any powers to direct the ultimate enjoyment of the property in any manner that is not limited by ascertainable standards. (Treas. Reg. §25.2518(e)(2).)

Note: In order for the surviving spouse's disclaimer to be a qualified disclaimer, the surviving spouse must also disclaim any power of appointment (general or special) given to the surviving spouse in the trust to which the disclaimed property passes as a result of the surviving spouse's disclaimer.

11. Partial Failure of a Disclaimer. If a person other than the surviving spouse makes a disclaimer which does not effectively pass the disclaimed property interest to someone other than the disclaimant, the disclaimer is not qualified with respect to that portion of the property for which the disclaimant has a right to receive. A disclaimant's right to receive the disclaimed property as an heir at law, residuary beneficiary, or by any other means is the type of interest that will disqualify a disclaimer. If the property which the disclaimant is entitled to receive is not a severable interest, the entire disclaimer will be non-qualified. (Treas. Reg. §25.2518(e)(3).)

Cure: Disclaimant should also disclaim any remainder or other interest in the disclaimed property.

12. Disclaimer of Less than an Entire Interest.

- (a) Partial Interests. If the disclaimer requirements are met, a disclaimer of an undivided portion of any separate interest may be a qualified disclaimer even though the disclaimant retains another interest in the property. As a general rule, each individual interest created by the transferor is treated as a separate interest. (E.g. - life and remainder interests.) Partial disclaimers of an undivided interest in a separate

interest are permitted as qualified disclaimers. (Treas. Reg. §25.2518-3(a)(1)(i).)

Example: A bequeathed rental property to C and D for life with remainder to C. C may disclaim all or an undivided portion of either the lifetime income interest or the remainder interest while retaining the non-disclaimed interest.

- (b) Severable Property. A partial disclaimer with regard to severable property is a qualified disclaimer if it meets the disclaimer requirements. Example. A bequeaths 100 shares of IBM stock to C. C may disclaim 25 shares and retain the remaining 75 shares. (Treas. Reg. §25.2518-3(a)(1)(ii).) Note, however, that C could not disclaim either the income interest nor the remainder interest with regard to the IBM stock because such interests were not separate interests created by the transferor.
 - (c) Transfers in Trust. A beneficiary may not disclaim particular assets in trust while retaining similar interests in other trust assets unless the disclaimed assets are removed from the trust as a result of the disclaimer and pass to the transferor's spouse or someone other than the disclaimant without direction on the part of the disclaimant. (Treas. Reg. §25.2518-3(a)(2).)
13. Undivided Portions. Treas. Reg. §25.2518-3(b) permits the disclaimer of an undivided portion of a separate property interest if such disclaimer is expressed as a fraction or percentage of each and every substantial interest or right owned by the disclaimant in the property and the disclaimer must extend over the entire life of the disclaimant's interest in the property.
14. Coordination with State Laws. Most states have statutory requirements regarding disclaimers which must be met in addition to the federal requirements. Remember, a disclaimer that meets the state law requirements is not a "qualified" disclaimer for federal estate and gift tax purposes unless it also meets the federal requirements.
- (a) Kentucky. Kentucky's disclaimer statutes are as follows:
 - (i) Disclaimers under nontestamentary instruments:
See KRS 394.035

- (ii) Disclaimers of transfers by will, intestacy, or appointment:
See KRS §§ 394.610 through 394.670
 - (b) Indiana. Indiana's disclaimer statutes are found in Indiana Code §§ 32-3-2-1 through 32-3-2-15.
 - (c) Florida. Florida's disclaimer statutes are as follows:
 - (i) Disclaimer of interests in property passing under certain nontestamentary instruments or under certain powers of appointment: See Florida Statute §689.21.
 - (ii) Disclaimer of interests in property passing by will, intestate succession, or under certain powers of appointment: See Florida Statute §732.801.
15. Disclaimers can be invaluable tools for post mortem estate planning. However, disclaimers are often overlooked due to their perceived complexity. Here are a couple of examples of effective ways to use disclaimers to achieve estate tax planning after the transferor's death:
- (a) Disclaimers to Increase Marital Deduction.
 - (i) Disclaimers by transferor's children with respect to the discretionary power of invasion in a trust for which the income is payable to the surviving spouse. Note that the children must also disclaim any remainder interests they may have in the trust.
 - (ii) Disclaimers by transferor's children with respect to property devolving to them under the intestate succession laws so as to cause such property to pass to the surviving spouse.
 - (iii) Disclaimer by the trustee of the power to invade corpus for the benefit of anyone other than the surviving spouse such that the trust will qualify for QTIP treatment. Note that the trust document must grant the trustee the power to disclaim or else the disclaimer is invalid without the consent of the beneficiaries. Also note that this scenario may cause a conflict of interest between the surviving spouse and the remainder beneficiaries for which the trustee would need to seek court guidance.

(b) Disclaimers to Utilize Decedent's GST Exemption.

- (i) A child may disclaim an outright bequest or distribution to the child such that the property will pass pursuant to the terms of the dispositive document (i.e. - Will or trust) or laws of intestacy to the child's descendants.
- (ii) Grandchildren may disclaim to reduce direct skips so that the direct skips will be within the decedent's available GST exemption.

16. Incorporation in the Estate Plan to Provide Flexibility. Planning in advance for the potential use of disclaimers can be very beneficial. For example, if a child insists on leaving property to the child's parent (who has worked very hard at diminishing his or her own potential estate taxes), if the bequest is worded properly with the proper contingent beneficiaries, then the parent may disclaim the bequest in order for it to pass to the child's siblings – the parent's intended ultimate beneficiaries – without incurring unnecessary taxes in the parent's estate.

V. **Allocation of Estate Administration Expenses Between Income and Principal.**

A. Estate of Hubert, 520 U.S. 93 (1997).

Mr. Hubert died in 1986 having an estate valued at \$30 million. Mr. Hubert's Will provided for a marital trust with remainder to charity. Following a lengthy Will contest, Mr. Hubert's estate was ultimately divided into a marital share and a charitable share. During the 6 years of estate administration, the estate received income of over \$4,500,000 and incurred expenses in excess of \$2,000,000, which included substantial attorney fees relating to the Will contest. The Executor of Mr. Hubert's estate allocated approximately \$500,000 of the expenses against principal (reducing the marital and charitable deductions accordingly) and charged the remaining \$1,500,000 of expenses against income received by the estate after Mr. Hubert's death. The expenses that were charged against the income were taken as income tax deductions on the estate's fiduciary income tax returns. However, the executors did not reduce the marital or charitable deductions by the amount of the expenses that were charged against the estate income. The IRS contended that the expenses charged against income materially limited the marital and charitable shares' right to income and, therefore, the marital and charitable deductions must be reduced dollar for dollar by the amount of the expenses that were charged against income.

The Tax Court held that, under the facts in question, no material limitation existed on the marital and charitable shares' right to receive income. The Eleventh Circuit

affirmed the Tax Court decision and the Supreme Court upheld the Eleventh Circuit decision. However, the Court noted that if a material limitation were found, a reduction in the marital or charitable deduction would be required. Justice O'Connor, in a concurring opinion, more or less invited the IRS to issue Regulations pertaining to how to determine if a material limitation exists.

B. Proposed Regulations. The IRS issued Proposed Regulations pertaining to the Hubert case on December 16, 1998. The Proposed Regulations removed the "material limitation" standard and offered in its place a two-tiered system of administration expenses contained in Proposed Regulation 20.2056(b)-4(e):

1. Estate Management Expenses. These are expenses that generally would have been incurred even if the decedent had not died, such as investment fees. Estate management expenses charged against income would not reduce the marital or charitable deduction.
2. Estate Transmission Expenses. These are all administration expenses that do not constitute management expenses, including expenses incurred in collecting estate assets, paying debts and estate and inheritance taxes, and distributing the decedent's assets among the appropriate beneficiaries. Estate transmission expenses, whether charged against income or principal, would reduce the marital or charitable deduction on a dollar for dollar basis.

C. Final Regulations. Final regulations were issued on December 3, 1999, almost 1 year to the day after the issuance of the proposed regulations. The final regulations are applicable to estates of decedents dying on or after the issue date. The Hubert rules continue to apply for decedents who died prior to December 3, 1999.

1. Estate Management Expenses. The final Regulations retained the definition of estate management expenses contained in the proposed Regulations, but added that such expenses must be incurred in a reasonable time period for administration. Again, estate management expenses that are charged against estate income of a marital or charitable share do not reduce the marital or charitable deduction.
2. Estate Transmission Expenses. The final Regulations also kept the definition of estate transmission expenses as expenses that do not constitute management expenses, but added that they are expenses that would not have been incurred "but for" the decedent's death. Estate transmission expenses result in a direct set-off of the marital or charitable deduction. Thus, estate transmission expenses should be deducted on the federal estate tax return as 2053 expenses, which, for estate tax purposes, offsets the reduction in the marital or charitable deduction.

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**TAX PLANNING FOR CHILDREN
AND THEIR EDUCATION**

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SECTION H



TAX PLANNING FOR CHILDREN AND THEIR EDUCATION

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TAX PLANNING FOR CHILDREN AND THEIR EDUCATION

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JULY 15, 2000

COLLEGE COSTS

As the following shows, there is a wide distribution of *tuition* and *fees* (not including *room* and *board*) among four-year colleges:

Under \$4,000	52.2%
\$4,000 – 7,999	20.2%
\$8,000 – 11,999	6.7%
\$12,000 – 15,999	9.0%
\$16,000 – 19,999	5.5%
\$20,000 or more	6.4%
	<u>100.0%</u>

(Source: *The College Board; 1998-99 Academic Year*)

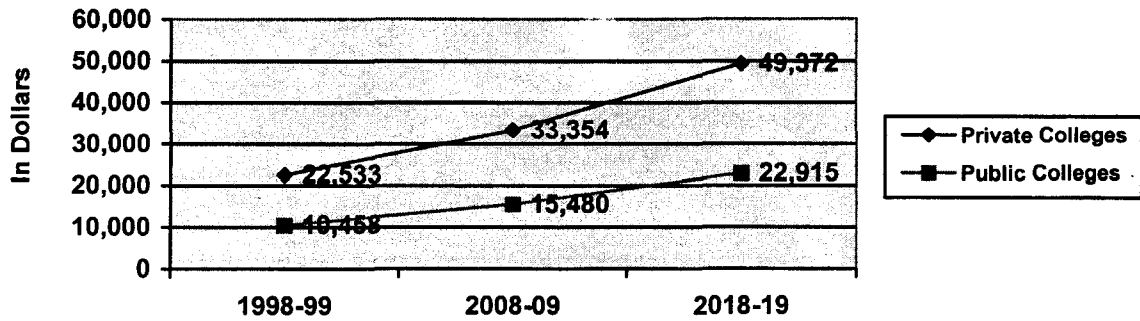
For resident students (as contrasted with commuting students), typical expenses are reported to be the following for public and private colleges:

	Public	Private
Tuition and fees	\$ 3,243	\$14,508
Room and board	4,530	5,765
Transportation	612	547
Books and supplies	662	667
Other expenses	1,411	1,046
Total	<u>\$10,458</u>	<u>\$22,533</u>

21% of students attend private colleges.

(Source: *The College Board; 1998-99 Academic Year*)

Until recently, college costs were growing between 7% and 12% annually. *The College Board* reports that the growth rate has slowed to 4%. Even at 4% annual growth, though, future costs are expected to be significantly higher, as this graph shows:



SAVING FOR COLLEGE

A parent of a newborn who wants (and is able) to set aside a lump sum for college would need the following amounts (in thousands) to fund the amount projected to be needed (based on 4% growth) for four years of undergraduate education:

After tax growth rate of fund	Public College	Private College
5%	\$37.5	\$80.9
7%	\$26.0	\$56.0
9%	\$18.1	\$39.1

If instead, the parents set aside a fixed amount annually for the newborn, annual (and total) funding (in thousands) would be:

After tax growth rate of fund	Public College	Private College
5%	\$3.1 (\$54.9)	\$6.6 (\$118.8)
7%	\$2.4 (\$43.2)	\$5.2 (\$93.6)
9%	\$1.9 (\$34.2)	\$4.1 (\$73.8)

If the parents are unable to start funding until the child turns age 12, these annual (and total) amounts (in thousands) are projected to be needed:

After tax growth rate of fund	Public College	Private College
5%	\$12.7 (\$75.9)	\$27.3 (\$163.5)
7%	\$11.5 (\$69.0)	\$24.7 (\$148.5)
9%	\$10.4 (\$62.7)	\$22.5 (\$135.0)

As you can see, early funding makes a substantial difference in the amount needed.

Before the advent of the “kiddie tax” in 1987, after-tax returns on funds set aside for education could be materially enhanced by transferring income-producing assets to children and utilizing

their lower tax brackets. This opportunity now is limited, because children under age 14 are taxed using their parents' tax brackets on investment income exceeding \$1,400. For children under 14, the first \$700 is tax-free and the next \$700 is taxed using the child's bracket. When the child reaches 14, his or her own tax brackets are used.

Similarly, complex trusts can be used to enhance after-tax returns in saving for college. However, trust income tax brackets, which impose high rates at relatively low income amounts, limit the benefits. The following table shows the contrast between trust income tax brackets and those for a married couple filing jointly (Federal only in each case):

Tax bracket	Taxable income: Trust	Taxable income: MFJ
15%	0 – 1,750	0 – 43,850
28%	1,750 – 4,150	43,850 – 105,950
31%	4,150 – 6,300	105,950 – 161,450
36%	6,300 – 8,650	161,450 – 288,350
39.6%	8,650 plus	288,350 plus

TAX INCENTIVES HELP FINANCE COLLEGE COSTS

Fortunately, several tax incentives exist to help families with college costs. These can be broken into programs to help with (1) reducing college costs (Hope and Lifetime Learning credits, scholarship exemption, and deductions for student loan interest) and (2) saving for college (education, traditional and Roth IRAs, Series EE U.S. bonds, and state tuition programs).

REDUCING CURRENT COLLEGE COSTS

The Hope Scholarship Credit – This credit (direct dollar-for-dollar reduction in tax) applies to each student for each of the first two years of college (as at least a half-time student). The credit equals 100% of the first \$1,000 of *tuition* and *fees* and 50% of the next \$1,000, for a maximum credit of \$1,500. The \$1,000 amounts are adjusted for inflation beginning in 2002. If there is more than one qualifying student in a family, the credit can be claimed for each.

Unfortunately, the credit is phased out for married couples filing jointly between \$80,000 and \$100,000 of adjusted gross income (AGI), and for single taxpayers between \$40,000 and \$50,000 AGI. The AGI limits also are adjusted for inflation beginning in 2002.

If unable to be used in the current year, the credit cannot be carried over or back. The credit offsets alternative minimum tax (AMT) as well as regular tax through 2001, then is scheduled to offset only regular tax.

The student for whom the credit is claimed must be the taxpayer, taxpayer's spouse, or a person claimed as a dependent.

Planning Idea → *If the parents have income too high to use the credit, and the child/student owes some income tax, the parents can forego claiming the child as a dependent, positioning the child to claim the credit himself, but only with respect to qualifying expenses paid by the child or by a third party, such as a grandparent. Note that if the parents qualify to claim the child/student as a dependent, but elect not to, the child cannot claim himself. However, with the deduction for personal exemptions being phased out for those with higher incomes, there may be little or no tax cost associated with no one claiming the exemption. This potential planning applies to the Hope Scholarship credit and to the Lifetime Learning credit, discussed next.*

The Lifetime Learning Credit – This credit, which is computed on a per-taxpayer rather than per-student basis, is based on *tuition* and *fees* up to \$5,000. The credit is 20% of qualifying expenses, so the maximum credit is \$1,000. After 2002, the maximum expenses qualifying for the credit are \$10,000, for a maximum \$2,000 credit.

Tuition and *fees* for undergraduate and graduate courses qualify. There is no requirement that the student be enrolled for at least one-half of a normal academic load to qualify for the Lifetime Learning credit. Individual courses, not part of a degree program, taken to acquire or improve job skills qualify. If the Lifetime Learning credit is taken for such courses, their cost cannot also

be taken as a deduction. Note that courses involving sports or hobbies do not qualify, unless they are part of a degree program.

The Lifetime Learning credit phases out at the same AGI amounts as the Hope Scholarship credit. This credit also cannot be carried over or back, and it also offsets AMT, at least until 2002.

If expenses qualify for both the Hope Scholarship and Lifetime Learning credit, they can be used only for purposes of the Hope Scholarship credit. "Excess Hope Scholarship expenses" don't qualify for the Lifetime Learning credit.

Here are some other significant rules applicable to both the Hope Scholarship and Lifetime Learning credits:

- Neither credit is allowed in a tax year if the taxpayer receives any excludible distributions from an education IRA (discussed later) in the same year.
- The amount of any nontaxable scholarships received reduces the amount of tuition and fees otherwise qualifying as the basis for a credit.
- Ordinarily, tuition must be paid in the same tax year as the related academic period begins, but credit can be claimed for the tax year of payment if the related academic period begins by March of the following year.

Scholarships – If certain conditions are met, scholarships represent income exempt from income tax (IRC Section 117). To be exempt, the scholarship must not be compensation for services, and it must be used for *tuition, fees, books, and supplies* (not *room and board*).

Interest on Student Loans – Subject to several conditions, interest paid on student loans of up to \$2,000 in 2000 and \$2,500 in 2001 and after is deductible. The deduction, however, is phased out between \$40,000 and \$55,000 AGI on single returns and \$60,000 and \$75,000 AGI on joint returns. The AGI limits are adjusted for inflation after 2002.

The deduction, if available, is claimed “above-the-line,” meaning that it is allowed whether or not one itemizes deductions. The interest deduction may be claimed by the student or a parent, but is only available to the one who is indebted and is paying the interest, and it cannot be claimed by a student who is claimed as a dependent by another person.

Only interest paid during the first 60 months (whether or not consecutive) in which interest payments are required qualifies.

Planning Idea → If the parents are expected to have too much income to be able to use the deduction, consider having the student, who normally may be expected to have less income, borrow the funds.

Planning Idea → A home equity loan, if available, may be a better financing arrangement. Interest deductions normally are less restricted on home equity loans.

TAX-ADVANTAGED SAVING FOR COLLEGE

Education IRAs – These accounts are structured so that contributions are nondeductible, current earnings are nontaxable, and distributions of cumulative earnings are nontaxable if distributions are used for qualified higher education expenses. Contributions are subject to AGI-based phase-outs: \$95,000-110,000 for single returns and \$150,000-160,000 for joint returns. The cap of \$500 contributions per child per year causes these accounts to be of limited value. If you contributed \$500 per year for a child from birth through age 18 (the limit), and earned 8% on the account, the education IRA when the child turns 18 would be worth \$18,725, unlikely to be sufficient to fund even one year of college at costs 18 years from now.

What happens if the IRA beneficiary doesn’t go to college? When the beneficiary reaches age 30, the account must be distributed to the beneficiary or rolled over into another education IRA for the benefit of a “family member.” Distributions from education IRAs exceeding qualifying

expenses are taxable (to the distributee, not the contributor) and, with limited exceptions, subject to a 10% penalty.

Contributions to an education IRA for a particular year must be made by December 31 of that year. Rules allowing contributions by April 15 of the following year for other types of IRAs don't apply.

Planning Idea → *Because the beneficiary of an education IRA can elect to waive the exclusion, it may be a good idea to do so if use of a Hope Scholarship or Lifetime Learning credit is more valuable to the student (or to his or her parents).*

Traditional IRAs – Traditional IRAs funded with deductible contributions are useful for higher education savings in limited situations. A significant factor is the exception to the 10% penalty tax for withdrawals to pay higher education expenses. Consider the following situations:

- Relatively older parents who expect to be retired when the child attends college may be able to defer income into a lower bracket during retirement years.
- A child with earned income may achieve tax deferral on up to \$2,000 annual earned income by utilizing a traditional IRA.

Traditional IRAs funded with nondeductible contributions may be used in the same situations, deferring tax on the earnings of the account. While anyone with earned income, regardless of the amount of total income, can fund nondeductible IRAs, deductions for contributions to traditional IRAs are limited by certain factors, including the taxpayer's or spouse's participation in an employer-sponsored plan and AGI.

Roth IRA – If withdrawals are taken from a Roth IRA to pay higher education expenses, the result is the same as in the case of a nondeductible traditional IRA, unless the account holder has reached age 59-1/2 and the account has been open at least 5 years. In this latter case, neither income tax nor the 10% penalty tax applies.

Planning Idea →Because the use of traditional or Roth IRAs for education expenses may force funds out of these retirement planning vehicles before they otherwise would be distributed, they generally are not viewed favorably for education savings.

EE Bonds – EE bonds are zero-coupon U.S. Treasury debt securities bought at a discount. If EE bond proceeds are used to pay college tuition and fees, the earnings (the spread between the proceeds and the discounted purchase price) are tax-exempt. Note that because EE bonds are U.S. Treasury obligations, the earnings are always exempt from state income taxes.

The exemption phases out on single returns with AGI of \$50,850 to \$65,850 and on joint returns with AGI of \$76,250 to \$106,250. Further, the expenses for which the proceeds are used must be those of the bond owner or the bond owner's spouse or a dependent; the bonds must have been issued since 1989; and the bond owner must have been at least 24 years old when the bond was issued.

As a practical matter, these bonds are of limited use. The greatest potential income exclusion is available the longer the bonds are held, but whether or not the income is exempt is determined when the bonds are redeemed to pay college expenses. The longer the period between buying and redeeming the bonds, the less predictable one's income is at the time of redemption. Further, the requirement that the bonds be issued since 1989 and that the owner have been at least 24 when they were issued makes it possible only in an extreme example of an older student for the bonds to be bought by the prospective student, rather than by a parent.

STATE TUITION PROGRAMS

Qualified State Tuition Programs (QSTPs), or Section 529 Plans - QSTPs have become the most attractive of college savings programs which are tax-advantaged. While the plans have been available for awhile, early versions were structured such that they were of questionable value. Newer plans are significantly more attractive.

QSTPs are unique in that they are subject to Internal Revenue Code qualification requirements, but are operated by sponsoring states under various policies defined at the state level. There are two basic types of QSTPs: (1) prepaid plans, and (2) savings plans.

Prepaid plans allow individuals (generally parents) to prepay for college education costs of a designated beneficiary (generally a child) at specified institutions and thereby lock in the price. The prepayments are invested by the QSTP. In effect, the investment return is guaranteed to keep pace with inflation in the cost of covered educational services. If the QSTP earns more than enough to finance covered educational expenses, the plan keeps the excess. If the QSTP has a deficit, the plan sponsor is responsible for it.

Unlike prepaid plans, QSTP savings plans make no promises that contributions will cover future college education expenses. As the name implies, these plans provide savings accounts for higher education expenses. The bad news is that a savings plan may not fully fund college education costs, but the good news is that a savings plan has upside potential. Some of the more recently established plans invest more aggressively and may deliver better returns. At college time, the account is drawn down to pay for some or all of the student's eligible expenses.

Plans vary widely from state to state. Some plans require the beneficiary to go to a specific college or group of colleges defined when the plan is established. Others allow the beneficiary to select from virtually any college to be determined at college age, not at initiation of the plan. Several plans accept out-of-state contributors. Therefore, if an individual lives in Kentucky, for example, and believes another state provides a better plan, that individual may be able to contribute to another state's plan. Some states use large investment companies such as Merrill Lynch, Fidelity, or TIAA-CREF to administer their plans and invest plan funds.

Among common features of QSTPs are the following:

- QSTPs maintain separate accounts for each designated beneficiary.
- QSTP funds can be used for *tuition, fees, room, board, books, and supplies* at accredited colleges or universities in the U.S.
- Both undergraduate and graduate school can be covered.

- Contributors and beneficiaries cannot direct how QSTPs are invested after contributions have been made. However, in some plans, the person establishing the account is permitted to select among different investment strategies offered by the plan.
- QSTPs must take steps to ensure contributions will not exceed the amount needed to finance the designated beneficiary's education expenses (actuarially determined).
- Money can be rolled-over to the QSTP account of another beneficiary.

How do QSTPs work from a tax standpoint? There are income, estate and gift tax implications involved with QSTPs:

- No eligibility phase-outs exist for high income taxpayers, so tuition savings plans represent the only college savings vehicle which is available regardless of income level.
- Earnings on QSTPs are tax-deferred.
- QSTP distributions result in taxable income (only on the earnings portion) even if the money is used for education expenses. However, the income is taxed to the student rather than to the parent, creating the potential to shift income to a lower tax rate.
- Contributions to QSTPs are considered to be taxable gifts (not of a future interest). Contributions to QSTPs are not transfers excluded from taxable gifts as tuition payments under IRC Section 2503(e). If the contribution for a prospective student exceeds \$10,000 in any year, an election can be made to spread the gift over 5 years, the year of the contribution and the succeeding 4 years. Therefore, a married couple may be able to contribute a lump sum of \$100,000 to the account in a particular year without causing taxable gifts.
- The portion of a contribution excludible from taxable gifts under the annual exclusion also would be excludible for purposes of the generation-skipping transfer tax.
- QSTP balances generally are not included in the contributor's gross estate. However, if the election was made to treat the contribution as a gift over 5 years, the portion of the contribution allocable to the post-death portion of the 5-year period is included in the donor's gross estate.
- The gross estate of the account's beneficiary would include the value in the account.

- QSTP earnings generally are exempt from state income tax.
- Qualifying withdrawals from QSTPs do not disqualify use of the Hope Scholarship and Lifetime Learning credits.

Planning Idea → *QSTPs may be especially attractive to wealthy grandparents who want to reduce the size of their taxable estates and assist with the education of their grandchildren. For example, a grandparent could contribute \$50,000 immediately to an account naming a newborn grandchild as beneficiary. With a return of 8% annually, that fund would total almost \$200,000 when the child turns age 18.*

What happens if the money isn't needed for educational purposes? If the person who establishes the plan withdraws funds, the earnings are subject to regular income tax and a 10% penalty. If the child receives a scholarship, the owner of the account can withdraw an amount equal to the scholarship without penalty, but will pay tax on that portion of the account's earnings. Alternatively, most plans allow the owner of the account to name another family member as the beneficiary, if the primary beneficiary does not use the account in full or in part.

A change in an account's beneficiary, or a rollover to the account of a new beneficiary, is treated as a taxable gift if the new beneficiary is assigned to a generation below the generation of the old beneficiary. Such a transfer would not be a taxable gift if the new beneficiary is a "family member" and is assigned to the same generation as the old beneficiary. If the new beneficiary is assigned to a lower generation than the old beneficiary, the transfer would be a gift from the old beneficiary to the new beneficiary, and would be subject to the GST tax if the new beneficiary is assigned to a generation which is two or more levels lower than the old beneficiary's generation. The 5-year averaging election, discussed above, can be applied to this transfer.

Planning Idea → *Should parents who ordinarily make maximum annual exclusion gifts to their children anyway consume their annual exclusions with contributions to college savings plans, considering that paying for their children's college educations later would not involve transfers treated as gifts?*

Stated differently, which is more valuable – removing maximum wealth from the parents' estate through annual exclusions, or the income tax deferral and the income tax savings resulting from lower tax rates expected through funding a QSTP? The answer will depend on the facts and assumptions applicable in each case, but in one "real case" we analyzed, maximum use of annual exclusion gifts was more valuable than the income tax benefits by a factor of more than 2-to-1.

Planning Idea → For a "reluctant donor," a QSTP's flexibility may be attractive. The donor/account owner can control the timing and amount of distributions, change the beneficiary, and even take the money back (incurring a tax penalty).

Here are a couple of useful Websites for obtaining more information about QSTPs:

- www.collegesavings.org (run by an affiliate of the National Association of State Treasurers)
- www.savingforcollege.com (a site which, among other features, rates and describes the main components of different states' plans)

Kentucky Education Savings Plan Trust – Kentucky has contracted with the huge New York-based investment firm TIAA-CREF to manage the investments of its tuition savings program. Kentucky has placed a limit of \$100,000 on the total amount that can be contributed for a single beneficiary through the trust. While withdrawals from Kentucky's plan will be taxed at the Federal level at the beneficiary's rate, these earnings will be exempt from Kentucky income tax. Kentucky has incorporated into its plan the flexibility many other states have – college costs at institutions not only within Kentucky, but at other accredited higher education institutions are covered. Further, amounts in the account are excluded from the calculation of state student aid eligibility for Kentucky residents. Also, Kentucky has included a feature in its plan which enables a student whose family has moved to another state to receive Kentucky in-state rates at its public institutions, if within 8 years after the account is opened a minimum of \$2,400 has been contributed to the account while the beneficiary is a Kentucky resident.

Kentucky's plan is available to anyone who has "Kentucky ties" – has a current or former residence in Kentucky, is currently or was formerly employed in Kentucky, or has a family member with a current or former residence in Kentucky. The beneficiary under Kentucky's plan must be a child under the age of 15. A beneficiary can have more than one account. The accounts are specific to the contributor/account owner, not to the beneficiary. Kentucky charges no fee for opening an account, but there is an annual asset-based management fee (0.8%) paid from the trust to TIAA-CREF to cover investment management and administrative services. Kentucky does allow the flexibility provided in Federal law by allowing transfers of money in an account to another beneficiary without considering this transfer to be a taxable distribution. There is a nominal administrative fee involved with changing beneficiaries - \$25 currently.

What happens to someone's account in the event of the account owner's death? The account owner can designate someone as a "contingent" account owner, to become the owner of the account upon death. This new owner will have the same control over the account that the original owner did – to direct withdrawals or change the beneficiary. While an account is treated as part of the decedent's estate and may be transferred to a new owner under the terms of a will or other applicable state law, the value is not treated as part of the owner's estate for Federal estate tax purposes.

If a withdrawal is made other than for qualified higher education expenses of the designated beneficiary, the earnings portion of the withdrawal is subject to a 10% penalty. No penalty applies, however, if the withdrawal is due to the beneficiary's death or disability, or to the award of a qualifying scholarship to the beneficiary.

Contributions are invested in portfolios based on the year of birth of the beneficiary. Generally, the younger the beneficiary is, the heavier will be the account's weighting toward equities, with a lighter weighting toward fixed income securities. As the beneficiary approaches college age, the money is invested more conservatively, with a greater weighting toward fixed income securities. Neither the principal nor any income is guaranteed; returns fluctuate based on the performance of the underlying mutual funds.

Account owners receive quarterly reports showing the amounts contributed and the value of accounts.

The 2000 Kentucky legislature has directed the State Treasurer to establish a prepaid tuition plan to commence no sooner than the 2001-2002 academic plan.

The SavingForCollege.com website gives Kentucky's plan a 5-cap rating, its highest.

**ETHICAL ISSUES
FOR ESTATE PLANNING
AND FAMILY BUSINESS SUCCESSION LAWYERS**

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ETHICAL ISSUES FOR ESTATE PLANNING AND FAMILY BUSINESS SUCCESSION LAWYERS

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Ethical Issues for Estate Planning and Family Business Succession Lawyers

by
Eric A. Manterfield

While estate planning is frequently non-adversarial and client-centered, there are numerous ways in which the estate planning lawyer can be confronted with ethical issues.

Someone once said that you either have integrity or you don't, but we can all learn something more about the rules that apply to ethical dilemmas!

Too many unhappy beneficiaries are seeking ways to premise malpractice actions by citing violations of the ethics rules, particularly conflicts of interest. All estate planning lawyers must be aware of the ethical constraints that apply to our work. To the extent that the lawyer becomes more aware of the issues involved, there can be more effective loss prevention.

Any examination of the ethical issues for estate planning lawyers must begin with Kentucky's Rules of Professional Conduct ("RPC"), which govern the ethical issues for lawyers (SCR 3.13 et seq.).

My hope in this work is not to provide an ironclad "road map" for every situation; rather, my goal is to illustrate the rules in several common situations, to give some thoughts on the resolution of the problems and to raise issues that are commonly ignored (perhaps in the mistaken belief that the problem will "go away" all by itself).

It is not particularly useful for a discussion of these issues to conclude with the observation that "this is an interesting problem," with no guidance on a solution!

Little can be obtained from reported decisions in the ethics arena. Perhaps this is because violations of a lawyer's ethical requirements more frequently lead to malpractice actions.

A lawyer's obligations begin with the need to provide a client with "competent representation" (RPC 1.1) and to keep the client "reasonably informed" (RPC 1.4). The latter obligation frequently causes problems for those lawyers who are less than diligent. Beyond these basic requirements, however, a lawyer can be presented with ethical issues involving conflicts of interest, the failure to exercise independent judgment, the violation of client confidences, incomplete or inadequate representation, even potential criminal liability for bankruptcy fraud and excessive fees. Starting with some thoughts on engagement letters and client communication, I will spend most of this paper on the other issues listed.

Engagement Letters

The lawyer and the client must agree on the scope of the lawyer's representation according to RPC 1.2. How should that agreement be documented? Should the lawyer use an engagement letter?

In its 1989 Commentary on RPC 1.2 (hereafter "Kentucky Commentaries"), the Kentucky Supreme Court noted that "the objectives or scope of services provided by a lawyer may be limited by agreement with the client...." The Kentucky Commentaries to RPC 1.5 states that "in a new client-lawyer relationship, ... an understanding as to the fee

should be promptly established....A written statement concerning the fee reduces the possibility of misunderstanding.”

Some lawyers may find a formal engagement letter to be intrusive on the so-called "open and honest" relationship they have with their clients. Why put "the objectives of the representation" [RPC 1.2(a)] in a letter, they wonder, when both the client and the lawyer know perfectly well that the client came in for estate planning services?

This issue was addressed in the Commentaries on Model Rules of Professional Conduct, adopted by the Regents of the American College of Trusts & Estates Counsel (hereafter "ACTEC Commentaries") on October 18, 1993:

"Variations in the circumstances and needs of trusts and estates clients and in the approach and practice of individual lawyers naturally result in lawyers and clients adopting very different methods of working together. The agreement between a lawyer and client regarding the scope and objectives of the representation is often best expressed formally in an engagement letter or other written communication. However, most often their agreement is implicitly reflected in the manner in which they choose to work together."

Estate planning engagement letters. I recommend that the lawyer consider the use of written engagement letters, however, particularly regarding the representation of a married couple. As will be discussed later in this material, it is frequently helpful if the lawyer advises the clients at the beginning of the representation that there can be no confidences in the lawyer's representation of a husband and wife. This engagement letter

can also set forth the method of the lawyer's compensation, the procedure for billing, the termination of the attorney-client relationship and dispute resolution.

A form of engagement letter for estate planning services is attached at the end of this material.

Family business succession planning engagement letters. These issues may become even more critical if you represent a family business and its multiple owners who come to you for family business succession planning advice.

The Kentucky Commentaries to RPC 1.13 provide that:

“There are times when the organization's interest may be or become adverse to those of one or more of its constituents [officers, directors, employees and shareholders]. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation.”

Potential conflicts of interest among the owners of the business should be acknowledged.

A written engagement letter can also set forth the method of the lawyer's compensation, whether the fees are to be paid by the business or its owners, the procedure for billing, the termination of the attorney-client relationship and dispute resolution.

A form of engagement letter for family business succession planning is also attached at the end of this material.

Diligence and Effective client communication

RPC 1.3 demands that "a lawyer shall act with reasonable diligence and promptness in representing a client." Indeed the Kentucky Commentaries note that "perhaps no professional shortcoming is more widely resented than procrastination."

The appearance of procrastination, as well as its reality, can be exacerbated by ineffective client communications.

The failure to communicate regularly with a client may be one of the leading causes of ethical lapses and estate planning malpractice complaints, particularly with respect to the reasonableness of fees. The problem may be more acute in representations where much of the work is done outside of the eyes of the client.

Examples include estate work, where the personal representative and beneficiaries are often unaware (in the absence of good client communication) of the extensive work done on tax returns, inventories and the like. Other examples include will contests with corresponding time spent on legal research, depositions, document review and other matters not commonly requiring client participation, and planning for lifetime gifts with difficult valuation issues.

The more the work is done beyond the client's eyes, the more important is the requirement that we keep the client "reasonably informed." This may be more a matter of common sense than of malpractice.

Conflicts of Interest

Kentucky's Rules of Professional Conduct have four provisions, with four different standards, that deal with conflicts of interest:

1. RPC 1.7(a) deals with the representation of multiple clients whose interests are **directly adverse** to each other;
2. RPC 1.7(b) deals with the representation of one client whose interests are only **materially limited** by the lawyer's representation of another client;
3. RPC 1.9 deals with the representation of a new client whose interests are **materially adverse** to those of a former client; and
4. RPC 2.2 deals with the lawyer's involvement as an intermediary between multiple clients, so long as there is little risk of **material prejudice** to their respective interests if the intermediation is unsuccessful.

These four rules can have significant implications for the estate planner in even the most common situation. The lawyer's representation of multiple clients often produces a better result than would be the case had each party sought separate counsel.

Economies of scale can be achieved, reducing the cost of legal services; the estate plans can be more effectively coordinated, particularly where the predominant relationship between the parties is cooperative and not adversarial.

But is it that simple?

Representation of a married couple. While the conflicts inherent in the lawyer's representation of a couple in a second marriage may be obvious, conflicts can arise even in the case of a first marriage:

- Should jointly held assets be divided between the spouses (so as to fund a credit trust at the death of whichever one is the first to die) or should the joint property just pass outright to the surviving spouse?
- Should a spouse waive statutory benefits under retirement benefits, so that those dollars can pass into a QTIP trust at the death of the participant?
- Can the lawyer represent both spouses when the marital gift will be to a QTIP trust for the benefit of children of a prior marriage?
- Can the lawyer represent both spouses when creditors of one spouse want to reach assets of the other spouse?
- Can the lawyer advise a client of the benefits of a QTIP trust, to assure that assets will pass as "they" intend, rather than an outright gift to the other client/spouse?

Even if the lawyer represents a happy couple (whether in a first or subsequent marriage) whose interests are today the same, there is always the potential for conflict.

Some lawyers may feel that the potential for conflict is so high that one spouse must always seek other counsel. However, that solution may be too drastic and not in the best wishes of the couple you represent. RPC 1.7 and 2.2 permits joint representation, so long as the potential for conflict is raised and the clients together consent to the joint

representation. This is clearly another reason to have a written engagement letter with a married couple.

The Kentucky Commentaries to RPC 1.7 state that

“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.” (Emphasis added)

Most married couples will wish to “accommodate the other interest involved” and have you represent both spouses. But you must document that consent.

Similar guidance is found in the Kentucky Commentary to RPC 2.2:

“A lawyer acts as intermediary in seeking to establish or adjust a relationship between clients on an amicable and mutually advantageous basis.... The lawyer seeks to resolve potentially conflicting interests by developing the parties’ mutual interests. The alternative can be that each party may have to obtain separate representation, with the possibility in some situations of incurring additional cost, complication or even litigation. Given these and other relevant factors, all the clients may prefer that the lawyer act as intermediary.”

Here is some language which I use in engagement letters sent to married couples:

"We represent you both. Our representation will be of you jointly in your estate planning. Because we represent both of you, anything disclosed by either one of you to me or to any personnel at [the law firm] will necessarily be open for complete disclosure to the other.

I am not suggesting that this would become an issue at any point; rather, it is appropriate for us to advise all married couples of the fact that our representation of you is as a couple, simply because we are representing two people whose interests are not always exactly the same."

This approach seems to me to be preferable to an engagement in which the lawyer represents each spouse independently of the lawyer's representation of the other spouse.

Even with this consent by both husband and wife to the lawyer's joint representation, conflicts can later arise.

1. Where the lawyer meets with only one spouse. The lawyer may have a conference with only one spouse, either because the other spouse is working, is with the children, is having a bad day or what have you. Suppose that the client with whom the lawyer meets assures the lawyer that the other spouse is in full accord with the estate plan. Can the lawyer simply prepare documents and have them signed on that assurance, perhaps with the lawyer never meeting that other spouse?

I suggest that the lawyer always meet with the other spouse, to verify the statement that he or she is in "full accord with the estate plan." Go over the options and decisions that were made in the first conference. Is there understanding? Is there agreement?

If, as is frequently the case, the answers to these questions are in the affirmative, the lawyer can proceed with the execution of the documents. If, on the other hand, there

is not agreement, the lawyer must decide whether joint representation can continue. It probably cannot.

2. Gift splitting. Suppose that both spouses have separate assets and that one client wants to make gifts to children from a prior marriage. Can the lawyer advise the other spouse with no further discussion merely to consent to gift splitting even with the knowledge that it may impair gifts by that other spouse?

Merely asking the question leads to the obvious answer of "no." However, if the lawyer advises both spouses of the implications of gift splitting, there is no reason why the lawyer cannot continue to represent both of them in my opinion.

3. Where the husband and wife cannot agree. While many couples agree on the basic components of an estate plan, there may easily be disagreements. Do those disagreements present the attorney with such a conflict that representation must be withdrawn? That may depend upon the nature of the disagreement.

If the husband and wife cannot agree, for example, on the people who should serve as guardian for minor children at the death of the surviving spouse, the attorney should be able to prepare wills for each spouse with conflicting wishes in that regard. Both spouses should be advised of the wishes of the other; each is advised that it is the will of the second to die which will probably be examined by the local court when determining the guardian. If they each want to proceed and sign a will on that

understanding, the disagreement of the couple is not sufficient that the lawyer must withdraw in my opinion.

If, on the other hand, the disagreement is more fundamental, the attorney can oftentimes be presented with an unreconcilable conflict. Suppose that the husband wants the marital share put into a QTIP trust and his wife is furious about that. Suppose that one spouse refuses to transfer ownership of a farm into their names as tenants in common, thereby giving up the right of survivorship. Suppose that one spouse creates a marital power of appointment trust on the assumption that the power will never be exercised, but the other spouse expresses an intent to exercise the power?

Here is language from the Kentucky Commentaries to RPC 2.2:

“Since the lawyer is required to be impartial between commonly represented clients, intermediation is improper when that impartiality cannot be maintained. For example, a lawyer who has represented one of the clients for a long period and in a variety of matters might have difficulty being impartial between that client and one to whom the lawyer has only been recently introduced.”

Can the lawyer then withdraw from representation of the spouse of your long time client only? May the lawyer continue to represent the long time client in the estate planning work, while sending the spouse to new counsel?

The answer to this question is more practical than ethical, in my opinion. If their differences on these issues are this fundamental, I recommend that you represent neither of the spouses on this work. It is reasonable to foresee this planning process becoming unpleasant. It might be preferable to have two new attorneys separately represent the

long time client and his wife on this work (with all its marital difficulties), after which the long time client should return to you for the recurring work (in other areas) you have always handled.

I suggest that, under those circumstances, it is advisable for the lawyer to withdraw from representation from either spouse and recommend that each seek separate counsel.

4. If the couple were later to divorce. Suppose that the lawyer prepared estate planning documents for a married couple. The husband was the CEO of a local corporation which also has used the lawyer's firm for legal representation.

Some years after the preparation of the estate plan, the husband consults the lawyer about a potential divorce from his wife. The only service performed for this wife was the preparation of a will years ago. Can the lawyer represent the husband in this divorce action?

RPC 1.9 deals with conflicts of interest with a former client, in which a lawyer who previously represented a client cannot later represent another person "in the same or a substantially related matter" where the former client's interests are "materially adverse" unless the former client consents to the representation.

To the extent that the pre-divorce counseling of the husband was a "substantially related matter" to the estate planning services previously provided to the wife, RPC 1.9 would apply. The lawyer presumably obtained confidential information about assets as

part of the estate planning work which could be used later (she asserts) to the wife's detriment in the divorce proceeding.

The Kentucky Commentaries to RPC 1.9 note specifically that "information acquired by the lawyer in the course of representing a client may not subsequently be used by the lawyer to the disadvantage of the client."

Can the now ex-wife (bitter over the terms of the divorce) file an ethics complaint against the lawyer on the basis of a conflict of interest? Had it not been for the lawyer's improper utilization of confidential information received from the wife in the estate planning process, she argues, a more favorable settlement could have been negotiated in the divorce property agreement.

Even if the lawyer refers the divorce work to another law firm, there may easily be liability to the extent that the lawyer counseled the husband before the divorce filing (proposed separation, probable amount of child support payments, possible terms of a division of the marital assets and the like).

Recall that RPC 1.9 permits the lawyer to consult with the husband only with the consent of the former client (wife) "after consultation." The lawyer should make full disclosure to the wife before any services are provided to the husband and obtain her consent to this new representation. The lawyer may believe that the divorce work was sent elsewhere because of this conflict of interest; however, if the lawyer merely discussed pre-divorce matters with the husband, an ethical violation may have occurred.

Family estate planning. Lawyers are frequently called upon to assist in estate planning for multiple generations. What conflicts may arise in that representation of both the parents and the children (and even grandchildren)?

Suppose that the parents discuss the advisability of creating generation skipping trusts for the benefit of children and grandchildren. The interests of the children may not be adequately met by a plan that gives them only an income interest. What is the lawyer's obligation to the children/clients to argue against a plan desired by the parents/clients?

Suppose that the parents own a successful company, with one child active in the business and the other child not involved. The parents counsel with the lawyer about a recapitalization of their S corporation, so as to create both voting and non-voting shares. The plan is to leave voting shares to the child who is active in the business and non-voting shares to the other child.

Can the lawyer continue to represent the children, recognizing that the interests of the child not active in the business may not be well served by a plan that distributes only non-voting shares?

Is the issue any different if the parents want a plan which distributes assets outright to one child and leaves the inheritance for another child in a generation skipping trust (perhaps because the latter child is irresponsible, on drugs and so forth). If the lawyer represents the parents and the child who will receive the outright distribution, is there a potential charge of undue influence with the lawyer caught in the middle?

Suppose that the parents want the lawyer to prepare a pre-marital agreement for a child, even to the extent of paying the lawyer's fee. The lawyer has provided legal services to the child before and she sees no reason for a pre-marital agreement. See RPC 1.8(f) dealing with fees paid by someone other than the client.

Some answers to these questions may be found in RPC 1.7(b) which reads as follows:

"(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." (Emphasis added)

The problem discussed earlier of conflicts with a former client may also arise in the family representation setting. Suppose that the lawyer represents the owner of a closely-held business and the son who actively works in the company. Estate plans are prepared for each client, with the father leaving control to the son and placing other assets in trust for the children who are not active in the business.

What is the consequence if the father later approaches the lawyer and requests a codicil to the will, in which the control shares are to be divided equally among all the

children? The son learns of this change in his father's estate plan only after the death of his father.

Remember that the lawyer also prepared estate planning documents for the son. The son is the lawyer's client or at least used to be the lawyer's client. When the father approached the lawyer about a codicil, was not the lawyer's new work for the father a "substantially related matter" to the estate planning that was done previously and will not the lawyer's new work be "materially adverse" to the interests of the son?

The preparation of the codicil for the father should be prepared only with the consent of the son. To proceed otherwise gives the son an open invitation to assert an ethics violation by the lawyer.

Representing multiple owners of a business (and the business itself). While many of the same issues associated with family estate planning arise in the context of family business succession planning, the opportunities for conflicts of interest compound:

1. **Where the lawyer meets with only one of the business owners.** The lawyer may have a conference with only one business owner, typically the majority owner. Suppose that the client with whom the lawyer meets assures the lawyer that the other owners of the business (the owner's children, for example) are in full accord with the business succession plan. Can the lawyer simply prepare documents and have them

signed on that assurance, perhaps with the lawyer never meeting that other owners of the business?

Just as in the case of marital estate planning, I suggest that you always meet with the other owners, to verify the statement that "they are in full agreement with my plan." Go over the options and decisions that were made in the first conference. Is there understanding? Is there agreement?

2. Where the owners of the business do not agree. While many of the owners may agree on the basic components of a business succession plan, there may easily be disagreements.

If the owners of the business cannot agree, for example, on whether all owners must also work in the business, on who will become the next manager upon the retirement or death of the majority owner or on the pricing mechanism for a buy-sell agreement, it is unlikely that you can represent all the owners of the business. Each should have his or her own separate counsel.

If there is a fundamental disagreement over an issue of this significance, you simply cannot represent everyone. But can you continue to represent the business and the majority owner who first approached you about this work? The answer to that question may depend on the extent of the work you have done so far and the extent to which your prior work had been on behalf of the now dissenting business owners.

If there is any chance that you have, in fact, provided legal representation to those owners of the business who are now in disagreement with the majority owner's wishes, you cannot continue to represent the majority owner without the written consent of all the owners.

I suppose that there may be a disagreement over "minor" issues, which are so insignificant that you may continue to represent all the owners in an effort to reach an amicable resolution; however, great caution should be exercised whenever there is **any** disagreement among the owners. Raise the conflict of interest issue and ask them whether each is willing to have you continue to advise **everyone**.

Even if you feel the issue is not significant and the owners all want you to continue, I advise you to get their consent to your continued representation in writing. If everything blows up in the future, people have too short a memory for you to rely on their assurance that it is "not necessary" for you to get this consent in writing.

3. If an owner of the business were later to leave. Suppose that you prepared business succession documents for a business and its owners with their consent. You did, in fact, represent everyone. Some time later one of the owners has a falling out and leaves the business. This departure is not pleasant and there are disagreements over issues such as the price to be paid under a buy-sell agreement or the nature and extent of any non-compete restrictions which you helped put in place.

Can you represent either side in the resolution of these issues? No. The departing owner was your client and you cannot take a position which is adverse to his or her interest without full disclosure and full written consent.

RPC 1.9 deals with conflicts of interest with a former client, in which a lawyer who previously represented a client cannot later represent another person "in the same or a substantially related matter" where the former client's interests are "materially adverse" unless the former client consents to the representation.

If you helped put the buy-sell agreement or the covenant not to compete in place, it seems clear that any disagreement over the provisions of these documents is a "substantially related matter" when you previously represented the departing owner of the business. It is not sufficient for you to protest that this departing owner was not your "real" client in the prior work. You did, in fact, provide legal services to that individual, who is entitled to the protection of the conflict of interest provisions of our ethical standards.

You cannot represent either side without everyone's written consent. Even if you refer the work to another law firm, there may easily be liability to the extent that you counseled the majority owner of the business before another attorney was brought in. Did you give any advice which might later have been used against the interest of the dissenting owner?

Recall that RPC 1.9 permits the lawyer to consult with the majority owner only with the consent of the former client (departing owner) "after consultation." The lawyer

should make full disclosure to the former client before any advice is given to the majority owner and obtain the written consent of the dissenting owner to this new representation of the majority owner.

Representing the elderly parent or child of an existing client. Lawyers are frequently asked for advice about elderly relatives. "How can we get Dad on Medicaid?" they wonder? Parents may want the lawyer to advise children about expected inheritances. The conflicts are apparent.

The existing client may bring in his or her parent to do estate planning. Sometimes, the parent is not able to come to the lawyer's office, but the lawyer is assured by the existing client that he or she will tell the parent all that he or she needs to know. Indeed, the child will arrange for the execution of the documents without it being necessary for the lawyer ever to meet the "client."

Suppose the lawyer represents the parent of a child who is about to receive a distribution from a trust established by another relative. The lawyer's client wants the lawyer to advise the child to take the inheritance and put it into an irrevocable trust for the child's benefit (perhaps revocable only with the consent of the parent, the lawyer's existing client).

Can you represent both the existing client and the relative, giving independent advice to each? Before the lawyer takes on the representation of this elderly parent or

this child of an existing client, RPC 1.7 requires the lawyer to determine that the new representation will not "adversely affect" the lawyer's representation of the existing client.

The rule goes on to require the lawyer to consult with both clients (the lawyer must meet with the elderly parent and with the child) to tell them of the possibility of a conflict. The lawyer must inform each client of the implications of the common representation and the risks and advantages involved.

RPC 2.2 may also be involved in multiple, generational representation of this sort, particularly where "the lawyer reasonably believes that the matter can be resolved on terms compatible with the clients' best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful...."

Written consents from both clients. If RPC 2.2 is applicable, the lawyer must consult with both clients, advising them of the implications of the joint representation, the advantages and risks involved, and the effect on the attorney-client privilege. Written consents must be obtained from everyone.

A client who is disabled. If one of the parties is under an incapacity, it appears that the conflict cannot be resolved. For example, if the elderly parent is incompetent,

can the child (existing client) consent on behalf of the parent on the authority of a durable power of attorney given to the child by the parent?

Perhaps, if it was an only child, there may be no other person with an interest; but what if the lawyer is consulted by only one child of several and the other children are not aware of the legal services to be provided to the incapacitated parent? I recommend that the lawyer not accept the waiver of a conflict signed by the single child without the knowledge and consent of the other children.

In a similar fashion, the consent of a minor cannot be obtained. Even when distribution is to be made on the day the child attains the age of majority, it is difficult to imagine a scenario in which the lawyer (with "consent" of the child) counsels the child -- just before his or her 18th birthday -- to put the expected inheritance into an irrevocable trust that cannot be changed by this new "client!"

How is putting the inheritance into an irrevocable trust in the best interests of the child (even though that is exactly what the parent desires)? Even if the lawyer believes that putting the inheritance in trust really is in the best interests of the child (presumably because the irresponsible child will waste the funds), the lawyer should consider RPC 1.14 (Client Under Disability) before advising this new client. A court appointed guardianship may be a more appropriate remedy.

Who pays the lawyer's fee? Finally, if the lawyer's fees are to be paid by the lawyer's existing client (the parents of the young child or the adult child of the elderly

parent, for example), RPC 1.8 requires the lawyer to disclose this fee arrangement to the new client and to determine that this fee arrangement will not interfere with the lawyer's independent judgment of what is best for the new client. The new client, of course, must then consent in writing to the fee arrangement.

The lawyer must exercise great care to overcome any argument that undue influence affected the lawyer's advice in these circumstances. This is an obvious problem when, at the urging of an existing client, the lawyer advises a young person to place assets in an irrevocable trust, primarily to protect the child from himself. In a similar fashion, you should be very wary when an existing client dictates the terms of his parents' wills, particularly if this new will gives to that child more than his "fair" share of the assets!

The safest avenue is to assume that full disclosure of the dual representation must be made to **both** parties and written consent must be obtained from each of them.

Multiple representation in an estate setting. It is clear that the lawyer is frequently presented with potential conflicts of interest when a client dies. That lawyer may represent the personal representative of the estate, the surviving spouse and, perhaps, the children, trustees or other beneficiaries of the estate.

RPC 1.7 states that the lawyer can represent these multiple clients, so long as the clients are advised of the implications of the common representation and the advantages and risks involved and if the clients all consent. Nevertheless, it is certainly possible that later, serious conflicts can arise during the estate administration, which will lead the

lawyer to withdraw as counsel for the personal representative, the surviving spouse or both.

If, as is frequently the case, there are estate beneficiaries who are not represented by the lawyer, the attorney for the personal representative must be certain that those beneficiaries understand that you do not represent them. RPC 4.3 provides that:

“In dealing on behalf of a client [the personal representative] with a person [the beneficiary] who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer’s role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding.”

Further guidance was given by KBA E-40, issued in 1997 by the Kentucky Bar

Association’s Ethics committee:

“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.

* * *

“4. The 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 multiple clients, and explains the limitations on the lawyer's actions in the event a conflict arises, and the consequences to the client 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." (emphasis in original)

Multiple representation in a trust setting. All these same rules and requirements relate to the lawyer who represents a trustee. The lawyer may simultaneously represent the surviving spouse and, perhaps, the children or other remainder beneficiaries of the trust if the requirements of KBA E-401 are followed.

Suppose that a question arises concerning the proper interpretation of the will or trust agreement. May the lawyer petition the court for instructions on behalf of the trustee and then take a position with respect to the resolution of the ambiguity? May the lawyer for the trustee represent the spouse in the subsequent hearing and assert a position on the merits of the matter before the court?

The answer is "no." Both the trustee and the trustee's lawyer are under a fiduciary duty of impartiality towards the interests of **all** trust beneficiaries.

This position is a well settled matter of common law. This principal was expressed well in the dissenting opinion in Estate of Goulet v. Goulet, 10 Cal.4th 1074, 1086, 898 P.2d425, 432 (1995), as follows:

“It has long been settled, not only in California but elsewhere, that a fiduciary (such as the trustee of a trust or the personal representative of a decedent’s estate) administering property on behalf of multiple beneficiaries must act impartially towards all the beneficiaries and must not favor, or expend funds litigating, the interest of one beneficiary over another. The fiduciary may not take sides when a dispute arises as to the relative rights and interests of various beneficiaries, and may not work to advance or oppose the claim of any beneficiary.” (emphasis added)

Other cases setting forth this rule of law include In the Matter of the Trust for Duke, 305 N.J. Super. 408, 702 A.2d 1008 (1995); The Northern Trust Company v. Heuer, 202 Ill.App.3d 1066, 560 N.E.2d 961 (1990); In re Cudahy, 26 Wis.2d 153, 131 N.W.2d 882 (1965); and In re James Estate, 86 N.Y.S.2d 78 (Surr. Ct. 1948).

In The Northern Trust Company case, the trustee had advocated a construction of the trust that was unfavorable to a beneficiary. The court held that while it was proper for the trustee to seek the court’s construction of the trust by filing the complaint for construction and in gathering and presenting the information necessary for the court to interpret the trust, it breached its duty of impartiality and exceeded its duty as trustee when it argued for an interpretation adverse to a beneficiary.

The court disallowed Northern Trust’s petition for attorney fees and costs related to the inappropriate activity. The court stated that while

“generally the costs of litigation to construe a trust in which there are adverse claims are paid by the trust estate,... where a trustee breaches its duty to administer the trust according to its terms and performs in a manner which favors one beneficiary over another, the trustee is not entitled to attorney fees and costs even though the breach is technical in nature, done in good faith and causes no harm.” (emphasis added)

The court stated further that "... it is preferable that we reiterate established precedent and foster every incentive for a trustee to adhere to its well-established duty of impartiality." 560 N.E.2d at 964, 965.

If the lawyer represents **most** of the trust beneficiaries, neither the trustee nor the trustee's lawyer may take a position on the merits because, to do so, must necessarily be adverse to the interests of some beneficiaries. Even if the lawyer represents **all** of the trust beneficiaries, a resolution of the ambiguity must have an negative impact on some of the lawyer's clients. That is an impermissible conflict of interest.

What if the beneficiaries agree on the resolution? If all the beneficiaries consent to a proposed resolution, the lawyer may present that settlement to the court; however, great care must be exercised by the attorney who attempts to negotiate that consent, to be certain that each of the lawyer's clients understand the role that is being played.

If the trust beneficiaries cannot agree on a resolution, the trustee must present the problem to the court, have the court give notice to all the beneficiaries and then the trustee must step back and let the beneficiaries make their own arguments as to the proper interpretation of the language. If the trustee were to argue in favor of one construction, it would violate the trustee's duty of impartiality because any interpretation will necessarily have a negative impact the interests of another beneficiary (if not, why have the interpretation issue presented to the court for resolution?).

The lawyer for the trustee may not assert a position for a beneficiary. Just as the trustee cannot assert a position in this action, the trustee's lawyer may not assert a position "solely" on behalf of a beneficiary. That representation conflicts with the lawyer's simultaneous representation of the trustee on all other trust matters, when the trustee must be impartial towards the interests of all beneficiaries in **everything**.

I suppose that it is possible for the lawyer to disclose to all the parties his or her joint representation of the trustee and some of the beneficiaries and to obtain their consent; however, I believe that the trustee should obtain the consent of the **other** trust beneficiaries (who are not to be represented by the lawyer) to this joint representation. And why would those other trust beneficiaries give their consent?

It is easier for the lawyer to decide whether to represent the fiduciary **or** the beneficiary, but not both.

The Failure to Exercise Independent Judgment

The lawyer can be presented with conflicts of interest, including the possible allegation that the lawyer violated his or her duty to exercise independent judgment, when a client asks the lawyer to serve as personal representative, to serve as trustee, to receive a gift under the will or trust agreement and so forth.

Gifts to the lawyer. While the lawyer may prepare estate planning documents for close relatives (parents, for example) from whom the lawyer will receive benefits in the future, the lawyer cannot do so if the client is not closely related. Guidance in these situations can be found in RPC 1.8(c):

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

The ACTEC Commentaries provide that "a closely related person is one who would receive part or all of the client's estate if the client were to die intestate; and the substantiality of a gift is determined by reference both to the size of the client's estate and to the size of the estate of the lawyer or the lawyer's spouse or children."

The prohibition against having an unrelated client make gifts to the lawyer also extends, of course, to gifts that are accomplished by use of joint ownership and beneficiary designations.

Selection of the lawyer as fiduciary. A client can name anyone he or she chooses as a fiduciary. There is nothing in the Rules of Professional Conduct which prohibits the selection of the lawyer as personal representative or trustee, so long as the client is properly advised, the appointment does not violate RPC 1.7 (Conflict of Interest -

General Rule) and 1.8 (Conflict of Interest - Prohibited Transactions) and the appointment is not the result of undue influence or improper solicitation.

Care must be exercised, however, to be certain that the lawyer's conduct (in preparing a will which names the lawyer as a fiduciary) does not have even the appearance of impropriety.

In order to advise the client "properly," the ACTEC Commentaries suggest that (before accepting an appointment as a fiduciary) the lawyer tell the client about the duties of the fiduciary, the ability of another individual or corporate fiduciary to serve in that capacity and the comparative costs of the different alternatives (including the fees to be paid to the lawyer as the fiduciary).

If the lawyer or the lawyer's firm also represents a prospective corporate fiduciary, the lawyer should disclose that representation to the client who is considering that bank as a fiduciary. Finally, the lawyer should advise the client if it is the bank's practice to employ as its counsel the attorney who wrote the will or trust agreement.

Can the lawyer serve both as fiduciary and as counsel to the fiduciary? While the ACTEC Commentaries note that such joint capacities may be appropriate when there has been a long standing attorney-client relationship,

"generally, a lawyer should serve in both capacities [both as fiduciary and as counsel to the fiduciary] only if the client insists and is fully aware of the alternatives, and the lawyer is fully competent to do so. A lawyer who is asked to

serve in both capacities should inform the client fully regarding the costs of such dual service and the alternatives to it. A lawyer undertaking to serve in both capacities should attempt to ameliorate any disadvantages that may come from dual service, including the potential loss of the benefits that are obtained by having a separate fiduciary and lawyer, such as the check that a separate fiduciary might provide upon the amount of fees sought by the lawyer and vice versa."

The document which directs the lawyer's employment as counsel. May a will or trust agreement direct the employment of a particular attorney as counsel for the fiduciary? Is that direction binding on the fiduciary or may the fiduciary employ any lawyer selected by the fiduciary?

If the direction is neither binding on the fiduciary nor a customary practice among the legal community in that marketplace, the lawyer should take steps to counter the appearance of impropriety and undue influence whenever a client mandates that provision in his or her estate planning documents.

I recommend that, if the client wants the lawyer to include such a direction in a will or trust agreement, the lawyer should advise the client that this "direction" may not be legally binding on the fiduciary, who is nevertheless free to employ as counsel any attorney of the fiduciary's selection. The lawyer should document the fact that this direction is being made at the request of the client and not at the instigation of the lawyer.

Charitable activities of the lawyer. Suppose that the lawyer is actively involved in a local charitable organization. Can the lawyer recommend to clients that they make gifts to that charity?

We are obligated to give to our clients independent advice and judgment, which may be clouded if we have a personal interest in the charity. Even if the lawyer will not receive a fee from the charity for this sort of gift, the lawyer's independence of judgment is clearly in question.

Guidance was provided by the Kentucky Bar Association Ethics Committee in KBA E-391 (1996):

“...we are of the view that if the decision to donate to the charitable organization is the result of the donor's independent decision making process, and the lawyer is satisfied that such decision is the decision of the donor free of undue or inappropriate influence of the charitable organization [and, presumably, of the lawyer], then the lawyer may proceed with the transaction....It is preferable that the donor's commitment to the charity be in writing.” (emphasis added)

If the client has also had a long-standing interest in the charity, the ethical issues may be lessened. The gift is not being made solely on the recommendation of the lawyer. If, on the other hand, the client has no demonstrated interest in the charity and the gift is being made on the basis of the lawyer's recommendation, care must be exercised to avoid the appearance of impropriety.

This problem can be resolved, in my opinion, by a disclosure to the client (in writing) of the lawyer's interest in the charitable organization, perhaps even to the point of giving that client a list of other charitable organizations which carry on the same work.

Other financial activities of the lawyer. What ethical issues are presented by the lawyer who also is a financial planner or sells insurance or mutual funds? Are these problems eliminated merely because those ancillary activities are carried on by a separate legal entity?

It seems clear that these other activities of the lawyer (or even of another organization in which the lawyer has an ownership or other financial interest) present issues of self-dealing and lack of independent professional judgment regarding which course of action is in the best interests of the client. These issues cannot be ameliorated just by having the other activities carried on by a separate entity controlled by the lawyer.

RPC 1.8(a) applies to these transactions, which states that

"a lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, security or other pecuniary interest adverse to the 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."

The Kentucky Commentaries to RPC 1.7 note that “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.”

The Kentucky Bar Association Ethics Committee addressed this question in KBA E-376, which responded to a question by a lawyer who sought to sell life insurance to the lawyer’s clients:

“...the Committee believes that the Kentucky Rules of Professional Conduct permit the lawyer to sell life insurance products to the lawyer’s clients when the sale of such insurance is related to the legal matter being handled by the lawyer, provided the applicable Rules of Professional Conduct are followed....On the other hand we find that the sale of life insurance products to clients constitutes a business transaction with a client, and that there is the potential for conflicts of interest; for example, the client’s need to maintain confidentiality regarding the client’s health, and an insurer’s need to have complete disclosure of all health questions....Further, all fees and commissions must be disclosed to the client, and the client should consent to such arrangement in writing.

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 conflict 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.”

It is irrelevant that the commission paid the lawyer is the same as would have been paid by the client had the transaction been concluded with another provider of the product or service. An ethics violation can result even if there is no financial harm to the

client. Full disclosure to the client, advice to seek independent counsel on this issue and the written consent of the client must all be obtained.

Clients who are referred to the lawyer. Many lawyers obtain new clients as a result of referrals from trust departments, accountants, life insurance professionals and so forth. Those referral sources obviously hope (expect?) that the estate plan resulting from this attorney-client relationship will result in the client's use of services or products provided by the referral sources. Is the use of those services an ethics violation?

The lawyer should advise the client of the ongoing relationship with the referral source and should affirm the lawyer's primary obligation to the client.

Recall the general obligation to provide clients with advise which is solely in the client's best interests. Surely, it is frequently in the best interests of clients that the estate plan utilize the services of these outside professionals, particularly when the client has had a long-standing relationship with the referral source and the service provided is comparable in cost and quality to that provided by others.

The lawyer can be presented with a dilemma, however, if he or she concludes that the best interests of the client will be served by doing business with someone other than the referral source. Suppose a bank trust officer refers a client to you and you are well aware that this trust department charges very high fees. What should the lawyer do?

Be certain that you are comparing "apples to apples" when evaluating the product or services provided by the referral source. Is the product or service provided by a

competitor really comparable? Are the higher trust fees fully justified by higher levels of service or investment results?

The first obligation is to the client. If the competing services or products are truly comparable, can the referral source meet the terms and conditions of the competing service provider? The lawyer should, after discussing the matter with the client, consult with the referral source and begin the conversation by confirming the lawyer's obligation to the client.

Without disclosing client confidences, it may be possible for the lawyer to obtain from the referral source better terms and conditions, such that use of the original referral source's products or services is, in fact, in the best interests of the client. Full disclosure should be made to the client.

Can the lawyer send the client to the referral source, so as to get more referrals in the future, even though the lawyer believes that alternative service providers will be more in the client's best interests? The answer must be "no," of course.

The Violation of Client Confidences

A fundamental tenant of our profession is the requirement that we keep confidential all information acquired from or about the client relative to the representation. RPC 1.6 states that "a lawyer shall not reveal information relating to

representation of a client unless the client consents after consultation" This obligation of confidentiality continues even after the death of the client.

There are several implications of this general rule.

Multiple representations. The lawyer may represent several clients simultaneously, subject to the requirements of RPC 1.7 (conflicts of interest) and RPC 2.2 (intermediary). This sort of representation typically involves the sharing of information among the multiple clients and preserving the confidentiality of the information from others. The lawyer should advise the clients, at the beginning of the representation, of the lack of confidentiality as between themselves.

Others in the lawyer's office. The lawyer may share confidential client information with others in the lawyer's office to the extent necessary for the representation. The lawyer should, of course, advise those other lawyers, legal assistants, secretaries, office staff and paralegals of the confidentiality of the information.

Confidential information from one spouse. Suppose that the lawyer prepared estate planning documents for a husband and wife, after advising them of conflicts inherent in this joint representation. What limitations occur when only one spouse shares confidences with the lawyer?

Just as in the case of the prior discussion regarding conflicts of interest, issues of client confidentiality may arise years later when one spouse returns and requests a "confidential" codicil that makes special gifts that this client does not want the other spouse to learn about (at least not until he is dead!).

Suppose the couple had an oral agreement that assets are to be left in a certain way at the death of the surviving spouse, but now the husband comes to the lawyer with the request that the lawyer prepare a codicil that will be contrary to this agreement?

Can the lawyer disclose this request to the husband's wife (the lawyer's prior client) without violating the husband's confidence? Must the lawyer disclose this request to the lawyer's prior client? Clearly, the lawyer can be put on the horns of a dilemma by one spouse who wishes the lawyer to keep confidences from the other spouse who had been (or may still be) a client.

There are at least these alternative solutions to the problem:

1. The lawyer can refuse to draft the codicil, but does that relieve the lawyer of the obligation to advise the wife of the requested change that may be adverse to his or her interests?
2. The lawyer could withdraw from the representation of the wife, make the requested change in the husband's estate plan and "hope" that the wife does not ask why

the lawyer withdrew from her representation. But does the lawyer's withdrawal relieve the lawyer of the duty to advise the wife who was the lawyer's client?

3. The lawyer could withdraw from representing either spouse, but (again) does that relieve the lawyer of a duty to advise the wife of the requested change in "their" estate plan?

4. Perhaps the recommended approach is to rely on a written engagement letter, in which the lawyer advised the couple at the beginning of the representation that there can be no secrets between them in the lawyer's representation. If the lawyer had such an engagement letter, the lawyer can remind the spouse who requests the change of the lawyer's obligation to advise the other spouse.

This solution puts the dilemma back on the shoulders of the client, who can then decide whether to seek another attorney. Nevertheless, even this "solution" does not necessarily relieve the lawyer of any obligation that may exist to advise the other spouse of the requested change in the estate plan.

Therefore, I recommend that the lawyer should stop the client before he or she discusses any matter which the client does not want shared with the other spouse. How can the lawyer stop someone from blurting out these matters? While that can oftentimes be difficult (or even impossible), there may be clues that the client is about to share a confidence with only the lawyer (the client comes alone to the lawyer's office, looks

embarrassed when the lawyer ask about the other spouse, starts by saying "Now, I don't want [the other spouse] to learn about this, but" and so forth).

If the lawyer does have these clues, I suggest that the lawyer stop the client before the disclosure is made, remind him or her of the lawyer's prior (hopefully written) agreement that there can be no confidences between the spouses in the lawyer's representation and advise the client that anything he or she is about to tell the lawyer must be disclosed to the other spouse.

Again, this approach puts the dilemma back on the client, who can then decide whether to proceed with the lawyer (knowing that the lawyer must advise the other spouse) or to seek other counsel.

The client who later becomes incapacitated. Suppose that, after representing a client in an estate planning matter, the lawyer become aware that the client is "slipping." This growing inability to manage his or her own affairs may be the result of medical problems, alcohol or drug abuse, dependency on prescription medicines or even the undue influence of others. The lawyer might learn, for example, that someone is "abusing" a durable power of attorney the lawyer drafted years ago.

Some guidance can be found in RPC 1.14, which provides that:

"(a) When a client's ability to make adequately considered decisions in connection with the representation is impaired, whether because of minority, mental disability or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.

(b) A lawyer may seek the appointment of a guardian or take other protective action with respect to a client, only when the lawyer reasonably believes that the client cannot adequately act in the client's own interest."

Nevertheless, the lawyer can be placed in a difficult decision when he or she learns (or even observes) that a long-standing client needs some help. Unfortunately, RPC 1.14 does not answer every situation.

The lawyer may observe, for example, that the client needs assistance in some situations, but not in others. The client has "good days and bad days." The client may be quite capable of handling day to day activities, but may need help with major transactions or decisions.

The Kentucky Commentaries to RPC 1.14 notes that "the fact that a client suffers a disability does not diminish the lawyer's obligation to treat the client with attention and respect." Disclosure of even the client's disability may adversely affect the client's interests. The ACTEC Comment to this Rule concludes with the obvious (but not helpful) note that "the lawyer's position in such cases is an unavoidably difficult one."

What obligation does the lawyer have to step forward and to take actions to protect the client? Can or should the lawyer consult with the family or the physician of the client without the consent of the client? What if the client is, in the lawyer's opinion, incapable of giving that consent?

Does the lawyer's answer to these questions change if the reason for the lawyer's concern is merely the fact that the client came to the lawyer with a request for an unusual

or controversial change in his or her estate plan? What if the client is brought to the lawyer's office by his housekeeper and the client requests a change in the estate plan so as to leave all his assets to her?

The lawyer suspects undue influence, but the client (without the housekeeper present) assures the lawyer that this is exactly what he wants to do. Does the lawyer's disclosure to family or physician of the requested change in the estate plan violate the lawyer's duty of confidentiality to the client?

While RPC 1.6 [Confidentiality of Information] authorizes the lawyer to disclose information which is "impliedly authorized in order to carry out the representation," I doubt whether the lawyer can rely on that Rule when disclosing client confidences, merely because the lawyer feels that the client wants to do something that "just isn't right."

The ABA Standing Committee on Ethics and Professional Judgment approved in Informal Opinion 1500 (1983) the lawyer's disclosure of the fact that a client was about to commit suicide. RPC 1.6(b)(1) authorizes the disclosure that a client is about to commit a crime. But what if the client wants to do something strange and the lawyer feels that, based on this request, the client must be suffering some incapacitation or may be the victim of undue influence?

The ABA Committee's Informal Opinion 1530 (1989) stated that the lawyer has implied authority to consult with a physician (a "diagnostician") regarding the condition of the client. Ethics Opinions on this issue have been given in Maine (Maine 84 [1988]

provided that the lawyer for an elderly client believed to be incapable of making rational financial decisions may inform the client's son if the son has no adverse interest or may consult with governmental agencies which provide services in that area) and Pennsylvania (Pennsylvania 88-72 [1988] provided that the lawyer who believed the client was being taken advantage of by relatives may seek the appointment of a guardian if the lawyer believes the client is unable to act in his own interests).

One strategy is to suggest to the client, who wants to create a controversial change in his or her estate plan, that to do so will undoubtedly result in a will contest at death. In order to prepare for this eventuality, you advise the client, a contemporaneous evaluation by the client's physician would be helpful.

If the physician reports, after examination, that the client lacks testamentary capacity, the new will cannot be prepared, of course. But what are the lawyer's obligations if the physician is not willing to make such an unequivocal statement? That is when the lawyer decides whether to be merely a scrivener (who merely writes out the client's direction) or to be a counselor in its finest sense (who strongly advises the client against a proposed course of action that, after many years representing the client, the lawyer knows is simply wrong).

Look, for example, at MPR 2.1, which provides that:

"In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

Interesting observations on this issue are found in the Kentucky Commentaries to RPC

2.1:

“A client is entitled to straightforward advice expressing the lawyer’s honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront. In presenting advice, a lawyer endeavors to sustain the client’s morale and may put advice in as acceptable a form as honesty permits. However, a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client.

“Advice couched in narrowly legal terms may be of little value to a client, especially where practical considerations, such as ... effects on other people, are predominant. Purely technical legal advice, therefore, can sometimes be inadequate. It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied.”

Further guidance might be found in Devine, The Ethics of Representing the Disabled Client: Does Model Rule 1.14 Adequately Resolve the Best Interests/Adequacy Dilemma?, 49 Mo. L. Rev. 493 (1984) and Donaldson, The Ethical Considerations of Representing the Elderly, 130 Trusts & Estates 18 (1991).

Incomplete or Inadequate Representation

Both the competence of the lawyer and the adequacy of his or her representation are addressed by the Rules of Professional Conduct.

RPC 1.1 states that "a lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." RPC 5.3 extends this same obligation to others in the lawyer's office.

RPC 1.2 provides that "a lawyer shall abide by a client's decisions concerning the objectives of the representation...." That is, the attorney and client can and must define the scope of the representation.

Most clients seek assistance in the preparation of a "short, simple will." No client comes in with the request that the lawyer prepare "a really complicated estate plan!" Nevertheless, many clients today need more than a short, simple will. There may be short wills and there may be simple lawyers, but there rarely is a short, simple will that is adequate for a client with substantial assets.

There are several problems involved:

1. What if the family business owner never gets around to a decision and then dies?
2. Does the lawyer have the technical competence required by the client?
3. Does the lawyer ask the "right" questions of the client, so that all the required information is disclosed? Do you have documentation of this?
4. Will the client be willing to follow through on the lawyer's advice regarding the steps required to implement the estate plan? and
5. Is the estate plan that results from the representation appropriate for the client under all the circumstances which should have been known?

Unwillingness of a family business owner to make a decision. One of the hardest decisions we ask our clients to make concerns future management of the family business. Who will take over when our client retires, becomes disabled or dies?

Many clients have no intention of retiring and cannot face realistically the possibility of their ultimate death. We expect clients to make very difficult, emotional decisions, yet we are surprised when we meet resistance.

If you have a long-standing business client, for whom you have done many transactions, it is critically important that you urge this client to engage in succession planning. Most family businesses fail to make it to the second (let alone third) generation primarily due to a lack of planning.

To the extent your client is unwilling to make these hard choices, you should emphasize the risks associated with his failure to act. What will happen to the business? What will happen to the family? Why should he continue to put in 70 hour work weeks when so much of what he has and will accomplish is at risk?

Ultimately, you should document your efforts to have this work done. If no action is ever taken and severe consequences result, you do not want to face the unhappy family members who survive with no evidence of your efforts to have "the old man" take action.

Inadequate information from the client. One of a lawyer's greatest challenges is to obtain accurate and complete information from clients. Some people are uncomfortable discussing estate planning matters and provide information only in

response to direct, specific questions. They do not openly speak of their daughter's disability, so the lawyer did not prepare a trust for her benefit in the will, for example.

It is gratifying to read in the ACTEC Commentaries that "in the ordinary case, a lawyer may reasonably rely upon a client's statement of facts." The Commentaries go on to provide, however, that the facts should be verified if the client appears to be uncertain or if there are "other circumstances" that raise doubts about the accuracy of the facts.

Questions the lawyer should have asked. Occasionally, we create our own problems. The lawyer did not ask how their assets are titled, for example, so the lawyer did not learn that all the property was jointly held until one spouse died and nothing went into the credit trust.

Incomplete implementation of the plan. Sometimes, the client is not willing to pay for the lawyer to implement the plan. The lawyer advises the client to change beneficiary designations, to put assets into a revocable trust to avoid probate and to assign group life insurance to an irrevocable trust.

Who is responsible for the implementation of the plan? Can the lawyer document that it was the client's (and not the lawyer's) job to carry out these critical activities? Will the client follow through on the lawyer's instructions? Can the lawyer later document the fact that the client was told what to do?

Co-counsel or other consulting arrangements. In a world of increasingly complex laws, it is difficult for the lawyer to stay "current" in every area of the law. Inadequate estate plans may constitute not only malpractice, but also ethical violations. Jeff Pennell's 1991 paper entitled "Professional Responsibility: Reforms are Needed to Accommodate Personal Family Counseling," (25 Miami Institute on Estate Planning, 18-1) includes this statement:

"Probably the most important act a 'general practitioner' can perform these days to protect against malpractice liability and the related ethical violation is to establish a good referral network to bring into a situation experts in areas in which the referring attorney is deficient."

The ACTEC Commentaries to RPC 1.1 call upon the lawyer's "additional research and study" as the first way to meet a client's needs. The Commentaries go on to provide that "the needs of the client may also be met by involving another lawyer or other professional who possesses the requisite degree of skill or knowledge. * * * The lawyer should be candid with the client regarding the lawyer's level of competence and need for additional research and preparation...."

Different types of consulting arrangements. The lawyer can call in another attorney on a consulting basis in at least two different ways:

1. The lawyer can employ another attorney to assist on an "as needed" basis on different estate planning matters, usually to review draft documents, to discuss

planning alternatives and the like for a variety of different clients. The lawyer's clients may not even be aware that these consultations occur. The consulting attorney's fees are paid directly by the lawyer; or

2. The lawyer can employ another attorney to assist a particular client on the development, drafting and even implementation of the estate plan. The client approves of this co-counsel arrangement and usually pays all the fees directly.

Written engagement letter. When an outside attorney is involved in the representation (in either approach identified above), there should be a written engagement letter between the lawyers, in which certain issues must be addressed:

1. What may the referring lawyer disclose to the other lawyer without the consent of the client?

2. Who will communicate with the client, so as to keep the client "reasonably informed" under RPC 1.4?

3. Who will be responsible for the due diligence requirement of RPC 1.3, so as to assure that the representation is proceeding properly?

4. Who will determine the amount of fees to be paid by the client and who suffers the loss if the client does not pay?

5. Does the consulting lawyer separately bill the client for services or is the statement sent to the original lawyer or is there one combined bill sent to the client, with

the resulting fee shared by the co-counsel? Note RPC 1.5(e) concerning a division of fees between lawyers who are not in the same firm.

6. Who is responsible for "mistakes," such as inaccurate or incomplete information provided to the new lawyer or malpractice by the new lawyer?

7. The scope of the representation provided by the new lawyer should be set forth, including a discussion concerning who will continue to represent the client in the future on estate planning and other matters ("don't steal my client!").

A Trap for the Unwary: Criminal Liability for Advising Clients on Lifetime Gifts

Suppose a new client seeks the lawyer's advice in connection with a lifetime gift program. This client has children and grandchildren and wants to transfer to them ownership interests in his closely held business. General estate planning, to dispose at death of the rest of the business, may also be involved. He mentions in passing that he has just been named a defendant in a big lawsuit, but that another law firm is handling that matter.

The lawyer advises the client on the creation of irrevocable trusts for the benefit of grandchildren, of outright gifts to the children and valuation issues for gift tax purposes. Following the lawyer's advice, the client makes gifts to the children and to the trusts for the grandchildren.

What is the consequence if this client later declares bankruptcy? The lawsuit he mentioned casually resulted in a huge judgment against the client and he sought bankruptcy protection. Is there a problem because the lawyer advised the client on ways he could give away his assets?

Be aware of 18 U.S.C. Section 152:

"A person who --

* * *

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation; ... shall be fined not more than \$5,000, imprisoned not more than 5 years, or both." (Emphasis added)

And beware of 18 U.S.C. Section 371:

"If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both"

But the lawyer just advised on gifts! How, if at all, do these criminal provisions apply to the lawyer who advises the client on the transfer of assets? Did the lawyer assist in the commission of bankruptcy fraud by the client?

It was the client, and not the lawyer, who may have had the criminal intent of trying to hide assets from creditors. Nevertheless, it was the lawyer who told the client how to commit what later became bankruptcy fraud. That is, the client could not have made the fraudulent transfers without the assistance of the estate planning lawyer.

Was there a conspiracy which will cause problems for the lawyer under Section 371? Was the lawyer an agent of the client which will cause problems under Section 152? Who needs these problems?

The Kentucky Commentaries to RPC 1.6 provide that “the lawyer may not counsel or assist a client in conduct that is criminal or fraudulent. ... 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....” Was the lawyer an innocent accomplice? How can you prove that fact, however?

Some bankruptcy lawyers believe that the U.S. Department of Justice and local prosecutors may actively target lawyers for fraud actions. Some people believe that it is politically useful if a prosecutor has a few lawyers’ “scalps” hanging from his or her belt!

Exercise great care with new clients who want to make gifts. Although I am not a bankruptcy attorney, the possibility of a problem here came as a surprise to me. **If the client mentions a possible large creditor, the estate planning lawyer must be very careful of the bankruptcy issues.** If the lawyer should have asked about creditors and

other liabilities, but simply failed to do so, there may be problems later when and if the client files bankruptcy.

There may be a simple rule. Always inquire about the existence of creditors, pending lawsuits, contingent liabilities and the like. **Document your inquiry!** If there are substantial creditors (even contingent), the estate planning lawyer should not in any way advise the client on lifetime gifts. To do otherwise may leave the lawyer open to a charge that the lawyer aided the client in the commission of bankruptcy fraud.

The problem may only arise if there are existing creditors of the client. Just because a physician believes that some patient may, in the indefinite future, bring a malpractice action, there is no current creditor whose interests should be considered before a gift program is initiated. Once this vague uneasiness becomes even a contingent liability (long before a lawsuit is filed against your client by a creditor) the estate planning attorney should not advise the physician to begin or to carry on a lifetime gift program.

For further reading on this critical issue, I recommend you consult the material from the 67th Annual Meeting of the National Conference of Bankruptcy Judges, held in Orlando, Florida, on October 17-20, 1993. See, for example, the articles entitled "Malpractice or Worse -- The Risk of Criminal Liability" by Joe B. Brown and "'The Slippery Slope' -- The Road From Ethical Practice to Attorney Negligence, Contempt or Fraud in Bankruptcy Cases" by Joan Bainbridge Safford.

The Reasonableness of Estate Planning Fees

RPC 1.5 states that "a lawyer's fee shall be reasonable." While many attorneys charge for estate planning matters on an hourly basis, RPC 1.5(a) authorizes you to consider other factors:

- "(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal services properly;
- (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
- (3) the fee customarily charged in the locality for similar legal services;
- (4) the amount involved and the results obtained;
- (5) the time limitations imposed by the client or by the circumstances;
- (6) the nature and length of the professional relationship with the client;
- (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) whether the fee is fixed or contingent."

The lawyer should advise the client at the beginning of the representation of the method of fee calculation, including whether the client will be charged for extra services, such as copying, postage, travel and the time of secretaries and other personnel.

Is the fee based on hourly charges? Is it a flat fee, for the preparation of papers to create a new limited liability company or a family limited partnership, for example?

Many lawyers will give to their clients an estimate of the fees to be charged, typically within a range.

What if the fees exceed the lawyer's estimate? The actual work required may cause the lawyer to exceed the estimated fee, perhaps because of later changes requested by the client, because the problems presented by the client were more complex than originally thought or for any other reason.

I recommend that the lawyer tell the client that the initial estimate must be revised before the extra time is spent on the representation.

It is far better, in my opinion, for the lawyer to have this conversation with the client before the time is put in; the alternative is to spend the time and then to explain, after the fact, why the client should pay more than the initial estimate.

What if the client asserts later that this extra work should not have been done, that there were other alternatives the client wanted to pursue (had he known that the initial estimate was not accurate) and so forth? Have that billing conversation with the client before you put in time that may later have to be written off when confronted with an angry client.

Fees paid by the client's employer. What considerations are presented when a fee is to be paid by a business of which the client is an officer, director, employee or owner (or all of the above)?

RPC 1.8(f) provides that:

"A lawyer shall not accept compensation for representing a client from one other than the client unless:

- (1) 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 [Confidentiality of Information]."

The ABA Standing Committee on Ethics and Professional Responsibility addressed this issue in Informal Opinion 1517, issued in 1986. Concern was expressed about the corporation's taking the fee as an income tax deduction when it would not be a deductible expense by the client individually. The Standing Committee also wondered whether the corporation was aware that corporate funds were being used to pay for personal services.

The ABA concluded, nevertheless, that the fee could be paid by the corporation, provided the basis of the fee was broken down between personal services for the client and services that might be viewed as for the corporation itself. The corporation can then decide whether to treat that portion of the fee which was for personal services as

additional compensation to the client and can decide the extent to which the corporation can deduct the fee from its own income.

I suggest that the lawyer address several issues before agreeing that the fee can be paid by the client's business:

1. If the client is not the sole owner of the business, must the other owners be advised that the entity's funds are being used to pay for one owner's personal estate planning?
2. If the business entity will benefit from the lawyer's representation (business succession planning), should the engagement be with the entity and not with the individual client? Should not all the owners then be involved in the planning?
3. What conflicts might arise between the lawyer's work for one client, the lawyer's work for the entity and the lawyer's work for the other owners of the entity?

Consideration should also be given to RPC 1.13(e), which provides that:

"A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 [Conflict of Interest]. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders."

Rebates, discounts, commissions and referral fees. The lawyer's acceptance of rebates, discounts, commissions or referral fees may involve an improper conflict of

interest in violation of RPC 1.7 and may violate RPC 5.4's prohibition against sharing legal fees with non-lawyers.

Even with full disclosure to the client, such an arrangement "involves too great a risk of overreaching by the lawyer and the potential for actual or apparent abuse," according to the ACTEC Commentaries.

Conclusion

The ethical issues presented to the lawyer engaged in estate and family business succession planning are ever present. Just being aware of the potential problems may be a step in the right direction. Ignoring these problems will not make them go away.

Eric A. Manterfield

July 5, 2000

Sample estate planning engagement letter

_____, 2000

XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX

Dear XXXXXXXXXXXXXXX:

I enjoyed having the opportunity to meet with you to discuss your estate plan. I will have drafts to you by _____ of a new will, a revocable trust agreement, an irrevocable life insurance trust agreement, a living will, a health care power of attorney and a general power of attorney. These are the documents which will carry out the plan you decided upon at our meeting.

[Give overview of the plan, decisions made by the client and any further information/decisions needed]

Terms of our engagement. Whenever we begin work with a new client, _____ requires an engagement letter and a retainer against future billings. I think that it is important that we get down in writing a common understanding of our relationship. If my understanding is correct, I ask that you indicate your approval by signing and returning the extra copy of this letter which is enclosed.

_____ is very pleased to have the opportunity to assist you and your family. Our firm is committed to providing legal services in an effective and economical manner.

We represent you both. Our representation will be of you jointly in your estate planning. Because we represent both of you, anything disclosed by either one of you to

me or to any personnel at _____ will necessarily be open for complete disclosure to the other.

I am not suggesting that this would become an issue at any point; rather, it is appropriate for us to advise all married couples of the fact that our representation of you is as a couple, simply because we are representing two people whose interests are not always exactly the same.

Fees are based upon the work performed. Our fees for legal services will be billed on an hourly basis according to the billing rates charged by each lawyer or paralegal of our firm, which currently range from \$_____ an hour for paralegals to \$_____ an hour for senior partners.

My personal billing rate is currently \$_____ an hour. I mention the billing rates for associates and paralegals because it might be more economical to have certain work performed by those people. These billing rates are subject to adjustment without notice from time to time by the firm.

In certain instances, other factors may be taken into consideration in determining our fees, including the responsibility and liability assumed, the novelty and difficulty of the legal problem involved, whether the firm is requested to issue its formal legal opinion associated with some facet of its representation, the benefit resulting to the client and any unforeseen circumstances arising in the course of our representation.

Invoices. We will provide invoices on a monthly basis. The invoices will describe our services and itemize our expenses in accordance with our standard firm policies. These expenses include such items as photocopying, long-distance telephone charges, facsimile charges, travel and related expenses, computerized legal research, postage and delivery or courier services.

Retainer. Our firm's policy is to require a retainer to be paid before we provide any legal services to new clients. **For this particular matter, _____ will require a \$_____ retainer from you before we proceed with any legal work on your behalf.** We will charge our initial fees and expenses against this retainer and credit them on our invoices.

The retainer is not an estimate of the total fees to be incurred or expenses advanced, of course, but is a prepayment of the initial fees to be incurred by you. Once the retainer amount is fully credited towards fees incurred and expenses advanced, it is

essential to our representation that you remain current in the payment of all invoices for fees and expenses. We reserve the right to require the payment of subsequent retainers after the initial retainer is depleted.

Prompt payment. Payment relating to all invoices will be due within thirty days after the invoices are mailed. Subject to any limitations imposed by the Indiana Code of Professional Responsibility, we reserve the right to discontinue work on any aspect of this representation in the event that any invoice is not paid within thirty days after the invoice is mailed.

If we are required to resort to collection proceedings to recover any amounts from you, we will also be entitled to recover, of course, all costs incurred in those collections proceedings, including reasonable attorney fees incurred either by us or by separate counsel. By signing and returning the additional copy of this letter, you agree that any collection proceedings shall be brought in the Superior or Circuit Court of _____ County, Kentucky, and you consent to the jurisdiction of that court.

Termination by either party. You have the right at any time to terminate our representation upon written notice. That termination will not relieve you, of course, of the obligation to pay for all services rendered before the termination.

We reserve the right to withdraw from this representation if, among other things, you fail to honor the terms of this engagement letter, you fail to cooperate or follow our advice on a material matter, or any fact or circumstance which would, in our view, render our continuing representation unlawful or unethical.

If we elect to withdraw from your representation, you agree to take all steps necessary to free us of any obligation to perform further and you agree to pay us for all services provided before the withdrawal.

Conclusion. If the foregoing terms and conditions accurately summarize and confirm the understanding of our new attorney-client relationship, please indicate your approval and acceptance by dating, signing and returning the extra copy of this letter which is enclosed. Your check for the amount of the retainer should also be returned with your signed copy of this engagement letter. An additional copy of this letter is enclosed for your records.

Once again, we appreciate this opportunity to serve you and your family. Should you have any questions or concerns with regard to the matters discussed in this letter, please do not hesitate to contact me. We look forward to working with you.

Very truly yours,

Eric A. Manterfield
Direct Dial: (317) 238-6202

Agreed to and accepted this _____ day of _____, 2000.

husband

wife

Sample family business succession planning engagement letter

_____, 2000

Owners of [name of business] _____.
[address]

PERSONAL & CONFIDENTIAL

Dear _____:

You have asked [name of law firm] _____ to perform certain services for you relating to your proposed business succession planning. This work may include the creation of a new buy-sell agreement among the owners of the business and other matters which may have an impact on all the business owners.

We are pleased to assist you with this work; however, it is in your best interests (and our own ethical obligation to each of you requires) that you fully understand the considerations involved in a "dual representation" of the business and its owners and of the owners with respect to each other.

The different owners may have differing (and sometimes conflicting) interests and objectives regarding business and personal planning matters. For example, you each may have different views on how to value the business and any ownership interest upon the death or retirement of an owner. There may be a conflict in whether the selling owner of the business should be subject to a covenant not to compete. There may be a conflict in how an installment payment is secured. These are just a few examples, of course; every situation is unique.

If you each had a separate lawyer, you would each have an "advocate" for your individual position and you would each receive totally independent advice. Information given to your own lawyer is confidential and could not be obtained by your fellow family business owners without your consent.

That may not be the case here (where we are advising all the business owners), but the opportunity for conflict does exist. We cannot be advocates for one of you against the other. Information that any of you gives us relating to your thoughts and special needs cannot be kept from the other owners of the business.

If you ask us to continue to serve you jointly and the business, as well, our effort will be to assist in developing a coordinated overall business succession plan and to encourage the resolution of differing interests in an equitable manner and in the best interests of your mutual business affairs. We will attempt to represent the business without a bias in favor of any of you.

In the event of an irreconcilable conflict in the future, we reserve the right to continue to represent the business and [majority owner] , if they wish us to do so, and we will decline thereafter to represent other owners.

If at any time any one of you wishes to have the advice of separate counsel, you are completely free to do so. We hope that this information will assist you in using our services effectively.

If you each agree with our representation under these circumstances, please read the following statement and, if you are in agreement with it, sign and return the extra copy of this letter which is enclosed.

Again, we appreciate the opportunity to be of service to all of you. I look forward to a long and successful professional relationship with each of you and with [family business] .

kindest personal regards,

Eric A. Manterfield
Direct dial: 317-238-6202
Email: eam@kdac.com

We have each read the foregoing letter. Each of us realizes that there are areas where our interests and objectives may differ and areas of potential or actual conflict of interest between us in connection with the family business succession, buy-sell planning and related matters.

We understand that each of us may retain separate, independent counsel in connection with these matters at any time. Each of us understands and agrees that communications and information which you receive from any of us relating to these matters will be shared with the others.

We understand that, in the event of an irreconcilable conflict in the future, you reserve the right to continue to represent the business and [majority owner] , if they wish you to do so, and you will decline thereafter to represent other owners.

After careful consideration, each of us requests that [law firm] represent us individually and the family business jointly in connection with our business succession, buy-sell planning and related matters.

Owner

Owner

Owner

Owner

_____, Inc.

By: _____

Its: _____