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ESTATE PLANNING INSTITUTE

July 2004

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MIDWEST/MIDSOUTH
ESTATE PLANNING INSTITUTE

July 2004

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

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2003-2004

NOTABLE DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS

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SECTION A

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2003-2004 NOTABLE DEVELOPMENTS OF INTEREST

TO ESTATE PLANNERS

A. INCOME TAX MATTERS

1. **Application of Cottage Savings to Trust Reformation**. An issue that has become prominent in the last several years is the income tax consequences of trust reformation and divisions. PLR 200231011 discusses the issue in detail. The background was summarized in the ruling:

> Section 1.1014-5(b) provides that in determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to § 1014 (relating to the basis of property acquired from a decedent) or § 1015 (relating to the basis of property acquired by gift or by a transfer in trust), that part of the adjusted uniform basis assignable under the rules of § 1014-5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by § 1001(e) and paragraph (f) of § 1.1001-1.
>
> * * *
>
> Section 1001(e)(1) provides that in determining gain or loss from the sale or disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to §§ 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. Under § 1001(e)(2), a "term interest in property" includes an income interest in a trust. Section 1001(e)(3) provides that the general rule of § 1001(e)(1) does not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.
>
> Section 1.1001-1(a) of the Income Tax Regulations provides that, except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.
>
> Section 1.1001-1(f)(1) provides that for purposes of determining the gain or loss from the sale or other disposition of a term interest in property, a taxpayer shall not take into account that portion of the adjusted basis of such interest, which is determined pursuant to § 1014 of the Code, to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property, as defined in § 1.1014-5.
>
> * * *
>
> An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566. In

> defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.
>
> The application of § 1001(a) to trust interests is illustrated by two cases. In Evans v. Commissioner, 30 T.C. 798 (1958), the taxpayer exchanged her income interest in a trust for an annuity, and the court concluded that this was a realization event. Taxpayer's income interest had entitled her to dividends paid by a corporation, the stock of which was owned by the trust. She transferred the income interest to her husband, who agreed in exchange to pay her fixed sums annually until her death.
>
> A contrary result was reached in Silverstein v. United States, 419 F.2d 999 (7th Cir. 1969). In that case, the taxpayer exchanged an interest in a trust for a right to specified annual payments from the remainderman of the trust, and the court held that taxpayer did not as a result dispose of her trust interest. After the transaction, taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The court distinguished the transaction from that found to be a realization event in Evans: "the amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this 'uncertainty' for definitely ascertained yearly payments from her husband." 419 F.2d. at 1003.

The facts of the ruling were that a trust that was to pay certain amounts to "grandson" for life and then distribute the remainder to various charities was converted into a trust for grandson only with the charities being paid off now. The ruling described the trust:

BEFORE

> Decedent died testate on Date 1, prior to 1985. Pursuant to the terms of Decedent's will, a residuary testamentary trust (Trust), was established primarily for the benefit of Decedent's grandson (Grandson). Under the terms of Trust, Grandson was to receive S dollars each year during his life. Upon Grandson's death, the corpus was to be distributed as follows: 1/3 to Charity 1; 1/3 to Charity 2; 1/6 to Charity 3; and 1/6 to Charity 4. The terms of Trust provide that no beneficiary could alienate or encumber his/her interest in the income or principal and no beneficiary's interest was subject to claims of his/her creditors prior to distribution. Trust was funded with stock of Corporation with an approximate value of X dollars.
>
> In Year 1, pursuant to a court order, the investments of Trust were restructured and the dispositive provisions of Trust were modified to provide or annual income distributions to Grandson in accordance with a Performance Chart. The order required distributions to Grandson of an amount equal to the lesser of the maximum income amount set forth in the Performance Chart or the actual net income of Trust. Grandson was guaranteed a minimum income amount even if actual Trust income was less than that minimum income amount. Thus, if earnings of Trust are sufficient, Grandson would receive more than the minimum stated amounts each accounting period. In addition, Charities 1, 2, 3 and 4 received a lump sum payment. Upon Grandson's death, the remaining corpus was to be distributed to the Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion as set forth in Trust.

AFTER

> Under the terms of the proposed agreement, corpus of Trust in excess of Z dollars will be distributed immediately to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. Upon distribution, the charities' interest in Trust will terminate. The remaining assets of Trust will continue in trust for the benefit of Grandson. Grandson will receive at least annually an amount equal to seven percent of the net fair market value of the property held in Trust determined on a specified date in each calendar year. In addition, the trustee may distribute income or principal to provide adequately for the reasonable support of Grandson. On Grandson's death, the remaining corpus will be distributed pursuant to Grandson's exercise of a testamentary general power to appoint the remaining corpus to anyone, including his estate or the creditors of his estate. Any portion of the Trust not effectively appointed by the exercise this power will be distributed to Grandson's surviving descendants free of trust.

The IRS determined that gain would be recognized:

> The proposed trust modification in this case more closely resembles the situation in Evans than that in Silverstein and should be considered a realization event. Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus, even though this was a necessary element in a favorable GST conclusion set forth in issue # 3, below.

The trust at issue was apparently not a charitable remainder trust. FLIP charitable remainder trusts are now authorized, and in the year 2000 a safe-harbor was created to convert some old charitable remainder trusts to FLIPs. Is there a principled difference between those facts and these? The possibility of income recognition must be considered in other situations; for example, where income and remainder beneficiaries, unable to agree on how a trust may be administered, desire to terminate the trust in whole or part.

2. **Passive Activity Losses in Trusts**. At issue – finally! – in Mattie K. Carter, et al. v. United States, 91 A.F.T.R.2d 2003-1946, was whether a "trust" or a "trustee" must be active in order for a loss in the trust to avoid being passive. The opinion recited the statute:

> IRS could disallow the losses only if they represented a "passive activity loss" within the meaning of I.R.C. §469(a):

> (1) In general. — If for any taxable year the taxpayer is described in paragraph (2), neither --
>
> > (A) the passive activity loss, nor
> >
> > (B) the passive activity credit, for the taxable year shall be allowed.

I.R.C. §469(a)(1). A "passive activity" is an activity "(A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." Id. §469(c)(1). IRS acknowledges that the ranch operations constitute a business. The statute defines "taxpayer" as:

> (2) Persons described. — The following are described in this paragraph:
>
> (A) any individual, estate, or trust,
> (B) any closely held C corporation, and
> (C) any personal service corporation.

* * *

In pertinent part, section 469(h) defines "material participation" by a taxpayer in a business activity as follows:

> (1) In general. — A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is --
>
> (A) regular,
> (B) continuous, and
> (C) substantial.

I.R.C. §469(h)(1).

The facts before the court were simple:

> Carter Trust is a testamentary trust established in 1956 under the Last Will and Testament of Mattie K. Carter, deceased. Fortson has been the trustee of Carter Trust since 1984, and manages its assets, including the Carter Ranch ("ranch"), which has been operated by Carter Trust since 1956.1
>
> The ranch covers some 15,000 acres, and is used for a cattle ranching operations and for oil and gas interests. Fortson, Jr. Decl. ¶ 2. In 1994, there were approximately 4,700 head of cattle on the ranch; there were approximately 3,300 head of cattle on the ranch in 1995. Id. ¶¶ 9-10. At the relevant times, Carter Trust employed a full-time ranch manager and other full- and part- time employees who performed essentially all of the activities for the ranch. The ranch manager in 1994 and 1995 was David Rohn ("Rohn"), who managed the ranch's day-to-day operations, subject to Fortson's approval. Id. ¶ 7. Rohn was "charged with overall management of livestock production and the management and conservation of pasture lands, as well as the supervision and direction of the other employees of the Trust involved in the Ranch operations." Id. ¶ 8.

> Fortson, as trustee of Carter Trust, dedicated a substantial amount of time and attention to ranch activities:
>
> 4. I was chosen to be Trustee because of my extensive business, managerial, and financial experience. My duties include reviewing and approving all financial and operating proposals for the Ranch and the Trust, budget and budgeting for the Ranch, all investment decisions for the Trust, asset acquisition and sales, supervising all employees and agents of the Trust and the Trust's service providers, reviewing all financial information, and responsibility for all banking relationships of the Trust. My duties and responsibilities as Trustee routinely require a significant percentage of my time and attention, and I maintain regular office hours during which I am consulted regarding any Trust matter that arises.
>
> . . . .
>
> 7. I have delegated certain aspects of the operation and management of the Ranch. It was necessary for the Ranch to employ someone with extensive experience in the management and operation of a large, active cattle ranch. . . . Now, the Trust employs a full-time ranch manager, who is responsible for the day-to-day operations of the Ranch, subject to my approval
>
> . . . .
>
> 8. I routinely discuss management issues pertaining to the Ranch with the ranch manager. . . .
>
> . . . .
>
> 12. I have also delegated oversight responsibility for the Ranch to Benjamin J. Fortson III. Mr. Fortson III is a beneficiary of the Trust and takes a very active, hands-on role in supervising the Ranch manager and general Ranch operations. He spent well in excess of 500 hours engaged in Ranch operations and management at the Ranch in both tax years 1994 and 1995.
>
> Id. ¶¶ 4, 7-8, 12. In this way, Fortson, Rohn, and other employees operated the ranch on behalf of Carter Trust.

The opinion states the claims of the parties:

> The question arises as to how to determine whether Carter Trust materially participated in the ranch operations. IRS takes the position that the material participation of a trust in a business should be made by reference only to the trustee's activities. See, e.g., Br. to IRS Mot. at 8. Carter Trust counters that, as a legal entity, it can "participate in an activity only through the actions of its fiduciaries, employees, and agents," and that through such collective efforts, its cattle ranching operations during 1994 and 1995 were regular, continuous, and substantial. Am. Br. to Carter Trust Mot. at 17.

The Court concluded the trust must actively participate:

> As discussed above, section 469 says that a trust is a taxpayer, I.R.C. §469(a)(2)(A), and that a taxpayer is treated as materially participating in a business if its activities in pursuit of that business are regular, continuous, and

> substantial, id. §469(h)(1). It is undisputed that Carter Trust, not Fortson, is the taxpayer. Common sense dictates that the participation of Carter Trust in the ranch operations should be scrutinized by reference to the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of Carter Trust. Cf. Fojtik v. First Nat'l Bank, 752 S.W.2d 669, 673 (Tex. App. — Corpus Christi 1988) (explaining that "the acts of a corporation's agents are deemed to be acts of the corporation itself"), writ denied per curiam, 775 S.W.2d 632 (Tex. 1989).[3]
>
> IRS' contention that Carter Trust's participation in the ranch operations should be measured by reference to Fortson finds no support within the plain meaning of the statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none. The court recognizes that IRS has not issued regulations that address a trust's participation in a business, see, e.g., Am. Br. to Carter Trust Mot. at 16-17, 20; Br. to IRS Mot. at 7, and that no case law bears on the issue. However, the absence of regulations and case law does not manufacture statutory ambiguity. The court has studied the snippet of legislative history IRS supplied that purports to lend insight on how Congress intended section 469 to apply to a trust's participation in a business.[4] Nevertheless, the court only resorts to legislative history where the statutory language is unclear, see Stockwell v. Comm'r, 736 F.2d 1051, 1053 (5th Cir. 1984), which, as noted above, is not the case here.
>
> The court concludes that the material participation of Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including Fortson. The summary judgment evidence makes clear that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation.
>
> Alternatively, the court concludes that, based on the undisputed summary judgment evidence, Fortson's activities with regard to the ranch operations, standing alone, were regular, continuous, and substantial so as to constitute material participation by him, as trustee, during relevant times. Consequently, even if the court were to accept the legal standard articulated by IRS, through counsel, during the April 3, 2003, telephone hearing, Carter Trust would prevail under the summary judgment record.

The case is favorable for taxpayers on an issue that has been unresolved since the passive activity rules were enacted.

3. **Interest Paid on Specific Bequest**. On May 9, 1993, Marvin Schwan died, leaving a Will which provided that each of his four children would receive $1,000,000 and set aside $1,500,000 to create a grandchildren's trust. These legacies were paid on September 21, 1998. Applicable state law – South Dakota – provided that legacies not paid within one year of a decedent's death accrued interest at a statutory rate until paid. At issue in Mark D. Schwan, et.al. v. United States, 264 F. Supp. 2d 887 (S.D. So. Div. 2003) was whether the interest (accrued at 12%) was deductible by the estate for income tax purposes.

The court first looked to section 212. The opinion states:

Here, the Plaintiffs claim that the interest expense incurred on the legacies was ordinary and necessary to the administration of the estate. The Plaintiffs argue that the payment of interest on deferred legacies is a relatively common occurrence for an estate and thus constitutes an ordinary expense. The Plaintiffs further contend that the expense was necessary because the estate was forced to keep liquid assets and marketable securities in the estate to cover the unresolved issues regarding estate tax liability and other litigation involving in estate assets, namely the children's litigation discussed above. The Plaintiffs claim that preserving estate assets was necessary for proper administration of the estate.

The Court finds the Plaintiffs argument unpersuasive. Under the facts presented, it was unnecessary for the estate to incur the interest charges at issue. As stated above, the terms of both the will and the trust directed that the estate taxes be paid out of trust, not probate, assets. The trust would have had more than sufficient assets to pay the liabilities of the estate if the trustees had not transferred all of the Schwan stock to the Foundation seven months after Marvin Schwan's death. The Plaintiff's contend that the transfer to the Foundation was done in accordance with the redemption agreement which directed that such securities be transferred to the Foundation "upon the death of Schwan." See Redemption and Repurchase Agreement, Article 1, paragraph 5. Again, the Court cannot agree with the Plaintiffs' argument.

Under both Minnesota and South Dakota law, agreements that pertain to the same transaction that the [sic] are executed within the same time frame and involve the same parties are to be construed together. See Simitar Entertainment, Inc. v. Silva Entertainment, 44 F.Supp.2d 986, 994 (D. Minn. 1999); Anderson v. Kammeier, 262 N.W.2d 366, 371 (Minn. 1978); Janssen v. Tusha, 287 N.W. 501, 505 (S.D. 1939). Applying this principle to the will, trust agreement, and redemption agreement leads to the inescapable conclusion that it was Marvin Schwan's intent that the Foundation be funded only after the other obligations of his estate had been satisfied. A general directive in the redemption agreement stating that the stock was to be transferred to the Foundation "upon the death of Schwan" cannot override the specific directives of the trust agreement and the will which both directed that the trust pay the estate's liabilities, including estate taxes. The trust agreement itself stated that trust assets should used to satisfy legacies under the will in the event that the probate assets were insufficient, indicating Schwan's intent that the gifts under the will be satisfied prior to the trust assets being gifted to the Foundation. The trust agreement also directed that all of the Schwan stock, except that which was used to satisfy a legacy, gift, or obligation under the will, be gifted to the Foundation. This statement clearly envisions that the obligations under the will would be satisfied prior to the funding of the Foundation. Therefore, when reading the three documents together, it is clear that Marvin Schwan's estate plan was drafted so that the Foundation would be funded last, and those administering his estate chose to frustrate that intent and fund the Foundation first.

Had the executors followed the dictates of Marvin Schwan's estate plan, they could have satisfied the legacies on time and would not have incurred the interest expense. At the time of his death, Marvin Schwan's probate estate contained assets totaling $19,018,311.47. The legacies that the estate failed to fully satisfy until 1998 totaled only $5.5 million. As the Defendant pointed out, the executors made a $5.1 million estimated estate tax payment out of probate assets although both the trust agreement and will directed that the estate taxes were to be paid out of trust assets. If the Schwan stock had not been transferred to the Foundation in contravention of Marvin Schwan's estate plan, the estate would have had sufficient assets to pay the legacies on time without concern for

> covering the other liabilities of the estate. Therefore, it was not necessary for the estate to incur interest expense on the legacies. Cf. Hibernia Bank v. United States, 581 F.2d 741 (1978) (disallowing an administrative expense deduction for federal estate tax purposes where the expense was unnecessary).

The court next examined, and rejected, the estate's section 163 argument:

> Section 163(a) of the tax code provides that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." I.R.C. 163(a). This section, however, is limited by the language of Section 163(h)(1) which states that "no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year." See I.R.C. 163(h)(1). Subsection (h) of I.R.C. 163 defines personal interest in all inclusive terms as "any interest allowable as a deduction under this chapter other than — . . ." and goes on to list a few exceptions. See I.R.C. 163(h)(2). The exception at issue here deals with the deductibility of investment interest See I.R.C. 163(h)(2)(B). Subsection(d)(3)(A)of I.R.C. 163 defines investment interest as "any interest allowable as a deduction under this chapter . . . which is paid or accrued on indebtedness properly allocable to property held for investment." Id.
>
> The Plaintiffs contend that the interest paid on the deferred legacies is deductible under I.R.C. Section 163 as investment interest. The Plaintiffs assert that absent liquidating the investment assets of the estate, the legacies could not be satisfied. Therefore, the executors chose to incur the interest expense under South Dakota law on the deferred legacies rather than liquidate the income-producing assets of the estate to satisfy the legacies. The Plaintiffs argue that since the interest expense was incurred to maintain investment property, it is properly allocable to property held for investment and qualifies as deductible investment interest. The Court cannot agree.
>
> As the Court has previously found, during the tax year in question, 1996, the estate did not own any Schwan stock. Therefore, maintaining the Schwan stock as an investment cannot serve as a reason for the estate to incur the interest expense at issue. Absent the Schwan stock, however, the estate still had other assets producing significant income. During the year in question, the probate estate earned $480,717.59 in interest on municipal bonds, treasury bills and notes, and a money market account. The probate estate also earned $106,391.04 in dividends on American Municipal Term stock. Therefore, the estate did earn substantial income on investment, and at least part of that income was earned because the executors chose not to pay the $5.5 million in legacies but rather retain those assets in the estate. It would be absurd, however, to conclude that such a scenario allowed for an interest expense deduction on the interest incurred on the deferred legacies.
>
> First, the legacies are not properly characterized as "indebtedness" in this instance. The legacies do constitute obligations of the estate, but they were not incurred by the estate as debts. They were not incurred by the execution in managing and operating the estate nor were they debts of the testator. Rather, they were created by the testator to devise his property upon his death. Furthermore, the job of the executors of the estate was not to retain the estate assets so that the assets would produce investment income, but rather to dispose of the assets in accordance with the decedent's estate plan. Here, Marvin Schwan will's directed that $1 million be paid to each of his four children and $1.5 million be placed in to a trust for his grandchildren. Rather than comply with his wishes, the executors of the estate held the property in the estate and

> incurred substantial interest expense at a rate of 12% to the legatees under South Dakota law. Under these circumstances. the interest incurred on the deferred legacies cannot be characterized as interest paid "on indebtedness properly allocable to property held for investment."
>
> Second, the Plaintiffs have made no effort to trace the interest expense at issue to a debt which was created in connection with maintaining investment property. Section 1.162-8T of the Treasury Regulations establishes the rules for allocating interest expense among expenditures. The regulation Provides that "[i]n general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures." See Treas. Reg. § 1.163-8T(a)(3). In the case of investment interest, the interest expense allocated to an investment expenditure is treated as investment interest. See Treas. Reg. § 1.163(a)(4)(C). The regulation defines investment expenditure as "an expenditure (other than passive activity expenditure) properly chargeable to capital account with respect to property held for investment . . . or "an expenditure in connection with the holding of such property." See Treas, Reg. § 1.163(b)(3). Here, there is no investment expenditure and no debt proceeds to trace.
>
> The legacies, upon which the interest at issue was incurred, did not arise in connection with the acquisition or maintenance of property held for investment purposes. This is not a situation in which the estate incurred a debt such as a loan to maintain investment property already in the estate. Here, the purported debt at issue was not incurred as an expenditure of the estate but rather was created as on obligation of the estate by the testator in the form of a legacy. As such it has no connection to property held for investment and a deduction under I.R.C. § 163 is inappropriate.

Many state statutes provide that specific bequests bear interest if not paid when due, or if no due date is provided, if not paid within one year after probate of the Will.

With respect to a spouse's elective share that is paid "late", Treas. Reg. § 1.663(c)-5, Example 7 states:

> (i) *Facts.* Testator, who dies in 2000, is survived by a Spouse and three adult children. Testator's will divides the residue of the estate equally among the three children. The surviving spouse files an election under the applicable state's elective share statute. Under this statute, a surviving spouse is entitled to one-third of the decedent's estate after the payment of debts and expenses. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. However, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the payment until the executor actually makes payment. During the estate's 2001 taxable year, the estate distributes to the surviving spouse $5,000,000 in partial satisfaction of the elective share and pays $200,000 of interest on the delayed payment of the elective share. During that year, the estate receives dividend income of $3,000,000 and pays expenses of $60,000 that are deductible on the estate's federal income tax return.
>
> (ii) *Conclusion.* The estate has four separate shares consisting of the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state

> law, none of the estate's gross income is allocated to the spouse's separate share for purposes of determining that share's distributable net income. Therefore, with respect to the $5,000,000 distribution, the estate is allowed no deduction under section 661, and no amount is included in the spouse's gross income under section 662. The $200,000 of interest paid to the spouse must be included in the spouse's gross income under section 61. Because no distributions were made to any other beneficiaries during the year, there is no need to compute the distributable net income of the other three separate shares. Thus, the taxable income of the estate for the 2000 taxable year is $2,939,400 ($3,000,000 (dividend income) minus $60,000 (expenses) and $600 (personal exemption)). The estate's $200,000 interest payment is a nondeductible personal interest expense described in section 163(h).

4. **Tax-Free Division of Family Farm**. In Rev. Rul. 2003-52, 2003-22 IRB1 the IRS approved a tax-free division of a farm corporation on the following facts:

> Corporation X is a domestic corporation that has been engaged in the farming business for more than five years. The stock of X is owned 25 percent each by Father, age 68, Mother, age 67, Son, and Daughter. Although Father and Mother participate in some major management decisions, most of the management and all of the operational activities are performed by Son, Daughter, and several farmhands. The farm operation consists of breeding and raising livestock and growing grain.
>
> Son and Daughter disagree over the appropriate future direction of X's farming business. Son wishes to expand the livestock business, but Daughter is opposed because this would require substantial borrowing by X. Daughter would prefer to sell the livestock business and concentrate on the grain business. Despite the disagreement, the two siblings have cooperated on the operation of the farm in its historical manner without disruption. Nevertheless, it has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested.
>
> Having transferred most of the responsibility for running the farm to the children, Father and Mother remain neutral on the disagreement between their children. However, because of the disagreement, Father and Mother would prefer to bequeath separate interests in the farm business to their children.
>
> For reasons unrelated to X's farm business, Son and Daughter's husband dislike each other. Although this has not impaired the farm's operation to date, Father and Mother believe that requiring Son and Daughter to run a single business together is likely to cause family discord over the long run.
>
> To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to Son in exchange for all of his stock in X. X distributes the remaining Y stock equally to Father and Mother in exchange for half of their X stock. Going forward, Daughter will manage and operate X and have no stock interest in Y, and Son will manage and operate Y and have no stock interest in X. Father and Mother will also amend their wills to provide that Son and Daughter will inherit stock only in Y and X, respectively. After the distribution, Father and Mother will still each own 25 percent of the outstanding stock of X and Y and

> will continue to participate in some major management decisions related to the business of each corporation.
>
> Apart from the issue of whether the business purpose requirement of §1.355-2(b) is satisfied, the distribution meets all of the requirements of §§ 368(a)(1)(D) and 355 of the Internal Revenue Code.

The ruling concludes:

> The disagreement of Son and Daughter over the farm's future direction has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested. The distribution will eliminate this disagreement and allow each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business will benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by a real and substantial non-Federal tax purpose that is germane to the business of X. Hence, the business purpose requirement of §1.355-2(b) is satisfied.

5. **Investment Advice Fees**. In J.H. Scott v. United States, 328 F. 3d 132 (4th Cir. 2003) the court followed Mellon Bank, N.A., v. United States, 265 F.3d 1275 (Fed. Cir.2001), and explicitly disagreed with the Sixth Circuit's holding in O'Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993), to subject a trust's deductions for outside investment advice fees to the 2% limitation of section 67(a). The opinion states:

> In reach our decision today, we find ourselves in agreement with the Federal Circuit's reasoning in Mellon Bank, and we thus render a decision at odds with the Sixth Circuit's holding in O'Neill. In O'Neill, the Sixth Circuit reasoned that "[w]here a trustee lacks experience in investment matters, professional assistance may be warranted." 994 F.2d at 304. According to the court, without investment advice, "the co-trustees would have put at risk the assets of the Trust. Thus, the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the cotrustees." Id. In our judgment, this analysis contains a fatal flaw. Of course, trustees often (and perhaps must) seek outside investment advice. But the second requirement of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred outside the administration of trusts. As the Federal Circuit decided in Mellon Bank, investment-advice fees are commonly incurred outside the administration of trusts, and they are therefore subject to the 2% floor established by § 67(a).

6. **Final Regulations; Section 643(b), Definition of Income**. Final regulations have been issued under section 643(b). T.D. 9102. Generally they are effective for tax years ending after January 2, 2004. The basic rule is contained in new § 1.643(b) - (1) which provides as follows:

> For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally

> not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

Thus, there must be a state statute allowing for a unitrust distribution or an allocation of capital gains to income. The Summary of Comments and Explanation of Revisions states as follows on this point:

> Some commentators suggested that, even in those states that have not enacted legislation specifically authorizing powers to adjust or a unitrust definition of income, trust instruments containing such provision should be respected as defining income for purposes of section 643(b). Under a unitrust or power to adjust, items traditionally allocable to principal (such as gains from the sale or exchange of trust assets) may, under certain circumstances, be allocated to

> income, and items traditionally allocable to income (such as dividends, interest, and rents) may, under certain circumstances, be allocated to principal. The proposed regulations already recognize that gains from the sale or exchange of trust assets may, under certain circumstances, be allocated to income under the terms of the governing instrument. However, § 1.643(b)-1 has always provided that the allocation to principal, under the terms of the governing instrument, of items that traditionally would be allocable to income will not be respected for purposes of section 643(b), and this position is maintained in the final regulations. Accordingly, the IRS and the Treasury Department believe that an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the regulations, a state statute specifically authorizing certain unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement. Further, the IRS and the Treasury Department acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for this purpose.

These provisions affect the marital and charitable deduction, and GST grandfathering. The Summary and Explanation states:

> The proposed regulations provide that a spouse will be treated as entitled to receive all net income from a trust, as required for the trust to qualify for the gift and estate tax marital deductions under § 20.2056(b)-5(a)(1) of the Estate Tax Regulations and § 25.2523(e)-1(f)(1) of the Gift Tax Regulations, if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1. Thus, a spouse who, as the income beneficiary, is entitled in accordance with the state statute and the governing instrument to a unitrust amount of no less than 3% and no more than 5% would be entitled to all the income from the trust for purposes of qualifying the trust for the marital deduction.
>
> Several commentators suggested that a trust that provides for a unitrust payment to the spouse should satisfy the income standard even in states that have not enacted legislation defining income as a unitrust amount or providing that a right to income may be satisfied by such a payment. The income distribution requirement that must be satisfied for a trust to qualify for the gift and estate tax marital deductions ensures that the spouse receives what is traditionally considered to be income from the assets held in trust. As previously discussed, the IRS and the Treasury Department believe that only if applicable state law has authorized a departure from traditional concepts of income and principal should such a departure be respected for Federal tax purposes. A state statute specifically authorizing certain unitrust amounts in satisfaction of an income interest or certain powers to adjust in conformance with the provisions of § 1.643(b)-1 would meet this standard. However, in the absence of a state statute, or, for example, a decision of the highest court of the state applicable to all trusts administered under that state's law, the applicable state law requirement will not be satisfied.

> It has also been suggested that, in some circumstances, the proposed regulations would allow the spouse to receive less than all the traditional trust income, and therefore would conflict with the section 2056 statutory requirement that the spouse receive all trust income. For example, a spouse who, in accordance with the state statute, receives a 4% unitrust amount would receive less than all the traditional income generated by the trust, if the trust's total dividends, interest, rents, etc. for the year exceed 4%. However, that spouse would receive more than the amount of traditional income earned by the trust in any year that the trust's total dividends, interest, rents, etc. do not exceed 4%. The regulations are intended to strike a reasonable balance between the marital deduction statutory requirements and the many state statutes intended to facilitate the investment of trust assets while ensuring equitable treatment for the income and remainder beneficiaries. Indeed, Congress contemplated that, in appropriate circumstances, an annuity could be treated as satisfying the statutory income distribution requirement. The flush language following section 2056(b)(7)(B)(ii) specifically authorizes regulations that treat an annuity "in a manner similar to an income interest in property." The IRS and Treasury Department believe that these regulations implement this statutory authorization in a reasonable manner by recognizing allocations under state statutes that provide for a reasonable apportionment of the total return of the trust.
>
> Trusts Exempt From Generation-Skipping Transfer Tax
>
> The proposed regulations expand the rules concerning changes that may be made to trusts that are exempt from the generation-skipping transfer tax because they were irrevocable on September 25, 1985, without causing the loss of the trusts' exempt status. If such an exempt trust is administered in conformance with applicable state law that permits a unitrust amount to be paid to the income beneficiary or permits adjustments between income and principal to ensure impartiality, and that meets the requirements of § 1.643(b)-1, its exempt status will not be affected.
>
> One commentator requested that the final regulations also provide that administration of an exempt trust as described in these regulations will not cause any trust beneficiary to be treated as making a gift and will not result in any taxable exchange by the trust or any of its beneficiaries. Another commentator requested that the final regulations clarify that changing the situs of a trust from a state with only a traditional definition of income to a state that permits unitrusts or powers to adjust will not affect the exempt status of the trust. Examples 11 and 12 have been revised to address these and similar concerns. The same conclusions apply to a change of situs in the opposite direction, from a state that permits unitrusts or the power to adjust to a state that has only the traditional definition of income.

The ability to change situs is of particular benefit. The final regulations also deal with allocations of capital gains to DNI and contain many examples. New section § 1.643(a) - 3 reads as follows:

> Capital gains and losses.
>
> (a) In general. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) --

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

(c) Charitable contributions included in distributable net income. If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) Capital losses. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

(e) Examples. The following examples illustrate the rules of this section:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 6. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 7. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See §1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 8. The facts are the same as Example 7, except Trustee is directed to pay B $10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as Example 7, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as Example 9, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The $500,000 distribution to A may be treated as including a minimum of $200,000 of capital gain (and all of the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax- exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

> Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

The final example (Ex. 14) is useful for corporate trustees which wish to have multiple "regular" practices.

Some issues are not covered. The Summary and Explanation notes:

> One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.

The final regulations also deal with pooled income funds and charitable remainder trusts. Treasury and the IRS seem concerned that the difference between a net income CRT and a standard CRT not be obviated by trustee allocations to income. With respect to that issue, the Summary and Explanation states:

> Several commentators were concerned about the requirement in the proposed regulations that net income CRUTs under sections 664(d)(2) and 664(d)(3) contain their own definition of income if applicable state law provides that income is a unitrust amount. The purpose of this proposed requirement was to avert potential problems with qualification of a net income CRUT in a state that defines income as a unitrust amount. Some commentators pointed out that state statutes provide alternative definitions of income and all that should be necessary is that the trust use a definition of income, whether contained in the terms of the governing instrument or applicable local law, that is not a unitrust amount. *Therefore, the requirement that the trust contain its own definition of income has been eliminated from the final regulations.*
>
> Several commentators were concerned about the provision in the proposed regulations that the allocation of post-contribution capital gain to income, if permitted under the terms of the governing instrument and applicable local law, may not be discretionary with the trustee. Some suggested eliminating the prohibition on discretionary powers held by the trustee. Some suggested that a discretionary power should be permitted if held by an independent trustee. Some

> requested clarification that this prohibition does not apply to a trustee's power to allocate receipts to income or principal pursuant to state law.
>
> The provision in the proposed regulations has no effect on the determination of trust accounting income under applicable state law that grants the trustee a power to reasonably apportion the total return of the trust. The provision is directed at discretion given the trustee under the terms of the governing instrument to allocate capital gains to income in some years and not others. Allowing the trustee this type of discretion is inconsistent with the requirements for net income CRUTs as explained in the legislative history. The settlor has the option of providing in the trust that the trustee is to distribute the lesser of the stated percentage payout or trust income. However, this option must be adopted in the trust instrument and not left to the discretion of the trustee. See H.R. Conf. Rep. No. 91-782, at 296 (1969), reprinted in 1969-3 C.B. 644, 655. A power to allocate capital gains to income in some years and not others in the trustee's sole discretion is similar to having the discretionary ability to pay out either the trust income or the stated percentage payout each year, regardless of their relative values. *Thus, the final regulations continue to provide that, for CRUTs, post-contribution capital gains may be included in the definition of income under the terms of the governing instrument or applicable local law, but not pursuant to a trustee's discretionary power granted by the trust instrument, rather than by state statute, to allocate capital gains to income.*
>
> [Italics added.]

7. **FDIC Insurance**. Effective April 1, 2004, the FDIC insurance rules for "living trust" accounts were liberalized. Under the new rules, the FDIC will provide insurance coverage of up to $100,000 per "qualified beneficiary" of the trust, even if the trust contains conditions on when the beneficiaries will receive the trust funds. A qualified beneficiary is the grantor's spouse, children, grandchildren, parents, and siblings.

8. **Sale of Lottery Winnings**. The sale of lottery winnings creates ordinary income not capital gain. United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004). In Alden L. Clapton v. Commissioner, T.C. memo 2004-95, several lottery participants formed a trust to receive any winnings; after a win, the taxpayer sold his trust interest, rather than the winnings. The Tax Court determined that was a distinction without a difference.

9. **Deferral of Gain Recognition Denied After Sale to ESOP**. Section 1042 allows gain from the sale of company stock to an ESOP to be deferred if the proceeds are reinvested in marketable securities, but an election must be made on the income tax return for the year of the sale. In Estate of John W. Clause v. Commissioner, 122 T.C. No. 5 (2004), the taxpayer did not make a timely election and the court refused a "substantial compliance" defense.

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

1. **Making Changes to a Charitable Remainder Trust**. In PLR 200127023 the Service explained the income tax consequences of the early termination of a CRT, and determined there was no self-dealing. The trust was for a 20 year term and the donor/unitrust recipient ("A"), trustee, and charitable beneficiary each agreed to terminate the trust and divide the trust assets actuarially. The ruling states:

> Accordingly, we conclude as follows: A is selling A's interest in Trust to the remainderman. Provided that the money and other property received by A are distributed to A in accordance with A's interest in Trust, the amount A will realize from the sale of A's interest in Trust is the amount of money and the fair market value of the property received by A.
>
> Pursuant to section 1001(e)(1), the portion of the adjusted uniform basis assigned to A's interest in Trust is disregarded. The exception contained in section 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, for purposes of this transaction, A has no basis in A's interest in Trust. Therefore, the amount of gain A must recognize under section 1001(c) is the amount A realized from the disposition of A's interest in Trust. The gain realized by A from the disposition of A's interest will be long term capital gain.
>
> We further conclude that no act of self-dealing, as defined in section 4941(d)(1) will result from the termination of Trust and the distribution of the assets of Trust to A and the charity.
>
> The above conclusions are based on the assumptions that the proposed termination of Trust is not prohibited by state law; that the proposed termination will be made pursuant to a court order resulting from a proceeding to which the state attorney general is a party; and that the amounts distributed to A are determined and distributed pursuant to the valuation rules set forth in section 7520. This ruling is also contingent on the fact that any distribution of assets in kind is made in a pro rata manner.

PLR 200208039 allowed termination of a net income CRUT where the donor had died and a child of the donor was the only remaining unitrust beneficiary. The CRUT was invested for total return and had typically paid out less than 3% of net fair market value. The remaindermen consented. Could the CRUT have been terminated if anyone had the power to change the charitable remainderman?

If a charitable remainder trust is to be partially terminated and a portion of the trust distributed to charity, the unitrust recipient may be entitled to an income tax deduction so long as the transaction is not deemed to be an end-run around the split-interest rules. See, e.g., 200140027.

In PLR 200301020 the IRS allowed a joint and survivor CRT to be divided as part of a divorce settlement. The original trust provided for unitrust payments to the spouse jointly and then to the survivor, the survivor could alter the identity of the charitable remaindermen, and the spouses were co-trustees. One of the new trusts would be first for husband, then wife, with husband as trustee, wife as successor, and with husband having the power to alter the charitable remaindermen. The second trust would have wife in the lead position, but otherwise would be identical to the first trust. The ruling confirms that no gain would be recognized on the division, that there is no self-dealing, and that the new trusts qualify under section 664. Also, the trust could pay the legal fees for the division.

PLR 200219012 allowed the recission of a CRT where the donors had been misled, had obtained no benefit from the charitable gift, filed amended income tax returns, and had a court approve the recission. The ruling states:

In the instant case, based on the representations made and statements contained in the pleadings submitted to the court, the Donors were misinformed regarding the operation of Charitable Trust as drafted and the requirement that the unitrust amount became payable immediately upon execution of Charitable Trust. In view of the nature of the assets transferred to Charitable Trust (non-income producing stock) and Donor's understanding that no unitrust payment would be made until the stock was sold, it appears that the scrivener intended to draft and the Donors intended to execute a charitable remainder trust described in §§ 664(d)(3), rather than one described in §§ 664(d)(2). Further, Donors were incorrectly informed regarding the tax consequences if Charitable Trust distributed assets in kind in satisfaction of the unitrust amount.

As noted above, in an attempt to reverse the income tax charitable deductions claimed by the Donors on the original income tax returns, Donors filed amended income tax returns on Date 6 and paid the additional tax due. However, also as noted above, because the period of limitations on assessment for Donors' income tax return filed on Date 2 has expired, the Donors made a statutory overpayment for the year in which Charitable Trust was created and funded and the Donors may make a claim for a refund of the additional tax paid for that year. The remaining assets of Charitable Trust were returned to Donors pursuant to the court order issued on Date 5. Traditionally, the tax benefit rule requires taxpayers to recognize income when the taxpayers "recover" an item or amount deducted in a previous tax year. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983). The rule is also applicable in cases involving charitable deductions and provides that if a taxpayer receives a deduction for a charitable contribution in one taxable year and recoups that donation in a later year, the value of the contribution, up to the amount of the charitable contribution previously taken, is treated as income in the year in which it was recouped. Rosen v. Commissioner, 611 F.2d 942 (1st Cir. 1980), anff'g 71 T.C. 226 (1978). It is irrelevant that the deduction taken in the prior year may have been improper or that the period of limitations on assessment has expired for the year in which the deduction was claimed. Unvert v. Commissioner, 656 F.2d 483 (9th Cir. 1981). Thus, the amount of the charitable deduction, $B, claimed by Donors on their income tax return filed on Date 2, for the present value of the remainder interest in the stock of Corporation transferred to Charitable Trust, will be includible in the Donors income for the year in which the remaining assets of Charitable Trust were returned to the Donors. Donors have represented that they will timely file an amended United States Individual Income Tax Return, Form 1040X, for that year reporting the value of the stock up to $B, the value of the contribution claimed by Donors on their income tax return filed on Date 2.

However, the amended income tax return filed for the year following the year of the transfer, in which the excess charitable deduction was claimed and the additional tax was paid, was filed within three years after Date 3, the date of the original return. Thus, the additional tax was paid for that year, which negated the charitable deduction claimed in that year for the transfer to Charitable Trust and, as to that year, the parties are in the same position that they would have been in if Charitable Trust had never been created.

Because of the application of the tax benefit rule for the year in which the transfer was made to Charitable Trust, the filing of the amended tax income return and payment of additional tax for the year following the transfer to Charitable Trust and the fact that Charitable Trust had no income, either ordinary or capital gains, and the Corporation paid no dividends from Date 1 until the date of the court order granting rescission, all parties are in the same position that they would have been in if Charitable Trust had never been created.

> Further, the court order rescinding Charitable Trust is consistent with applicable state law.
>
> Accordingly, we conclude that the rescission will be recognized for federal tax purposes as effective as of the date Charitable Trust was created.

In PLR 200251010 the donors intended to create a CRUT but their attorney drafted a CRAT instead. The synopsis received by the client had the correct unitrust payment schedule – quarterly – instead of annual annuity payments as set forth in the document. Upon discovery by the tax preparer a judicial reformation was undertaken. The IRS approved the trust as reformed, retroactive to the funding of the trust (assets had been sold). Similarly, in PLR 200244011 the IRS allowed a NIMCRUT to be reformed judicially to create a CRUT. The grantor was a co-trustee; the grantor and other trustee each stated they believed the grantor's attorney had created a CRUT and would not have "signed" otherwise. The trust had been administered as a CRUT. In PLR 200338006 the donor had intended to create a standard CRUT but what was drafted was a net income with makeup CRUT (NIMCRUT). The error was discovered in a later year. Judicial reformation was effective for income tax purposes because the donor had received no extra income tax benefit from the error and the trust had been administered as a standard CRUT,

2. **Meaning of "Qualified Appreciated Stock" Contribution to a Private Foundation**. Section 170(e) allows only an income tax deduction for basis when making contributions to a private foundation. Section 170(e)(5) contains an exception which allows a fair market value deduction for "qualified appreciated stock" which the statute states is any corporate stock:

> (i) for which (as of the date of the contribution) market quotations are readily available on an established securities market, and
>
> (ii) which is capital gain property (as defined in subsection (b)(1)(C)(iv)).

At issue in John C. Todd, et ux. v. Commissioner, 118 T.C. No. 19 (2002), was whether certain securities were publicly traded. The opinion discussed the securities:

> Bancorp and the Bank
>
> On the transfer date, Bancorp was a bank holding company, owning all of the issued and outstanding shares of stock of Union Colony Bank, Greeley, Colorado, a state-chartered Colorado bank (the bank). On that date, shares of Bancorp were not listed on the New York Stock Exchange, the American Stock Exchange, or any city or any regional stock exchange, nor were the shares regularly traded in the national or any regional over-the-counter (OTC) market for which published quotations are available. The shares were not shares of an open-end investment company (commonly know as a mutual fund), as provided in section 1.170A-13(c)(7)(xi)(A)(3), Income Tax Regs.
>
> Procedure for Purchase or Sale of Shares of Bancorp
>
> Before and throughout 1994, the procedure for someone wishing to purchase or sell shares of Bancorp was to contact an officer of the bank or a local stockbroker specializing in the shares of Bancorp. The bank or broker would try

> to match a potential seller with a potential buyer. That could prove difficult, since Bancorp shares were not frequently sold. The bank maintained a numerical list, by certificate number, of all share transactions (the bank's list). The bank's list showed the date, seller, buyer, number of shares, share cost (if available), and certificate number. Gill & Associates, Inc. (Gill & Associates), a member of the National Association of Securities Dealers since 1984, acted as a placement agent or "matchmaker" for certain of the sales of the shares. As a matchmaker, Gill & Associates maintained a list of individuals wishing to purchase shares and contacted these individuals when approached by others interested in selling shares. In order to quote a price to an interested purchaser, a representative from Gill & Associates would call the bank to obtain the net asset value on the books of the corporation. Gill & Associates believed the book value was a fair value for the stock of Bancorp, and it used the book value to compute what it believed was a fair price for a share of Bancorp. Gill & Associates did not have access to the bank's list. Although Gill & Associates could readily quote to an interested buyer what it believed to be a fair price for Bancorp shares, Bancorp shares were not necessarily then available for sale. If no shares were available, Gill & Associates would put the interested person's name on a list and contact that person when shares became available. On six to eight occasions during the 10-year period from 1984 through 1994, when Bancorp shares became available for sale, Gill & Associates would place an advertisement, for a brief period, in the local newspaper. Gill & Associates charged a fee of 25 cents for each share placed, and acted as placement agent as an accommodation to the bank, to encourage its business relationship with the bank.
>
> On December 1, 1994, eight individuals, including petitioner, owned or controlled 50.5 percent of the issued and outstanding shares of Bancorp. Petitioner owned or controlled 7 percent of those shares.

The court concluded that a market maker did not make the stock publicly-traded:

> 2. Market Quotations Requirement
>
> In general, if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution. Sec. 1.170A-1(c)(1), Income Tax Regs. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Sec. 1.170A- 1(c)(2), Income Tax Regs. The fair market value of a share of stock or a security is not necessarily equal to its market quotation. See sec. 1.170A-13(c)(7)(xi)(D), Income Tax Regs. Nevertheless, we assume that Congress believed that the existence of readily available market quotations would substantially assist in, if not determine, fair market valuation (and discourage overvaluation). We do not agree with petitioners that the market quotations requirement was met because Bancorp shares were occasionally traded by Gill & Associates, who could provide a suggested share price based on the net asset value of the bank. Such share price did not necessarily reflect a price that any willing buyer or seller had accepted or would accept. Gill & Associates charged a flat fee of 25 cents for each share traded, and acted as a placement agent as an accommodation to the bank, to encourage its business relationship with the bank. We do not accept Gill & Associates' procedures for quoting prices as a reliable proxy for fair market valuation. The intendment of the market quotations requirement would not be served by accepting procedures such as those followed by Gill & Associates with respect to Bancorp shares as satisfying the requirement.

> 3. Section 1.170A-13(c)(7)(xi)(A), Income Tax Regs.
>
> Section 1.170A-13(c)(7)(xi)(A), Income Tax Regs., describes circumstances in which the market quotations requirement is met for purposes of exempting contributions of certain publicly traded securities from the substantiation requirements. See sec. 1.170A-13(c)(1)(i), Income Tax Regs. Section 1.170A-13(c)(7)(xi)(A), Income Tax Regs., does not purport to be applicable to the interpretation of the term "qualified appreciated stock". Nevertheless, given our conclusion as to the consistent meaning of the market quotations requirement, we believe that section 1.170A- 13(c)(7)(xi)(A), Income Tax Regs., also describes circumstances in which the market quotations requirement is met for the purpose of determining whether the shares constituted qualified appreciated stock.
>
> In the petition, petitioners aver that the market quotations requirement was satisfied by virtue of the Bancorp shares' satisfying either subdivision (1) or (2) of section 1.170A- 13(c)(7)(xi)(A), Income Tax Regs. During the trial of this case, however, petitioners conceded that, on the transfer date, the Bancorp shares did not satisfy any of the subdivisions of section 1.170A- 13(c)(7)(xi)(A), Income Tax Regs. Petitioners rely on their plain language reading of the market quotations requirement and argue that the regulation is invalid because inconsistent with that reading. Since we reject petitioners' plain language reading, we reject petitioners' argument based on that reading, that the regulation is invalid.
>
> Petitioners have failed to satisfy the market quotations requirement for purposes of determining whether the shares were (1) publicly traded so as to be exempt from the substantiation requirements and (2) qualified appreciated stock.

In PLRs 200322005 and 200322018 the IRS determined that American Depository Shares (ADS) are qualified appreciated stock under section 170(e)(5). The rulings state:

> We further conclude that Company 1 ADSs are stock for purposes of § 170(e)(5). An ADS is issued by a U.S. depository bank and represents an interest in the underlying ordinary shares of a non-U.S. company. An ADS is evidenced by an American Depository Receipt (an ADR). An ADR is a negotiable receipt issued in certificate form representing an ADS. The holder of an ADR is entitled to demand delivery of the underlying shares. Each Company 1 ADS represents one ordinary share of Company 1. The Company 1 ADSs are the equivalent of an ADR pursuant to the Merger agreement, which states that direct holders of Company 1 ADSs whose ownership is registered on the books of the depository are Company 1 ADR holders. The Service has interpreted ADRs to be treated as shares of stock for various tax purposes, such as the foreign tax credit, Rev. Rul. 65- 218, 1965-2 C.B. 566, and the interest equalization tax, Rev. Rul. 72-271, 1972-1 C.B. 369. Therefore, for purposes of § 170(e)(5), Company 1 ADSs are stock for which market quotations are readily available on an established securities market.
>
> The Taxpayers represent that the Taxpayers have taken steps to ensure that the Donees will be able to sell the contributed ADSs in compliance with Rule 145. The Taxpayers also represent that the aggregate contributions of the Donees will be limited such that the total number of Company 1 ADSs contributed by the Taxpayers to the Donees (including any ADSs already held by the Donees) will be substantially less than 1% of the shares outstanding of Company 1 as shown by the most recent report or statement published by Company 1. The taxpayers

> also represent that contributions will be made to the Donees only at such times when, to the best of their knowledge, there will not be any proposed recapitalization, tender or exchange offer, stock repurchase program or similar plan that would have the effect of substantially reducing the number of outstanding shares of Company 1 within the 3-month period following the contribution. The Taxpayers represent that the Taxpayers will, prior to the proposed contribution, provide a statement to the Donees that the requirements of Rule 145 are met for all transfers of the Company 1 ADSs by the Taxpayers and that the Taxpayers will not take any steps that will prevent the Donees from making transfers of Company 1 ADSs free of any Rule 145 resale restrictions.
>
> The Taxpayers also represent that, under the Governance Agreement, the Family Shareholders may contribute Company 1 ADSs to the Donees without restriction and that such contributed Company 1 ADSs may be sold by the Donees without restriction.

3. **Assignment of Income Issues ("Palmer Problems")**. In PLR 200230004 husband and wife proposed to transfer 495 of 500 shares of a C corporation to a charitable remainder unitrust and asked whether the redemption by the corporation would be self-dealing. The ruling determined it would not be self-dealing because there is an exception to the self-dealing rules:

> Section 53.4941(d)-3(d)(1) of the foundation regulations provides that, in general, under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities.

The taxpayers also asked whether the C corporation dividends would be unrelated taxable income and the answer was no, even though the corporation would be a controlled corporation, because dividends are excepted:

> Section 512(b)(13)(A) of the Code provides that notwithstanding section 512(b)(1), (2), and (3), an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.
>
> Section 512(b)(13)(C) of the Code provides that the term "specified payment" means any interest, annuity, royalty, or rent.
>
> Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation, and in any other case (other than a

> corporation or a partnership) ownership of more than 50 percent of the beneficial interests in the entity.
>
> The modifications contained in section 512(b) of the Code, in effect, constitute an exception to the general rule by excluding from the computation of unrelated business taxable income items such as dividends, interest, annuities, royalties, and rents. If these modifications, which are provided in section 512(b)(1), (2), and (3), are considered an exception to the general rule of taxing the unrelated business income of exempt organizations, then section 512(b)(13) may be considered an exception to the exception. Under section 512(b)(13), the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) does not apply where such amounts are derived from "controlled organizations."
>
> The exception to the modifications contained in section 512(b) of the Code is not applicable in this case. Although Trust, which holds the majority of X stock, is a "controlling organization" within the meaning of section 512(b)(13), the income earned by X while part of its stock is owned by Trust will not constitute UBTI to Trust. The distributions to Trust from X while Trust owns part of its stock are dividends. The receipt of dividends is not taxable to Trust, because section 512(b)(1) excludes dividends from the UBTI, and the rules of section 512(b)(13) do not apply to the payment of dividends.
>
> Therefore, the income earned by X while part of its stock is owned by Trust will not constitute unrelated business taxable income to Trust. In addition, distributions to Trust from X while Trust owns part of its stock will constitute dividends that are excluded from unrelated business income under section 512(b)(1) of the Code, so long as they are not interest, annuities, royalties, and rents derived from the controlled corporation.

Finally, the taxpayers asked whether the redemption would be treated as an assignment of income. The ruling states:

> This request involves Palmer v. Commissioner, 62 T.C. 684 (1974), affd. on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq., 1978-1 C.B. 2. In the Palmer case, the Tax Court held that a taxpayer's gift of stock in a closely held corporation to a private foundation, followed by a redemption, was not to be recharacterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, even though the taxpayer held voting control over both the corporation and the foundation. The Tax Court based its opinion, in part, on the fact that the foundation was not legally obligated to redeem the stock at the time it received title to the shares.
>
> In Rev. Rul. 78-197, 1978-1 C.B. 83, the Internal Revenue Service announced that it will treat the proceeds of a redemption of stock under facts similar to those in the Palmer case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.
>
> In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.

> Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

Among the representations made – whether required or given voluntarily – was:

> In addition, A, as president and sole shareholder of X and grantor and co-trustee of Trust, represents the following:
>
> (1) I, A, grantor and co-trustee of Trust, hereby represent that neither I nor any family member of me will acquire, offer to acquire, or become obligated to acquire shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust.
>
> (2) I, A, President and sole shareholder of X, hereby represent that X will not redeem, offer to redeem, or become obligated to redeem shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust, directly or indirectly, by the grantor of Trust or a family member of the grantor.
>
> (3) I, A, President and sole shareholder of X, and grantor and co-trustee of Trust, hereby represent that neither X nor I am aware of any plan or intention of Trust to transfer any corporate stock, or to have any person acquire any corporate stock from Trust.

The application of Revenue Ruling 78-197 arose in Gerald A. Rauenhorst, et ux. v. Commissioner, 119 T.C. No. 9 (2002). Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned come warrants to four charities. On November 19 sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock.

The government argued that the bright-line rule of Rev. Rul. 78-197 was not controlling. The Opinion states:

> Respondent argues that petitioners are not entitled to judgment as a matter of law and that genuine issues of material fact remain for trial. Respondent argues that the question whether the donees were bound or could be legally compelled to surrender their NMG warrants is not "the critical issue" to be resolved and, accordingly, neither Carrington v. Commissioner, supra, nor Rev. Rul. 78-197, supra, controls this case. It is respondent's position that "the critical issue" in this case is "a factual one": whether petitioners' rights to receive the proceeds of the stock transaction involving WCP "ripened to a practical certainty" at the time of the assignments. Respondent relies on Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), Jones v. United States, supra, Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973), affg. 58 T.C. 259 (1972), Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972), and Estate of Applestein v. Commissioner, supra.

> Respondent purports to distinguish both Carrington and Rev. Rul. 78-197, supra, on the facts of the case and the ruling. To that end, he contends that Carrington and Rev. Rul. 78-197, supra, are not inconsistent with the cases he relies upon above. Respondent claims that in this case, and the cases upon which he relies, there was a pending "global" transaction for the purchase and sale of all the stock of a corporation at the time of the gift or transfer at issue. He then surmises that because Carrington and Rev. Rul. 78-197, supra, did not involve a pending "global" transaction, the legal principles of those authorities do not apply. Instead, he argues that we must apply the principles of the cases he relies upon, and, accordingly, we must conduct a detailed factual inquiry for purposes of determining whether the sale of the stock warrants had ripened to a practical certainty at the time of the assignments.
>
> We cannot agree that respondent has effectively distinguished Carrington and Rev. Rul. 78-197, supra, on their facts. First, neither this Court nor the Courts of Appeals have adopted respondent's theory of a pending "global" transaction as a means of distinguishing cases such as Carrington and Palmer v. Commissioner, 62 T.C. 684 (1974). Indeed, the case law in this area applies essentially the same anticipatory assignment of income principles to cases of a "global" nature as those applicable to cases of a "nonglobal" nature. See, e.g., Greene v. United States, supra at 581. We can only interpret respondent's use of the phrase "pending global transaction" as simply a restatement of the principles contained in the cases upon which he relies. Thus, we cannot agree that respondent's reliance on a pending global transaction distinguishes either Carrington, Rev. Rul. 78-197, supra, or other cases upon which petitioners rely. With that being said and leaving Carrington and those other cases aside at this point, the bright-line test of Rev. Rul. 78-197, supra, which focuses solely on the donee's control over the contributed property, stands in stark contrast to the legal test and the cases upon which respondent relies and which consider the donee's control to be only a factor.

The Court took a dim view of the government's urging that Rev. Rul. 78-197 be ignored:

> While this Court may not be bound by the Commissioner's revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, see Stark v. Commissioner, 86 T.C. 243, 251 (1986), in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

On the facts, the court found in favor of the taxpayer:

> Petitioners argue that as of November 12, 1993, the date the warrants were transferred on the books of NMG, the donees had not entered into any agreement to sell the warrants and could not be compelled by any legal means to transfer the warrants. Accordingly, they contend that, as a matter of law, there was not an assignment of income. Petitioners submitted affidavits from representatives of the donees in support of their motion for partial summary

judgment. Each of those affidavits outlines the events which preceded the assignments, each states that the stock warrants were received on November 12, 1993, and each also states that, as of that date, the donees had not entered into agreements to sell the stock warrants.

Respondent questioned the reliability of those affidavits, and he contended that the affidavits were deficient in that they failed to state the personal involvement of the representatives with respect to petitioners' contributions. He also asserted that the testimony of those affiants is "unknown", and he questioned whether they were involved in any negotiations or discussions with NMG, WCP, or Arbeit regarding WCP's proposed acquisition of NMG stock and warrants. Respondent also questioned the affiants' competency "to opine upon, or reach any conclusion as to, what constitutes a binding agreement or whether their respective organizations had indeed entered binding agreements in connection with the transactions at issue." We do not share respondent's reservations with respect to the affidavits, and we find those affidavits credible.

First, in response to respondent's allegations, petitioners submitted additional affidavits from each of the affiants. Each of those affidavits states: (1) The affiants were personally involved with respect to petitioners' contributions; (2) before the donees' execution of the warrant purchase and sale agreement, there were no agreements amongst the donees, Arbeit, Mr. Rauenhorst, or any other person or entity regarding the sale of the warrants; and (3) through November 12, 1993, there were no negotiations or communications between the donees and NMG or parties representing NMG, except for the letters from NMG's legal counsel requesting that the donees sign an Additional Party Signature Page.

Second, respondent relies on nonspecific allegations of an informal agreement or understanding between the donees and NMG, WCP, Mr. Rauenhorst, and/or Arbeit. Summary assertions and conclusory allegations are simply not enough evidence to raise a genuine issue of material fact. [citations omitted]

Respondent alleges no facts or evidence to substantiate his position, and he has submitted no affidavits in response to the affidavits that petitioners submitted. Instead, he points out that the record lacks information regarding any discussions, deliberations, or negotiations which may have taken place between the donees and the other parties. Respondent has had ample opportunity to investigate the facts surrounding these transactions, and it is clear that respondent could have requested additional information from the individuals involved. See Rule 121(e). He has requested neither additional discovery nor a continuance for purposes of additional discovery. He has not demonstrated to our satisfaction that the only available method for opposing the statements in the affidavits is through cross- examination at trial. Further, it is insufficient for the opposing party to argue in the abstract that the legal theory involved in the case encompasses factual questions. Hibernia Natl. Bank v. Carner, 997 F.2d 94, 98 (5th Cir. 1993); Daniels v. Commissioner, supra. Since petitioners have offered affidavits directly supporting their position on a material issue of fact, and since respondent has failed to counter those affidavits with anything other than unsupported allegations, respondent cannot avoid summary judgment on this issue. See Greene v. United States, 806 F. Supp. 1165, 1171 (S.D.N.Y. 1992), affd. 13 F.3d 577 (2d Cir. 1994). Thus, we find that there is no genuine issue of material fact regarding whether the donees entered into a legally binding agreement to sell their stock warrants before, or at the time of, the assignments by petitioners.

Footnote 14 states:

> The record indicates that no agreement was entered into by the donees before Nov. 19, 1993, the date they signed the warrant purchase and sale agreement. On Nov. 16, 1993, NMG's legal counsel sent letters to each of the donees enclosing a warrant purchase and sale agreement. Those letters state that pursuant to the warrant purchase and sale agreement, the donees would agree to sell their reissued warrants to WCP and "to abstain from either exercising its Warrant or selling or otherwise transferring it to any other party through Dec. 31, 1993." Certainly, the formality of having the donees enter into the warrant purchase and sale agreements suggests that they had not entered into any binding agreements before Nov. 19, 1993.

Subsequent to the decision, the government has reiterated its intention, generally, to follow its own rulings in litigation.

In PLR 200321010 a retired officer of a corporation intended to give shares of the corporation to a CRUT. The corporation had the right to purchase the stock if it so desired, and the agreement also bound the trust:

> X proposes to establish a CRUT (as defined in § 664 of the Internal Revenue Code). Upon establishment of the CRUT, X will notify Company of X's intent to transfer a portion of X's Company stock purchased under the Plan to the CRUT, thereby triggering Company's option to purchase the stock for the formula price set forth in the stock restriction agreements applicable to such stock. Taxpayer represents that Company will likely decline to purchase the stock for the formula price set forth in the stock restriction agreements and thus X will be free to transfer the stock to the CRUT. The stock transferred to the CRUT will continue to be subject to the terms of the stock restriction agreements under the Plan in accordance with the terms of the stock restriction agreements. Therefore, if the trustee of the CRUT wishes to sell or otherwise dispose of the stock, Company will have a right to purchase the stock for the formula price set forth in the stock restriction agreements. The trustee will notify Company that the CRUT wishes to sell Company stock prior to any proposed sale or disposition. X represents that Company has always exercised its option under the stock restriction agreements in the past for the formula price set forth therein.

The ruling described the "bright-line" test of Palmer, citing Rauenhorst:

> The Service has acquiesced in the Palmer decision. See 1978-1 C.B. 2. In Rev. Rul. 78-197, 1978-1 C.B. 83, the Service concluded that it will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. The Tax Court has characterized the "legally bound" standard in Rev. Rul. 78-197 as a "bright line" test for determining if a contribution of stock to a charity followed by a redemption of that stock from that charity should be respected in form or recharacterized as a redemption of the stock from the donor followed by a contribution of the proceeds by the donor to the charity. See generally, Rauenhorst v. Commissioner, 119 T.C. No. 9 (October 7, 2002).

Thus, the ruling concludes:

> Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to transfer the Company stock to the CRUT. Under the restrictions contained in each year's stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.
>
> Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78-197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

4. **Sample Charitable Trust Forms**. Rev. Procs. 2003-53 through 2003-60 provide various sample charitable remainder annuity trust forms, including one-life, two-life, and term of years inter vivos and testamentary trusts. The sample forms are unsurprising but are much better, with many more options and annotations, than the 1989 and 1990 forms. Unitrust forms may be issued by the end of June, 2004.

5. **Final Boeshore Regulations**. The IRS has issued final regulations eliminating the requirement that a charitable interest cannot be preceded in point of time by a noncharitable interest that is in the form of an annuity or unitrust interest. T.D. 9068, IRB 2003-37 at 538. The final regulations conform to Boeshore, 78 T.C. 523 (1982).

6. **Charitable Remainder Trust Ordering Rules**. On November 20, 2003, proposed regulations were issued dealing with the character of distributions from charitable remainder trusts effective for tax years ending after November 20, 2003. REG - 110896 - 98. Income would be categorized as ordinary income, capital gains or other income, and within categories items of income would be treated as being distributed beginning with items subject to the highest federal income tax rate, interest ahead of dividends, for instance. The regulations also contain

the rules set forth in Notice 97-59, 1997-2 CB 309 for netting gains and losses (effective for tax year ending on or after December 31, 1998).

7. **Charitable Crummey Trust**. Suppose a gift is made to a trust and a charity may withdraw the contribution within 30 days of the gift. Will the donor receive a gift tax charitable deduction or may the gift qualify for the annual exclusion? Such was the issue presented in TAM 200341002. Specifically withdrawal rights were held 20% by Child A, 20% by Child A's spouse, 20% by Child B, 25% by Charity 1, and 5% each by Charities 2, 3 and 4. The trust assets were insurance premiums (cash) and policies. Trustee could distribute income and principal for the health, education, maintenance and support of the beneficiaries so long as a reserve existed to satisfy any withdrawal rights.

The TAM states:

> In this case, under the terms of Trust, an interest in property passed for both charitable and private purposes. Because Trust did not satisfy the requirements of § 2522(c), a charitable deduction is not allowable with respect to any transfer to Trust. This is the case, notwithstanding the withdrawal powers held by the charities with respect to contributions to Trust. First, there is no statutory or regulatory exception that alleviates the need to comply with the requirements of § 2522(c) and the applicable regulations merely because charity has a power to withdraw a portion of each contribution to the trust. Further, as discussed below, under the facts presented, we do not believe that the charities' withdrawal powers were viable powers. However, even assuming there was no impediment to the exercise of these powers, under the provisions of Trust, each charity's right to withdraw a respective portion of a transfer expired 30 days after the charity received the corresponding Notification Letter. Once this withdrawal period terminated, the charity's right to receive any portion of the transfer as a result of the withdrawal power terminated, and the transfers remained in Trust subject to invasion for the benefit of the individual beneficiaries. Thus, the situation presented here is analogous to a transfer subject to a condition or power described in § 25.2522(c)-3(b)(2).

With respect to the second question, the TAM states:

> Under the terms of Trust, each charity could withdraw a percentage of each contribution, if a written request was delivered to Trustee during the 30-day notice period. If the withdrawal right was not exercised, the amount subject to withdrawal was to be held in the trust subject to distribution, at the trustee's discretion, to Child A, Child A's Spouse, and Child B, for the beneficiary's education, health, maintenance, and support during Decedent's life. Thus, the Trustee could disperse all of the Trust property among the individuals and terminate Trust before Decedent's death, leaving nothing remaining for the charities at Decedent's death. Moreover, because the standard for invasion (education, health, maintenance and support) was ascertainable, the individual beneficiaries possessed an enforceable right to distributions that a beneficiary could enforce in the appropriate State court. II The Law of Trusts, supra at § 128.4. Thus, any amounts the charities failed to withdraw could have been distributed to the individual beneficiaries during Decedent's life.

> Similarly, under the terms of Trust, Trustee could lend the Trust property to other trusts created by Decedent and his family members. Similar in effect to Trustee's distribution power, this power could be exercised by Trustee, before Decedent's death, to transfer the Trust property to the other family trusts under circumstances that could jeopardize the value of the Trust principal and the charities' remainder interest. Consequently, if a withdrawal right was not exercised, the forfeited amount would become Trust property and be thereby exposed to dissipation for the private interests of Decedent's family.
>
> It is clear that the charitable remainder trust, pursuant to which property has been transferred in trust for the lifetime benefit of an individual or individuals with the remainder passing to charity, is a common estate planning vehicle. Prior to the Tax Reform Act of 1969 and the enactment of §§ 664, 2055(e)(2), and 2522(c), it was common that the trust corpus was subject to invasion for the benefit of the income beneficiary. Charities' interests in these trusts as remainder beneficiaries, or even as potential discretionary distributees during the income beneficiaries' lifetime, presented no legal issues to the charities.
>
> However, the charities' withdrawal rights in this case present a different situation. Here, Trust purportedly gave the charities the option of either withdrawing the funds from each contribution, or allowing the funds to remain in the trust subject to distribution to Decedent's relatives for private noncharitable purposes with the possibility of the charities receiving a distribution on Decedent's death. *In view of the strict prohibition on the use of a charity's property for private purposes and the fiduciary obligations imposed on a charity and its directors, it is doubtful that any officer or director of a charity could properly participate in this kind of gamble, where funds charity purportedly controls are to be set aside for private utilization until some future date.*
>
> Thus, we believe that there was a legal impediment prohibiting these withdrawal powers from ever becoming effective. Indeed, as noted above, the charities, in the aggregate, were granted 44 separate withdrawal rights, none of which were ever exercised. Further, as discussed above, in some cases, the Notification Letter was sent to the charities before the transfer was made, such that the withdrawal period expired before the date of the transfer. In other cases, the Notification letter did not accurately describe the amount subject to withdrawal or was undated, so it was unclear when the withdrawal period commenced. The failure to make any of the withdrawals coupled with the haphazard execution of the notification procedure, without any adverse comment from the charities, evidence that at least the charities' understood that they were legally precluded from actively participating in this withdrawal arrangement that allowed funds to enure for private purposes.
>
> [Italics added.]

Essentially the IRS' reasoning was that (1) the fact a charity did not exercise a withdrawal right meant (2) there was no withdrawal right. Such reasoning may be criticized. Suppose the trust were primarily for charitable purposes or entirely for charitable purposes but did not qualify as a charitable remainder trust. Would the annual exclusion have been available even if the charities did not withdraw?

8. Conservation Easement and Partnership Pass-Through Deductions. Rev. Rul 2003-123, 2003-50 IRB at 1200, provides a trust that puts a conservation easement on trust property will not receive an income tax deduction for the value of the easement. Section 642(c) allows a trust to deduct from taxable income amounts paid from gross income for charitable purposes pursuant to the terms of the trust instrument. Because a conservation easement is not paid from the income there is no charitable contribution.

A similar issue was addressed in Rev. Rul. 2004-05, 2004-3 IRB 295. A trust does not authorize charitable contributions but directs all income to be distributed to A for life, reminder to B. The trust (called TR) owns an interest in a partnership, PRS, which makes charitable contributions.

The ruling states:

> For a trust to claim a charitable deduction under § 642(c) for amounts of gross income that it contributes for charitable purposes, the governing instrument of the trust must give the trustee the authority to make charitable contributions. This requirement is an essential element to qualify the trust to claim a deduction for a charitable contribution made directly by the trust. In the case of a trust's investment in a partnership, the partnership may make a charitable contribution from the partnership's gross income, and that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits. Under these circumstances, a trust's deduction for its distributive share of a charitable contribution made by a partnership will not be disallowed under § 642(c) merely because the trust's governing instrument does not authorize the trustee to make charitable contributions. *See Estate of Bluestein v. Commissioner*, 15 T.C. 770 (1950), *acq.*, 1951-1 C.B. 1, and *Estate of Lowenstein v. Commissioner* 12 T.C. 694 (1949), *acq.* 1949-2 C.B. 2, *aff 'd sub nom, First National Bank of Mobile v. Commissioner*, 183 F.2d 172 (5th Cir. 1950), reaching similar conclusions under the statutory predecessor to § 642(c).
>
> In the present situation, *PRS*'s charitable contribution is made from *PRS*'s gross income. *TR* is allowed a charitable deduction for its distributive share of this contribution, even though *TR*'s governing instrument does not authorize the trustee to make charitable contributions. Because none of *TR*'s income for the taxable year would be considered "unrelated business income" for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681. *TR* is a complex trust for the taxable year because it is allowed a charitable deduction under § 642(c) for that year.
>
> The same result would apply if *TR* were always a complex trust because it was not required to distribute all its income currently.

The Revenue Ruling does not discuss how the trust came to own the partnership interest. If the trustee and beneficiaries of a trust wanted the trust to have a charitable deduction could the trust invest in a partnership which would make charitable contributions? If that were a breach of trust, does the breach have income tax consequences? Does it matter if the partnership's charitable contribution is "income" or "principal?"

9. Improper Operation Dooms CRAT. Estate of Melvine B. Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002). In August, 1991 Melvine B. Atkinson gave $4,000,000 of stock to a charitable remainder annuity trust which would pay her $200,000 for life then $200,000 among four beneficiaries for their lives, and then the remaining trust assets would pass to charity. The four successor annuitants were obligated to pay Ms. Atkinson's estate taxes on account of the CRAT.

The Eleventh Circuit reviewed certain other facts:

> The Tax Court found that no annuity payments were ever actually made to Atkinson from the assets of the annuity trust. The estate continues to claim that checks were sent to Atkinson, but that Atkinson saw no need to cash them because her material needs were amply met by non-trust assets. However, this claim is undercut by the fact that the estate produced no copies of these checks or the cover letters that supposedly accompanied the checks to Atkinson, nor did the annuity trust's ledger reflect any outgoing annuity payments to Atkinson during her lifetime.
>
> Upon Atkinson's death, the non-charitable beneficiaries next in line to the annuity trust's assets were compelled to make an election. Either they could accept the annuity and pay their share of Atkinson's estate taxes according to the terms of the annuity trust, or they could refuse Atkinson's gift. None of these non-charitable beneficiaries elected to accept the annuity under the terms of the trust. One potential beneficiary, Atkinson's caretaker Mary Birchfield, citing a putative inter vivos promise by Atkinson that Birchfield would not be held liable for any estate taxes resulting from her annuity from the trust, instigated litigation against the estate. Eventually, the trustee paid a settlement of $667,000 to Birchfield in satisfaction of all her claims against the estate and also resumed annuity payments to Birchfield in the amount set by the trust, which payments continued until Birchfield's death in 1997. Birchfield never paid her share of the estate taxes due on the money she received.
>
> Before the settlement of Birchfield's claim, the estate was required to file its federal estate tax return. The taxable gross estate, according to the executor, consisted of Atkinson's annuity rights under the trust ($366,334.92) as well as the date-of-death value of both the annuity and administrative trusts ($4,284,308 and $1,484,854, respectively). The estate claimed a charitable deduction in the amount of $3,894,535, representing the present value of the remainder interest in the annuity trust as of the date of Atkinson's death, measured under the assumption that Birchfield, whose claim against the estate had not been settled at that time, would prevail on that claim and be entitled to an annuity from the trust for the balance of her lifetime and, correlatively, that the charities would not take their remainder interest in the trust until Birchfield's death.
>
> The Internal Revenue Service ("IRS") selected the estate's tax return for audit, and found that the estate was not entitled to take any charitable deduction because the annuity trust failed to comply with certain statutory procedures applicable to the deductibility of charitable remainders. With the disallowance of the charitable deduction, the IRS determined that the estate owed $2,654,976 in taxes. Because the administrative trust and the balance of other estate assets would not be sufficient to satisfy this tax liability, it became apparent that the remaining amount due would be paid by the annuity trust. The estate challenged the IRS's decision in the United States Tax Court, which agreed with the IRS that a charitable deduction was not appropriate. See Atkinson v. Comm'r, 115 T.C. 26, 32 (2000).

The court found that failure to comply with the CRAT requirements was fatal:

> The documents that establish the Atkinson annuity trust track the CRAT requirements to the letter. However, the Atkinson annuity trust failed to comply with the CRAT rules throughout its existence. Yearly annuity payments to Atkinson were not made during her lifetime. Accordingly, since the CRAT regulations were not scrupulously followed through the life of the trust, a charitable deduction is not appropriate.
>
> The estate complains that this stringent focus on the CRAT rules amount to a denial of a substantial charitable deduction because of what amounts to a "foot fault," or a minor mistake. However, the scheme established by Congress is specifically designed to combat the problems associated with the donation of charitable remainders. In exchange for the significant benefits of allowing a present charitable deduction, even when the actual charitable donation is not to occur until the remainder interest in the property becomes possessory, and in allowing the assets of the trust to grow tax-free, the Code requires adherence to the CRAT rules. It is not sufficient to establish a trust under the CRAT rules, then completely ignore the rules during the trust's administration, thereby defeating the policy interests advanced by Congress in enacting the rules themselves. Despite the certain charitable donation in this case, the countervailing Congressional concerns surrounding the deductibility of charitable remainders in general counsel strict adherence to the Code, and, barring such adherence, mandate a complete denial of the charitable deduction.

10. **Bequest of Art**. PLR 200418002 deals with a bequest of art to a museum will qualify for a section 2055 charitable deduction. The bequest would be subject to extensive requirements of the museum. The ruling summarizes the agreement:

> The Taxpayers entered into an Agreement on Date 1 with Foundation and the Trustees of Museum concerning the Taxpayers' donation of the Collection either during the lifetime of either or both of them or upon the death of the survivor of them (Donation). The Agreement was later amended on Date 2 and Date 3.
>
> Section 1.A of the Agreement provides that in the event the Taxpayers elect, in their sole discretion, to make the Donation, the Trustees of Museum shall accept the Collection on behalf of the Museum, and the Trustees shall display and maintain the Collection in accordance with the terms and conditions set forth herein. Immediately upon the occurrence of the Donation, title to the Collection shall vest in the Trustees, for the benefit of Museum, and at all times thereafter the Trustees shall be and remain solely responsible for the custody, control, management, exhibition, conservation of and curatorial services for, the Collection in accordance with the terms of this Agreement. Trustees acknowledge and agree that nothing contained in this Agreement shall be deemed to obligate the Taxpayers to make the Donation.
>
> Section 2.A (i) provides that the intention of the parties is that each work of art comprising the Collection shall at all times be located, housed and permanently displayed, in perpetuity, at either the Museum or Donors' Gallery. The Museum shall at all times utilize the Donors' Gallery to its capacity for the exhibition of works of art from the Collection, or the exhibition of works of art by artists whose works comprise part of the Collection which are either part of the Museum's collection, or on loan to the Museum, or exhibited in connection with special temporary exhibitions. At all times, a minimum number of works of art

from the entire Collection shall be housed and permanently displayed, in perpetuity, at the Museum. The minimum number is defined as a number not less than the total number of gifts of works of art made by the Taxpayers prior to the Donation, excluding works on paper. In accordance with the provisions of the Agreement, if after utilizing the Donors' Gallery to its capacity and adhering to the provisions of paragraph 2.A.(i) in the Agreement with respect to the Minimum Number, there remain works of art in the Collection not on display, the Museum will use its best efforts to exhibit such works of art at the Museum.

Section 2.A (ii) provides that all works of art on paper comprising part of the Collection shall at all times be located, housed and/or displayed at the Donors' Gallery, consistent with generally accepted conservation guidelines in effect from time to time. Such works of art on paper shall be subject to temporary relocation to the Museum for the sole purpose of exhibiting such works of art on paper at the Museum, or in connection with research.

Section 2.B provides that upon the Donation, the Trustees of Museum shall promptly cause all works of art in the Collection to be included within the Museum's blanket insurance policy, which insures the Museum's entire collection from time to time. The proceeds of any such insurance shall, at the option of the Trustees, be used either for the restoration of the damaged work, or the purchase of a replacement work of art by any of the artists whose works of art comprise the Collection.

Section 2.C provides that the Museum will provide all conservation and curatorial services for each work of art in the Collection, wherever located, in the same manner as is provided for the Museum's permanent collection, at the sole cost and expense of Museum. The conservation and curatorial services for the Collection shall include, but shall not be limited to, all cleaning, framing, hanging, handling, restoration, transportation, and insurance. In the event that any work of art in the Collection requires restoration, the Museum shall select a restorer who is an expert in the school of art and/or artist of the work involved, whether or not that restorer is employed by Museum.

Section 2.D provides that all of the works in the Collection which are displayed at the Museum will be displayed in galleries which have been decorated, equipped, and maintained in a manner which, in the professional judgment of the Director or Chief Curator of Museum, will enhance the aesthetic appeal of the works in the Collection, will provide for the comfortable enjoyment of the Collection by the public, and will be comparable in quality and aesthetic appeal to the permanent collection currently displayed at the Museum. The Museum will be solely responsible for all reasonable costs and expenses relating to the decoration, equipping and maintenance of the galleries at the Museum in which the Collection is displayed, which will include the responsibility for all lighting, air conditioning and humidity controls, cleaning, installation, security systems, security, seating and floor coverings in the galleries. In addition, the galleries in which the Collection is displayed shall be in locations which are at all times during Museum hours easily accessible to the public.

Section 2.E provides that the Museum shall be responsible for all conservation and curatorial services for each work of art from the Collection located at the Donors' Gallery, including all cleaning, framing, hanging, handling, restoration, transportation, and insurance, and all costs and expenses related thereto. The Trustees shall select an administrator of the Donor's Gallery who shall coordinate the respective duties and activities of the Trustees and the Board, and act as liaison between them. The Trustees shall have the right to change the

Administrator from time to time in their sole discretion. The Administrator shall be responsible for the administration and operation of the Donors' Gallery and the Taxpayers' residence, including, but not limited to, all lighting, air conditioning and humidity controls, cleaning (other that the works of art in the Collection), security systems, security, seating and floor coverings; and all of the expenses in connection with the foregoing, including the salary of the Administrator, shall be borne by the Foundation.

Section 2.F provides that each work of art in the Collection, as well as the entire Collection, wherever located, will at all times be attributed, clearly and visibly, as part of the Collection.

Section 2.G provides that the Trustees of Museum shall not, at any time, sell, trade, transfer or otherwise dispose of, or permit the sale, trade, transfer or other disposition of, all or any of the works of art in the Collection. In the event of any attempted sale, trade, transfer or disposition of any work of art in the Collection in violation of the terms of this Agreement, the ownership of that work of art shall immediately and automatically vest in the Foundation, without any action on the part of the Foundation.

Section 2.H provides that subject to the provisions of paragraph 2.A hereof, the Trustees shall not, at any time, store, loan or relocate, or permit the storage, lending or relocation, of any of the works of art in the Collection (other than the relocation of works of art in the Collection between the Donors' Gallery and the Museum), except under special circumstances approved by the Museum's senior staff Member(s) of Period art, such as a major retrospective or in order to enhance the reputation of a particular artist or artists in connection with an exhibition of the works of such artist or artists.

Section 2.I provides that the Trustees agree to display works of art at the Donors' Gallery at all times of sufficient quantity, quality and variety so as to establish the high standards established by Taxpayers. Accordingly, in the event that the Trustees remove any works of art which are part of the Collection from the Donors' Gallery for the purpose of exhibiting such works of art at the Museum, or for any reason permitted under the provisions of this Agreement, the Trustees shall, in place of the works of art so removed, exhibit works of art which are not part of the Collection, provided that such works of art are by artists whose works of art are part of the Collection.

Section 2.J provides that the Museum will promote the use of Donors' Gallery so as to make the public aware of the quality of the Collection and the setting in which the Collection is displayed, all to the end that the Collection shall become open and accessible to, and stimulate the interest of, the general public.

Section 3 provides that prior to or simultaneously with the Donation, the Taxpayers will contribute to the Foundation the Donors' Gallery, the Taxpayers' residence, and funds to generate an income stream which will, in the opinion of the Taxpayers, be sufficient to operate the Foundation, operate and maintain the Donors' Gallery and the Taxpayers' residence, and otherwise comply with the Foundation's other obligations under this Agreement.

Section 6 provides that in the event that Museum defaults in its obligations, the Foundation shall have the option, upon written notice to the Trustees, to terminate the Agreement, and/or to exercise any other remedies available to them at law or in equity. Upon termination of the Agreement, the ownership of all of the works of art comprising the Collection which have been given or

> donated to the Trustees for the benefit of Museum shall immediately revert to the Foundation.
>
> Section 7.A provides that the Foundation shall operate the Donors' Gallery for a minimum of ten years from the date of the Donation. At any time after the expiration of such ten year period, the Foundation shall have the right to terminate this Agreement, upon thirty days written notice to the Trustees, in the event that: (i) the Collection is on permanent display at the Museum; (ii) in the opinion of the Foundation, it is not economically feasible to continue to operate and maintain the Donors' Gallery and the Taxpayers' residence; or (iii) in the opinion of the Foundation, the continued operation of the Donors' Gallery and the Taxpayers' residence is not consistent with the intent of the Taxpayers.
>
> Section 7.B provides that in the event that the Foundation elects to terminate this Agreement in accordance with the provisions set forth in Paragraph A, the Trustees shall promptly cause any portion of the Collection remaining at the Donors' Gallery to be delivered to the Museum, which delivery shall be fully insured, all at the cost and expense of the Museum. After termination of this Agreement, neither the Trustees nor the Museum shall have any claim to any assets of the Foundation.
>
> Section 7.C provides that in the event that the Foundation terminates this Agreement in accordance with the provisions of Paragraph A above, or in the event that the Foundation has not terminated this Agreement and there is a material diminution of the gallery space at the Donors' Gallery for other than a temporary period of time, the Trustees shall thereafter use their best efforts to locate, house and display the entire Collection at the Museum in accordance with the provisions of Paragraph 2.A.

The ruling concludes favorably:

> In the present case, under the terms of both Husband's and Wife's will, the works of art comprising the Collection will pass to the Museum upon the death of the survivor of the Taxpayers. Museum is an organization described in section 501(c)(3). If the Museum does not accept the Collection, then the Collection will pass to the Foundation, an organization described in section 501(c)(3). Under the Agreement, Museum may not sell any of the Collection and may loan art in the Collection under specially defined circumstances. Further, under the Agreement, if Museum defaults on its obligation, the Collection reverts to the Foundation. Under no circumstances will the Collection revert to the Taxpayers or inure to the benefit of other private individuals. Accordingly, based upon the facts submitted and the representations made, we conclude that:
>
> > 1. The value of the proposed bequest upon the death of the survivor of Taxpayers to the Museum (or if the Museum refuses to accept the contribution, to the Foundation), of the Taxpayer's interest in the works of art comprising the Collection, subject to the conditions of the Agreement, will be deductible from the Taxpayer's gross estate under section 2055.
> >
> > 2. The amount of the deduction under section 2055 for the proposed bequest, upon the death of the survivor of the Taxpayers, to the Museum (or if the Museum refuses to accept the contribution, to the Foundation), of the Taxpayer's interest in the works of art comprising the Collection, will be equal to the full fair market value of the

> Taxpayer's interest in the works of art comprising the Collection includible in the Taxpayer's gross estate under sections 2031 and 2033.

C. SECTION 408 — IRAs AND RETIREMENT PLANS

1. **IRA Paid to Revocable Trust**. PLR 200317043 is one of a series of rulings dealing with a common planning technique:

> Taxpayer A, whose date of birth was Date 1, 1942, died on Date 2, 2002, at age 60. As of his date of death, Taxpayer A was the owner of IRA X maintained with Company M.
>
> On Date 4, 1999, Taxpayer A signed and adopted Trust T for the benefit of his three children, Taxpayer B, Taxpayer D, and Taxpayer E. Taxpayer B's date of birth was Date 3, 1972. Taxpayer B is older than either Taxpayer D or Taxpayer E. Taxpayer C is the Trustee of Trust T.
>
> Taxpayer B was alive as of the date of this ruling request.
>
> The provisions of Trust T provide, in relevant part, that Trust T is intended to be the beneficiary of an individual retirement arrangement (IRA) maintained by Taxpayer A. The terms of Trust T further provide, that upon the death of the Trustor, the Trustee shall divide the trust estate into equal shares, one (1) for Taxpayer B if he is then living. Each share shall constitute a separate trust and shall be held and administered as such. The terms of Trust T also provide that the Trust T trustee is required to maintain separate accounts on a pro rata basis in accordance with Proposed Treasury Regulation 1.401(a)(9)- 1, Q&A H-2(b), for the separate beneficiaries of Trust T. Finally, the terms of Trust T provide that its Trustee shall withdraw from the beneficiary's share of any IRA and distribute to the beneficiary such beneficiary's share of the minimum distribution required to be distributed annually from the IRA.
>
> On Date 5, 1999, Taxpayer A signed a beneficiary designation with respect to his IRA X pursuant to which IRA X was to be distributed to the trustee of Trust T at the death of Taxpayer A. Said beneficiary designation provides, in relevant part, that Trust T is to be divided into equal accounts for three beneficiaries named therein. Taxpayer B is one of the three named beneficiaries. The beneficiary designation also provides that the Trust T trustee may establish separate IRAs in the name of Taxpayer A for the benefit of the three above-referenced named beneficiaries. In effect, the trustee of Trust T was authorized to establish a separate IRA for the benefit of Taxpayer B.
>
> Your authorized representative has asserted that Trust T and the separate trusts created under its terms are valid under the laws of State N. He has also asserted that Trust T and the separate trusts created under its terms became irrevocable upon the death of Taxpayer A. Company M was provided with a copy of Trust T and of the related beneficiary designation prior to the death of Taxpayer A.
>
> Your authorized representative has provided the Service with documentation which indicates that, prior to Date 6, 2002, IRA X was subdivided into three IRAs after the death of Taxpayer A. Each posthumously created IRA is titled in the name of Taxpayer A (Deceased) for the benefit of a distinct individual. Thus, one IRA (IRA W) is titled Taxpayer A (Deceased) for the benefit of the Trust for Taxpayer B. IRA W has an Account Number which is different from

> the Account Numbers assigned to the IRAs maintained for the benefit of Taxpayer A's other two children.
>
> Additionally, documentation provided by your authorized representative indicates that the trust created for the benefit of Taxpayer B under the terms of Trust T has a Taxpayer Identification Number which is different from the Taxpayer Identification Numbers assigned to the trusts created for the benefit of Taxpayer A's other children.
>
> Your authorized representative has asserted on your behalf that the one-third of IRA X which became IRA W after IRA X was subdivided is payable to the subtrust created under the terms of Trust T for the benefit of Taxpayer B. Your authorized representative asserts that distributions from IRA W have not been made, are not being made, and will not be paid to Trust T.

At issue was whether the division created separate trusts for purposes of calculating the required minimum distribution rules. The ruling reviews the final regulation:

> § 1.401(a)(9)-8 of the "Final" Regulations, Q&A-2(a) provides the "separate account" rules with respect to defined contribution plans. A "separate account" is an account under which the beneficiary or beneficiaries differ from the beneficiary or beneficiaries of the other accounts. In general, if separate accounts are set up, for years subsequent to the calendar year containing the date on which the separate accounts were established, or the date of death if later, a separate account under a plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account satisfy the requirements of Code § 401(a)(9). Instead, the rules in Code § 401(a)(9) apply separately to each separate account under the plan.
>
> § 1.401(a)(9)-8 of the "Final" Regulations, Q&A-3, provides that a separate account is a separate portion of an employee's benefit which reflects the separate interest of an employee's beneficiary under the plan as of the employee's death for which separate accounting is maintained. The separate accounting must allocate all post-death investment gains and losses, contributions and forfeitures, for the period prior to the establishment of the separate accounts on a pro-rata basis in a consistent and reasonable manner among the separate accounts.
>
> § 1.401(a)(9)-4 of the "Final" Regulations, Q&A-5(c), provides, in relevant part, that the separate account rules under A-2 of § 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit.
>
> * * *
>
> As noted above, if distributions are made to a trust, even if the trust is a "see-through" trust within the meaning of Q&A-5 of § 1.401(a)(9)-4 of the "Final" Regulations, the separate account rules of A-2 of § 1.401(a)(9)-8 of the "Final Regulations" are not available to the beneficiaries of the trust. Thus, in general, each beneficiary of a trust must receive minimum required distributions over the life expectancy of the eldest beneficiary.

> The issue raised in this ruling request is whether the general rule, above, applies where IRA distributions are made directly to a subtrust created under the terms of a trust.
>
> In this case, distributions from IRA W, which was created for and is being maintained for the benefit of Taxpayer B, are being made directly to the subtrust created under the terms of Trust T for Taxpayer B's benefit and are not being paid to Trust T. Taxpayer B is the only beneficiary of the subtrust created for his benefit. However, the facts presented in this case indicate that the subtrust for the benefit of Taxpayer B was created by the trustee of Trust T pursuant to the terms of Trust T. Furthermore, as noted above, the terms of Trust T provide that the trustee thereof is charged with the responsibility of creating separate accounts.
>
> Although neither the Code nor the "Final" Regulations promulgated under Code § 401(a)(9) preclude the posthumous division of IRA X into three IRAs, including IRA W, the "Final" Regulations do preclude "separate account" treatment for Code § 401(a)(9) purposes where amounts pass through a trust. In this case, amounts pass through a trust. Thus, even though IRA X has been divided into three IRAs, including IRA W, the life expectancy of the eldest beneficiary of all of the IRAs, not merely IRA W, is the life expectancy to be used to determine the Code § 401(a)(9) payout period for distributions from IRA W. TP B is said eldest beneficiary.

The rulings substantially limit the usefulness of having IRAs or plan benefits paid to a client's revocable trust, especially where the difference in ages among beneficiaries is substantial. The rulings arise from a change made in the section 409 final regulations; the proposed regulations would have allowed a favorable result for taxpayer.

In PLR 200349009 the decedent's daughter were the sole beneficiary of the decedent's trust which was the designated beneficiary of the IRA. The daughter divided the IRA into two shares, one for each, as a "trustee to trustee" transfer.

2. **Roth IRA Roll-Over**. The IRS applied the same rollover rules to ROTH IRAs as to traditional IRAs in PLR 200424011. The facts were:

> Trust W is a joint revocable trust created by Taxpayers A and B as joint Settlors and Trustees on Date 1, Year 1. Your authorized representative asserts that Trust W is valid under the laws of State E. Item C, paragraph 1, of Trust W provides that upon the death of the first Settlor to die, and after payment of debts and funeral expenses, the surviving Settlor/Trustee is to divide Trust W into two separate and continuing trusts, Subtrust A and Subtrust B. Item C, paragraph 1, grants Taxpayer B the authority to select the assets with which to fund each subtrust. Item C, paragraph 2, of Trust W provides that Subtrust A is to be funded with the first $* * * of assets, and Subtrust B is to be funded with the next $* * * of trust assets. Any assets in excess of $* * * are to be allocated to Subtrust A. Item G of Trust W provides, in relevant part, that Subtrust B became irrevocable at the death of Taxpayer A.
>
> Item C, paragraph 3, of Trust W provides that Subtrust A shall be considered the sole and separate property of Taxpayer B and shall be administered as she

> directs. Taxpayer B is the sole trustee of Subtrust A who retains the right to revoke Subtrust A.
>
> Item F of Trust W designated Taxpayer B and her son, Taxpayer C, as the co-trustees of Subtrust B. Pursuant to Item C, paragraph 4(a), of Trust W, Taxpayer B is entitled to receive all of the income from Subtrust B. Item C, paragraph 4(b), of Trust W, provides that Taxpayer B is entitled to receive principal from Subtrust B only in cases of dire need after taking into account the assets in Subtrust A and all other sources of income or assets. Item C, paragraph 4(c), of Trust W provides that, upon the death of Taxpayer B, the assets remaining in Subtrust B are to be distributed to the issue of the Settlors.
>
> As surviving Settlor and Trustee of Trust W, Taxpayer B is authorized to allocate Roth IRA X to Subtrust A. Taxpayer B intends to do so. Once so allocated, Taxpayer B will distribute outright and free of trust said Roth IRA X to herself as beneficiary of Subtrust A. Within 60 days of the date Roth IRA X is paid to Taxpayer B as trustee of Trust W for the purpose of being allocated to Subtrust A and paid to Taxpayer B, Taxpayer B will roll over said Roth IRA X proceeds into another Roth IRA set up and maintained in her, Taxpayer B's, name.

The ruling concluded:

> In this case, Taxpayer B, the surviving spouse of Taxpayer A, who owned Roth IRA X at his death, is the sole trustee of Trust W, the named beneficiary of Roth IRA X. As sole Trust W trustee, Taxpayer B will allocate Roth IRA X to Subtrust A created under the terms of Trust W. Once allocated to Subtrust A, Taxpayer B, as beneficiary thereof, will request that Roth IRA X be paid or distributed to her pursuant to the language of Trust W which provides that Taxpayer B may administer Subtrust A as she directs. After receiving Roth IRA X, Taxpayer B will contribute said Roth IRA X to another Roth IRA set up and maintained in her name.
>
> Since every action to be taken with respect to Roth IRA X from it's being distributed to the trustee of Trust W to it's being rolled over into another Roth IRA will be taken by Taxpayer B, the Service will not apply the general rule, set forth above. Thus, with respect to your first two ruling requests, the Service concludes as follows:
>
> > 1. that Roth IRA X is not an inherited IRA as that term is defined in Code section 408(d)(3)(C)(i) with respect to Taxpayer B; and
> >
> > 2. that Taxpayer B will be treated as the payee or distributee of Roth IRA X and, * * * as such, is eligible to roll over the proceeds of Roth IRA X set up and maintained in her, Taxpayer B's, name as long as said rollover occurs no later that the 60th day from the date said distribution is received by Taxpayer B as the trustee of Trust W.
>
> With respect to your third ruling request, Code section 4973(a) imposes a 6 percent excise tax on the amount of excess contributions to (1) an IRA within the meaning of Code section 408(a), (2) an Archer MSA within the meaning of Code section 220(d), (3) an individual retirement annuity within the meaning of section 408(b), or a custodial account described in Code section 403(b)(7)(A), (4) a Coverdell account as described in Code section 530, or (5) a health savings

> account within the meaning of Code section 223(d). Code section 4973(a) does not reference Roth IRAs described in Code section 408A.
>
> However, Code section 4973(f) defines "excess contributions" as said term relates to Roth IRAs. In relevant part, Code section 4973(f)(1) provides that an "excess contribution" to a Roth IRA does not include a qualified rollover contribution described in Code section 408A(e).
>
> As noted above, Code section 408A(e), in relevant part, defines the term "qualified rollover contribution".
>
> In response to your first and second ruling requests, we have concluded that you, Taxpayer B, may accomplish a rollover of Roth IRA X into a Roth IRA set up and maintained in your name. Such a rollover will comply with the requirements of Code section 408(d)(3).
>
> Thus, with respect to your third ruling request, we conclude as follows:
>
>> 3. that no portion of the proceeds distributed from Roth IRA X and timely rolled over into another Roth IRA set up and maintained in Taxpayer B's name will be subject to the tax on excess contributions imposed by Code section 4973.

D. SECTIONS 671-678 — GRANTOR TRUST RULES

1. **Non-Grantor, Non-Gift Trust Created**. PLR 200148028 is very helpful. The taxpayer established a trust that is not a grantor trust but gifts to which are incomplete. The facts were:

> Grantor proposes to establish an irrevocable Trust which will be funded by intervivos and testamentary transfers. The Trust provides for one trustee (Trustee) and two members of a Distribution Committee. Article 1.1 provides that during the lifetime of the Grantor ("Initial Term"), the Trustee shall have no power or authority to make any distribution of net income or principal of the trust estate, to, or for the benefit of, any trust beneficiary at any time when any person is serving as a member of the Distribution Committee unless the distribution is made at the direction of the Distribution Committee. Distributions may be made to the Grantor, the Grantor's Spouse or any of the descendants of the Grantor's parents.
>
> Article 3.6 provides that the initial members of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). At all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). During the Initial Term, the Distribution Committee shall direct the Trustee with regard to (i) all discretionary distributions from the Trust estate to beneficiaries, and (ii) certain of the Trustee's powers. The Trustee is authorized and directed to follow the direction of the Distribution Committee. All rights and powers conferred on the Distribution Committee shall be exercisable only by unanimous action of all members of the Distribution Committee except that any member of the Distribution Committee acting alone may direct the Trustee to make one or more distributions upon obtaining the Grantor's prior written consent to each such distribution and filing such consent with the Trustee.

> The Trust lasts during the lifetime of the Grantor. Under Article 1.2, upon the death of the Grantor, income and principal of the Trust estate, as it is then constituted shall be transferred, conveyed and paid over to such person or persons then eligible to receive distributions out of the Trust estate, other than the Grantor, as the Grantor appoints by the Grantor's will. To the extent all, or any portion of the income and principal of the Trust estate is not so effectively appointed, such income and principal shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for each child of the Grantor who is then living, and one such share for the collective descendants who are then living of any child of the Grantor who is not then living. From each such share so set aside for the collective descendants who are then living of any child of the Grantor who is not then living there shall be set aside per stirpital parts for such descendants. If no descendant of the Grantor is living at the death of the Grantor, the income and principal of the Trust, to the extent not effectively appointed, shall be distributed, free from Trust, to the then living descendants per stirpes, of the Grantor's parents.
>
> Article 1.3 provides that the Grantor may, at any time during the Grantor's life release the Grantor's right to receive discretionary distributions of income and principal from the trust estate, the right to consent to distributions as described in Article 3.6, and/or the power of appointment described in Article 1.2, and may limit the persons or entities in whose favor the power of appointment described in Article 1.2 may be exercised. Article 1.3 further provides that notwithstanding any of the foregoing or any other provision of this Agreement, the Grantor shall have no power or authority to change the class of persons eligible to receive distributions during the Initial Term (except to cause the Grantor personally to be excluded from the class by releasing the Grantor's own right to be eligible to receive such distributions.)

With respect to why the trust would not be a grantor trust the ruling states:

> Because of the discretion of the Distribution Committee, acting together, or singly with the consent of the Grantor, to make distributions from income and/or corpus to one or more of the beneficiaries which includes the members of the Distribution Committee, the members of the Distribution Committee have a substantial beneficial interest in both the income and corpus portions of the Trust. Any distribution that the Grantor wishes to make from assets contributed to the Trust by that Grantor, could be made only if one of the members of the Distribution Committee agrees. Since each of the two Distribution Committee members is a potential recipient of Trust distributions, a consent to a distribution could adversely affect that individual's beneficial interest in the Trust. Thus, with respect to the Grantor, both of the members of the Distribution Committee are adverse parties within the meaning of section 672(a).
>
> The requirement in Article 3.6 that the initial members, and any current or successor member of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate and that at all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of Trust estate, ensures that the Grantor will not be able to act independently of an adverse party. The restrictions on the powers of the Trustee preclude the Trustee from independently controlling distributions or making loans without the consent of an adverse party.

> The Grantor does not have a reversionary interest in excess of five percent in any portion of the Trust. Accordingly, section 673 does not apply to treat Grantor as owner of any portion of the Trust. Because control over the beneficial enjoyment of, and any distributions of, income and corpus is exercisable by the Grantor, only with the consent of a Distribution Committee member, who is an adverse party, Grantor will not be treated as the owner of any portion of the Trust under section 674 or section 677. The Trust agreement does not authorize any of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of the grantor under section 675. Section 676 does not apply to Grantor because Grantor cannot revest title in the Grantor in any portion of the Trust. Section 678 is not applicable since none of the trustees and no other person will have a power exercisable solely by that person to vest the corpus or income of the Trust in that person.

The existence of the grantor's special testamentary power of appointment prevented the gift from being complete until such time as distributions were made from the trust to someone other than the grantor.

In PLR 200247013 the taxpayer was arguably more aggressive. The class of beneficiaries was the descendants of the Taxpayer's parents, and two of the taxpayers siblings were the Distribution Committee.

This kind of trust will help grantors avoid state capital gains taxes on sales of assets.

E. SECTION 1361 - S CORPORATIONS

1. **ESBT Regulations**. The IRS issued proposed regulations on December 28, 2000. REG - 251701-96. The most important issues covered are which trusts are ESBTs and what is the income tax treatment of an ESBT with both S corporation stock and other assets. The regulations were finalized on July 17, 2003. T.D. 9078. The Final Regulations are substantially similar to the proposed regulations. The Supplementary Information to the proposed regulations provided:

> 1. Beneficiary
>
> The proposed regulations provide guidance as to who is an ESBT beneficiary. Generally, a beneficiary includes any person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest. If an ESBT makes distributions to another trust (the distributee trust), the distributee trust is not treated as a beneficiary of the ESBT. However, the beneficiaries of the distributee trust will be counted as beneficiaries of the ESBT. Persons whose future beneficial interest is so remote as to be negligible are not beneficiaries. Generally, when the probability that a person will receive any distribution from the trust is less than 5 percent, at a particular time, that person's interest would be so remote as to be negligible. Finally, the term beneficiary does not include a person in whose favor a power of appointment may be exercised until the power is actually exercised.

This provision is helpful because most trusts have alternate beneficiaries.

2. Interests Acquired by Purchase

> The proposed regulations provide guidance regarding the prohibition on acquiring an interest in an ESBT by purchase. The proposed regulations provide that the prohibition applies if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012. Thus, a part-gift, part-sale of a beneficial interest will terminate the trust's status as an ESBT. Beneficiaries may not purchase interests in the trust, but the ESBT itself is allowed to purchase S corporation stock.

3. Grantor Trusts

> The proposed regulations provide that a trust, all or a portion of which is treated as owned by an individual under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (Code) (a grantor trust), may elect to be an ESBT. The Treasury Department and the IRS believe that Congress did not intend to preclude this type of trust, which is a common family estate planning tool, from electing ESBT status. The proposed regulations provide rules for the treatment of grantor trusts electing ESBT status.

This provision is important because it allows trusts with multiple grantors to qualify as ESBTs.

4. Potential Current Beneficiaries

> The proposed regulations provide that the term potential current beneficiary means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. In general, a person who may receive a distribution from the ESBT under a currently exercisable power of appointment is a potential current beneficiary. In addition, in the case of an ESBT that is a grantor trust, the proposed regulations provide that the deemed owner of the grantor trust is also to be treated as a potential current beneficiary.
>
> Under the definitions set forth in the proposed regulations, a potential current beneficiary is not necessarily a beneficiary of the trust and vice versa. For example, a person in whose favor property could currently be appointed, but to whom no such appointment has been made, is a potential current beneficiary, but not a beneficiary. Conversely, a person who is a non-contingent remainder beneficiary of a non-grantor trust is a beneficiary, but not a potential current beneficiary.
>
> The proposed regulations provide special rules if current distributions can be made to a distributee trust. If the distributee trust does not qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), then the trust is considered the potential current beneficiary and thus a shareholder. In that case, the corporation's S election terminates because the corporation has an ineligible shareholder. For this purpose, a trust is deemed to qualify to be a shareholder of an S corporation under section 1361 (c)(2)(A) if it would be eligible to make a QSST or ESBT election if it owned S corporation stock.
>
> If the distributee trust does qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), in general, the potential current beneficiaries of the distributing ESBT will include the potential current beneficiaries of the distributee trust. However, if the distributee trust is a former grantor trust prior to the owner's death (that is, a trust described in section 1361(c)(2)(A)(ii)), or is

a trust receiving a distribution of S stock from a decedent's estate (that is, a trust described in section 1361(c)(2)(A)(iii)), the estate of the decedent is treated as the only potential current beneficiary of the trust In no case will the same person be counted twice when determining the number of S corporation shareholders.

5. ESBT Election

Notice 97-12 (1997-1 C.B. 385) provides the procedures for making the ESBT election. Under that notice, the ESBT election is required to contain certain information and representations, and is required to be filed with the service center where the S corporation files its income tax returns. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, the trustee of an ESBT makes a single ESBT election by filing a statement with the service center where the ESBT files its Form 1041, U.S. Income Tax Return for Estates and Trusts. This procedure will be more convenient for taxpayers than the procedures of Notice 97-12 if the ESBT holds stock in more than one S corporation. No trust documents are required to be attached to the election statement.

The proposed regulations provide that if a trust satisfies the ESBT requirements and makes an ESBT election, the trust will be treated as an ESBT for federal income tax purposes as of the effective date of the ESBT election. These effective dates generally follow the rules of section 1.1361-1(j)(6)(iii) for qualified subchapter S trust (QSST) elections. Protective ESBT elections, which are intended to become effective only if the trust fails to satisfy the requirements for a trust described in section 1361(c)(2)(A)(i) through (iv), are prohibited. Unlike a protective QSST election, a protective ESBT election could result in a change in the incidence of taxation from the owner of the trust to the trust itself. If a trust fails to qualify as an eligible S corporation shareholder under section 1361(c)(2), and consequently the S corporation election is ineffective or terminated, relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation termination.

6. Conversions of QSSTs and ESBTs

Rev. Proc. 98-23 (1998-1 C.B. 662) provides procedures for the conversion of a QSST to an ESBT and an ESBT to a QSST. The proposed regulations, when finalized, will modify and replace the procedures of Rev. Proc. 98-23 and provide rules with respect to these conversions.

The conversion procedure provided in the proposed regulations differs from that provided in Rev. Proc. 98-23, in that the election must be filed with the service center where the trust files its income tax return, as well as with the service center where the S corporation files its income tax return. The election must be filed in both service centers if the service center for the trust is different from the service center for the S corporation because QSST elections are filed with the service center where the S corporation files its income tax return and ESBT elections will be filed where the trust files its income tax return under the new procedures set forth in these proposed regulations, when finalized. The IRS and the Treasury Department specifically request comments on whether the rules for filing QSST elections similarly should be changed to permit the filing of a QSST election with the service center where the trust files its return rather than with the service center for the S corporation(s).

7. Consent to the S Corporation Election

Notice 97-12 provides that, for purposes of the ESBT's consent to the S corporation election under section 1362(a), only the trustee needs to consent to the S corporation election because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, if the ESBT is also a grantor trust, the deemed owner must also consent to the S corporation election because such owner will be taxed on all or a portion of the S corporation's income. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

8. ESBT Taxation

The proposed regulations provide that, for federal income tax purposes, an ESBT consists of an S portion, a non-S portion, and in some instances a grantor portion. The items of income, deduction, and credit attributable to any portion of the ESBT treated as owned by a person under the grantor trust rules of subpart E, including S corporation stock and other property (the grantor portion), are taken into account on that individual's tax return pursuant to the normal rules applicable to grantor trusts. Other items of income, deduction, and credit are, pursuant to these proposed regulations, attributed to either the S portion, which includes the S corporation stock, or the non-S portion, which includes all other assets of the trust. The S portion is subject to tax under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible by the S portion, and the deduction is limited to the amount of the gross income of the S portion. If a payment is made to a charitable organization by the ESBT pursuant to the terms of its governing instrument, such payment is deductible, subject to the provisions of section 642(c)(1), to the extent it is paid from the gross income of the non-S portion of the trust. Thus, if the ESBT contributes S corporation stock to a charitable organization, no deduction is allowed under section 642(c)(1) because the contribution is not paid out of the gross income of the non-S portion.

The proposed regulations provide guidance regarding the treatment of proceeds received by an ESBT from the sale of S corporation stock when income from the sale is reported on the installment method under section 453. The income recognized with respect to the installment proceeds is taken into account by the S portion. The interest on the installment obligation is taken into account by the non-S portion.

The proposed regulations provide that if a trust holds S corporation stock and is already an eligible S corporation shareholder and the trust makes an ESBT election during the trust's taxable year, the electing trust will be treated as a separate taxpayer for purposes of allocating S corporation items under section 1377(a)(1). However, the ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of

> section 1.1377-1(b), unless the prior trust is one described in section 1361(c)(2)(A)(ii) or (iii). Therefore, the S corporation is generally not permitted to make the election to terminate the taxable year under section 1377(a)(2). The trust will be treated as a single taxpayer for purposes of determining the taxation of distributions from the trust. Thus, distributions made after the effective date of the ESBT election may still carry out distributable net income of the trust earned during the taxable year before the effective date of the ESBT election.
>
> The proposed regulations provide that for purposes of determining whether the exception to estimated taxes under section 6654(d)(1)(B) applies, the trust will not be considered a different taxpayer as a result of the ESBT election. Therefore, if the ESBT makes estimated tax payments equal to 100 percent of the prior year's tax liability, no penalties will apply.
>
> The proposed regulations provide that interest expenses paid on loans used to purchase the S corporation stock must be allocated to the S portion of the ESBT but are not deductible by the S portion because they are not administrative expenses.
>
> 9. ESBT Terminations
>
> The proposed regulations provide that generally a trustee must seek the consent of the Commissioner to revoke its ESBT election by obtaining a private letter ruling. However, the Commissioner's consent is granted for revocations that occur on the conversion of an ESBT to a QSST under the procedures set forth in the proposed regulations.
>
> The proposed regulations provide that if an ESBT fails to meet the definitional requirements of an ESBT under section 1361(e), the trust's ESBT status terminates immediately upon such failure to qualify. However, if an ESBT acquires an ineligible potential current beneficiary, the ESBT has 60 days in which to dispose of all of its S corporation stock to prevent termination of the S corporation election. If the S corporation stock is not disposed of within the 60-day period, then the S corporation election will terminate as of the first day that the ineligible person became a potential current beneficiary.
>
> Finally, the proposed regulations provide that an ESBT election generally is terminated if the ESBT fails to hold any S corporation stock. However, a trust will continue to be treated as an ESBT if it is reporting income from the sale of S corporation stock under the installment method of section 453.

The effective date is July 17, 2003.

Two changes in the final regulations are worth noting, as summarized in the Summary of Contents and Explanation of Provisions:

> The final regulations clarify that if a former qualified subpart E trust or a testamentary trust continues to won stock of an S corporation after the 2-year period and is not otherwise a qualified subpart E trust, an electing QSST, or an ESBT, the trust is not a permitted shareholder. Additionally, the final regulations clarify that a QSST or an ESBT election may be made for a former qualified subpart E trust or a testamentary trust that qualifies as a QSST or an ESBT.

> Another commentator suggested that after August 5, 1997, the effective date of section 645, a testamentary trust should also include a trust that receives S corporation stock from a qualified revocable trust (QRT) for which an election under section 645 has been made (an electing trust). Under section 645, an electing trust is treated and taxed as part of the decedent's estate (and not as a separate trust) for purposes of subtitle A of the Code for all taxable years of the estate during the section 645 election period. The section 645 election period begins on the date of the decedent's death and generally terminates on the day before the applicable date described in section 645(b)(2). Section 1.645-1(h)(1) provides that on the close of the last day of the election period the share comprising the electing trust is deemed to be distributed to a new trust.
>
> Thus, according to the commentator, the final regulations should clarify that testamentary trusts include trusts to which S corporation stock is transferred pursuant to the terms of the electing trust during the section 645 election period as well as new trusts to which S corporation stock is deemed to be distributed at the end of the section 645 election period. The commentator noted that the purpose of section 645 is to create parity between electing trusts and wills. In furtherance of this purpose, the commentator reasoned that if an electing trust transfers or is deemed to distribute S corporation stock to a new trust, the new trust should be a permitted shareholder for the 2-year period beginning on the day the stock is transferred or deemed distributed to the new trust. The final regulations adopt the commentator's suggestion to clarify that a testamentary trust also includes a trust that receives S corporation stock from an electing trust.

2. **Life Tenant as Qualified Shareholder**. PLR 200404033 allowed a life estate to qualify as a Qualified Subchapter S Trust. The life tenant received all the income annually, could sell the shares and reinvest the proceeds, and could not dispose of the shares in a manner to defeat the remainderman's interest.

3. **Voting and Non-Voting Shares as One-Class of Stock**. PLR 200407006 confirms that voting and non-voting shares are one class of stock for S corporation purposes.

F. SECTIONS 2031 and 2512 — VALUATION

1. **Relevance of Post-Death Events, and Importance of Competent Appraisers**. 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.

However, on the substance, the Ninth Circuit reversed in James J. Morrissey, et.al. v. Commissioner, 87 AFTR2d ¶2001-643 (2001). The Court held that the post-death sales were reliable:

> In 1993, A. Max Weitzenhoffer, Jr. (Weitzenhoffer) asked Merrill Lynch to appraise the value of a minority interest. The Merrill Lynch final report was delivered to him on July 5, 1994. However, on March 29, 1994 Merrill Lynch wrote Weitzenhoffer giving its formal opinion that the fair market value of a minority interest was $29.77 per share.
>
> On the basis of this report Weitzenhoffer advised two shareholders that Merrill Lynch set the value at $29.70 per share, and each sold to him at this price. Edmund Hoffman sold him his 10,000 shares on May 12, 1994; Jacquelyne Weitzenhoffer Branch sold him her 6,960 shares on June 16, 1994. Each seller subsequently testified before the Tax Court that the price was fair and that the sale had been under no compulsion.
>
> The Estate filed an estate tax return valuing the stock at $29.77 per share. The Commissioner of Internal Revenue assessed the stock at $70.79 per share and asserted a deficiency based on this amount.
>
> * * * * * *
>
> No good reason existed to reject the sales by Branch and Hoffman as evidence of the fair market value of Seminole stock on April 14, 1994. The sales took place close to the valuation date. The sellers were under no compulsion to sell. There was no reason for them to doubt Weitzenhoffer's report of the Merrill Lynch valuation. That the final report was delivered only in July did not undercut the weight of the formal opinion letter written in March. The sellers had no obligation to hire another investment firm to duplicate Merrill Lynch's work.
>
> The Commissioner tries to make something out of the family connections of the sellers with the buyers. They were not especially close. Hoffman had an uncle related by marriage to Weitzenhoffer's uncle; there is no English word to name this relationship. Branch was Weitzenhoffer's first cousin. Each seller testified that there was no intention to make a gift to Weitzenhoffer.
>
> The Commissioner notes that Hoffman was a very successful businessman, so that the Seminole stock may not have meant much to him. People don't get to be very successful in business by treating valuable property carelessly. To be sure, there was a seven cents spread between Merrill Lynch's price and Weitzenhoffer's offer; the resulting difference of $700 and $487.20 were in context de minimis.
>
> The Commissioner also notes that Branch had a misimpression that Seminole still owned a losing facility that it had, in fact, already sold. Nonetheless Branch was rightly aware that a substantial loss had occurred due to this facility in 1991 when no dividends had been paid. Both sellers were aware that dividends had, even in prosperous years, been meager.

Similar issues arose in Estate of Elizabeth P. O'Neal, et. al. v. United States, 81 F.Supp.2d 1205 (N.D. Ala. 1999), aff'd in part, vacated in part by 258 F.3d 1265 (11th Cir. 2001), decided on remand at 228 F.Supp.2d 1290 (N.D.Ala. 2002). The District Court stated the issue as follows:

> The central issue in this case involves the estate tax deduction by the Estate of Elizabeth P. O'Neal, deceased, ("Mrs. O'Neal's Estate") under 26 U.S.C. § 2053(a)(3) for claims against Mrs. O'Neal's Estate resulting from transferee gift tax and generation-skipping transfer tax liabilities asserted against the children and grandchildren of Elizabeth P. O'Neal ("Mrs. O'Neal") as donees of certain gifts made by Mrs. O'Neal. The Court of Appeals held that for purposes of the deduction, the claims are to be valued as of the date of Mrs. O'Neal's death without regarded to events occurring after her death and remanded this issue with instructions to conduct an evidentiary hearing to value the claims giving rise to the deduction as of the date of Mrs. O'Neal's death, 258 F.3d at 1266, 1275.

The court summarized the holding of the Eleventh Circuit:

> The appeal by Mrs. O'Neal's Estate was based, inter alia, upon its contention that this Court should have considered only pre-death events in determining the amount of the deduction and the deduction should be in the amount demanded by the IRS.7 In opposing the arguments presented by Mrs. O'Neal's Estate on appeal, the government argued that the amount of the deduction should be based upon the post-death settlement.
>
> The Court of Appeals rejected the government's argument and held that the deduction to be taken by Mrs. O'Neal's Estate for the children's and grandchildren's claims against Mrs. O'Neal's Estate is the value of such claims as of the date of Mrs. O'Neal's death, determined without consideration of post-death events. 258 F.3d at 1275. The Court of Appeals plainly held that Mrs. O'Neal's Estate is entitled to a deduction in some amount (clearly not zero). Id. at 1271 n.20. The Court of Appeals also stated, however, that the value of the deduction is not necessarily the amount that was demanded by the IRS. Id. at 1275.
>
> The Court of Appeals then remanded the valuation issue with instructions to hold an evidentiary bearing to value the claims giving rise to the deduction at the date of death. Id. at 1276. Events that occurred after Mrs. O'Neal's death that alter value were to be disregarded. The mandate of the Court of Appeals included the following:
>
> > On remand, the district court is instructed neither to admit nor consider evidence of post-death occurrences when determining the date of death value of the Section 2053(a)(3) deduction. [Citation to Estate of Smith v. Commissioner, 198 F.3d 515, 526 (5th Cir. 1999).] It will be incumbent on each party to supply the district court with relevant evidence of pre-death facts and occurrences supporting the date-of-death value of the deductions as advocated by that party. Id. The district court will then, by using informed judgment, reasonableness and common sense, weighing all relevant facts and evaluating their aggregate significance, determine a sound valuation. See Revenue Ruling, 1959-1 C.B. 237, Rev. Rul. 59-60 (1959).

The District Court was frustrated by the government's lack of expert testimony. The opinion states:

> The government chose not to offer an expert to assist the Court. Instead, the government sought to establish a timeline of events by cross-examining Mr. Aughtry and the taxpayer's experts, and offering the testimony of Mr. Breen, Mrs. O'Neal's accountant, the IRS estate tax attorney who conducted the tax audit, and an IRS employee who participated in the engagement of Mr. Kaye. However, the government offered no evidence which would transform the timeline of events into admissible evidence of value, which is the question that the Court of Appeals placed before this Court. What this Court needed from the government, and did not receive, was evidence to assist this Court in determining the value of the claims as of Mrs. O'Neal's date of death. [footnote omitted]
>
> In Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999), the Fifth Circuit offered the following guidance regarding the type of evidence that assists a court in establishing the date-of-death value of claims against an estate:
>
> > The actual value of Exxon's claim prior to either settlement or entry of a judgment is inherently imprecise, yet "even a disputed claim may have a value to which lawyers who settle cases every day may well testify, fully as measurable as the possible future amounts that may eventually accrue on an uncontested claim." [Footnote citing Gowetz v. Commissioner, 320 F.2d 874, 876 (1st Cir. 1963)]
> >
> > In fact, when addressing situations that are the obverse of the one in the instant case, i.e., when the decedent-estate taxpayer is a plaintiff rather than a defendant in a pending lawsuit, the Commissioner has considered himself capable of determining the value of a pending lawsuit in exact dollars and cents, even when the claim has not been reduced to judgment. [Footnote citing Estate of Davis v. Commissioner, 65 T.C.M. (CCH) 2365 (1993)] Furthermore, courts have consistently held that "inexactitude is often a by-product in estimating claims or assets without an established market and provides no excuse for failing to value the claims . . . in the light of the vicissitudes attending their recovery." [Footnote citing Estate of Curry v. Commissioner, 74 T.C. (CCH) 540, 551 (1980)]
>
> Estate of Smith, 198 F.3d at 525 (emphasis in original).

The taxpayer offered two experts whom the court found helpful:

> As previously stated, Mrs. O'Neal's Estate offered the reports and testimony of two experts, both of whom currently practice as attorneys and one of whom is also a recently retired Federal District Judge. Tax cases valuing legal claims often use attorneys and retired judges as expert witnesses, See, e.g., Estate of Smith v. Commissioner, 82 T.C.M. (CCH) 909, 915-916 (2001) (IRS used testimony of a lawyer who had settled and mediated numerous cases involving similar disputes to value claim against estate); Estate of Davis v. Commissioner, 65 T.C.M. (CCH) 2365, 2366 (1993) (lawsuit included as asset in estate valued by attorney with experience evaluating lawsuits); Estate of Lennon v. Commissioner, 62 T.C.M. (CCH) 326, 328 (1991) (retired judge who practiced appellate law following retirement from the bench testified as to value of lawsuit on appeal at death). Indeed, both the First Circuit in Gowetz v. Commissioner, 320 F.2d 874 (1st Cir. 1963), and the Fifth Circuit in Estate of Smith held that

> "lawyers who settle cases every day" can testify as to the value of disputed claims. Gowetz, 320 F.2d at 876; Estate of Smith, 198 F.3d at 525.
>
> Both experts testified as to the date-of-death value of the claims against Mrs. O'Neal based upon the likely outcome of the transferee tax litigation given the facts known as of Mrs. O'Neal's death.10 Each expert then discounted that value to reflect contingencies related to restitution litigation between Mrs. O'Neal or her estate as donor and her children and grandchildren as donees. Neither expert considered or relied upon events, facts or occurrences after Mrs. O'Neal's death on July 23, 1994.

The court concluded:

> In remanding this case, the Court of Appeals instructed this Court to determine a sound valuation "using informed judgment, reasonableness and common sense, weighing all relevant facts and evaluating their aggregate significance." 258 F.3d at 1275. Like both [the taxpayer's experts] Judge Pointer and Mr. Apolinsky, informed judgment, reasonableness and common sense tell this Court that, when faced with potential transferee liability in excess of $16,000,000.00 as of the date of Mrs. O'Neal's death, the value of the children's and grandchildren's restitution claims on that date was at least as great as the $5,835,000.00 value determined by Judge Pointer.
>
> With respect to the opinions of both expert witnesses, the Court concludes that Judge Pointer's opinion is more persuasive. Since the issue before the Court involves determinations of the likely outcome of litigation in the Tax Court and litigation of a claim for restitution, the Court places great weight on the experience of Judge Pointer who spent twenty-nine and one-half years on the federal bench resolving cases, many of which were of a similar nature. Moreover, having reviewed the exhibits offered into evidence and having heard the testimony of the witnesses, particularly the testimony of the lead attorneys for the parties in the Tax Court Cases, the Court has reached the same conclusion as Judge Pointer. The value of the children's and grandchildren's claims as of Mrs. O'Neal's date of death is $5,835,000.00.
>
> While the value of the claims is $5,835,000,00, the amount of the deduction under 26 U.S.C. § 2053(a)(3) is less. 26 U.S.C. § 2053(c)(2) disallows a deduction for amounts described in 26 U.S.C. § 2053(a) to the extent that the amounts exceed the value as of the decedent's death of the property subject to claims (except to the extent that the deductions represent amounts paid before the date for filing the estate tax return). In this case, the value of Mrs. O'Neal's property that was subject to claims as of the date of her death was $5,303,744.00, and the amount of the deductions under 26 U.S.C. § 2053(a) cannot exceed this amount.
>
> CONCLUSION
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> The Court finds that the value of the children's and grandchildren's claims as of Mrs. O'Neal's date of death was $5,835,000.00. The Court further finds that the amount of the deduction allowed to Mrs. O'Neal's Estate for the children's and grandchildren's claims is limited by 26 U.S.C. § 2053(c)(2) to $5,303,744.00. Since the deduction for the children's and grandchildren's claims reduces the taxable estate to zero, the Court finds that the full amount of the estate taxes paid by Mrs. O'Neal's Estate, together with interest as provided by law, is due to be refunded.

After the remand, the government argued so persistently for the value of the deduction to be zero that the District Court awarded attorneys fees against the government 90 A.F.T.R.2d 2002-7214 (2002):

> In spite of the Eleventh Circuit's pronouncement that "the estate is entitled to a deduction with respect to claims against the estate by the nine heirs for reimbursement of their transferee gift tax liability on the 1987 gifts of stock by Mrs. O'Neal," O'Neal at 1271, the defendant has repeatedly argued that the value of that deduction was zero. On March 14, 2002, the plaintiffs filed a motion for partial summary judgment, requesting this court order that the defendant was foreclosed from arguing that the value of the claims of the donees was zero. Plaintiffs' motion for partial summary judgment (doc. 81), at ¶ 2. This court ordered that "the defendant may not allege that the estate of Mrs. O'Neal is not entitled to any deduction for the value of the claims of the donees." Order of April 2, 2002 (doc. 87), at 2.
>
> On April 3, 2002, the defendant filed a motion requesting this court hold the motion for partial summary judgment in abeyance pending discovery on the issue of "the value, if any, of the donees' claims as of July 23, 1994" (doc. 89). The court found this motion to be moot on April 4, 2002 (doc. 95). On April 11, 2002, the defendant filed a motion asking this court to reconsider its granting of the plaintiffs' motion for partial summary judgment (doc. 93). The court denied that motion, stating its April 2, 2002 Order merely required the parties to comply with the instructions from the Eleventh Circuit regarding the issues on remand. Court Order of April 11, 2002 (doc. 94), at 2. The court, by footnote, stated:
>
>> "the court notes that the plaintiffs filed that motion [for partial summary judgment] due to a concern that the defendant would argue that the plaintiffs were estopped from claiming the estate was entitled to any deduction. As the Eleventh Circuit stated that 'there is no dispute that the estate is entitled to a deduction . . .' this court will not allow the defendant to argue otherwise, whether before, during, or after discovery is completed."
>
> Order of April 11, 2002, at n.1. In its trial brief, the defendant again argued that, because the court could not consider post-death events, the value of the deduction for the donees' claims would be zero. Trial brief of defendant United States (doc. 121), at 14-15. The defendant then argues in that brief that "[e]xcepting (sic), arguendo, that the plaintiffs' reading of Smith is correct, the valuations performed by the plaintiffs' (sic) indicate that the deduction for the donees' claims as of July 23, 1994 is zero (citation omitted). . . . As a consequence, no deduction for the donees' claims can be permitted under Treas. Reg. § 20.2053- 1(b)(3)." Trial brief of defendant United States, at 19-20. In its conclusion, the United States argued, "Applying a strict interpretation of the Eleventh Circuit's Opinion in this case, the amount of the deduction for the donees' claims as of July 23, 1994 is zero because no cause of action had accrued at the time of Mrs. O'Neal's death." Id. at 24-25.
>
> At the evidentiary hearing, which commenced June 6, 2002, the court stated it was "concerned about . . . the government's argument that the plaintiffs are entitled to zero deduction, because I think the Eleventh Circuit closed that out." See Tab 11 to plaintiffs' evidentiary submission (doc. 126). The government responded:

> Let me explain. . . . This is the way we're interpreting. We're not saying that that restitution claim would not be entitled to a deduction (sic). What we are saying is is [sic] the value would be zero, because the Eleventh Circuit said, what you will go back and do, is you will value the deduction.
>
> It's the same thing as if, on July 23rd, 1994 you were valuing stock and it was determined to be worthless. . . . But we're not saying that there's — there is a difference between they are not entitled to a deduction — we're not saying that, Your Honor. What we're saying is is [sic] the value as of July 23rd, 1994, based on those facts, you have to assign it as I we're using zero as, in effect, worthless.

> Id. This court has repeatedly found this position of the United States to be irreconcilable with the Eleventh Circuit's finding that "that there is no dispute that the estate is entitled to a deduction with respect to claims against the estate by the nine heirs for reimbursement of their transferee gift tax liability on the 1987 gifts of stock by Mrs. O'Neal." O'Neal, supra, at 1271. As such, the court finds that the government "should have known that [its] position was invalid" from the time this case was remanded by the Eleventh Circuit. See Cervin, 111 F.3d at 1262; see also In re Rasbury, 24 F.3d 159, 168 (11th Cir. 1994).
>
> Having considered the foregoing, the court is of the opinion the plaintiffs are entitled to recover reasonable litigation costs, including attorney fees, solely for costs and fees incurred after July 26, 2001.

On October 8, 2003 Estate of Kirkman O'Neal v. United States, 291 F. Supp. 2d 1253 (N.D. Ala. 2003) was decided, dealing with Mr. O'Neal's estate. That decision was different from the earlier ones because, the opinion states, the applicable facts were different. The opinion states:

> The court starts with a consideration of the possible application of the holdings of *O'Neal v. United States,* 258 F.3d 1265 (11th Cir. 2001) (*O'Neal I*) to the facts of this case. It should first be noted that the primary holding of *O'Neal I* is that "the *value* of the deduction claimed by the estate for claims against the estate under Section 2053(a)(3) must be valued as of the date of the decedent's death. All events occurring after the decedent's death that alter the *value* must be disregarded." (Emphasis added; citations omitted). *Id.* at 1276.
>
> The facts of *O'Neal I* are obviously distinguishable from those here for a number of reasons. First, the plaintiff(s) are not the same. Further, there are the following distinctions: (1) Mr. O'Neal died on August 7, 1988 after his gift tax return was filed on April 15, 1988. Mrs. O'Neal died on July 23, 1994 after her gift tax return was filed on April 15, 1988. (2) As of the date of Mrs. O'Neal's death, the statute of limitations for assessing and collecting any unpaid gift taxes from her estate had run. This was not true as to Mr. O'Neal's gift taxes and his estate. (3) As of Mrs. O'Neal's death, the IRS had begun an examination of Mrs. O'Neal's gift tax return and had proposed to assess transferee liability against her donees. This was not true as to Mr. O'Neal. (4) As of the date of Mrs. O'Neal's death, further appraisals of her stock had been made and her donees had begun to contest proposed transferee liability. This was not true as to Mr. O'Neal. (5) The donees early on asserted alleged "restitution" claims against the estate of Mrs. O'Neal. The claims against Mr. O'Neal's estate were not filed by donees until June 24, 1992, over forty-six months after Letters Testamentary were issued by the Probate Court with regard to his estate.[27]

* * *

Again, the primary holding of O'Neal I is the method prescribed for determining value. It does not address the issue of post-death events as to any issue other than valuation. Unlike the position of the Government in this case, it did not dispute in O'Neal I that the estate there was entitled to a deduction with respect to donees' claims. Id. at 1271. The parties have not cited any cases, one way or the other, which discuss whether post-death events may be considered in determining whether a deduction of any amount may be claimed by an estate as opposed to a consideration of the value of a deduction which can be claimed.

There is an obvious distinction between a determination of the valuation of a deductible amount and the determination of whether any amount is deductible. Before the question of valuation is determined, the court must first decide if there can be a deduction. See Estate of Hagmann, etc. v. Comm'r, 60 T.C. 465 (1973), aff'd, 492 F.2d 396 (5th Cir. 1974). While O'Neal I apparently makes it clear that the court should not consider post- death events in making valuations, it does not address the issue of whether post-death events may be otherwise considered with regard to deductibility. Compare Commr v. Shively's Estate, 276 F.2d 372 (2d Cir. 1960).

Issues In This Case

The present legal issues, based upon apparently undisputed facts, which this court is to decide are the following:

(1) Is the $700,000.00 paid on Mrs. O'Neal's gift taxes from an estimated income taxes amount remitted by Mr. O'Neal from his separate bank account due to be added to Mr. O'Neal's estate?

(2) Is any amount deductible from Mr. O'Neal's estate for donees' claims against Mr. O'Neal's estate?

(3) Is Mr. O'Neal's estate due to be increased due to a reduction in his state income tax deduction for 1988?

(4) May Mr. O'Neal's estate presently deduct unpaid gift taxes, although not collectible, on additional gift taxes due based on his 1987 gifts?

The court will address each of these issues.

$700,000.00 Payment

The parties agree that if Mr. O'Neal had directly paid from his separate funds the $700,000.00 on Mrs. O'Neal's gift taxes, the $700,000.00 would be due to be added to Mr. O'Neal's estate. The only purported substantive argument that the plaintiffs make to oppose the Government's position is their citation to IRS Regulation § 6015(b)-1(b). See Treas. Reg. §1.6015(b)-1(b). This court rejects that argument of the plaintiffs.

There is no dispute that Mr. O'Neal paid $1,437,000.00 from his separate funds on December 29, 1987 toward tax estimate(s) on behalf of Mr. O'Neal and Mrs. O'Neal. After the tax estimate was paid the O'Neals determined that the estimate was overstated and requested that the IRS apply $737,000.00 to Mr. O'Neal's gift taxes and $700,000.00 to Mrs. O'Neal's gift taxes. This court concludes that this resulted, in substance, to a payment by Mr. O'Neal of $700,000.00 of Mrs. O'Neal's gift taxes from his separate funds. This court further concludes that said § 1.6015(b)-1(b) has no application to the payment. It is clear that the section pertains to the allocation of payments to the separate income tax returns of spouses. It is not necessary for the court to determine whether some amount would be due to be added to Mr. O'Neal's estate if a proportionate amount of the estimate had been allocated to Mrs. O'Neal's separate income tax liability. Here, it is clear that it was paid on her separate gift tax obligation and that the original source was Mr. O'Neal's separate funds. The court concludes that the $700,000.00 is due to be added to Mr. O'Neal's estate. The court's conclusion in this regard also determines the issue of state income tax liability which this court declares in favor of the Government.

Deduction of Donees' Claims

The Government makes several substantive arguments in opposition to the right of Mr. O'Neal's estate to deduct any amounts for the claims of the donees. These arguments include: (1) Any purported claims at the date of Mr. O'Neal's death were so vague, uncertain, and speculative as to be non-deductible. (2) The value of the claims as of the date of Mr. O'Neal's death would be zero because of one of either of two facts: Using the same hypotheticals as proposed by the plaintiffs, (a) the estate's probate assets would be exhausted by primary federal gift tax claims having priority over all other claims, leaving no assets to pay donee claims, or (b) the additional gift tax asserted on Mr. O'Neal's gifts would be fully satisfied out of the estate's probate assets, so that no transferee liability would be imposed on the donees and, thus, they would have no deductible claims. (3) The Government further argues, even assuming that the donees' claims have a value greater than zero, that any purported tax benefit to the estate would be zero because, under 26 U.S.C. § 2035(b), the amount of any such deduction would be offset by a corresponding increase in Mr. O'Neal's gross estate.

* * *

The court has previously summarized the parties' positions with regard to the donee liability deductions and will not totally repeat them here. The court will refer to some of those positions in reaching its own conclusions. The court will discuss the arguments in order.

(1) This court does not reach the issue of whether the claims are so vague, uncertain and speculative as to not allow a deduction of donee claims. The court does note that the plaintiffs' reliance on O'Neal I is not likely appropriate since it related only to the date of valuation determination if a deduction is allowable. The allowance of the deduction was not an issue in O'Neal I. Although this court does not reach the issue of whether the claims of the donees at the time of death were too speculative or uncertain to be deductible, it calls attention to the case of Frank Armstrong, Jr. Trust ex rel. v. United States, 132 F. Supp 2d 421 (W.D. Va. 2001), aff'd, 277 F.3d 490 (4th Cir. 2002). Further, while this court does not specifically decide the issue of whether the donees' claims are speculative and uncertain, it does note the following factors, some intermingled with issues which this court does decide, which could reasonably lead, on some later de novo review, to alternative reason(s) for granting summary judgment as to the donees' claims.

First, the hypotheticals of the plaintiffs' experts may be so speculative as to either be inadmissible or, at best, too uncertain to support donee claims deductions. Second, there is the uncertainty of whether any claims would have ever been made against the donees by the Government since the gift tax claims could have been made against the donor, the primary obligor, or his estate. Third, the timing of the donees' filing of their claims with the Probate Court may make them generally uncertain. Fourth, the above- referenced Sachs-type issue may render the donees' claims uncertain and speculative. Fifth, there are the uncertainties, if not absolute bars, raised by the attorneys for Mr. O'Neal's estate and/or the attorneys for the donees in their letter dated November 26, 1991. Sixth, Treasury Regulation § 20-2053-4 (1958) provides that claims are deductible only to the extent that they represent "personal obligations of the decedent existing at the time of his death." It may not be clear that the donees' claims against Mr. O'Neal existed at the time of his death. Finally, but perhaps not completely, the uncertainty of calculating the claims may make them uncertain.

In a letter dated November 26, 1991, the attorneys for the plaintiffs and/or the donees stated, "The reasons why the donees are not liable for an additional gift tax on the 1987 gifts of O'Neal Steel, Inc. stock by Elizabeth O'Neal and Kirkman O'Neal are too numerous for us to fully cover in this letter." The attorneys then stated: "[T]he prior discussion of § 2504(c) reveals that there is no transferee liability on any donee. . . ." The attorneys added that "[§ 2504(c)] clearly establishes that any taxes on these gifts must be determined based on the values of those gifts reported in the gift tax returns filed with the government. The gift taxes on these amounts were timely paid, therefore no deficiency or liability could exist." These statements at least suggest uncertainty as to whether there were certain, non-speculative donee claims at the time of Mr. O'Neal's' death. Further, the continued disparities in appraisals suggest not only different valuations, but also uncertainties.

(2) The court agrees with the Government's second argument as addressed above. It should be considered axiomatic that if the Government, as asserted in the plaintiffs' hypotheticals, was likely to redetermine gift tax liability, it was also similarly likely to assert a primary claim against Mr. O'Neal's estate which would either exhaust the estate or cause the gift tax liability to be collected from the estate so as to eliminate donee liability.

The plaintiffs in a "now you see it, now you don't" argument assert that there was a 90-100% chance of an audit leading to a gift tax liability of Mr. O'Neal's estate of several million dollars. On the other hand, the plaintiffs would apparently have the court determine that the IRS would not have pursued the primary liability of Mr. O'Neal's estate, but would have relied solely on pursuing the donees. In an extension of this "now you see it, and now you don't" argument, the plaintiffs further suggest that, even now, Mr. O'Neal's estate should be reduced by the amount of the hypothetical gift tax claim which it acknowledges would not be collectible. The court concludes that the amount of any alleged donee liability deduction would be zero. In so determining, the court is not determining value, just that there could be no value.

(3) The court agrees with the logic and reasoning of Sachs and accepts the Government's 26 U.S.C. § 2035(b) argument as an alternative reason for disallowing the donee deductions. The plaintiffs argue that Sachs is not applicable here because it involved a "net gift." The Eighth Circuit in Sachs agreed with the Tax Court "that the donor of a net gift uses the donee as a conduit for the payment of his tax liability, and '[a]s donor of a net gift, he may be deemed to have paid the tax by ordering the donee to pay it over. . . .' 88 T.C. at 778." There is no apparent substantive difference in gift tax liability (except in

> amount) being directly imposed by the donor and the gift tax liability being imposed by law as the result of the donor's failure to pay the gift tax. Arguably, the latter situation would create even a more logical reason to apply Sachs since the donor has caused his primary liability to be imposed on the donee.
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> Summary
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> In O'Neal I, the court advised the trial court to use common sense. In a somewhat different context, this court has attempted to use common sense, logic, and controlling law to the extent that it can be determined. The court ultimately concludes that: (1) The subject $700,000.00 paid on Mrs. O'Neal's gift tax is due to be added to Mr. O'Neal's gross estate; (2) The state income tax liability on Mr. O'Neal's estate tax return is due to be adjusted as argued by the Government; and (3) Mr. O'Neal's estate will not be allowed deductions for any of the asserted donee gift tax claims.

In FSA 200217022 the Service determined that an estate may deduct the entire amount it paid to settle a wrongful death action. The Service stated:

> With respect to whether post-death events may be considered in determining the amount of a deduction under §§ 2053(a)(3), the Eleventh Circuit noted recently in Estate of O'Neal v. Commissioner, 258 F.3d 1265, 1271 (11th Cir. 2001), that this area of law is generally governed by "two distinct and irreconcilable lines of cases" namely, the cases that follow *Ithaca Trust*, and the cases that follow *Jacobs*. The Commissioner's published position is that post-death events are controlling in determining the amount that may be deducted as a claim against the estate whether or not the claim is contested or contingent. Revenue Ruling 77-274 states that where the right to claim an amount is not fixed by the deadline for filing the estate tax return, the taxpayer can protect his right to claim the deduction by filing a protective claim on Form 843. Rev. Rul. 77-274, 1977-2 C.B. 326. The Service has also ruled that regardless of the nature of the claim, no deduction will be allowed for claims against the estate which have not been paid or will not be paid because the creditor waives payment, fails to file his claim within the prescribed time limit and under the conditions prescribed by applicable local law, or otherwise fails to enforce payment. See Rev. Rul. 60-247, 1960-2 C.B. 272 (denying a deduction for an otherwise valid claim which became void and uncollectible after the date of death by virtue of noncompliance with a state statute of limitations on filing probate claims). See also Rev. Rul. 75-24, 1975 C.B. 306, and Rev. Rul. 75-177, 1975-1 C.B. 307.
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> Some courts, including the Ninth Circuit, have either held or noted that where the claim is contested, contingent, or unenforceable on the date of death, post death events are considered in determining the allowable deduction. Propstra v. United States, 680 F.2d 1248, 1253 (9th Cir. 1982) ("The law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims."), Gowetz v. Commissioner, 320 F.2d 874 (1st Cir. 1963), in Taylor v. Commissioner, 39 T.C. 371 (1962) (denying a deduction for a contested claim for a marital settlement rendered unenforceable by a spouse's remarriage); Estate of Van Horne v. Commissioner, 78 T.C. 728, 734 (1982), aff'd, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984) (noting in dicta that post-death events are relevant in cases where the claims are potential, unmatured, contingent, or contested at the date of death); Estate of Courtney v. Commissioner, 62 T.C. 317 (1974) (denying a deduction for mortgages that were never presented to the estate); Estate of Cafaro v.

> Commissioner, T.C. Memo. 1989-348 (limiting deductions for contested business debts existing at the date of death to amounts actually paid).
>
> The Ninth Circuit decision in Propstra involved lien claims against an estate that had been compromised for a lesser amount. Although the government argued to the contrary, the court found that at the date of death, the estate had no colorable defense to the claims, and the claimant did not have the ability to compromise the claim. Propstra, 680 F.2d at 1254. The court, citing Treas. Reg. §§ 20.2053-1(b)(3), stated that the preliminary determination to be made was the nature of lien claims against the estate. Propstra, 680 F.2d at 1253. The court then held that "as a matter of law, when claims are for sums certain and are legally enforceable as of the date of death, post-death events are not relevant in computing the permissible deduction." Propstra, 680 F.2d at 1254. However, the court noted in dicta that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed and contingent claims." *Id.* at 1253. Based upon the facts, the court determined that the lien claims were certain and enforceable at the time of death, and therefore the post-death compromise of the claim could not be considered in determining the amount of the deduction.
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> Estate of Van Horne involved an undisputed spousal support obligation calculated by using actuarial tables. The obligation was terminated after four monthly payments when the recipient died. In Van Horne the Ninth Circuit makes clear that its holding is limited to "certain and enforceable" claims. The government argued that the spousal support obligations were not a "sum certain" and therefore should not be governed by the rule enunciated in Propstra. The court disagreed and held that, "legally enforceable claims valued by reference to an actuarial table meet the test of certainty for estate tax purposes." Van Horne, 720 F.2d at 1117.
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> In the present case, appeal will lie to the Ninth Circuit. The claims filed by Wife, Daughter and Son with the executor of Decedent's estate were denied by the estate. In addition, the estate actively contested the subsequent litigation. The estate appears to have had affirmative defenses to the suit filed by Family. We believe that, based upon the Ninth Circuit's dicta in *Propstra* and *Van Horne*, the Ninth Circuit would hold in this case that post-death events are relevant in computing the permissible §§ 2053(a)(3) deduction because the claims in this case were disputed and contingent. Based upon published Service position and the Ninth Circuit's guidance in this area, the estate's deduction should be limited to the amounts eventually paid in settlement of the claims. The estate, accordingly, may deduct $w as a claim against the estate under §§ 2053(a)(3).

2. **Closely-Held Company Stock**. At issue in Okerlund v. United States, 53 Fed.Cl. 341 (2002) was the lack of marketability discount, and the value of non-voting stock. Schwan's Sales Enterprises, Inc. (SSE) was capitalized with 99.98% non-voting stock and 0.2% voting stock. Mr. Schwan, founder and CEO, died unexpectedly on May 9, 1993 and about two-thirds of the SSE's stock went to a foundation. 16.69% of the voting stock was held in a great-great grandchildren's trust (3G Trust) as well. Various gifts were made in 1992 and 1994:

> Marvin Schwan's four children and three of their spouses, Lorrie Schwan-Okerlund (Lorrie) and her husband Jeffrey Okerlund (Jeffrey), David J. Schwan (David) and his wife Diane (Diane), Paul M. Schwan (Paul) and his wife Christine H.M. Weigel-Schwan (Christine), and Mark D. Schwan (Mark) established separate trusts on December 31, 1992 for the primary benefit of their

respective children. Plaintiffs Lorrie, David and Paul each transferred as gifts 50,000 shares of nonvoting stock to their respective trusts, splitting their gifts with their spouses pursuant to § 2513 Mark, electing not to split his gift, transferred only 25,000 shares of SSE which were previously distributed to the Schwan children by Marvin Schwan's previously established trusts. Plaintiffs obtained a valuation of the SSE stock from Business Valuation Consultants (Gray) in June 1993. Based on Gray's per share value of $24.03, each plaintiff filed a gift tax return which reported a gift of $600,750, a unified credit of $192,800, a Generation-Skipping Tax (GST) exemption of $600,750, and a tax of $277.

In 1996, Willamette Management Associates (Willamette) provided plaintiffs with a lower value for SSE minority shares in connection with federal district court litigation involving a dispute between the Schwan children and SSE over the redemption of stock after Marvin Schwan's death in 1993. The matter was ultimately settled, and the nonvoting stock sold back to SSE at a value of $26.00 per share in 1997. The Willamette appraisal reported a value of $17.40 per share for the valuation date of December 31, 1992. As a result of this reduced appraisal from $24.03 to $17.40 per share, in July 1996, the plaintiffs filed for a Claim for Refund and Request for Abatement with the IRS, seeking restoration of their respective unified credits in the amount of $59,100, a restoration of their respective GST exemptions in the amount of $165,760 each, and a gift tax refund of $277.

* * *

In January 1994, Lorrie, Mark, David and Paul each transferred $650,000 in cash to the Marvin M. Schwan 1992 Grandchildren's Irrevocable Trust. Accordingly, in April 1995, each plaintiff filed with the IRS a gift tax return reporting the $650,000 cash transfers. Lorrie, David and Paul consented to split their gifts with their spouses pursuant to § 2513. As a result, Lorrie, Jeffrey, David, Diane, Paul and Christine each reported GST exemptions in the amount of $325,000 for their 1994 gifts and $600,750 for their prior 1992 gifts. Each of their taxable gifts for 1994 and prior periods totaled $925,750.

In December 1994, Lorrie also transferred 1,000 shares of nonvoting SSE stock to two separate trusts established for her children. Lorrie and Jeffrey reported the value of the 2,000 shares of nonvoting capital stock as $12.51 per share and a tax liability of $123,765. In October 1995, Lorrie and Jeffrey each submitted another gift tax return which added the $12,510 gift, representing the 1,000 share transfer in 1994, for a total taxable gift of $938,260.

In July 1996, plaintiffs filed claims for refund with respect to their 1994 gift tax returns, based on the adjustments reported in their 1992 claims for refund. Specifically, the 1994 refund claims stated that the 1992 transfers of SSE nonvoting stock were overvalued by $165,750 per transfer, based on the 1992 Willamette appraisal of $17.40 per share, resulting in a reduction from $925,750 to $760,000 in the total individual taxable gifts for 1992. The 1994 claims for refund reflected a revised gift tax liability of $59,400. Accordingly, each plaintiff's claim sought a gift tax refund of $64,365.

Dr. Pratt (and Willamette) was the taxpayer's expert and Dr. Spiro (and AVG) was the government's expert. With respect to the lack of marketability, the opinion states:

> Both experts relied on two sources of empirical data for aid in quantifying the discount for lack of marketability: (1) discounts on sales of restricted shares of publicly traded companies; and (2) discounts on private transactions prior to initial public offerings (IPO's). Based on these studies, and an examination of the perceived risks facing a potential investor in SSE stock, Dr. Pratt concluded that a 45 percent discount for lack of marketability was appropriate, and Dr. Spiro concluded that a 30 percent discount was justified.
>
> Dr. Pratt's expert reports contain a far more detailed analysis of the empirical studies of trading prices of restricted shares and pre-initial public offering transactions than the AVG Report. The eight independent studies of restricted stock transactions reviewed in the Willamette Reports reported average discounts ranging from 25 to 45 percent. According to Dr. Pratt. the two most important factors in determining the size of the discount were the amount of dividends paid (more dividends are associated with a lower discount for lack of marketability) and the perceived holding period (the longer the holding period the greater the discount for lack of marketability). (Tr. at 71-72.) The second major line of studies, involving pre-IPO transactions, observed discounts averaging approximately 45 to 47 percent.18 (Tr. at 74.) Unlike the AVG Report, the Willamette Report considered the pre-IPO studies more relevant for the purpose of determining the appropriate discount for lack of marketability. According to Dr. Pratt, the discounts observed in restricted stock studies reflect the existence of a public market for the stock once the temporary restrictions lapse. For a variety of reasons, including an increasing number of transactions under Rule 144(a), which relaxes some of the restrictions, thus making the restricted securities more marketable, purchasers of restricted stock "generally expect to be able to resell the stock in the public market in the foreseeable future." (J. Ex. 508, at 78.) Pre-IPO discounts, on the other hand, are based on purely private transactions before a company enters the public market, a situation more comparable to closely held companies such as SSE. (Tr. at 205.) A total discount that "is only slightly above the averages of the discounts observed in the pre-IPO transactions" is appropriate, according to Dr. Pratt, because SSE stock, unlike the stock observed in the pre-IPO studies, had no prospect of an initial public offering (Tr. at 74, 205.)
>
> The AVG Report's discussion of lack of marketability discounts relies on a smaller number of studies of restricted stock and pre-IPO transaction prices. The restricted stock studies cited in the AVG Report revealed discounts ranging from 10 to 90 percent, with an average discount of at least 35 percent (Def.'s Ex. 1003, at 62- 63.), while the pre-IPO study cited reported mean and median discounts of 45 percent. The AVG Report concluded that the discount rate observed by the major pre-IPO study cited may be overstated because it reflects factors not reflected in insider transaction prices. For example, "a company's value may increase significantly leading up to the stock offering, due to the greater growth prospects typically associated with access to public capital as well as the prevailing market demand for public offerings." (Def.'s Ex. 1603, at 63.) This argument supports a higher discount for marketability for SSE stock than that observed in the pre-IPO study for the reason articulated by Dr. Pratt with respect to restricted stock studies. There is no public market for SSE Stock, and the company does not contemplate entering the public market in the future.

Chief among the factors weighing in favor of a higher than average discount rate, in Dr. Pratt's view, are shareholder risks in the form of restrictive stock transfer provisions, and the provisions of Marvin Schwan's estate plan. The company by-laws contain a restrictive stock transfer provision in the form of a ninety day right-of-first-refusal, which Dr. Pratt viewed as a deterrent to investment and Dr. Spiro dismissed as a "red herring" because he believed it would not impede long-term investment. (Tr. at 318.)

Two restrictions triggered by Marvin Schwan's death would, according to Dr. Pratt, have a far greater impact on investment in SSE. First, the 3G Trust would severely impinge upon SSE stock liquidity because the 3G Trust held the controlling share of SSE voting stock for three generations, amounting to almost 200 years in perpetuity. Second, Marvin Schwan's estate plan required the implementation of an agreement between the company and the Foundation whereby the Foundation received 5.076 shares of voting common stock and 25,910,000 shares of non-voting common stock owned by the Marvin Schwan Revocable Trust. SSE was then required to redeem the stock from the Foundation. The redemption agreement, once triggered by Marvin Schwan's death and the implementation of his estate plan, would increase the company's indebtedness by approximately $869 million, thereby rendering the company highly leveraged and hindering its ability to grow through acquisitions. Dr. Pratt opined that the ninety day right of first refusal and the 200-year holding period imposed by the 3G Trust would make SSE stock unattractive to investors (Tr. at 49, 87).

Based on his discussions with SSE management, Dr. Pratt identified additional shareholder risks affecting the discount for lack of marketability. First and foremost, with one exception, SSE had never paid dividends to shareholders and had no intention of paying dividends in the foreseeable future, thereby closing off one means of obtaining a return on an investment. Members of management communicated to Dr. Pratt that SSE would remain a closely-held company and had no intention of either pursuing a third party sale or public offering, in accordance with the express wishes of Marvin Schwan. Dr. Pratt's interviews further revealed that the shareholders did not have easy access to company information because SSE management did not readily provide an annual report to the shareholders. Based on these factors, Dr. Pratt's determined that there was no real market for SSE's stock.

Dr. Spiro also identified specific factors influencing the applicable liquidity discount, which reflects the inability to convert the fair market value of an investment to its cash equivalent value.20 According to the AVG Report, the factors suggesting a liquidity discount at the low end of the applicable range included SSE's high profitability and strong sales and earnings growth and the company's competitive position and favorable economic outlook. Recognizing that highly competitive nature of the food industry, the AVG Report nevertheless considered SSE's unique distribution system an advantage, and believed that SSE was well-positioned as an established leading supplier of prepared foods for future growth. (Def.'s Ex. 1003, at 54.)

Balanced against these advantages, the AVG Report identified three major factors that would make investment in SSE relatively unattractive to an investor, and thus increase the applicable liquidity discount: 1] the lack of dividend payment history, 2] SSE's relative lack of management depth and dependence on Marvin Schwan, and 3] the company's right of first refusal with regard to the purchase of SSE shares. Unlike Dr. Pratt, who found the restrictive stock transfer provision a very significant deterrent to an investor, Dr. Spiro concluded that the 90 day right of first refusal period should "only cause a minor increase in the applicable liquidity discount" because "a potential investor would consider an equity interest in SSE to be a long-term investment."21 (Def's Ex. 1003, at 55.)

Dr. Spiro attached minimal if any significance to the redemption agreement on the ground that it was not in effect as of December 31, 1992. Instead of viewing the 3G Trust as a major deterrent to investment, Dr. Spiro hypothesized that shareholders of SSE stock would not tolerate the tying up of a controlling majority of voting shares for three generations. Dr. Spiro opined that later generations are often "no longer interested in the company," but are "interested in receiving the rewards;" therefore, the trustees of the 3G Trust would "have an obligation to serve their interests" that might force Schwan to either " merge with another company or go public" to create liquid assets for the 3G beneficiaries. (Tr. at 331.) Consequently, Dr. Spiro concluded that the 3G Trust was not a relevant factor affecting SSE's marketability.

The Court finds Dr. Pratt's analysis of the appropriate discount for lack of marketability more persuasive than that of the government's expert. First, Dr. Spiro's speculation about the pressure to go public created by the 3G Trust may not be considered under the objective standard applicable to valuation of closely held stock. The court is precluded from considering imaginary scenarios as to "who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with [] children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest." Estate of Simplot v. Comm'r 249 F.3d 1191, 1195 (9th Cir. 2001). Dr. Spiro's imaginary scenario, however plausible, may not be considered in valuing what a hypothetical willing buyer and willing seller would pay for closely held stock. Second, the factors identified in the AVG Report that weigh against a high liquidity discount relating to company performance and competitiveness were already taken into account in determining the appropriate pricing multiples under the market approach. Thus, the re-emphasis of these factors in the liquidity discount analysis may result in overstatement. Finally, the Court finds Dr. Pratt's analysis of the relevant empirical studies and shareholder risks more persuasive than the AVG report's rather truncated analysis. In particular, the Court is persuaded that the Marvin Schwan estate plan provisions would deter investment to a greater extent than Dr. Spiro suggests.

However, rather than accepting Dr. Pratt's estimate of 45 percent, the Court holds that a 40 percent discount for lack of marketability is warranted for the December 31, 1992 valuation date. The Court agrees that the company's dividend payment history, restrictive stock transfer provision, the 3G Trust and the redemption agreement constitute significant deterrents to investment because of the restraints they impose on short or long term returns. However, in 1992 the estate plan provisions, although in place, had neither been triggered nor anticipated in the immediate future. In other words, they were prospective concerns rather than actual concerns as of the 1992 valuation date. It is well-established that " valuation of the stock must be made as of the relevant dates without regard to events occurring subsequent to the crucial dates." Bader v. United States, 172 F. Supp. 833, 840 (S.D. 111. 1959); accord Hermes Consol., Inc. v. United States, 14 Cl. Ct. 398, 415, n. 28 (1988), Fehrs v. United States, 223 Ct. Cl. 488, 620 F.2d 255, 264 n. 6 (1980), Central Trust Co. v. United States, 158 Ct. Cl. 504, 305 F.2d 393, 403 (1962).22 In 1992, the major shareholder risks identified in the Willamette Report, and in Dr. Pratt's testimony, were in place, but had not yet been triggered by Marvin Schwan's

> death. The difference between potential versus actual deterrents to investment supports a 5 percent disparity between the appropriate discount for lack of marketability in 1992 (40 percent) and in 1994 (45 percent).

The court also allowed a discount for a lack of voting rights:

> The Court accepts the shared view of the experts that a 5 percent discount for lack of voting rights is justified. A prospective buyer usually will pay a premium for shares with voting power or seek a discount for nonvoting shares. Wallace v. United States, 566 F. Supp. 904, 917 (D. Mass. 1981) (voting shares appraised at a 5 percent premium over nonvoting shares). SSE's capital structure reflects a great disparity between the number of voting and nonvoting shares (7,610 voting to 38,550,000) issued by the company. Where there is a skewed distribution between the two classes of stock, the voting shares are at a premium. Based on their review of empirical studies, and other relevant literature, which observed lack of voting rights discounts ranging from 4 to 5.44 percent (in Dr. Spiro's report) and from 3 to 10 percent (in Dr. Pratt's report), both experts applied a 5 percent discount, which the Court adopts as well-founded.

In Johann T. Hess v. Commissioner, T.C. Memo 2003-251, the Tax Court allowed a 15% minority interest, and 25% lack of marketability, discount when valuing a 10% interest in a C corporation involved in manufacturing. In Estate of Mildred Green v. Commissioner, T.C. Memo 2003-348, the Court valued 5% of a C corporation bank, which was the fifth largest block of stock, allowing a 17% minority interest discount and 35% lack of marketability discount.

The Federal Circuit has affirmed the Court of Federal Claims in Okerlund v. United States, 365 F.3d 1044 (C.A. Fed. 2004). The opinion states:

> The Plaintiffs contend that the Court of Federal Claims' failure to consider SSE's actual earnings results in 1993 and 1994 in assessing the 1992 valuation is a legal error subject to de novo review, while the Court of Federal Claims' underassessment of the significance of one particular risk factor -- the potential triggering of the Redemption Agreement -- is a clearly erroneous factual determination.
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> The Plaintiffs did not point to a single case suggesting that the failure to consider subsequent events constitutes legal error. Furthermore, and contrary to the Plaintiffs' contention, the relationship between Dr. Spiro's projections [taxpayer's expert] and SSE's actual performance supports the reasonableness of those projections. Dr. Spiro's projections of both revenues and gross profits were off by about 5% for 1993 and by less than 10% for 1994. Given the number of exogenous low-probability high-risk events that intervened, Dr. Spiro's projections appear to have been highly reliable and based upon reasonable assumptions. The closest that the Plaintiffs come to precedent supporting their assertion that the Court of Federal Claims was required to consider ex post information lies in our rejection of the Claims Court's proposed bright-line test excluding ex post information. *Krapf*, 977 F.2d at 1459. In Krapf,
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> > [t]he Claims Court [had] ruled that the valuation of closely held stock must generally be made without reference to events which occur after

> the date of the donation. As "exceptions" to this general "rule," the Claims Court further stated that post-donation data may be used in valuation only where: (1) no material change of circumstances or conditions in the corporation has occurred between the time of donation and the time of the post-donation evidence, or (2) the post-donation changes could have been foreseen at the time of the donation.

Id. at 1458. On appeal, we declined to

> adopt the Claims Court view that there is an exclusionary rule with two exceptions respecting admissibility of evidence of post-donation data and events. The question respecting such evidence may involve its relevancy, i.e., its admissibility, but more usually the question is the evidence's probative value. The post-transaction evidence must always be proffered, of course, in support of finding the value of the stock on the donative date. Evidence of post-transaction events may or may not be relevant depending on what events are sought to be proved. Where there was a series of arms length sales at the same price before and after the donation, such evidence might well give rise to an inference that the gift had the same value and, thus, would be admissible. Such a situation would likely fit into the second "exception" noted by the Claims Court, but we conclude that the "rule" of exclusion is simply the usual rule of relevancy. Further, even if relevant, the evidence may have little probative value. On the other hand, evidence of a post- gift sale price may give rise to an inference of the stock's earlier value, in light of other circumstantial evidence.

Id. at 1459. The valuation of a closely held company is an inexact science (some might say an art), and relevant probative evidence should never be ignored. It would be absurd to rule an arms- length stock sale made moments after a gift of that same stock inadmissible as post-valuation date data -- as we noted in Krapf, id. The key to the use of any data in a valuation remains that all evidence must be proffered in support of finding the value of the stock on the donative date. Id.

The present matter could hardly differ more from the circumstances that we anticipated in Krapf. Here, a number of exogenous shocks befell SSE shortly after the December 31, 1992 valuation date. Dr. Pratt's 1992 Willamette report correctly identified both the reliance on a key executive and the possibility of contamination as risk factors relevant to valuation. All of the proffered valuations incorporate them accordingly: the selection of guideline companies implies that SSE's risk of contamination was about the same as that of its competitors, and the discount attributed to the small management team incorporated the risk to SSE of losing part of that team.

Had SSE gone public or engaged in a number of arms-length transactions between the valuation date and the occurrence of these exogenous events, the prices of those transactions might have been deemed relevant and probative -- at least as sanity checks on the assumptions underlying the valuation models. But the occurrence of intervening events, or for that matter of even less probable unforeseen events, reduces the probative value of subsequent transactions. Even an arms-length sale of SSE made after Marvin's death would have represented a valuation of a company that differed in a significant manner from the one valued on December 31, 1992.

Our holding in Krapf was correct. Valuation must always be made as of the donative date relying primarily on ex ante information; ex post data should be

> used sparingly. As with all evidentiary submissions, however, the critical question is relevance. The closer the profile of the later-date company to that of the valuation-date company, the more likely ex post data are to be relevant (though even in some cases, they may not be). The greater the significance of exogenous or unforeseen events occurring between the valuation date and the date of the proffered evidence, the less likely ex post evidence is to be relevant--even as a sanity check on the assumptions underlying a valuation model. Krapf provides no support for the Plaintiffs' assertion that the Court of Federal Claims erred in excluding SSE's 1993 and 1994 performance from its 1992 valuation.

At issue in Estate of Helen A. Deputy v. Commissioner, T.C. Memo 2003-176, was the value of 99% of a family owned corporation, Godfrey Conveyor Co., Inc., owned by a family partnership. The Tax Court accepted the opinion of the government expert (Mr. Burns) that the income approach was the best valuation approach for a "long-established, financially successful, closely-held operating company that has shown consistent profit and growth."

With respect to discounts, the opinion states:

> Respondent's expert, Mr. Burns, concluded that no minority discount should be used to compute decedent's interest in the property. He reached that conclusion on the basis of his expedient logic that the exclusive use of capitalized earnings and the income method in the valuation would result in treating all interests in the entity equally. In other words, he concluded that minority interests would receive the same percentage return on their investment as a majority interest. Mr. Burns did, however, employ a 25-percent marketability discount. To compute the discounted value, Mr. Burns began with his $30,740,869 income method valuation of Godfrey and calculated that a 19.99-percent interest resulted in an undiscounted value of $6,145,100. After applying a 25-percent marketability discount of $1,536,275, he arrived at his discounted fair market value of $4,608,825.
>
> Mr. Burns relied on two different studies that surveyed restricted stock transactions of otherwise publicly traded stock. Based on those studies and his analysis, Mr. Burns concluded that a 25-percent marketability discount was appropriate for the 19.99- percent interest in Godfrey. One study, which was conducted by FAIR MARKET VALUE Opinions, Inc., surveyed restricted stock transactions from 1979 through 1992 and resulted in a mean discount of 23 percent. A second study, conducted by Management Planning, Inc. (MPI), with respect to restricted stock transactions occurring from 1980 through 1995, resulted in an average discount of 19.4 percent for companies with revenues ranging from $50 million to $100 million. In the MPI study, the share prices paid in private placements of restricted stock were compared with the same company's freely traded market price. After considering those studies, Mr. Burns arrived at a 25- percent discount to account for "the fact that an interest in Godfrey * * * would likely not be able to be sold immediately."
>
> The estate's expert, Mr. Dorman, reached the conclusion that the 19.99-percent interest in Godfrey should be discounted by 44 percent to account for the minority interest and marketability limitations. He calculated a discounted value of $1,941,000 by dividing his $17,341,379 adjusted net asset value by 938 (the number of Godfrey shares outstanding) to arrive at an $18,488-per-share value. He then multiplied the per-share value by 187.5 (the number of shares being valued) to arrive at an undiscounted value of $3,466,427. By applying the

44-percent discount ($1,525,228) for lack of marketability and the minority interest, Mr. Dorman arrived at a discounted value of $1,941,199, which he rounded to $1,941,000.

Mr. Dorman's combined 44-percent minority interest and lack of marketability discount was derived by use of a matrix table devised by his company. The table is divided into six rating factors, which Mr. Dorman believes "replicate an investor's decision process." The table has values (amounts of percentage discount) assigned to each of five categories (descending from good to poor) for each of the six factors. The matrix also has built-in indexing to place more emphasis on some categories over others. For purposes of our analysis and clarification, we replicate the table used by Mr. Dorman with the final column showing the percentage discount he assigned with respect to the 19.99-percent interest in Godfrey:

* * *

The first category of the matrix rates the subject's financial information availability and reliability with a range from one discount point for the best to five discount points for the poorest condition. Mr. Dorman selected an above-average 2-percent rating, noting that Godfrey had available financial statements that were audited by independent public accounts. It is enigmatic that Mr. Dorman would assign a less than favorable rating under these circumstances. Moreover, there is no reason provided as to why any discount should be attributable here, where the subject has ample and quality financial information available. Accordingly, we do not attribute any discount to this factor.

The scale provided to rate investment size is an arithmetic progression by 2, starting with one and proceeding to eight discount points. Mr. Dorman explains that this adjustment is made to reflect the premise that the larger the necessary capital investment, the less likely a buyer would be willing to place it at risk. Because Mr. Dorman reached a $3,466,000 undiscounted value for the 187.5 shares in Godfrey, he considered the investment quite large and therefore assigned six discount points to this aspect. We view this aspect as one of the considerations associated with the risk factor in investing in a minority interest in a closely held family corporation. It would be reasonable to assess six discount points for this factor.

The third category concerns Godfrey's financial outlook, management, and growth potential, and the scale is another arithmetic progression by 2. However, it starts with 2 and proceeds to 10 discount points. Here Mr. Dorman indicates that Godfrey has had some sales fluctuation, but that operating expenses have shown continuous and steady decline, and that the short-term financial information indicates an improving trend. The record here reflects a much more positive picture of Godfrey's financial record and prospects. Accordingly, we consider Mr. Dorman's evaluation to be too conservative.

From another perspective, the financial outlook category should ostensibly be addressing the potential for return on invested capital. In that regard, the sixth category of the matrix more directly addresses that aspect and assigns as much as 14 discount points for that aspect. The third category appears, in that respect, to be a duplication. Mr. Dorman has given an "above average" rating, assigning 4 discount points to the third category. In any event, Godfrey's financial picture is such that we would assign no discount for that aspect.

> Ability to control is the fourth category, and Mr. Dorman assigns a median discount of 10 in an arithmetic progression by 5, ranging from 0 to 20. His reasoning is that the 187.5 shares "represents 20 percent of the outstanding common stock, and is therefore the second largest holding out of approximately twenty shareholders." He concludes that the investor would not have control but "would enjoy swing power, and have a strong voice in the day-to-day operations and decision making of the company." We agree with Mr. Dorman's use of 10 discount points for lack of ability to control.
>
> In the fifth category, which concerns restrictions on transfer and anticipated holding period, Mr. Dorman selected a median 8 discount points in an arithmetic progression by 3, ranging from 2 to 14. His conclusion is based on a holding period of 5 years or more. Mr. Dorman stated that "To the best of * * * [his] knowledge at the present time, there is no likelihood that Godfrey * * * will be sold within the foreseeable future." We agree that there would be restrictions and possible delay in a sale of an interest in a family-owned entity as opposed to a publicly traded stock. The record before us, however, does not reflect that the holding period would be extended for 5 years or more, or that there are any particular difficulties in connection with the Deputy family. Accordingly, five discount points would be more appropriate to reflect the restriction situation in these cases.
>
> Finally, the sixth category, which addresses dividend payout history, seems to address the return on capital factor. In this category, Mr. Dorman selected the poorest rating of 14 discount points from an arithmetic progression by 3, ranging from 2 to 14. His reason for the rating is that Godfrey has not paid any dividends and it is unlikely that any will be paid in the future. However, the actual payment of dividends is not the sole measure. The potential to pay dividends must also be considered. A return may also be expected in the form of increase in the value of the investment or potential for capital gain. In other words, prospective earning power is important. See sec. 20.2031-2(f), Estate Tax Regs.; Rev. Rul. 59-60, 1959-1 C.B. 237.
>
> Mr. Dorman's analysis completely ignores any potential for gain due to increase in value. Godfrey's financial performance and future prospects would likely result in an increase in the investment value. The lack of dividends, when factored with the prospect of capital appreciation, would place Godfrey's return potential more in the middle range. Accordingly, 8 discount points would seem a better match than the 14 discount points attributed by Mr. Dorman to this aspect.
>
> Using the matrix as a guide, we would have arrived at a sum of 29 percent after considering the six factors. Factoring in the studies cited in the reports of the experts, considering the record in these cases, and recognizing the imprecise nature of the process in which we are engaged, we hold that a 30-percent discount is appropriate to reflect the lack of marketability and minority discounts connected with the 187.5 shares of Godfrey. Accordingly, we hold that the 187.5 shares of Godfrey had a discounted value of $3,358,20912 on September 15, 1997, the date of decedent's death.

Counsel for the taxpayer stated to this writer that, "We were pleased with the outcome in Deputy. The IRS expert was very good. The FLP discounts agreed to were 35% for the lifetime gifts and 30% for the estate. The estate included a .5% general partnership interest and a 75% limited partnership interest. The notice of deficiency included a Section 2036 argument which was abandoned before trial."

3. **Discounting Other Assets For Built-In Income Taxes**. The Tax Court of New Jersey rejected the argument that an IRA should be valued "net" of income taxes in Carlin v. Director, 2001 WL 1677449 (N.J. Tax):

> New Jersey Transfer Inheritance Tax is computed "upon the clear market value of the property transferred" subject to certain specific deductions, none of which expressly includes income tax liability, "and no others." N.J.S.A. 54:34-5. Plaintiff contends that his claimed reduction in the taxable value of the IRA is not a *547 deduction under N.J.S.A. 54:34-5. He characterizes the reduction as a discount in value resulting from the income tax liability inherent in the IRA. Defendant responds that plaintiff's attempt to reduce the taxable value of the IRA represents an effort to take a deduction not permitted by N.J.S.A. 54:34-5 and further contends that, even if the reduction in taxable value is treated as a discount to clear market value, the discount is not allowable under In re Estate of Romnes, supra 79 N.J. 139, 398 A.2d 543.
>
> The Romnes decision is critical to the determination of this appeal. Accordingly, a detailed explanation and analysis of that decision is warranted. There, the executors of the estate of Haakon I. Romnes sought a reduction, based on income tax liability, in the value for Transfer Inheritance Tax purposes of an annuity providing annual fixed income payments to the decedent's widow for the duration of her life. The fund from which the annuity was to be paid was accumulated during the decedent's lifetime from contributions to a pension plan by his employer. Income taxes on contributions to the fund were deferred, and, as a result, the annual annuity payments to Mrs. Romnes were subject to federal income tax. The estate argued that, as of the date of death, the deferred tax obligation was a burden upon the annuity payments to be received by Mrs. Romnes, and reduced their value. "Otherwise expressed, it is argued that since Mrs. Romnes will never enjoy in a beneficial sense that portion of her annuity payments that must be devoted to paying income taxes, she should not now be required to pay an inheritance tax upon what she will never beneficially receive." Id. at 143, 398 A.2d 543. The estate sought a value discount equal to the taxes payable by Mrs. Romnes with respect to the annuity payments, assuming each payment was added to her other income.
>
> In analyzing the estate's argument, the Supreme Court defined "clear market value" under N.J.S.A. 54:34-5 as the equivalent of fair market value, that is, the price which would be paid by a willing buyer to a willing seller when neither is under compulsion to buy or sell and both parties have reasonable knowledge of the relevant facts. Id. at 144-45, 398 A.2d 543. The Court commented that, in determining the clear market value of assets for which there is not an active market, a court must "create a hypothetical buyer and a hypothetical seller, whom we then place in a hypothetical market place. We attribute to each of these persons all information which might affect value, and then, weighing all relevant factors, decide how they would reach a price satisfactory to each." Id. at 145, 398 A.2d 543. This price or value must be determined objectively without consideration of any factors personal to either the hypothetical buyer or the hypothetical seller. "The use of an objective standard necessarily precludes resort to any factors personal to the seller or the buyer. Courts have consistently so held." Id. at 147, 398 A.2d 543.
>
> In applying these principles to the annuity in question, the Supreme Court concluded that neither a hypothetical seller nor a hypothetical buyer would be concerned with Mrs. Romnes' tax liability.

> A hypothetical purchaser of such an income interest as this annuity would be interested in the annuitant's health, in her life style, and in the solvency of the payor.... He would be utterly unconcerned with the annuitant's personal income tax picture.
>
> Nor would a hypothetical seller, about to divest himself of the income interest, be concerned in any way with a presumptive future liability he would never be called upon to meet. As soon as he divested himself of the interest, the prospective future liability would cease to exist. The same would be true if Mrs. Romnes herself is thought of as the seller. She would have no interest in a prospective liability that was about to end.
>
> Finally, is there any even remote possibility that Mrs. Romnes would accept as the purchase price of her annuity the amount of money that she asks the State of New Jersey to accept as being the value of this asset? There is of course no such possibility.

[Id. at 148-49, 398 A.2d 543.]

The Court also noted that the result of permitting a valuation discount calculated in the manner suggested by the estate would be that the wealthier the recipient, the greater the tax liability attributable to the annuity (because of the graduated tax rates under the Internal Revenue Code) and, therefore, the greater the discount in value which would be claimed.

> Thus it would follow that the rich would pay a smaller [transfer inheritance] tax than the less affluent and the very rich less than the rich. This rather startling result must again rest upon presumed legislative intent. But of course neither this nor any other tax statute has ever been intentionally drafted to classify taxpayers according to wealth and then impose graduated taxes in such a way that the richest pay the least.

[Id. at 153, 398 A.2d 543.]

* * *

The law is well established that each taxpayer should pay his or her fair share of taxes. See Phelps Dodge Industries, Inc. v. Director, Div. of Taxation, 8 N.J.Tax 354, 358-59 (1986). If Transfer Inheritance Taxes are reduced on a purely artificial or hypothetical basis, without taking into account the actual amount that will be received by the beneficiary, then the beneficiary may pay less than his or her fair share of taxes, or may pay excessive taxes. Calculating a proper valuation discount, therefore, must involve consideration of the actual tax circumstances of the beneficiary. However, consideration of those circumstances results in a deviation from the objective standard of value applicable for purposes of determining Transfer Inheritance Tax. In re Estate of Romnes, supra, 79 N.J. at 147, 398 A.2d 543.

Plaintiff is correct in asserting that, without a discount in the value of the IRA, he will pay Transfer Inheritance Tax on a portion of the IRA which must be used to pay federal and New Jersey income taxes. There appears to be some degree of unfairness in this result. But, as the preceding analysis demonstrates, allowing a discount based on income tax liability is not appropriate for two

> reasons: 1) determining the proper discount requires abandonment of the objective standard of value, because calculating income tax liability without regard to the actual tax circumstances of the beneficiary could result in an excessive or inadequate discount, and 2) the Romnes decision precludes such a discount.

In TAM 200247001 the IRS agreed. The TAM states:

> In Estate of Robinson v. Commissioner, 69 T.C. 222 (1977), during her lifetime, the decedent sold stock in exchange for a promissory note. The decedent properly elected to report the gain on this sale ratably as each payment was received, under the installment method pursuant to section 453. The decedent died before the note was satisfied. In determining the value of the note includible in the gross estate, Decedent's executor discounted the note to reflect the potential income taxes that would be payable on receipt of subsequent installment payments. The court concluded that under the "willing buyer-willing seller" standard of the regulations, property is to be valued at the price a hypothetical willing buyer would pay a willing seller and not the intrinsic value of the property in the hands of the individual decedent or his beneficiaries. In this case, on purchase of the note, a willing buyer's basis in the note would be increased to the purchase price, and thus, the buyer would not incur any income tax on receipt of the installments. The fact that the willing seller might incur income tax on the sale of the note does not impact on the sales price. Accordingly, a willing buyer would not take potential income tax into account in determining what he would be willing to pay for the note, and a willing seller would not accept any discount for potential income tax in determining the price of sale. The court also noted that taking potential income tax into account would require consideration of many factors that are peculiar to the individual decedent, the decedent's estate and the beneficiaries. Consideration of these subjective factors would not be consistent with the "willing buyer-willing seller" standard that looks to hypothetical parties.
>
> Finally, the court in Estate of Robinson stated that Congress focused on the problem of income tax inherent in certain assets included in the gross estate by allowing an income tax deduction under section 691(c). As discussed above, section 691(c) provides an income tax deduction determined by reference to the estate tax attributable to the assets. The court reasoned that Congress recognized that an installment obligation which includes income in respect of a decedent is subject to both income tax and estate tax. Congress chose to ameliorate the impact of the income taxation of the property by allowing an income tax deduction under section 691(c). The court found that there was no basis for supplementing this income tax relief with additional estate tax relief.
>
> We believe the court's rationale in Estate of Robinson is equally applicable in the instant case involving Decedent's IRAs. As was the case in Estate of Robinson, the fact that these assets are subject to income tax on distribution, should not impact on the application of the "willing buyer- willing seller" standard. The IRA distributee can sell the assets at market price without any discount. A willing seller would not accept any discount on the sales price. The situation is analogous to that presented where a donor transfers low basis property by gift. The value of the gift for gift tax purposes is the undiscounted value of the property because that is the amount a willing buyer would be willing to pay for the property, and it is also the minimum amount for which the willing seller would sell the property. The fact that the donee might incur

> income tax upon a later sale of the property does not decrease the value of the gift, which is determined under the "willing buyer-willing seller" standard.
>
> Further, as was the case in Estate of Robinson, the adverse impact of the potential income tax inherent in the IRAs is alleviated by the section 691(c) deduction. Thus, this income tax benefit functions as a statutory substitute for the valuation discount. Under these circumstances, any additional reduction in estate tax for the potential income tax would be unwarranted. See Estate of Robinson, 69 T.C. at 226 - 227.
>
> Finally, the value of the IRAs should not be discounted due to lack of marketability. While section 408(e) imposes penalties on the transfer or assignment of the IRA, there are no restrictions preventing the distribution of assets to the beneficiaries after decedent's death. The beneficiaries can request that the custodian distribute the assets of the IRAs and the beneficiaries can then sell the assets to any willing buyer. Furthermore, short administrative delays in processing the beneficiaries' request for distribution should not warrant a discount. The underlying assets are marketable, so no valuation discount should apply. Accordingly, the value of Decedent's IRAs should not be discounted for estate tax purposes to reflect income taxes that will be payable by the beneficiaries upon receipt of distributions from the IRAs, or for lack of marketability.

The TAM distinguished Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998):

> The situation in Eisenberg is distinguishable from the facts in this case. Upon sale of the stock of the corporation, a hypothetical buyer of the stock in Eisenberg will obtain a cost basis for the stock that he purchases, but the corporation's basis in its assets will not change. When the corporation liquidates or distributes the assets, a capital gains tax will be imposed. This potential liability reduces the inherent value of the corporation to the buyer. However, in the instant case, if we assume arguendo that the IRAs could be sold, the hypothetical buyer, as in Estate of Robinson, would receive a cost basis in the assets and would not incur any income tax on the resale of those assets, unless the assets appreciate in value. Therefore, the hypothetical buyer will be willing to pay the full value of the underlying assets for the IRA. Although the seller might incur income tax on the sale (see section 408(e)(2)), this income tax liability cannot be the basis for an estate tax valuation discount.
>
> Further, we do not believe that for valuation purposes an IRA is properly viewed as a separate entity, like a corporation. Rather, an IRA is a custodial arrangement and the stocks, bonds, and mutual funds held in the IRA are properly viewed as individual assets no different than stocks and bonds held in a brokerage account.
>
> Finally, and most significantly, Eisenberg did not involve a situation where the adverse impacts of the potential income tax is alleviated by the section 691(c) deduction as is the case here. As discussed above, we believe that this deduction is a statutory remedy for the adverse income tax impact and makes any valuation discount inappropriate, if the deduction applies.
>
> The estate also cites Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999), rev'g 108 T.C. 412 (1997), nonacq. 2000-19 IRB 1 (May 8, 2000). In Estate of Smith, prior to his death, the decedent had been paid oil and gas royalties and had reported the payments as income. Subsequently, the corporate

> payor of the royalties sued the decedent for $2.48 million dollars, claiming the payments had been excessive by that amount. The proceeding was still pending at the time of decedent's death. Fifteen months after decedents' death, the estate settled the suit for $681,840. The estate claimed a deduction under section 2053, as a claim against the estate, for $2.48 million, the amount the decedent was being sued for at the date of death. The Fifth Circuit held that the amount deductible was the value of the claim as of the date of death determined without consideration of the post-death settlement. Further, the Fifth Circuit concluded that the income tax benefit inuring to the estate under section 1341 (providing relief in the form of an income tax deduction or credit to taxpayers who are forced to repay an amount previously taken into income) was one of the factors to be considered in valuing the claim, and was not to be included as a separate asset, as the Tax Court had concluded. Similarly, in the instant case, it could be argued that tax benefit available under section 691(c) is merely a factor to be taken into account in determining the appropriate discount.

In TAM 200303010 the IRS refused to allow income taxes due on accrued interest on Series E U.S. savings bonds to create a lack of marketability discount. The TAM states:

> In Rev. Rul. 55-278, 1955-1 C.B. 471, in 1948, A purchased entirely with his own funds Series E United States savings bonds and registered the bonds in the names of A and his son B. In 1953, the bonds were reissued in the name of B alone in order to effect a gift to him. The Service held that the redemption value of Series E United States savings bonds at the time reissued is the proper value to be used by A with respect to the gift for federal gift tax purposes. In the ruling, the Service stated "since Series E United States savings bonds are generally nonnegotiable and nontransferable, they are nonmarketable and, accordingly, have no particular 'market' value. Although ownership therein is transferable by death and by reissue in certain cases, (citing Department Circular No. 530, supra) their only definitely indicated or ascertainable value is the amount at which they are redeemable by the United States Treasury." In that ruling, the Service referred to an earlier memorandum issued by the Service in which the Service held that Series E United States savings bonds are includible in the gross estate at their redemption value. Mim. 5109, C.B. 1940-2, 283, and Mim. 5002, C.B. 1941-2, 241.
>
> The estate asserts that the interpretation by the Service in Rev. Rul. 55-278 "clearly contravenes the definition of willing buyer discussed in section 20.2031-1(b)." The estate argues that "[t]he contractual limitation on U.S. Savings Bonds, that they are only redeemable by the United States Treasury, does not change the definition of a hypothetical willing buyer." According to the estate, "a hypothetical willing buyer of the bonds would consider the built-in income tax liability in determining the amount he would be willing to pay for those bonds." In support of this position, the estate relies on Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998) and Estate of Davis v. Commissioner, 110 T.C. 530 (1998).
>
> * * *
>
> Under consideration in this case and in the revenue ruling is an issue similar to the issue considered by the United States Supreme Court in United States v. Cartwright, 411 U.S. 546 (1973). In Cartwright, the Court granted certiorari to determine the value of shares of mutual funds to be included in a decedent's gross estate under section 2031. The mutual fund shares were not traded on exchanges or generally in the over-the-counter market, but were sold by the

> investment fund through a principal underwriter, and redeemed by the fund, at prices which were related to the net asset value. The Court stated that in implementing section 2031, the value of property is to be determined by its fair market value at the time of decedent's death and the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.
>
> The Court recognized the fact that the fund was under an obligation to redeem its shares at the redemption price and stated "that shares so held are, in important respects, similar to ordinary corporate stock held subject to a restrictive agreement, . . . so long as the restriction is a bona fide one, the value of the shares in the hands of the restricted stockholder is determined in accordance with the terms of the restriction. Treas. Reg. § 20.2031-2(h). Outstanding mutual fund shares are likewise held subject to a restriction, as the Court of Appeals noted. . . . Those shares may not be "sold" at the public offering price. By statute, they may be "sold" back to the mutual fund only at the redemption price. We see no valid justification for disregarding this reality connected with the ownership of mutual fund shares." Accordingly, the Court concluded that the redemption price was the value to be used in reporting the funds in the gross estate of the decedent.
>
> Similarly, in this case and the revenue ruling, the only willing seller is the decedent or decedent's estate and the only willing buyer is the United States government. By contractual arrangement, the Bonds will be redeemed by the United States Treasury at the redemption price.
>
> Eisenberg and Davis are distinguishable from this case. In those cases, the taxpayers transferred stock in a closely held corporation to family members. In valuing the stock for gift tax purposes, the taxpayers discounted the value of the stock to take into account the potential capital gains tax liabilities that may be incurred by the corporation if the corporation were to liquidate or distribute and sell its appreciated assets. In each case, the court held that the taxpayer was entitled to a discount for the potential capital gains tax liabilities because the court determined that a hypothetical buyer would take the corporation's potential capital gains tax liabilities into account in determining the value of the stock.
>
> Eisenberg and Davis involve situations in which the hypothetical willing buyer acquires stock in a corporation that owns appreciated assets with built-in capital gain. The fact that the buyer will pay tax on the sale of the appreciated assets may be a factor in determining the price the willing buyer would pay for the stock. This case involves a situation in which the hypothetical willing seller must include in his/her gross income the interest accrued on the Bonds prior to the date of the "sale" (the redemption). Under section 454(c), the accrued interest on the Bonds is includible in the gross income of the taxpayer in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The income tax on the accrued interest is paid by the seller in this case. The courts recognize that it is not appropriate to allow a discount for the hypothetical willing seller's costs in determining the fair market value of an asset for estate tax purposes.

No discount was allowed in valuing retirement plans by the U.S. District Court in Estate of Louis R. Smith v. United States, 300 F. Supp. 2d 474 (S.D. Tex. 2004). The opinion states that the IRD deduction under section 691(c) remedies any "fairness concerns" of the estate.

4. **Lottery Payments**. Valuation of a stream of lottery payments continues to generation litigation. In Estate of Paul C. Gubauskas v. Commissioner, 342 F. 3d 85 (2003), the Second Circuit reversed the Tax Court and held that lottery winnings in an estate should not be valued using section 7520. The Ninth Circuit held the same in Shackleford v. U.S., 262 F.3d 1028 (2001). On the other hand, the Fifth Circuit applied section 7520 in Cook v. Commissioner, 349 F.3d 850 (2003). So, there is a split among the Circuits which may lead to Supreme Court review (imagine!).

5. **Mitchell Affirmed.** The Ninth District has affirmed the Tax Court's redetermination of the value of 49.094% of John Paul Mitchell Systems, with a total discount of 35%. Patrick T. Fujieki v. Commissioner, No. 02-72043 (2003)(not for publication).

6. **Real Estate Valued Using Comparables**. Estate of Michael Dunia v. Commissioner, T.C. Memo. 2004-123, involved the straightforward valuation of a tract of land using comparables.

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

1. **Corporate Distributions**. An interesting issue was presented in TAM 200343002:

> Whether amounts earned by Corporation during the six month period after Decedent's death that were not distributed to the Decedent's estate as the sole shareholder during that period are "excluded property" for purposes of determining the value of the stock of Corporation included in Decedent's gross estate under § 2032 of the Internal Revenue Code.

The answer given was "no." Section 2.2032-1(d)(4) sets forth the treatment of corporate stock under alternate valution:

> Stock of a corporation. Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. On the other hand, ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to shareholders of record after the date of decedent's death are "excluded property" and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property," except to the extent that they are out of earnings of the corporation after, the date of the decedent's death. For example, if a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period which is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution received on stock included in the gross, estate is itself "included property," except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Similarly, if a corporation, in which the decedent owned a substantial interest and

> > which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to stockholders of record during the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method. Likewise, a stock dividend distributed under such circumstances is "included property".

That regulation was in response to a 1941 Supreme Court decision, Maass v. Higgins, 312 U.S. 443 (1941).

> In Maass v. Higgins, the applicable Treasury Regulation governing the (optional) alternate valuation rules provided that, in the case of stocks, the value of the stock and the value of the right to dividends thereon constituted separable property and each constituted an element of the value of the stock. Thus, under the regulation, if a dividend was received during the alternate valuation period, the portion attributable to the period after death had to be included in full in the gross estate. The Commissioner argued that, under the regulation, the amount received was either a payment on account of principal, or a disposition of property existing on the date of death that was included in the gross estate. The Court, however, concluded that dividends, rents and interest received during the alternate valuation period, are commonly considered income rather than a payment or disposition of principal, and are not to be included in the value of the gross estate under the alternate method of valuation. The Court stated:
>
> > [I]n common understanding, rents, interest, and dividends are income. Under the revenue acts, if such items are collected by a decedent's estate, the executors are bound to return them and pay tax upon them as income. In the case of a living holder, such receipts are never treated as on account of principal. Nor does the promise to pay interest, rents or dividends either to a living owner of the asset or to his executor after death, which has not been legally separated from the asset of which it is an incident, have any market value apart from the asset, or bear any invariable relation to the value of the capital asset.
> >
> > . . . [T]he promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments. . . . and other elements bearing upon the expectation of the receipt of income affect the value of any income producing property. But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all elements that go to give it value in the market.
>
> (Emphasis added.) Maass v. Higgins, 312 U.S. at 447 - 448. In reaching its conclusion, the Court also noted that "[T]he method always adopted for valuation at death is the same used in fixing a sale price; that is, to take the market value of the bond and add accrued interest to the date of transfer, at the rate stipulated in the instrument. It is not believed that Congress, in providing for two dates of valuation, intended that a different method should be followed if one date were chosen rather than the other." Maass v. Higgins, 312 U.S. at 448.

The TAM concludes:

> These regulations, rulings and cases make it clear that in order for post-death corporate earnings to be considered excluded property under § 2032(a), the

property must be sufficiently severed from the corporate estate. Prior to such severance, these amounts have not been "earned or accrued" by the estate or the beneficiary of the shares. Rather, these amounts are part of the "corporate estate" and are reflected in the value of the corporate stock. The value of the stock on the alternate valuation date properly includes post-death appreciation and depreciation during the alternate valuation period, which is directly effected by profits and losses during that period. These amounts are a part of the corporate assets until the corporation severs these assets from the corporate estate and the assets pass to the shareholders.

Finally, to the extent the Taxpayer's argument results in the use of a different method to value stock subject to alternate valuation than is used in the absence of the alternate valuation election, the position conflicts with the Court's decision in Maass v. Higgins, indicating that the alternate valuation provision in providing for two dates of valuation, was not intended to sanction different methods of valuation if one valuation date were chosen rather than the other. Maass v. Higgins, 312 U.S. at 448.

The Taxpayer contends that post-death corporate earnings are per se "excluded property" citing § 20.2031-1(d), providing that "property earned or accrued (whether received or not) after the decedent's death and during the alternate valuation period" with respect to property existing on the date of death, is excluded property. However, as noted above, for federal estate tax purposes, there is no accrual of corporate earnings to the shareholder prior to the declaration of the dividend and the shareholder record date. Thus, the corporate earnings in this case do not constitute property "earned or accrued" within the meaning of § 20.2032-1(d). Further, § 20.2032-1(d)(4), the regulation specifically addressing the alternate valuation of corporations, and the cases cited above, make it clear that a necessary prerequisite for characterization as excluded property, is a "severance of earnings and profits from the corporate estate." Estate of Schlosser v. Commissioner, 277 F.2d at 269. Thus, we do not believe that the regulations contain any "per se" rule.

The Taxpayer next argues that, it is clear that under § 20.2032-1(d)(4), ordinary dividends declared after the date of death are excluded property. In this case, the Decedent owned 100 percent of the stock in Corporation and therefore, Decedent's estate could have withdrawn and distributed earnings at any time, with or without formal action. Consequently, the Taxpayer argues that. in this case, the declaration of dividends would have been a mere ministerial act or formality, that under the regulations, should not constitute a prerequisite to qualification as excluded property. We have not reviewed whether under the corporate by-laws, or other documents and rules governing the operation of Corporation, the declaration of a dividend by Corporation, that is engaged in Business X, had a book value of $W, and employed Y personnel, would be a mere formality or ministerial act. In any event, we do not believe that § 20.2032-1(d)(4) draws any distinction between a corporation controlled by the Decedent's estate and one that is not so controlled, in determining what constitutes excludible property. Indeed such a test, dependent on the extent to which a shareholder could influence corporate actions, would be difficult, if not impossible, to apply. Rather, as discussed above, the test that is applicable requires a severance of the earnings and profits.

2. **Manner and Time of Election**. New proposed regulations have been issued changing Treas. Reg. § 20.2032-1(b). REG-139845-02. The proposed regulations state:

> Method and effect of election -- (1) In general. The election to use the alternate valuation method is made on the return of tax imposed by section 2001. For purposes of this paragraph (b), the term return of tax imposed by section 2001 means the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted). Once the election is made, it is irrevocable, provided that an election may be revoked on a subsequent return filed on or before the due date of the return (including extensions of time to file actually granted). The election may be made only if it will decrease both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax with respect to the property includible in the decedent=s gross estate. If the election is made, the alternate valuation method applies to all property included in the gross estate and cannot be applied to only a portion of the property.

The proposed regulations allow a protective election, which is helpful:

> Protective election. If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax liability of the estate, a protective election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur. A protective election made on the return of tax imposed by section 2001 is irrevocable, provided that it may be revoked on a subsequent return filed on or before the due date of the return (including extensions of time to file actually granted). Absent such revocation, if it is later determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum (reduced by allowable credits) of the estate tax and generation- skipping transfer tax liability of the estate, the protective election becomes effective and cannot thereafter be revoked.

H. SECTIONS 2035-2038 — RETAINED INTERESTS

1. **Application of Section 2036 to Family Limited Partnerships**. The IRS has attempted to minimize or eliminate the discounts claimed by taxpayers through family limited partnerships with various arguments, some based on general tax principles like the step-transaction doctrine and others more specifically Code based, typically sections 2703 and 2704. None of these arguments have been proven winners for the government. In fact, to date, most of the instances in which taxpayers have had difficulty have been when the form of the partnership was not respected by those involved. Stated another way, mistakes by the taxpayer and the taxpayer's family have generated about as many wins for the government as the government has earned on its own. Most recently the government has scored a significant victory in Strangi, but suffered a significant defeat in the Fifth Circuit in Kimbell.

The case of Estate of Morton B. Harper v. Commissioner, T.C. Memo. 2002-121, illustrates how taxpayers often hurt their case. The decedent, Mr. Harper, and his children formed a limited partnership using the assets in Mr. Harper's living trust. The particular facts recited by the court are important:

At a time not entirely clear from the record, decedent made the decision to form a limited partnership and to contribute thereto the majority of his assets. An Agreement of Limited Partnership for Harper Financial Company, L. P. (HFLP), was prepared and sets forth the governing provisions for the entity. The document begins with language stating that the Agreement was made "as of the 1st day of January, 1994", but later recites that the partnership shall commence its existence upon the date a certificate of limited partnership is duly filed with the California Secretary of State.

* * *

Michael and Lynn were named as the general partners of HFLP and the Trust as the sole limited partner, with interests of .4 percent, .6 percent, and 99 percent, respectively. Michael was also designated to serve as the managing general partner.

* * *

Although "the Portfolio" is not defined in the Agreement, there appears to be no dispute between the parties that it consisted of: (1) Securities held in a brokerage account at M. L. Stern & Co., Inc., (2) securities held in a Putnam Investments account, (3) securities held in two Franklin Fund accounts, (4) 2,500 shares of Rockefeller Center Properties, Inc., and (5) a $450,000 note receivable from Jack P. Marsh. The parties value these assets at between $1.6 and $1.7 million (rounded), an amount representing approximately 94 percent of decedent's total assets. The Trust's capital account in HFLP was credited with 99 percent of the value of the property contributed. Decedent retained, personally or through the Trust, his personal effects, a checking account, an automobile, and his Palm Springs condominium.

* * *

The Agreement was signed by decedent on behalf of the Trust, by Michael, and by Lynn. Although the signatures are undated, the document was executed by Michael in May or June of 1994. Lynn could not remember when she signed the Agreement and did not read it prior to signing. A certificate of limited partnership was filed on behalf of HFLP with the California Secretary of State on June 14, 1994.

From June 17 to June 20, 1994, decedent was hospitalized in Palm Springs. Medical records prepared at that time contain the explanation set forth below:

> This is one of multiple Desert Hospital admissions for this 85-year-old Caucasian who is well known to have metastatic colonic carcinoma and prostatic carcinoma and admitted at the present time for poor oral intake, poor fluid intake, dehydration and for further rehydration, close observation, nutrition support, etc.

After his release, decedent went to Oregon, where he resided until his death. He first stayed with Michael for approximately a month and then moved into a nearby Oregon retirement facility known as Carmen Oaks. Carmen Oaks served independent individuals and was not a nursing center.

Thereafter, by a document entitled Assignment of Partnership Interest and Amendment No. 1 to Agreement of Limited Partnership for Harper Financial

> Company, L. P., dated and made effective as of July 1, 1994, the Trust transferred to Michael and Lynn 60 percent of the Trust's partnership interest. As a result, Michael and Lynn became holders of 24-and 36-percent limited partnership interests, respectively, and were given corresponding percentages of the Trust's capital account balance. The limited partnership interests held by Michael and Lynn were designated as "Class B Limited Partnership Interest[s]" and were entitled to 60 percent of the income and loss of the entity, with 40 percent thereof going to Michael and 60 percent to Lynn.
>
> The Amendment also reclassified the Trust's remaining 39- percent limited partnership interest as a "Class A Limited Partnership Interest" which was entitled to 39 percent of the entity's income and losses and to a "Guaranteed Payment" of "4.25% annually of its Capital Account balance on the Effective Date, payable quarterly no later than twenty (20) days after the close of any such calendar quarter (or sooner, if cash flow permits)." Decedent, as trustee of the Trust, Michael, and Lynn signed the document.
>
> On July 26, 1994, decedent commenced the process of transferring the Trust's portfolio to the partnership, which process continued for approximately the next 4 months. On July 26, 1994, decedent executed as trustee an allonge endorsement assigning to HFLP the Trust's interest in the Marsh note. A collateral assignment of the Trust's interest in property securing the note was also signed on that date. Then, on August 28, 1994, a letter agreement confirming and/or finalizing the transfer was executed by or on behalf of Mr. Marsh, the Trust, and HFLP.
>
> Next, a letter dated September 29, 1994, was sent by decedent to M. L. Stern & Co. confirming instructions for (1) the sale of all securities held in the Trust's account and (2) the use of the proceeds for the immediate repurchase of the same securities for an account established on behalf of the partnership. Michael, as managing general partner, completed the requisite form opening a new account with M. L. Stern & Co. for the partnership. The form designated Michael as the "individual * * * authorized to enter orders on behalf of customer". Neil Hattem served as decedent's broker and subsequently as the broker on the HFLP account.
>
> Letters dated September 30, 1994, were then sent by decedent to Putnam Investor Services and to Franklin Templeton requesting transfer of the respective Putnam and Franklin Fund accounts to HFLP. Lastly, by a letter dated November 22, 1994, decedent requested transfer of the Trust's stock in Rockefeller Center Properties to the partnership.
>
> During this period, on September 23, 1994, Michael opened a checking account at Bank of America in the name of the partnership with a $200 deposit. Thereafter, the first activity in the account, other than the debiting of a monthly service charge, was a deposit on October 13, 1994, of $3,750 representing interest paid on the Marsh note.

The Tax Court concluded that the form of the partnership was not respected. Again, the facts are instructive:

> As previously indicated, section 2036 mandates inclusion in the gross estate of transferred property with respect to which the decedent retained, by express or implied agreement, possession, control, enjoyment, or the right to income. The focus here is on whether there existed an implicit agreement that decedent would

retain control or enjoyment, i.e., economic benefit, of the assets he transferred to HFLP.

Respondent avers that section 2036's applicability is established on these facts, emphasizing in particular actual conduct with respect to partnership funds. Respondent further maintains that this case is indistinguishable from the situations presented in Estate of Reichardt v. Commissioner, supra, and Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. The estate, on the other hand, discounts the evidence and cases relied on by respondent, emphasizing instead the formal terms of the partnership arrangement and the accounting treatment of entity assets.

In Estate of Reichardt v. Commissioner, supra at 147-148, the decedent formed a family limited partnership, the general partner of which was a revocable trust created on the same date. The decedent and his two children were named as cotrustees, but only the decedent performed any meaningful functions as trustee. Id. at 147, 152. He was the only trustee to sign the articles of limited partnership, to open brokerage accounts, or to sign partnership checks. Id. at 152. He transferred his residence and all of his other property (except for his car, personal effects, and a small amount of cash in his checking account) to the partnership and subsequently gave his two children limited partnership interests. Id. at 148-149, 152-153. The decedent deposited partnership income in his personal account, used the partnership checking account as his personal account, and lived at his residence without paying rent to the partnership. Id. at 152. Based on these facts, we concluded that nothing but legal title changed in the decedent's relationship to his assets after he transferred them to the partnership. Id. at 152-153.

In Estate of Schauerhamer v. Commissioner, supra, the decedent formed three limited partnerships. The decedent and one of her three children were named as the general partners of each partnership, with the decedent's being designated as the managing partner. Id. The decedent transferred business assets, including real estate, partnership interests, and notes receivable, to the partnerships in undivided one-third shares. Id. Limited partnership interests in these entities were given to family members. Id. Partnership bank accounts were opened, but the decedent deposited the income earned by the partnerships into the account she used as her personal checking account, where it was commingled with funds from other sources. Id. Checks were then written from this account to pay both personal and partnership expenses. Id. The decedent's children later acknowledged at trial that formation of the partnerships was merely a way to enable the decedent to assign interests in the partnership assets to family members, with the assets to be managed by the decedent exactly as in the past. Id. We therefore found the assets includable under section 2036(a). Id.

We agree with respondent that the circumstances before us bear many similarities to those in Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000), and Estate of Schauerhamer v. Commissioner, supra, and are convinced that a like result should obtain. We focus particularly on the commingling of funds, the history of disproportionate distributions, and the testamentary characteristics of the arrangement in support of our conclusion that there existed an implied agreement that decedent would retain the economic benefit of the assets transferred to HFLP.

As regards commingling of funds, we note that this fact was one of the most heavily relied upon in both Estate of Reichardt v. Commissioner, supra at 152, and Estate of Schauerhamer v. Commissioner, supra. We find the disregard here for partnership form to be equally egregious. The Agreement specified: "All funds of the Partnership shall be deposited in a separate bank account or accounts". Yet no such account was even opened for HFLP until September 23, 1994, more than 3 months after the entity began its legal existence. Prior to that time, partnership income was deposited in the Trust's account, resulting in an unavoidable commingling of funds.

Michael testified concerning this delay as follows:

> Inadvertently, either my account or I failed to apply timely for any — an employee [sic] identification number. That is required before a checking account is open. So I just made the determination that without a checking account and I wanted the flow of cash, what we would do is use the Morton B. Harper Trust account as a holding account, and then I instructed the accountant to properly credit and account for those funds. * * *

This explanation, however, seems to beg the question. Had Michael sought promptly upon HFLP's creation to establish a bank account, he would have been immediately alerted to the need for an EIN. Hence, he either neglected to attempt opening and/or using an account or allowed the lack of an EIN to continue for several months after having been reminded of its necessity. Both reflect at best a less than orderly approach to the formal partnership structure so pressed by the estate.

Moreover, we find Michael's reliance on post mortem accounting manipulations to be especially unavailing. Michael and Mr. Blankstein, HFLP's accountant, each testified that no moneys actually changed hands in connection with the adjustments. In response to similar contentions in Estate of Reichardt v. Commissioner, supra at 154-155, we stated:

> The 1993 yearend and 1994 post mortem adjusting entries made by Hannah's firm were a belated attempt to undo decedent's commingling of partnership and personal accounts. There is no evidence that the partnership or decedent transferred any funds to the other as a result of the adjusting entries. After-the- fact paperwork by decedent's C. P. A. does not refute that decedent and his children had agreed that decedent could continue to use and control the property during his life. [Fn. ref. omitted.]

Here Michael did not even hire Mr. Blankstein until after decedent's death, strengthening the inference that the partners had little concern for establishing any precise demarcation between partnership and other funds during decedent's life.

Closely related to the delay in opening the partnership bank account and consequent commingling of income is the delay in formally transferring the underlying portfolio assets to HFLP. No attempt was made to begin the process of title transfer until July 26, 1994, when decedent executed an allonge endorsement assigning the Marsh note to HFLP. No action was taken with respect to any of the other securities until September 29 and 30, 1994, when letters addressing transfer of the M. L. Stern & Co., Putnam, and Franklin accounts were drafted and an account with M. L. Stern & Co. was opened on behalf of HFLP. A letter requesting transfer of the Rockefeller Center Properties stock was not prepared until November 22, 1994.

When Michael was asked on cross-examination to explain this delay between the effective date of the partnership and the formal transfer of assets into the entity, he replied: "Probably for different reasons, some mechanical delays and who we're dealing with, but generally, there was no rush to do it. We were just doing it in an orderly fashion." Next, in response to a further question asking why there was no rush, he continued: "There was no rush. I mean, we were just handling the business in an orderly fashion. There wasn't any deadline or urgency to do it and get it done." The following colloquy then ensued:

Q Now let's talk for a moment about the income from the portfolio assets. Before the title to the assets was transferred to the partnership, your father or his trust continued to receive the income from those assets. Isn't that right?

A Would you restate that? I'm lost.

Q Okay. At a certain point in time the assets were contributed to the partnership, correct?

A Yes.

Q Okay. Before that happened, your father's trust continued to receive the income from those assets, correct?

A Probably.

Q Well, why isn't it Yes?

A Well, before he contributed it, he was in control of that. Who else would get it? I say probably.

Hence, we are again met with an example of indifference by those involved toward the formal structure of the partnership arrangement and, as a corollary, toward the degree of separation that the Agreement facially purports to establish. Moreover, until title to the assets was transferred to HFLP, decedent would not have forfeited the control over the underlying securities that he through the Trust possessed as legal holder. Thus, at the time of the June 14, 1994, creation of HFLP and for some months following, decedent's Trust retained title to the underlying assets and was issued the dividends and interest generated thereby. In addition, according to Michael's own testimony, the partners were in no hurry to alter this state of affairs. This speaks volumes concerning how little the partners understood to have changed in decedent's relationship to his assets as a result of the entity's formation.

Turning to facts regarding distribution of partnership funds, we find equally compelling indicia of an implied understanding or agreement that the partnership arrangement would not curtail decedent's ability to enjoy the economic benefit of assets contributed to HFLP. In addition to the deemed distributions engendered by the commingling discussed above, even the distributions made by Michael from the partnership checking account are heavily weighted in favor of decedent. The check register indicates that during the period extending from September of 1994 through early November 1995, partnership funds were distributed for the benefit of Michael and Lynn in the amounts of $5,800 and $8,700, respectively. These distributions occurred on November 9, 1994, December 19, 1994, and January 10, 1995. During that same

> time frame, partnership checks totaling $231,820, were remitted to the Trust, with the last being written on October 30, 1995. Only then did distributions to Michael and Lynn resume with checks drawn on November 15, 1995, in the amounts of $4,800 and $7,200, respectively. Given this pattern, we would be hard pressed to conclude other than that the partnership arrangement did little to curtail the access of decedent or his estate to the economic benefit of the contributed property.
>
> Similarly significant is the evidence that certain of the distributions to the Trust were linked to a contemporaneous expense of decedent personally or of his estate. These amounts, variously labeled by Michael "additional distribution", "return of capital", or "capital return", totaled $220,520 and even included $4,000 to enable decedent to complete a gift 2 days before he died. This evidence buttresses the inference that decedent and his estate had ready access to partnership cash when needed.

The estate also argued that the partnership units were consideration sufficient to move the transaction out of section 2036. The court rejected the contention:

> Having decided that decedent retained enjoyment of the transferred assets for purposes of section 2036(a), we turn to the question whether the statute's application may nonetheless be avoided on the basis of the parenthetical exception for "a bona fide sale for an adequate and full consideration in money or money's worth". The estate contends:
>
>> The primary reason why I.R.C. 2036 does not apply to Petitioner is that the Trust's transfer of the Portfolio to the Partnership in exchange for a credit to its capital account for 99% of the fair market value of the Portfolio assets and a 99% interest in profits and losses is a "bona fide sale for an adequate and full consideration in money or money's worth." * * *
>
> We, however, disagree on the ground that the estate's position fails to take into account significant aspects of the jurisprudence addressing this exclusionary language. The phrase, as used in a predecessor statute, was explained in early caselaw of this Court, as follows:
>
>> Accordingly, the exemption from tax is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a genuine arm's length transaction; and the exemption is not to be allowed in a case where there is only contractual consideration but not "adequate and full consideration in money or money's worth." * * * [Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951).]
>
> * * *
>
> On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one

can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.

Furthermore, lack of a bona fide sale aside, we believe that to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property. We see little practical difference in whether the Trust held the property directly or as a 99-percent partner (and entitled to a commensurate 99-percent share of profits) in a partnership holding the property. Essentially, the value of the partnership interest the Trust received derived solely from the assets the Trust had just contributed. Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.

We note that the foregoing interpretation is supported by our holdings in both Estate of Reichardt v. Commissioner, 114 +T.C. 144 (2000), and, by implication, Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. In Estate of Reichardt v. Commissioner, supra at 155-156, the taxpayer contended that the parenthetical exception should apply. We, however, rejected this argument, observing that neither did the decedent's children give anything to him or to the partnership at the time he contributed his assets nor did he sell the transferred property to the entity. Id. In Estate of Schauerhamer v. Commissioner, supra, the contributed assets were included in the decedent's gross estate under section 2036(a) without discussion of the exception, leading to the inference that it would not apply in such circumstances.

We further are convinced that the cases cited by the estate do not require a contrary conclusion. The estate points in particular to Estate of Jones v. Commissioner, 116 T.C. 121 (2001); Estate of Strangi v. Commissioner, 115 T.C. 478 (2000); Shepherd v. Commissioner, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th Cir. 2002); Estate of Harrison v. Commissioner, T.C. Memo. 1987-8; and Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W. D. Tex. 2000), affd. without published opinion 268 F.3d 1063 (5th Cir. 2001). The estate apparently argues that the just-cited cases establish that a proportionate partnership interest constitutes per se adequate and full consideration for contributed assets. We believe, however, that any such global formulation would overreach what can be drawn from the decisions.

First, with respect to Estate of Jones v. Commissioner, supra, Estate of Strangi v. Commissioner, supra, and Shepherd v. Commissioner, supra, none of these opinions involved section 2036. Rather, they considered whether gifts were made at the inception of family limited partnership arrangements. [citations omitted] The cases therefore do not control interpretation of the requirements of section 2036. Furthermore, while section 2512(b) describes a gift as a transfer of property "for less than an adequate and full consideration in money or money's worth", there exists an equally fundamental principle that a gift requires a donee — some other individual must be enriched. In this connection, we note that Estate of Jones v. Commissioner, supra at 127-128, and Estate of Strangi v. Commissioner, supra at 489-490, which find no gift at inception, say nothing explicit about adequate and full consideration but do refer to enhancement, or

> lack thereof, of other partners' interests. Hence, even if relevant here, we would be unable to conclude that these rulings resolve the question of whether a proportionate entity interest, in and of itself, constitutes adequate and full consideration for contributed assets.
>
> Second, although Estate of Harrison v. Commissioner, supra, and Church v. United States, supra, do address section 2036, there exist significant differences between these cases, on the one hand, and Estate of Reichardt v. Commissioner, supra, and Estate of Schauerhamer v. Commissioner, supra, on the other, which distinguish the two groups. In both Estate of Harrison v. Commissioner, supra, and Church v. United States, supra, the other partners made contributions at the formation of the entity which were not de minimis in nature. The partnership entity thus served as the vehicle for a genuine pooling of interests. The court in each case then went on to conclude that the partnerships had been created for a business purpose. Estate of Harrison v. Commissioner, supra; Church v. United States, supra.
>
> Accordingly, it is not unreasonable to assume that a genuine pooling for business purposes injects something different into the adequate and full consideration calculus than does mere, unilateral value "recycling" as seen in Estate of Reichardt v. Commissioner, supra, Estate of Schauerhamer v. Commissioner, supra, and the present matter. In the former situation, there is at least the potential that intangibles stemming from a pooling for joint enterprise might support a ruling of adequate and full consideration. We also note that section 25.2512-8, Gift Tax Regs., specifies that transfers "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."
>
> We therefore hold that where a transaction involves only the genre of value "recycling" described above and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place. Hence, the exception provided in that statute is inapplicable. Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration.

Similarly, the Tax Court applied section 2036 in Estate of Theodore R. Thompson v. Commissioner, T.C.Memo. 2002-246 (2002). The opinion states:

> In this case, the circumstances surrounding establishment of the partnerships show that, at the time of the transfer, there was an implied agreement or understanding that decedent would retain the enjoyment and economic benefit of the property he had transferred. Before the partnerships were formed, Betsy [decedent's daughter] sought assurances from the financial advisers that decedent would be able to withdraw assets from the partnerships in order to make cash gifts each year to his children, grandchildren, and great grandchildren. In late November 1993 after the partnerships were formed, George [decedent's son-in-law] asked the advisers how decedent could get $40,000 out of the partnerships to give as Christmas presents. The implied agreement among decedent, Robert [decedent's son], Betsy, and George that decedent would retain the enjoyment and economic benefit of the transferred property is reflected also by the distributions made by the partnerships to decedent. Late in 1993 and again in 1994, both the Turner Partnership and the

> Thompson Partnership made distributions to decedent of $40,000 so that he could continue his practice of giving substantial gifts at Christmastime to his family members.
>
> The circumstances also demonstrate an understanding that decedent's interest in the transferred property would last until his death. When the partnerships were established, decedent parted with almost all of his wealth, retaining enough to support himself for less than 2 years. Betsy's correspondence in early 1995 to Robert shows that the amount decedent retained was insufficient — his original holdings had diminished to $31,806, while his expenses for the prior year totaled $57,202. Betsy informed Robert that decedent would need "an infusion" of funds to cover the balance of decedent's anticipated 1995 expenses. She proposed that the Turner Partnership and the Thompson Partnership transfer assets of equal value to their father. In March 1995 the Thompson Partnership distributed $12,500 to decedent.
>
> We are not persuaded otherwise by the insistence of decedent's estate that decedent always asked Betsy and Robert, in their respective capacity as officers of the corporate general partners of their partnerships, for the cash decedent needed to provide Christmas gifts.11 The fact that decedent requested those sums does not vitiate the existence of an understanding that he would receive them.
>
> Here, decedent's outright transfer of the vast bulk of his assets to the partnerships would have deprived him of the assets needed for his own support. Thus, the transfers from the partnerships to decedent can only be explained if decedent had at least an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived.
>
> While we acknowledge that, as a result of the creation of the partnerships, prior to decedent's death some change ensued in the formal relationship of decedent to the assets he contributed to the partnerships, we are satisfied that the practical effect of these changes during decedent's life was minimal. Decedent continued to be the principal economic beneficiary of the contributed property after the partnerships were created. Based on these facts, we conclude that nothing but legal title changed in the decedent's relationship to his assets after he transferred them to the partnerships. Estate of Reichardt v. Commissioner, supra at 152-153.
>
> Any control over management and distributions by Betsy and Robert is likewise of little import. Documents in the record show that the composition of the portfolio changed little prior to decedent's death. We place little weight on averments concerning change, during decedent's life, in the partners' relationships to the contributed property.

Reichardt, Schauerhamer, Harper, and Thompson guide those who create and operate family limited partnerships, but are not generally troubling because they do not attack the theory behind those entities. Stated differently, those cases are based on section 2036(a)(1) which include in the gross estate property over which decedent has the right to enjoyment. The application of 2036(a)(1) may be avoided by respecting the form of the entity and ensuring that minimal (or no) benefits, such as income distributions are made to the decedent limited partner.

On June 17, 2002 the Fifth Circuit remanded Estate of Strangi, now called Rosalie Gulig v. Commissioner, No. 01-60538, so that the Tax Court could consider section 2036. In Strangi the decedent's attorney-in-fact formed the partnership two month's before the decedent's death. The decedent retained a 99% limited interest and a 47% interest in the 1% corporate general partner. The decedent's children paid for the other shares in the general partner. Over 75% of the partnerships' assets were marketable securities. The point here is not only section 2036(a)(1) but also 2036(a)(2), namely that by having an interest in the general partner the decedent had the right to designate those who would enjoy property.

In its initial Strangi opinion, which did not consider section 2036, the Tax Court first determined that the "business purposes" for the partnership were bogus but that the partnership would be respected anyway because the partnership was validly formed under state law. The Tax Court then rejected the applicability of section 2703 and went on to consider whether there was a gift on formation:

> In this case, the estate claims that the assets were transferred to SFLP for the business purposes discussed above. Following the formation of SFLP, decedent owned a 99-percent limited partnership interest in SFLP and 47 percent of the corporate general partner, Stranco. Even assuming arguendo that decedent's asserted business purposes were real, we do not believe that decedent would give up over $3 million in value to achieve those business purposes.
>
> Nonetheless, in this case, because we do not believe that decedent gave up control over the assets, his beneficial interest in them exceeded 99 percent, and his contribution was allocated to his own capital account, the instinctive reaction that there was a gift at the inception of the partnership does not lead to a determination of gift tax liability. In a situation such as that in Kincaid, where other shareholders or partners have a significant interest in an entity that is enhanced as a result of a transfer to the entity, or in a situation such as Shepherd v. Commissioner, 115 T.C. __, __ (2000) (slip. op. at 21), where contributions of a taxpayer are allocated to the capital accounts of other partners, there is a gift. However, in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest. See Kincaid v. United States, supra at 1224. Realistically, in this case, the disparity between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift.

Clearly the court thought another theory should be asserted, but was not — section 2036:

> The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47- percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036. See, e.g., Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000). Section 2036 is not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely. Applying the economic substance doctrine in this case on the basis of decedent's continuing control would be equivalent to applying section 2036(a) and including the transferred assets in decedent's estate. As discussed

> below, absent application of section 2036, Congress has adopted an alternative approach to perceived valuation abuses.

The IRS expert allowed a 31% discount which the court, reluctantly, accepted.

The Fifth Circuit stated on remand:

> Fifty-two days before trial, the Commissioner filed a motion to amend to add a claim that under §§ 2036 the estate should include the value of SFLP's assets transferred from the decedent. The tax court denied the motion to amend, apparently because it considered the motion untimely. We review the tax court's decision to deny leave to amend for abuse of discretion. Halbert v. City of Sherman, Tex., 33 F.3d 526, 529 (5th Cir. 1994). "A decision to grant leave is within the discretion of the court, although if the court lacks a substantial reason to deny leave, its discretion is not broad enough to permit denial." State of Louisiana v. Litton Mortgage Co., 50 F.3d 1298, 1302-03 (5th Cir. 1995) (internal citations and quotes omitted). "In the absence of any apparent or declared reason — such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of amendment, etc. — the leave sought should, as the rules require, be 'freely give.'" Foman v. Davis, 371 U.S. 178, 182 (1962).
>
> The only insight we have into the tax court's reasoning for the denial is its statement that, even though §§ 2036 might apply on the facts, it was "not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely." However, the motion was made nearly two months, not "shortly," before trial and was unlikely to cause delay or prejudice. If the tax court's true reasoning was that the Commissioner could have sought to assert the applicability of §§ 2036 earlier in the proceedings, it did not assert such and did not discuss any evidence of bad faith or dilatory motive. We cannot assume bad faith on the record here. The record does not present an obvious reason for denial of leave to amend. See Ashe v. Corley, 992 F.2d 540, 542-43 (5th Cir. 1993) ("Where reasons for denying leave to amend are 'ample and obvious,' the district court's failure to articulate specific reasons does not indicate an abuse of discretion."). We find that the denial was an abuse of discretion.

Judge Cohen issued the second Tax Court opinion in Strangi on May 20, 2003. T. C. Memo 2003 - 145. The opinion is not a reviewed decision. The opinion deals with both section 2036(a)(1) and 2036(a)(2). The latter analysis will cause more concern. The opinion summarizes the relevant facts as follows:

> The SFLP agreement provides that distributions of proceeds and assets from the entity shall be made in the sole discretion of the managing general partner. The SFLP agreement also designates Stranco as the managing general partner. Stranco, in turn, executed the management agreement employing Mr. Gulig to manage the day-to-day business of SFLP, as well as of Stranco itself. Yet Mr. Gulig was already decedent's attorney in fact pursuant to the 1988 general power of attorney. Under this instrument, Mr. Gulig was granted full and durable authority to act for decedent in his "name, place and stead". Mr. Gulig set up the SFLP/Stranco arrangement to facilitate decedent's estate planning goals and capitalized the partnership primarily with decedent's property.

> When distilled to their most essential terms, the governing documents gave Mr. Gulig authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney. Although the estate protests that Mr. Gulig's authority under the management agreement was limited to managing "the day-to-day business" of the partnership and did not extend to making distributions or loans, the pertinent instruments provide no basis for concluding that making distributions would be outside the day-to-day business of a partnership capitalized nearly exclusively with investment assets. As a practical matter, actual disbursement of funds occurred when checks were issued by Mr. and Mrs. Gulig in their various related capacities, pursuant to rights granted to them by decedent, acting through Mr. Gulig.
>
> Hence, to summarize, the SFLP agreement named Stranco managing general partner with the sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate such authority to Mr. Gulig under the management agreement. Decedent's attorney in fact thereby stood in a position to make distribution decisions. Mrs. Gulig effectuated these decisions by signing checks to the recipients so designated.

The first issue for the court was the application of section 2036(a)(1). The taxpayer attempted to distinguish this case from the Schauerhamer to Reichardt and Harper line of cases. The court acknowledged that the taxpayer here dotted more "i's" and crossed more "t's" than in the aforementioned cases but ultimately reached the same result. Judge Cohen writes:

> At the outset, we acknowledge that, in contrast to certain of the prior cases, the participants involved in the SFLP/Stranco arrangement generally proceeded such that "the proverbial 'i's were dotted' and 't's were crossed'." Strangi I at 486. Steps were taken to abide by the formal terms of the structure created. Such measures may give SFLP and Stranco sufficient substance to be recognized as legal entities in the context of valuation, which requires assumption of a hypothetical buyer and seller. They do not preclude implicit retention by decedent of economic benefit from the transferred property for purposes of section 2036(a)(1).
>
> First, we cannot lose sight of the fact that decedent contributed approximately 98 percent of his wealth, including his residence, to the SFLP/Stranco arrangement. Respondent alleges that the transfer left decedent with inadequate assets and cash flow to meet his living expenses, to which the estate takes objection. The estate goes to great lengths to counter respondent's assertion, claiming that decedent at his death possessed liquefiable assets of at least $172,000 and received on a monthly basis a pension of $1,438.18 and Social Security of $1,559. The estate also stresses that respondent has not established the amount of decedent's living expenses and maintains that, even if the $33,323.22 in checks paid from decedent's account in August and September were used as an estimate, the purported liquefiable assets would have covered decedent's needs for his concededly short life expectancy of 12 to 24 months. However, the relative dearth of liquefied (decedent's Form 706 showed two bank accounts with funds totaling $762), as opposed to "liquefiable", assets persuades us that decedent and his children and Mr. Gulig all expected that SFLP and Stranco would be a primary source of decedent's liquidity. It is unreasonable to expect that decedent would be forced to rely on sale of assets to meet his basic costs of living.

A second feature highly probative under section 2036(a)(1) is decedent's continued physical possession of his residence after its transfer to SFLP. The estate maintains that any otherwise negative implications of this circumstance are neutralized by the fact that SFLP "charged Mr. Strangi rent" on occupancy of the home and reported rental income on its 1994 tax return. Decedent likewise reported a rent obligation on his estate tax return. For accounting purposes, the accrued rent was recorded by SFLP on its books. Yet the accrued amount was not paid until January 1997. A residential lessor dealing at arm's length would hardly be content merely to accrue a rental obligation for eventual payment more than 2 years later. As we have remarked, accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment. Estate of Reichardt v. Commissioner, 114 T.C. at 154-155; Estate of Harper v. Commissioner, T.C. Memo. 2002-121.

Concerning factors that relate to use of entity funds, the estate emphasizes that each disbursement for decedent or his estate was accompanied by a pro rata allotment to Stranco. Where, as here, the only interest in the partnership other than that held by the decedent is de minimis, a pro rata payment is hardly more than a token in nature. In these circumstances, pro rata disbursements are insufficient to negate the probability that the decedent retained economic enjoyment of his or her assets. After all, distributing 1 percent to Stranco would not in any substantial way operate to curb decedent's ability to benefit from SFLP property. Accordingly, we direct our attention to the purpose, as opposed to the mechanics, of partnership distributions and expenditures.

The record reveals several instances where SFLP expended funds in response to a need of decedent or his estate. SFLP paid for Ms. Stone's back surgery to alleviate an injury she sustained in caring for decedent prior to the formation of SFLP. In 1994, SFLP expended nearly $40,000 for funeral expenses, estate administration, and related debts, including a $19,810.28 check to Olsten to pay for nursing services rendered to decedent before his death. These sums were followed in 1995 and 1996 by further payment of over $65,000 for estate expenses and a specific bequest. SFLP also disbursed approximately $3 million directed toward decedent's estate and inheritance taxes.

The estate seeks to justify these payments primarily by emphasizing that they were accounted for on SFLP's books as advances to partners and later closed as distributions, with pro rata amounts either advanced or distributed to Stranco. The evidence also indicates that the $65,000-plus amount was repaid in January 1997. The estate further explains that certain of these payments from SFLP were necessitated by the delay in probate of decedent's estate engendered by the process of getting TCB to decline executorship.

To the extent that the estate's arguments focus on accounting manipulations, they are unavailing. As demonstrated in Estate of Reichardt v. Commissioner, supra at 154-155, and Estate of Harper v. Commissioner, supra, accounting adjustments do not preclude a conclusion that those involved understood that the decedent's assets would be made available as needs materialized. Belated repayment of certain amounts likewise does not refute the inference of an implicit agreement for retained enjoyment that arises from the demonstrated and contemporaneous availability of large sums. Furthermore, to the extent that the estate's explanations focus on a delay in probate, they lack specificity. The more salient feature would appear to be the insufficiency of the assets not contributed to SFLP and Stranco to cover the significant expenses reasonably to be expected to ensue in connection with decedent's poor health and death. That, in turn, speaks to retained enjoyment.

Regarding testamentary characteristics, the SFLP/Stranco arrangement also bears greater resemblance to one man's estate plan than to any sort of arm's-length, joint enterprise. As in Estate of Harper v. Commissioner, supra, "the largely unilateral nature of the formation, the extent and type of the assets contributed thereto, and decedent's personal situation are indicative." Mr. Gulig established the entities using Fortress documents with little, if any, input from other family members. The contributed property included the majority of decedent's assets in general and his investments, a prime concern of estate planning, in particular. Decedent was advanced in age and suffering from serious health conditions. Furthermore, as discussed in Strangi I at 485-486, the purpose of the partnership arrangement was not to provide a joint investment vehicle for the management of decedent's assets, but was consistent with testamentary intent.

Moreover, the crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets. Mr. Gulig managed decedent's affairs both before and after the transfer. Decedent's children did not obtain a meaningful economic stake in the property during decedent's life. They raised no objections or concerns when large sums were advanced for expenditures of decedent or his estate, thus implying an understanding that decedent's access thereto would not be restricted.

In face of the foregoing realities, the estate argues that whatever possession or enjoyment of the contributed property decedent may have experienced was neither "retained" by means of a contemporaneous agreement nor "with respect to the transferred property". As regards the first point, the estate contends that respondent has offered no evidence to prove a contemporaneous agreement requiring the distributions made, as opposed to an independent subsequent decision by Stranco to make the same outlay. According to the estate:

> Even if decisions to make distributions were made based on "sympathy for poor old dad," i. e., "Oops, Mr. Strangi imprudently put too much money into SFLP and we need to give some back" that would not meet the criteria set by judicial precedent for determining the existence of a retained expectation of possession of [sic] enjoyment: which is that there must have been an implied agreement that was contemporaneous with the transfer of the property at issue, not a subsequent agreement or act. * * * [Fn. ref. omitted.]

We are persuaded that the evidence and circumstances detailed above render such a contemporaneous agreement more likely than not.

The second point mentioned stems from the estate's view that pro rata distributions were made not with respect to the transferred property, in which decedent possessed no legal interest under the Texas Revised Limited Partnership Act (TRLPA), Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 7.01 (Vernon Supp. 2003), but with respect to his partnership interest. Yet this argument relies on paper title to the exclusion of the practicalities that are the focus of section 2036(a)(1). The property contributed by decedent was the source of the payments made. Furthermore, the record suggests that the impetus underlying a number of significant SFLP disbursements was needs of decedent or his estate, rather than exigencies pertaining to Stranco or the partnership itself.

To this point, the opinion has been a bit more aggressively anti-taxpayer than the previous 2036(a)(1) cases have been, but nonetheless the issues raised were essentially the same. However, the court did not stop there. Noting that the taxpayer and the government argued extensively about the application of section 2036(a)(2) the court decided to weigh in. (So, before going further, remember this is arguably dicta in an unreviewed Tax Court opinion.)

Judge Cohen describes the application of section 2036(a)(2) and the meaning of Byrum as follows:

> As stated above, section 2036(a)(2) mandates inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income. This provision was interpreted by the Supreme Court in United States v. Byrum, 408 U.S. 125 (1972), and both parties devote a significant portion of their respective arguments to the implications of that decision. We address these arguments as an alternative to our conclusions concerning section 2036(a)(1) and with particular consideration of the facts of this case.
>
> In United States v. Byrum, supra at 126, the decedent, Mr. Byrum, created an irrevocable trust for the benefit of his children. He funded the trust with shares of three closely held corporations but retained the right to vote the shares and to veto any sale or transfer of the stock. Id. at 126-127. As a result, Mr. Byrum at his death continued to have the right to vote not less than 71 percent of the common stock in each of the three corporations. Id. at 128-129. The three corporations were involved in lithography-related businesses and had a substantial number of minority shareholders unrelated to Mr. Byrum. Id. at 130 & n. 2, 142 & n.20. (The Supreme Court noted that 11 of 12, 5 of 8, and 11 of 14 stockholders, respectively, in the three corporations appeared to be unrelated to Mr. Byrum. Id. at 142 n.20.) The trust instrument specified that there be, and Mr. Byrum named, an independent corporate trustee. Id. at 126. The trustee was authorized in its "absolute and sole discretion" to pay income and principal to or for the benefit of the beneficiaries. Id. at 127.
>
> The Commissioner argued that, by retaining voting control over the corporations, Mr. Byrum was in a position to select the corporate directors and thereby to control corporate dividend policy. Id. at 131-132. According to the Commissioner, the scenario in dispute gave Mr. Byrum the ability to regulate the flow of income to the trust, which ability was characterized as tantamount to a grantor-trustee's power to accumulate trust income for remaindermen or to distribute to present beneficiaries. Id. at 132. The Court had previously ruled that the latter power to accumulate rather than disburse constituted a right to designate under section 2036(a)(2). Id. at 135-136; United States v. O'Malley, 383 U.S. 627, 631 (1966).
>
> Given the above facts, the Supreme Court held "that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the 'right' to designate who was to enjoy the income from trust property." United States v. Byrum, 408 U.S. at 143. The Court rejected the Commissioner's "control rationale" as it "would create a standard — not specified in the statute — so vague and amorphous as to be impossible of ascertainment in many instances." Id. at 137 n. 10. In reaching its conclusion, the Court relied on a series of "economic and legal constraints" to which any power that Mr. Byrum might have had was subject and which prevented such

> power from being equivalent to a right to designate persons to enjoy trust income. Id. at 144.
>
> The Court emphasized that the independent corporate trustee alone had the right under the trust instrument to pay out or withhold income. Id. at 137. Even if Mr. Byrum had managed to flood the trust with dividends, he had no way of compelling the trustee to pay out or accumulate that income. Id. at 143. The Court also noted that the power to elect directors conferred no legal right to command them to pay or not pay dividends. Id. at 137. Moreover, the flow of dividends from the corporations would be subject to economic vicissitudes, retained earnings policies, and business needs. Id. at 139-140. In this regard, the Court explained:
>
>> There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises — bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy — prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control. [Id. at 249.]
>
> Furthermore, the Supreme Court stressed that "A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests" and the directors of a corporation "have a fiduciary duty to promote the interests of the corporation." Id. at 137-138. Such duties were legally enforceable by means of, for example, a derivative suit. Id. at 141-142.

The court then noted that in fact Mr. Strangi had the ability to designate who would receive the benefits of the partnership acting in conjunction with others, namely the general partner. The simplest illustration of the principle is that Mr. Strangi, as limited partner, could act with the general partner to liquidate the partnership, and thus receive the vast majority of the partnership assets. The opinion states:

> With respect to SFLP income and as previously recounted in greater detail, the SFLP agreement named Stranco managing general partner and conferred on the managing general partner sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate this authority to Mr. Gulig through the management agreement. The effect of these actions placed decedent's attorney in fact in a position to make distribution decisions. Mrs. Gulig effectuated such decisions by executing checks to the recipients so designated.
>
> In addition to the rights described above related to income, decedent also retained the right, acting in conjunction with other Stranco shareholders, to designate who shall enjoy the transferred SFLP property itself. The Supreme Court indicated in United States v. Byrum, 408 U.S. at 143 n.23 (citing Commissioner v. Estate of Holmes, 326 U.S. 480 (1946)), that a "power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor" would implicate section 2036(a)(2). Pursuant to the SFLP agreement, the partnership would be dissolved and terminated upon a

> unanimous vote of the limited partners and the unanimous consent of the general partner. The shareholders agreement likewise specifies that dissolution of SFLP requires the affirmative vote of all Stranco shareholders. Once dissolution and termination occur, liquidation is accomplished as set forth in the SFLP agreement. The managing general partner is named as the liquidator, which in turn disburses partnership assets first in payment of debts and then in repayment of partners' capital account balances. Authority is expressly granted for distributions in kind. Accordingly, decedent can act together with other Stranco shareholders essentially to revoke the SFLP arrangement and thereby to bring about or accelerate present enjoyment of partnership assets. Furthermore, it is noteworthy that such action would likely revest in decedent himself, as the 99-percent limited partner, the majority of the contributed property.
>
> As regards property transferred to Stranco and income therefrom, decedent held the right, in conjunction with one or more other Stranco directors, to declare dividends. The corporation's bylaws authorize the board of directors to declare dividends from the entity. For the board to take such action, a majority vote of the directors at a meeting with a quorum present is sufficient. Under the bylaws, a majority of the directors then serving constitutes a quorum. Because Stranco had five directors, a quorum would consist of three, so two directors (e. g., decedent through Mr. Gulig and one other) could potentially act together to declare a dividend. The Stranco shareholders agreement further provided that each of the initial five directors would be reelected annually, thus effectively ensuring decedent's position on the board.
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> In response to various of the above concepts pertaining to joint action, particularly by stockowners, the estate suggests: "If the mere fact that a shareholder could band together with all of the other shareholders of a corporation and such banding together would be sufficient to cause inclusion under Section 2036, then it would have been impossible for the United States Supreme Court to reach the decision that it did in Byrum." The estate's observation ignores the existence in United States v. Byrum, supra, of the independent trustee who alone had the ability to determine distributions from the disputed trust, notwithstanding any prior action by corporate owners or directors. It also ignores the identity of the shareholders in this case and the dual roles played by Mr. Gulig.
>
> To summarize, review of the documentary evidence discussed above reveals that decedent here retained rights of a far different genre from those at issue in United States v. Byrum, supra. Rather than mere "control", management, or influence, there are traceable to decedent through the explicit provisions of the governing instruments ascertainable and legally enforceable rights to designate persons who shall enjoy the transferred property and its income. The estate's reliance on a limited partner's lack under the TRLPA of participation in control and under the SFLP agreement of management authority is thus misplaced. The alleged absence of such powers cannot negate the dispositive rights granted in the instant case. The SFLP/Stranco arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed infra, therefore fall within the purview of section 2036(a)(2).

What about the fiduciary duty argument that saved the taxpayer in Byrum? The court gave the argument short-shrift finding that the fiduciary duties which existed mostly ran to Mr. Strangi himself:

The fiduciary duties present in United States v. Byrum, 408 U.S. 125 (1972), ran to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interests of the entity. As a result, there existed both a realistic possibility for enforcement and an objective business environment against which to judge potential dereliction. Given the emphasis that the Supreme Court laid on these factual realities, Byrum simply does not require blind application of its holding to scenarios where the purported fiduciary duties have no comparable substance. We therefore analyze the situation before us to determine whether the fiduciary duties relied upon by the estate would genuinely circumscribe use of powers to designate.

The estate summarizes its contentions regarding fiduciary duties as follows:

> Just like Mr. Byrum, Mr. Strangi's "rights" (whatever those rights appear to be) were severely limited by the fiduciary duties of other people who (according to Byrum) presumably could be counted on the [sic] observe those restraints against whatever desires they might otherwise have had to run pell-mell to do the bidding of the Decedent: (1) Mr. Gulig, who (separate and apart from his role as attorney-in-fact for Mr. Strangi) had fiduciary duties to Stranco, whom he served as manager; (2) the directors of Stranco, who had fiduciary duties to both Stranco and to SFLP as a whole; and (3) McLennan County Community College ("MCCC"), which had rights as a minority shareholder of Stranco and a fiduciary obligation to enforce such rights for the benefit of its own beneficiaries as well as the people of the State of Texas (with the Attorney General of Texas having the ability to step in to enforce such rights if MCCC failed in its duties). * * *

None of the foregoing obligations cited by the estate is sufficiently on par with those detailed in United States v. Byrum, supra, to bring the present case within the Supreme Court's rationale.

Concerning Mr. Gulig, any fiduciary duties that Mr. Gulig might have had in his role as manager of Stranco (and thereby of SFLP) are entitled to comparatively little weight on these facts. Prior to his instigation of the SFLP/Stranco arrangement, Mr. Gulig stood in a confidential relationship, and owed fiduciary duties, to decedent personally as his attorney in fact. Thus, to the extent that Stranco or SFLP's interests might diverge from those of decedent, we do not believe that Mr. Gulig would disregard his preexisting obligation to decedent.

As regards fiduciary obligations of Stranco and its directors, these duties, too, have little significance in the present context. Although Stranco would owe a fiduciary duty to SFLP and to the limited partners, decedent owned the sole, 99-percent limited partnership interest. The rights to designate traceable to decedent through Stranco cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of Stranco directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of Stranco, and his own children held 52 of the remaining 53 percent. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario.

With respect to the role of MCC Foundation, United States v. Byrum, supra, affords no basis for permitting outcomes under section 2036(a)(2) to turn on factors amounting to no more than window dressing. A charity given a

> gratuitous 1-percent interest would not realistically exercise any meaningful oversight.

Finally, and not unsurprisingly, Judge Cohen concluded that the arrangement had not been entered into for full and adequate consideration. She writes:

> We see no distinction of consequence between the scenario analyzed in Estate of Harper v. Commissioner, supra, and that of the present case. Decedent contributed more than 99 percent of the total property placed in the SFLP/Stranco arrangement and received back an interest the value of which derived almost exclusively from the assets he had just assigned. Furthermore, the SFLP/Stranco arrangement patently fails to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling. Cf. Estate of Harrison v. Commissioner, T.C. Memo. 1987-8; Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000), affd. without published opinion 268 F.3d 1063 (5th Cir. 2001) (both involving contributions by other participants not de minimis in nature, for a genuine pooling of interests). We therefore hold that decedent did not engage in any transfer for consideration upon the creation and funding of SFLP and Stranco. Accordingly, the estate is entitled to no exception to the treatment mandated by section 2036(a).

If the limited interests had been held in a marital trust included in Mr. Strangi's estate would the result have been different? What if Mr. Strangi had transferred the limited interests to a trust over which he retained a special power of appointment but no other rights? That is, if the limited partnership interests had been included in his estate but in fact he had not had the right to assist in the liquidation of the partnership would Judge Cohen have held differently? Supposing such were the case, presumable section 2035 would impose the three-year rule. Is the effect any different were the limited interests given away prior to death?

The practical effect of Strangi will be to embolden the IRS to argue against significant discounts when valuing limited partnership interests in estates. The theoretical underpinnings of Strangi are more suspect. The opinion pushes taxpayers to create partnership arrangements and avoid ever having control over the partnership. In turn, that raises the possibility that the "gift on formation" issue reappears. Arguably, the Tax Court analysis dealing with the gift on formation has not directly confronted a situation in which the Tax Court believes the creator did not retain de facto control over the partnership.

The taxpayers defeated a section 2036(a)(1) argument in Estate of Eugene E. Stone, III v. Commissioner, T.C. Memo 2003-309, because the Court found full and adequate consideration rather than a "mere recycling" of value. The Court held as follows:

> On the record before us, we agree with the estates' position and reject respondent's position. The instant cases are distinguishable from *Estate of Harper v. Commissioner, supra*, and other cases factually similar to *Estate of Harper* on which respondent relies, and respondent's reliance on such cases is misplaced. Unlike the transfers involved in *Estate of Harper* and those other cases, we have found on the record in the instant cases that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships,

as well as the respective transfers of assets by the other partners to each such partnership, were bona fide, arm's-length transfers.

On the record before us, we reject respondent's contention that, because Mr. Stone and Ms. Stone did not actively participate in the negotiations by the children, the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were not bona fide, arm's-length transfers. Each member of the Stone family was represented by his or her own independent counsel and had input into the decision-making as to how each of the Five Partnerships was to be structured and operated and what property was to be transferred to each such partnership. The Stone family understood that Mr. Stone and Ms. Stone would not be bound by any agreements that the children were able to reach as a result of the children's negotiations and that Mr. Stone and Ms. Stone would make the ultimate decision as to which, if any, of their respective assets to transfer to each of the Five Partnerships. In this connection, although Mr. Stone and Ms. Stone agreed to form the Five Partnerships, they did not intend to, and did not, transfer all their respective assets to such partnerships. Instead, they retained sufficient assets to enable them to maintain their respective accustomed standards of living. Mr. Stone and Ms. Stone did not accept the children's recommendations resulting from the children's negotiations regarding the structure, funding, and operation of the Five Partnerships without thought, comment, or question. For example, it was Mr. Merline, Mr. Stone's attorney, who drafted proposed partnership agreements for the Five Partnerships. Mr. Merline discussed with Mr. Stone the children's and their respective attorneys' suggested changes to those proposed agreements. Only after Mr. Stone agreed to certain of those suggested changes did Mr. Merline revise the proposed partnerships agreements to reflect the changes to which Mr. Stone agreed.

The record also establishes that the respective transfers at issue did not constitute gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each of the Five Partnerships. In addition, the record shows that those transfers were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Ms. Stone during their lives [and thereafter and the resolution of the litigation among the children.

Unlike the decedent in Estate of Harper and other cases factually similar to that case, the record in the instant cases establishes that Mr. Stone and Ms. Stone did substantially more than "change the form in which he [and she] held his [and her] beneficial interest in the contributed property." Estate of Harper v. Commissioner, T.C. Memo. 2002-121. The record in the instant cases shows that the Five Partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets of such partnerships during their parents' lives (and thereafter). When the partners of ES3LP formed and funded that partnership, they contemplated and intended that ES3LP operate as a joint enterprise for profit for the management of its assets and that the children contribute their services in providing such management. After ES3LP was funded in April 1997, the children actively managed the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of ES4LP formed and funded that partnership, they contemplated and intended that ES4LP operate as a joint enterprise for profit for the management of its assets and that Eugene Earle Stone, IV, contribute his services in providing such management. After the funding of ES4LP in April 1997, Eugene Earle Stone, IV, began actively managing the assets of ES4LP, as Mr. Stone and Ms. Stone intended. When the partners of CRSLP formed and funded that partnership, they contemplated and intended that CRSLP operate as a joint enterprise for profit for the management of its assets and that C. Rivers Stone contribute his services in providing such management. After the funding of CRSLP in April 1997, C. Rivers Stone began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of RSMLP formed and funded that partnership, they contemplated and intended that RSMLP operate as a joint enterprise for profit for the management of its assets and that Ms. Morris contribute her services in providing such management. After the funding of RSMLP in April 1997, Ms. Morris began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of MSFLP formed and funded that partnership, they contemplated and intended that MSFLP operate as a joint enterprise for profit for the management of its assets and that Ms. Fraser contribute her services in providing such management. After the funding of MSFLP in April 1997, Ms. Fraser began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended.

On the record in the instant cases, we find that, unlike the transfers involved in Estate of Harper and other cases factually similar to that case, the respective transfers at issue by Mr. Stone and Ms. Stone did not constitute "circuitous 'recycling' of value".

On the record before us, we further find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were for adequate and full consideration in money or money's worth. We have found that such transfers were not, and respondent does not claim that they were, gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each such partnership. We have also found, and respondent agrees and/or does not dispute, that after all the partners of each of the Five Partnerships transferred to each such partnership certain of their respective assets and after certain gifts were made by Mr. Stone in April 1997 to correct the unintended consequences of certain inadvertent valuation errors: (1) All partners of each of the Five Partnerships held respective partnership interests in each such partnership that were proportionate to the fair market value of the assets that such partners respectively transferred to each such partnership; (2) the respective assets that the partners of each such partnership transferred to each such partnership were properly credited to the respective capital accounts of such partners; and (3) upon the termination or dissolution of each of the Five Partnerships, the partners of each such partnership were entitled to distributions from each such partnership in amounts equal to their respective capital accounts. Under the circumstances presented in the instant cases, we find that Mr. Stone and Ms. Stone, as well as the other partners of each of the Five Partnerships, received in exchange for their respective transfers of assets to each such partnership respective partnership interests in each such partnership that were adequate and full equivalents reducible to a money value. See secs. 20.2036-1(a), 20.2043-1(a), Estate Tax Regs.; see also Estate of Goetchius, 17 T.C. at 503.

Respondent nonetheless argues that, because Mr. Stone and Ms. Stone received respective partnership interests in each of the Five Partnerships the value of which, taking into account appropriate discounts, was less than the value of the respective assets that they transferred to each such partnership, they did not receive adequate and full consideration for the assets transferred. Respondent's argument in effect reads out of section 2036(a) the exception for "a bona fide sale for an adequate and full consideration in money or money's worth" in any case where there is a bona fide, arm's- length transfer of property to a business entity (e.g., a partnership or a corporation) for which the transferor receives an interest in such entity (e.g., a partnership interest or stock) that is proportionate

> to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) the exception that Congress expressly prescribed when it enacted that statute.
>
> Respondent's argument about the discounted values of the partnership interests at issue also ignores the fact that each of the Five Partnerships was created, funded, and operated as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services. We have found that, when the partners of each of the Five Partnerships formed and funded each such partnership, they contemplated and intended that each such partnership operate as a joint enterprise for profit for the management of its assets and that the children contribute services in providing such management in the case of ES3LP and that Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser contribute services in providing such management in the case of ES4LP, CRSLP, RSMLP, and MSFLP, respectively. As Mr. Stone and Ms. Stone intended, after the funding of ES3LP, the children actively participated in the management of the assets of that partnership, and after the funding of ES4LP, CRSLP, RSMLP, and MSFLP, Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, respectively, actively participated in the management of the assets of such partnerships.
>
> Based upon our examination of the entire record before us, we find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a).

Estate of Ida Abraham v. Commissioner, T.C. Memo 2004-39, involved 2036(a)(1). Mrs. Abraham was declared incompetent on March 10, 1993; on December 30, 1993 the guardians received court permission to make gifts on behalf of Mrs. Abraham; and on June 13, 1994 Mrs. Abraham's children and the guardians agreed upon a giving plan involving various partnerships, corporate general partners, and trusts.

Judge Ruwe held that Mrs. Abraham was always to receive the income from the assets transferred to the partnerships because that was the plan. The opinion states:

> It is clear from the documentary evidence and the testimony elicited at trial that, regardless of the form of decedent's transfers, she continued to enjoy the right to support and maintenance from all the income that the FLPs generated. According to the decree (the document which authorized the creation of the FLPs), decedent's needs for support were contemplated first from the income that the FLPs generated. Only after decedent's support needs, if any, were met did the children/limited partners receive their proportionate share of the partnership income. Decedent's support needs were treated as an obligation of the FLPs. For example, the decree provided that decedent's children
>
>> shall receive income from said * * * [FLPs] * * * after deducting from the gross income of the partnership all fees, taxes, partnership administration expenses, reserve for expenses and monies needed in the discretion of the limited Guardian ad litem * * * for Ida Abraham's support.

In the decree, decedent's children agreed that they would

> share equally any and all costs and expenses related to * * * the support of Ida Abraham insofar as the funds generated by Ida Abraham's properties maintained by her do not provide sufficient funds for her adequate health, safety, welfare and comfort as determined by the limited Guardian ad litem * * *

The document further provided:

> Ida Abraham's living arrangement shall remain in accordance with the present arrangement and every effort will be made to maintain her in "status quo." Her segregated assets shall be maintained at a level established by the limited Guardian ad litem in his sole discretion.

Estate of Lea K. Hillgren v. Commissioner, T.C. Memo 2004-46, also involved section 2036 (a)(1). On October 31, 1996 the decedent attempted suicide; on January 1, 1997 the decedent and her brother formed a limited partnership together; on June 5, 1997 the decedent committed suicide. The decedent and her brother had a variety of business deals together, loans between them, etc. The opinion describes the formation and operation of the partnership, known as LKHP:

> Decedent and Hillgren formed LKHP with an effective date of January 1, 1997. The term of the partnership was set for 29 years. Walsworth represented both decedent and Hillgren in the formation of the partnership. Decedent held a 99.95-percent capital interest and a 75-percent profit interest in LKHP. Decedent gave Hillgren a .05- percent capital interest and a 25-percent profit interest in the partnership. The term "profit interest" was defined in the partnership agreement as "a partnership interest other than a capital interest * * * which will give rise to a partnership capital account * * * only if and when there is future economic income" (25-percent profit interest). The partnership agreement also provided Hillgren with 25 percent of the amount, if any, by which the partnership profits from operations in any year exceeded profits from operations realized by decedent in 1996 from the properties transferred (25-percent operational interest). The 25-percent operational interest was compensation to Hillgren for time spent in the management of LKHP. Decedent made no other gifts of partnership interests.
>
> Decedent contributed seven properties (the LKHP properties) to LKHP, as described in exhibit B to the partnership agreement. Hillgren did not contribute any property to LKHP. The seven LKHP properties that were contributed to the partnership at its formation included the three Orange County properties and the University property that were already the subject of the BLA and that were used to fund the amended trust. In addition, the other three properties that were contributed were the Crescent Bay, Railroad, and Manzanita properties in California that also previously were used to fund the amended trust. After the initial contributions were made, no additional property was transferred to the partnership.
>
> Decedent did not deed or transfer title to the seven LKHP properties to the partnership. The partnership agreement provided that title to any

property that was contributed by a limited partner, and was deemed to be owned by the partnership, would remain in the name of the limited partner for the benefit of the partnership. The leases that encumbered the LKHP properties were not formally assigned to LKHP prior to decedent's death. The leases remained in the name of decedent, or in the name of Sea Shell [a sole proprietorship of decedent], after LKHP was formed. The title remained in the name of decedent or Sea Shell in order to hide the change of ownership from the general public and from the tenants of the properties. Under the partnership agreement, Hillgren could conduct partnership business without disclosing the existence of the partnership. The partnership was designed generally to be invisible to the public and to persons with whom decedent and Hillgren did business.

On May 27, 1997, decedent executed seven quitclaim deeds, transferring her interest in the LKHP properties to the amended trust. The deeds were unrecorded at the time of her death. Also on May 27, 1997, decedent assigned her partnership interest to the amended trust.

2. Operation of LKHP

The partnership agreement provided that the general partner need not open a bank account in the name of the partnership, but could instead maintain the existing bank account that was used by Sea Shell and the amended trust. As a result, LKHP did not have a dedicated bank account during decedent's lifetime. Decedent held a bank account at Wells Fargo Bank (Wells Fargo) that operated under the name of the amended trust, doing business as Sea Shell. The Wells Fargo account was used for operation of LKHP.

LKHP's financial statement dated June 5, 1997, and its general ledger from January 1 through June 30, 1997, included decedent's residence, the mortgage on her residence, and the mortgage and property tax payments that were made on the residence. Decedent's residence and the expenses attributed to the residence were removed from the ledger in a journal entry by an adjustment dated January 1, 1997. The adjusted journal entry was not posted until after decedent's death. It was the practice of decedent and Hillgren to post the opening entries on their accounting books anywhere from 6 to 8 months after the start of the year. As a result, the opening entries for LKHP were not made until after decedent's death. Also, the balance sheets, ledgers, and check registers that represented the financial information of LKHP were actually maintained under the name of Sea Shell.

After the formation of LKHP, leases were executed on the LKHP properties in the name of Sea Shell. Also after the formation, all contracts that were entered into for maintenance and improvement of the LKHP properties, as well as all bills that were received, were in names other than that of LKHP. On March 12, 1997, a check was issued under the name of Sea Shell to pay property taxes for various properties including Manzanita and Enterprise. On May 22, 1998, Sea Shell also paid for landlord's insurance on the Manzanita property.

After the formation of LKHP, Nordica completed refinancing of its properties. During the loan application process, it was represented to a mortgage broker, Walker Mortgage, and a lender, Homesteader's Life

Co., that decedent owned and controlled all of the LKHP properties. No mention was made to either the mortgage broker or the lender that the properties were restricted by the BLA or that they were owned by LKHP. The disclosure was not made to the lender because it might have caused the refinancing to fail.

There were no recorded minutes of any meetings of partners of LKHP. On May 13, 1999, after decedent's death, a certificate of limited partnership was filed for LKHP with the California Secretary of State.

3. LKHP Distributions

The partnership agreement provided for distributions of cash at the sole discretion of Hillgren, as the general partner. From January 1 through June 5, 1997, decedent received distributions totaling $99,363. Hillgren did not receive any distributions during this period. The distributions that were received by decedent during 1997 were made specifically to enable decedent to pay her living expenses, and she was dependent on the cashflow of the partnership to cover her personal expenses.

LKHP also paid the costs of the estate. On March 5, 1998, distributions in the amounts of $135,000 and $80,000 were made from the partnership to the amended trust. The distributions were applied to pay installments of decedent's estate taxes due to the Internal Revenue Service (IRS) and to the California State Treasurer. From 1998 until 2002, distributions were consistently made from LKHP to the amended trust to continue payment of decedent's estate taxes to the IRS and to the California Franchise Tax Board.

4. Management of the LKHP Properties

MSL Properties, Inc. (MSL), is a property management company in Orange, California, with the same business address as Hillgren. Debra Gates (Gates) is the president and registered agent of MSL. Gates and decedent met in 1984 and became friends. Decedent appointed Gates as an alternate under decedent's durable power of attorney for health care.

Since MSL was incorporated in 1986, MSL continuously managed properties that were owned by Hillgren family entities. MSL had approximately 12 clients in addition to LKHP, all of which were related entities of the Hillgren family. The related entities included, among others, the amended trust, Carl C. Hillgren, Hillgren, Hillgren's children, the Mark Hillgren Children's Trust, and Seaward. The duties that were performed by MSL included property management, general office functions, and bookkeeping. Gates worked with decedent in managing the properties, and decedent would set parameters for Gates's responsibilities.

Prior to the formation of LKHP, MSL managed the seven LKHP properties. In 1997, MSL continued to manage the LKHP properties after the formation of LKHP. Gates understood that LKHP was to continue using the Wells Fargo bank account, used previously by Sea Shell and the amended trust, after the partnership commenced.

To perform its bookkeeping duties, MSL gave each client an individual company number in order to keep their books. The LKHP properties were managed under "company number 50" prior to the formation of LKHP. From January 1 through June 30, 1997, the LKHP properties continued to be managed for LKHP under company number 50. After formation of the partnership, the books remained the same as before. Gates planned to make journal adjustments for the partnership for "year-end tax return purposes".

5. LKHP's Federal Tax Returns

For 1997, LKHP filed a Form 1065, U.S. Partnership Return of Income (1997 return). The 1997 return reported no ordinary income to LKHP. On LKHP's Schedule K, Partners' Shares of Income, Credits, Deductions, etc., the partnership reported net income from real estate activities of $93,304, depreciation of $1,011, and distributions of $100,601. On LKHP's Schedule K-1, Partner's Share of Income, Credits, Deductions, etc., filed for the amended trust, as a partner, the partnership reported income from rental activities of $93,257, depreciation of $1,010, and distributions of $100,601. The amended trust was allocated a 99.95-percent interest in LKHP. The Schedule K-1 filed for Hillgren reported income from rental activities of $47 and depreciation of $1. The schedule of activities that was filed with the 1997 return reported rental real estate income or loss associated with the seven LKHP properties as allocated to both the amended trust and Hillgren, as reported on their respective Schedules K-1. The partnership also filed a statement with the 1997 return notifying the IRS that it intended to file an amended return.

For 1997, LKHP filed an additional Form 1065 as an amended return (1997 first amended return). The 1997 first amended return made an election to adjust the basis in the LKHP properties under section 754. The Schedule K and Schedules K-1 remained the same as in the original return.

Also for 1997, LKHP filed an additional Form 1065 as an amended return (1997 second amended return). The 1997 second amended return was filed to correct the allocation of partnership income as 75 percent to the amended trust and 25 percent to Hillgren. The Schedules K-1 for the amended trust, and for Hillgren, were adjusted for this change, showing that the amended trust held a 99.0027- percent capital interest and a 75-percent profit interest and that Hillgren held a .9973-percent capital interest and a 25-percent profit interest. As a result, the net income from real estate and the depreciation on the Schedules K-1 were reallocated accordingly. The reported distribution of $100,601 to the amended trust remained allocated to the amended trust on the Schedule K-1.

For 1998, LKHP filed a Form 1065 (1998 return) with attached Schedule K reporting net income of $389,124 and distributions of $423,500. The 1998 return's Schedule K-1 for the amended trust reported allocations of $388,929 of income in accordance with the 99.95-percent profit interest and the entire amount of the distribution. Hillgren's Schedule K-1 reported $195 in income and no distribution. Also for 1998, LKHP filed an amended Form 1065 (1998 amended return). The 1998 amended return reduced the net income to $320,369

> and reported guaranteed payments to partners of $68,755. The distribution remained unchanged. Similar to the 1997 second amended return, the 1998 amended return reported a corrected allocation of the 25-percent profit interest to Hillgren. The income that was reported on the Schedules K-1 was reallocated accordingly, but the amount of the distribution to the amended trust remained the same.
>
> For 1999, LKHP filed a Form 1065 and an amended Form 1065 to report again the corrected allocation of the profits interest and to report guaranteed payments to partners. For 2000 and 2001, LKHP filed Forms 1065 with the correct allocation of the profits interest, and no amended returns were filed.

Judge Cohen concluded:

> The estate claims that decedent was "in excellent physical health, on new antidepressant medication, and not contemplating suicide" and that, therefore, the partnership was not an alternate testamentary vehicle. The evidence contradicts this claim. Shortly before her death, decedent attempted suicide, was on various medications, was under the care of a psychiatrist, and suffered from severe pain due to degenerative disc disease. After her initial suicide attempt, LKHP was formed.
>
> Decedent and Hillgren started many businesses over the years and disregarded entities as they saw fit, making various "situational representations", i. e., statements about their property ownership and values to support a then existing purpose, without regard to accuracy. Even the stipulated facts contain inconsistencies regarding entity names and dates of creation and dissolution. The stipulations of the parties were often contradicted by the documents that were provided by Hillgren. Hillgren and the estate's representatives continued to disregard the LKHP agreement both prior to and after decedent's death.

Interestingly, the taxpayer won on valuation using a different theory, namely that the decedent and her brother had previously entered into a "business loan agreement ("BLA") which was respected and had business purposes. Among other features, the decedent's brother's agreement was necessary if decedent wanted to sell any of the properties. The IRS argued the partnership superseded the BLA but Judge Cohen held the partnership had zero effect. The Form 706 had reported various discounts for different properties ranging from 35% to 50% which the court allowed.

Hillgren points out the importance of considering, and arguing for, all possible discounts, and rationales for discounts, on the Form 706 as well as in court. The Form 706 is treated a stipulation.

The most important case in 2004 dealing with partnerships is Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004), where the Fifth Circuit reversed the District Court directly on 2036 grounds. The District Court had held that section 2036(a)(1) would apply to assets in a partnership where the decedent was a 99% limited partner and the partnership agreement allowed a 70% partner to remove and replace the general partner. The opinion states:

> Plaintiff argues that Decedent's transfer of assets to the Partnership was a bona fide sale for an adequate and full consideration in money or money's worth. The Tax Court has explained, and this Court agrees, that "applicability of the [bona fide sale] exception rests on two requirements: (1) [a] bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration." Harper, T.C.M. (RIA) 2002-121, *21.
>
> In the instant case, Decedent's transfer fails both requirements. Plaintiff has produced no credible evidence that the formation of the Partnership was the product of an arm's length transaction, i.e. a transaction "between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." Black's Law Dictionary 103 (7th ed. 1999). Indeed, one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a "bona fide sale". See Mollenberg's Estate v. Commissioner, 173 F.2d 698, 701 (2d Cir. 1949)(quoted in Harper, T.C.M. (RIA) 2002-121, *21)(defining a 'sale' as "an exchange resulting from a bargain"). Ownership interests in the Partnership are held by two entities: 99% by the Trust which was wholly-owned by Decedent, and 1% by the LLC which was 50% owned by the Trust. Therefore, Decedent not only "stood on both sides of the transaction," but, for all intensive purposes, was both sides of the transaction. Harper, T.C.M. (RIA) 2002-121, *21 (noting that "it would be an oxymoron to say that one can engage in an arm's length transaction with oneself").
>
> Moreover, even if one assumes the Partnership was the result of "a bona fide sale," Plaintiff has failed to establish that the Decedent received "adequate and full consideration" for the sale. While "adequate and full consideration" is not defined in the Code, Wheeler v. U.S., 116 F.3d 749, 754-55 (5th Cir. 1997), this Court agrees with the Tax Court that the meaning of "adequate and full consideration" does not include paper transactions such as the one at issue in the current case. The Decedent, through the Trust, contributed 99% of the capital for the Partnership and in return received a 99% interest in the partnership. Decedent received no consideration other than the interest in the Partnership. Plaintiff, before becoming the general partner of the Partnership, was already managing both the Trust, from where 99% of the assets of the Partnership came and the LLC from where the other 1% came (of which 0.5% were from the Trust). Nothing appears to have changed.

The taxpayer also argued that the fiduciary duty of the general partner precludes the application of section 2036:

> Plaintiff contends that Decedent did not have the power to take over the partnership because she had fiduciary duties. Plaintiff makes much of a Supreme Court case, U.S. v. Byrum, 408 U.S. 125 (1972), in which the Court held that §§2036 did not apply to a decedent who retained voting interest in several corporations. However, Byrum, is not only distinguishable on its facts from our case, but was expressly overruled by Congressional enactment of §§2036(b) which states that "the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of the transferred property." Moreover, section 2.95 of the Partnership Agreement states: "The General Partner will not owe a fiduciary duty to the Partnership or to any Partner."6 If Decedent, at any time, could remove the general partner and herself become general partner, then, by the terms of the Agreement, she would not owe a fiduciary duty to the other Partners, who, in any case, own only a minuscule share of the Partnership.

> Assuming such fiduciary duties exist, to whom does a party which owns 99.% of the Partnership owe them? The fiduciary argument falls flat.

The Fifth Circuit approached the case differently, finding that section 2036(a) did not apply ab initio. The opinion summarizes section 2036(a) like this:

> The statute provides two exceptions that will allow a transfer to escape the operation of § 2036(a). First, if the transfer is a bona fide sale for full and adequate consideration, then § 2036(a) does not apply. See Treas. Reg. §§ 20.2036-1(a), 20.2043- 1(1)(as amended in 1960). If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception, if the decedent did not retain either the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property. Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551, 578 [TC Memo 2003-309] (T.C. 2003); 26 U.S.C. § 2036(a).

The Fifth Circuit found that the first exception applied here. The opinion states:

> In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine. We now turn to the application of these principles to today's case.

The first question was whether the transfer was for “full and adequate consideration.” The language quoted above -- that a sale is for full and adequate consideration -- suggested a problem for the taxpayer. However, the court applied a different test:

> The district court found that the exchange of a limited partnership interest for the assets Mrs. Kimbell transferred to the Partnership was not a bona fide sale for adequate and full consideration. It did not separately analyze the two requirements. Rather it concluded that Mrs. Kimbell's contribution of more than 99% of the assets into the Partnership to be managed (as they were before the transfer) by her son was nothing more than a recycling of value and the interest in the Partnership Mrs. Kimbell received not a transfer of consideration. The government adopted that position and argues in addition that it is inconsistent for the estate to assert, on one hand, that the value of Mrs. Kimbell's interest in the Partnership is worth only 50% of the assets she transferred (as discounted for lack of control and marketability), and on the other hand claim that the Partnership interest Mrs. Kimbell received in exchange for the assets transferred was adequate and full consideration for the transfer.
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> ***

> We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non- managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid — a classic informed trade-off.
>
> As this principle applies to wholly unrelated buyers and sellers of interests in limited partnerships, it must be equally true of buyers and sellers of such interests who happen to be related by blood or affinity, unless (1) the evidence demonstrates the absence of good faith, i.e., a sham transaction motivated solely by tax avoidance, or (2) Congress or the courts are ready to change long-held positions and establish a per se rule that related parties can never enter into arms-length transactions for adequate and full consideration — positions that none has shown any inclination to assume. Certainly, close scrutiny must be applied when the parties are related, but close scrutiny is not synonymous with automatic proscription or impossibility vel non.
>
> The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. Id. at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances.

Thus the court is clear: if a proper allocation to capital accounts is made there is full and adequate consideration.

The court next considers whether the creation of the partnership was a bona fide sale. Recall that it was formed by her son as attorney-in-fact two months before the 96 year old decedent died.

The opinion states:

> Our review of the record reveals that the taxpayer established the following objective facts (uncontroverted by the government) that would support their position that the transfer to the Partnership was a bona fide sale:
>
> > (1) Mrs. Kimbell retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets. See Estate of Strangi, 85 T.C.M. at 1338–39; Estate of Harper, 83 T.C.M. at 1650.
> >
> > (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership. Id.
> >
> > (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management. A working interest in an oil and gas lease is a cost-bearing operating interest in the property. Lowe, Oil and Gas Law in a Nutshell 40 (2003). The owners of the working interest have the exclusive right to exploit the minerals on the land. Williams & Meyers, Manual of Oil and Gas Terms 1207, 11th edition (2000). Nonoperating working interest owners are called upon to pay their share of operating expenses and to make elections whether to participate in drilling operations or various phases thereof. Lowe at 387–92. A royalty interest, in contrast, is a passive right to receive a share of production, if and when there is production, free of costs. Manual of Oil & Gas Terms at 964. At formation, $438,000 of approximately $2.5 million in assets were oil and gas properties. Approximately 71% of the oil and gas interests were working interests. Strangi, 85 T.C.M. at 1344; Thompson, 84 T.C.M at 388.
> >
> > (4) David Kimbell and Michael Elyea advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Mrs. Kimbell's Trust. Harper, 83 T.C.M. at 1654; Thompson, 84 T.C.M. at 389.
>
> Michael Elyea, Mrs. Kimbell's business advisor, testified as follows regarding the business strategy for forming the Partnership. He stated that he and Mrs. Kimbell first discussed placing the assets in a limited partnership around the same time the living trust was formed in the early 1990's. Although some business strategies were accomplished by the trust, others were not. Specifically, a living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by Mr. Elyea and Mrs. Kimbell because she was investing as a working interest owner in oil and gas properties and could be personally liable for any environmental issues that arose in the operation of those properties. Mr. Elyea also stated that Mrs. Kimbell wanted the oil and gas operations to continue beyond her lifetime and they felt that by putting the assets in a limited partnership, they could keep the pool of capital together in one entity that would be enhanced over time rather than subdivided by distributions to subsequent generations. Keeping the assets in one pool, under one management would reduce administrative costs by keeping all accounting functions together. The partnership would also avoid costs of recording transfers of oil and gas properties as the property was passed from generation to generation. Mrs. Kimbell wanted to keep the asset in an entity that would preserve the property as separate property of her descendants.

> The family had faced that issue during the divorce of one of Mrs. Kimbell's grandsons. The partnership also served the purpose of setting up the management of the assets if something should happen to her son, which was a concern as he had experienced some heart problems and had undergone a serious surgery. The partnership agreement provided that all disputes be resolved through mediation or arbitration to avoid interfamily litigation if disputes should arise. This statement of reasons is supported by the recitation of purposes in the formation documents of the Partnership (which the government and the district court selectively excerpt) and the deposition testimony of Mrs. Kimbell's son. More to the point, the stated reasons for the formation of the Partnership are confirmed by objective facts, many of which relate to the rights and responsibilities associated with investments in oil and gas investments.

The partnership owned a substantial portion of the decedent's assets which would not be sheltered from creditors created by the oil and gas interests, and, of course, the decedent had presumably lived with the liability for many years already. Thus the true relevance of the oil and gas interest -- 11% working interests, 4% royalty interests, of the total partnership -- may be questioned.

The court rejected the need for others to make substantial contributions, or for investments to change after the partnerships wee formed:

> The government contends that one fact pointing toward a conclusion that Mrs. Kimbell's transfer to the Partnership was not a bona fide sale is the de minimis contribution to the partnership made by the other partners. Mrs. Kimbell's son and his wife contributed approximately $20,000 of the $2.4 million in assets in the Partnership. This argument amounts to a restatement of the government's recycling of value argument and does not justify treating the transaction as a sham. In addition, we know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide. The government also points out that the management of the Partnership assets did not change as a result of the transaction. Prior to the formation of the Partnership, David Kimbell managed Mrs. Kimbell's assets in the Trust. He continued to manage the assets once they were transferred to the Partnership. However, the important fact is that David Kimbell contributed his management expertise to the Partnership after its formation. Given the business reasons established above for the change in business form, the fact that David Kimbell performed the same services for the assets in the Trust is irrelevant.

Interestingly, the court also rejected the direct inclusion of one-half of 1% of the underlying partnership assets through the decedent's 50% ownership of an LLC which was the 1% general partner. In what would appear to be a holding clearly contrary to Judge Cohen's opinion in Strangi, the court stated:

> The district court's application of § 2036(a) to the LLC transfer was erroneous. Even if the transfer did not constitute a bona fide sale for full and adequate consideration, Mrs. Kimbell did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to § 2036(a). Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property. Accordingly, we vacate the ruling of the district court on this issue.

A different issue was present in Estate of Threefoot, 316 F. Supp. 2d 636 (W.D. Tenn. 2004). The decedent died before forming a limited partnership with her daughter ("Miller") in which she would own 99% and daughter 1%. The court noted the following facts:

> Under the Partnership Agreement and a related Subscription Agreement, Threefoot would have agreed to contribute to the Partnership all of her interest in certain tracts of real estate in Perry County, Tennessee (the "Perry County real estate") and in certain securities, bonds, and cash in her brokerage accounts. The Certificate of Formation for the Partnership was signed by Miller and filed with the Tennessee Secretary of State on September 16, 2002, and with the Shelby County Register on September 23, 2002. The Partnership Agreement and Subscription Materials for the Partnership were prepared by September 20, 2002, but they were not executed prior to Threefoot's death on September 23, 2002. Threefoot died testate.
>
> Miller alleges that she and Threefoot made a binding oral agreement to enter into the Partnership Agreement and seeks to enforce that oral agreement. As executrix, she requests that the court authorize the execution and consummation of the transactions outlined in the Partnership Agreement and the Subscription Agreement. Additionally, she states that there are insufficient liquid assets in Threefoot's estate to fully fund the Partnership and satisfy all current expenses, including estate taxes She requests that the court authorize the sale of an apartment located at 585 South Greer in Memphis, Tennessee (the "Memphis real estate") so that the proceeds can be used to satisfy those obligations.

The case began in Probate Court but was removed by the government to federal district court:

> On August 27, 2003, Anne W. Miller, as executrix of the estate of her mother, Anne F. Threefoot, brought a petition in the Probate Court of Shelby County, Tennessee. In that petition, Miller seeks to execute a Partnership Agreement on behalf of the estate, to transfer certain property to the partnership, and to sell certain real estate and fund the partnership with the proceeds. She also seeks a determination that the lien for federal estate taxes arising under 26 U.S.C. § 6324(a)(1) applies to the partnership interest which is part of the decedent's estate rather than to the property to be transferred to the partnership. Miller joined the United States as a party under 28 U.S.C. § 2410. The United States removed the case to this court on October 2, 2003, asserting that the court has federal question jurisdiction. Miller filed a motion to remand to state court on October 31, 2003, in which she also requests attorney's fees, and the United States filed a brief in opposition to the motion to remand on November 18, 2003. For the following reasons, Miller's motion to remand is GRANTED, and her request for attorney's fees is DENIED.

The issue before the court, then, was subject matter jurisdiction. The opinion states:

> When a federal court lacks subject-matter jurisdiction over an action that has been removed, it should remand the case to state court, 28 U.S.C. § 1447(c). The party seeking removal bears the burden of establishing that federal jurisdiction exists. Ahearn v. Charter Township of Bloomfield, 100 F.3d 451, 453-54 (6th Cir. 1996). "Due regard for state governments' rightful independence requires federal courts scrupulously to confine their own jurisdiction to precise statutory limits." Id. at 454.

The government contends that this court has federal question jurisdiction under the quiet title provision of the Judiciary Code, which provides in part:

> [T]he United States may be named a party in any civil action or suit in any district court, or in any State court having jurisdiction of the subject matter -- (1) to quiet title to . . . real or personal property on which the United States has or claims a mortgage or other lien.

28 U.S.C. § 2410(a). The government asserts that it has a federal estate tax lien against the gross estate of Threefoot, which arose under 26 U.S.C. § 63241 on the date of her death.

A related statute, 28 U.S.C. § 1444, provides:

> Any action brought under section 2410 of this title against the United States in any State court may be removed by the United States to the district court of the United States for the district and division in which the action is pending.

Miller argues that her petition is not an action to quiet title within the meaning of § 2410, although her petition does state that the United States should be joined as a party under § 2410 "for the purpose of quieting title to the property that the decedent agreed to transfer to the Partnership." Rather, she seeks to determine the property that is subject to the federal estate tax lien. In other words, among other relief, she seeks to determine whether certain property is part of the gross estate. The United States characterizes the action as follows: "the Court need only determine if an alleged oral contract and a family limited partnership are valid."

In support of her argument, Miller cites Walters v. Schmidt, 1979 WL 1376 (E.D. Mo. March 14, 1979). In Walters, the plaintiff brought suit in Missouri state court to contest the probate of her husband's will. Id. at *1. She alleged that a determination about the validity of the will would affect the amount due to the United States under 26 U.S.C. § 6324. Id. The United States removed the case to federal court. The court dismissed the action for lack of subject matter jurisdiction, finding that "[i]n order for the United States to be a proper party to this will contest under 28 U.S.C. § 2410(a), the plaintiff's allegations must relate to the legality of the procedures used by the United States to enforce the tax lien and not to the validity of the tax assessment itself." Id. See also Aqua Bar & Lounge, Inc. v. United States Dep't of Treasury Internal Rev. Serv., 539 F.2d 935, 939-40 (3d Cir. 1976) (stating that § 2410 is a waiver of sovereign immunity to a suit brought by a taxpayer against the United States which challenges the validity of a federal tax lien and sale "so long as the taxpayer refrains from contesting the merits of the underlying tax assessment itself.)"

In Walters, the court noted that the § 6324 lien attaches to all assets of the gross estate, and that the lien would be valid regardless of the will contest. "The effect of the will contest is only to determine which assets are includable in the gross estate to which the lien attaches." 1979 WL 1376 at *1. Therefore, the court dismissed the action for lack of subject-matter jurisdiction. Id.

In a later case, Wieland v. Savetz, 734 F. Supp. 409 (E.D. Mo. 1990), the court reached a similar result. In Wieland, the plaintiffs filed suit in state court seeking a declaration as to the proper construction of a testamentary trust. Id. at 409. They joined as a defendant the Commissioner of the Internal Revenue Service, who removed the case to federal court. Id. The plaintiffs sought no affirmative

> relief from the Commissioner, but joined him as a defendant because Internal Revenue Service agents had raised the controversy regarding the interpretation of the trust by disallowing a marital deduction with respect to the trust estate. Id. The court remanded the action to state court, stating:
>
> > Upon reviewing plaintiffs' complaint, the Court concludes that plaintiffs seek a declaration of the proper construction of a testamentary trust under state law. Although this determination may have resulting tax implications, plaintiffs do not seek a determination of federal tax liability nor is such a determination necessary to their state law cause of action. The mere fact that the Commissioner, a federal official, has been named as a defendant herein does not provide a basis for the exercise of federal question jurisdiction.
>
> Id. at 410.
>
> Miller argues that hers is not an action to quiet title. Quiet title actions have been defined as those seeking "a determination that a tax lien does not exist, has been extinguished, or is inferior in rank." Estate of Johnson v. United States, 836 F.2d 940, 946 (5th Cir. 1988) (citation and emphasis omitted). Miller's action seeks enforcement of an alleged oral agreement, authorization to sell certain property, and a determination as to what property is subject to the § 6324 lien. Although Miller stated in her petition that she sought to quiet title to certain property, that statement does not give rise to federal jurisdiction if § 2410 does not in fact apply to her action. See Walters, 1979 WL 1376, at *1 (finding that no subject matter jurisdiction existed although the plaintiff cited § 6324 and joined the United States as a party pursuant to § 2410). This case does not involve the types of actions described in Johnson. Rather, in this case, as in Walters and Wieland, the resolution of the state law issues will determine whether certain property is included in the gross estate, which in turn affects the amount of federal estate tax, if any, owed. Miller seeks no affirmative relief from the United States. The United States has not satisfied its burden of demonstrating that federal subject matter jurisdiction exists.

Even if the court had found subject matter jurisdiction it would have remanded the case because of the probate exception, which the court discussed as follows:

> Alternatively, even assuming that Millers probate court petition did raise a federal question, it would be inappropriate for this court to consider the case because of the probate exception to federal jurisdiction, which extends to matters that would require a federal court to interfere with the probate of an estate. *See, e.g.,* Bedo v. McGuire, 767 F.2d 305, 306 (6th Cir. 1985) ("It is well settled that federal courts have no probate jurisdiction."); Mangieri v. Mangieri, 226 F.3d 1, 2-3 (1st Cir. 2000) ("As a general matter, courts tend to view the probate exception as extending to all suits 'ancillary' to the probate of a will.") (internal quotation omitted). In Markham v. Allen, the Supreme Court stated that "a federal court has no jurisdiction to probate a will or administer an estate, the reason being that the equity jurisdiction conferred by the Judiciary Act of 1789 . . . did not extend to probate matters." 326 U.S. 490, 494 (1946). "[F]ederal courts of equity have jurisdiction to entertain suits in favor of creditors, legatees and heirs and other claimants against a decedent's estate to establish their claims so long as the federal court does not interfere with the probate proceedings or assume general jurisdiction of the probate or control of the property in the custody of the state court." *Id.* (internal quotations omitted, citing Waterman v. Canal-Louisiana Bank & Trust Co., 215 U.S. 33, 43 (1909)).

There are several policy reasons underlying the probate exception to federal jurisdiction. See Dragan v. Miller, 679 F.2d 712, 714 (7th Cir. 1982). First, it promotes legal certainty by limiting probate matters to one court system. "Certainty is desirable in every area of the law but has been thought especially so with regard to the transfer of property at death." *Id.* Second, it promotes judicial economy. The disposition of a decedent's assets normally begins in state court, and the probate exception "serves to preserve the resources of both the federal and state judicial systems and avoids the piecemeal or haphazard resolution of all matters surrounding the disposition of the decedent's wishes." Storm v. Storm, 328 F.3d 941, 944 (7th Cir. 2003). Third, the state probate courts have more expertise in deciding probate questions. "Because state courts have nearly exclusive jurisdiction over probate matters, state judges vested with probate jurisdiction develop a greater familiarity with such legal issues. " *Id.* A final, related reason for the probate exception is to avoid unnecessary interference with state courts: "if state courts have the exclusive task of probating a will, and thus develop the relative expertise to do so (including the expertise to deal with all matters ancillary to probate), then federal court resolution of such matters is . . . an unnecessary interference with the state system." *Id.*

***

A two-part inquiry governs whether the probate exception applies to bar Miller's suit from federal court. The first question is whether the court is being asked to probate a will or administer an estate. The second question is whether entertaining the action would cause the court to interfere with the probate proceedings or assume general jurisdiction or control of property in custody of the state court. Moser v. Pollin, 294 F.3d 335, 340 (2d Cir. 2002). If the answer to either question is yes, the case should be remanded for lack of subject matter jurisdiction. The "interference prong" is "the workhorse of the probate exception." Id.

The Moser court stated that the first question, whether the court is being asked to probate a will or an [sic] administer an estate directly, is rarely answered affirmatively, "since few practitioners would be so misdirected as to seek, for example, letters testamentary or letters of administration from a federal judge. Id. The same is true here; the first test is not met because Miller's action is not a "purely probate" matter.

The second question is whether the court is being asked to interfere with the probate proceedings, to assume general jurisdiction of the probate, or to assume control of property in the custody of the state court. If any of those three situations exists, the probate exception applies and the action should be remanded.

Miller's petition seeks resolution of three questions: (1) whether the alleged oral agreement between Threefoot and Miller is enforceable, (2) whether Miller may sell the Memphis real estate in order to satisfy the estate's obligations, and (3) whether the property Threefoot allegedly agreed to transfer to the Partnership is part of her gross estate. The first question is a contract question that merely involves an estate, and it is the sort of question that federal courts can answer despite the probate exception where jurisdiction exists. See Markham, 326 U.S. at 494 (noting that federal courts can entertain suits in favor of claimants against an estate to establish their claims). The second question presented by Miller's petition, however, is much more closely related to the probate proceeding in that it asks the court to order the sale of an asset of the estate. In requesting that the court authorize the sale of the Memphis real estate, Miller does not seek to determine the rights of a specific creditor, legatee, or heir. Rather, she asks that the court authorize the transfer of that property in order that its proceeds be used to pay "all costs of administration, including attorneys, fees and all just and lawful claims against the decedent's estate." Deciding whether to authorize the sale of real estate in Threefoot's estate would require the court to interfere with the probate proceedings, in the sense that this court would be directing disposition of the estate's assets. See Torelli v. Torelli, 941 F. Supp. 36, 39 (S.D.N.Y. 1996) (holding that probate exception applied to bar suit seeking to clear title to real estate and arrange for its sale); cf. Ashton v. Josephine Bay Paul and C. Michael Paul Found., Inc., 918 F.2d 1065, 1072 (2d Cir. 1990) ("[T]he Supreme Court has regularly rebuked the few efforts of lower federal courts to take over, generally, the administration of a decedent's estate, including the exercise of otherwise proper jurisdiction over the accounting of an estate.") (internal quotations and citations omitted). Therefore, as an alternate ground for remanding the suit the probate exception applies to bar this court from exercising jurisdiction.

The government argues that the issues presented by Miller will not interfere with the probate of Threefoot's estate. (Govt.'s Opp'n at 6-7.) It states that "[n]o party is contesting the will itself or any bequest made pursuant to the will. Moreover, Miller alleges that the real property at issue is not even part of the decedent's estate. To the contrary: she alleges that the decedent transferred the property before her death into a family limited partnership." (Id.) However, Miller does seek to sell real property in Threefoot's estate (the Memphis real estate), which is separate from the real property she contends Threefoot agreed to transfer to the Partnership (the Perry County real estate).

The government also argues that the probate exception does not apply to disputes over will substitutes, such as trusts. That argument is not supported by case law. See Macken ex rel. Macken v. Jensen, 333 F.3d 797, 799 (7th Cir. 2003) ("the probate exception applies to disputes about trusts used in lieu of wills, if the parties present an issue that would be resolved in probate had a will been used, or the issue is ancillary to such a dispute"); Storm, 328 F.3d at 947 ("Given the growth in recent years of various 'will substitutes,' we are loath to throw open the doors of the federal courts to disputes over testamentary intent simply because a decedent chose to use a will substitute rather than a traditional will to dispose of his or her estate."); Georges v. Glick, 856 F.2d 971, 974 n. 2 (7th Cir. 1988) (rejecting argument that probate exception was inapplicable because the action related to an inter vivos trust rather than a will). The single case cited by the government in support of its argument, Beattie v. J.M. Tull Foundation, 941 F. Supp. 57, 59 (D.S.C. 1996), is distinguishable. In Beattie, a trustee brought suit seeking a declaratory judgment that the terms of a testamentary trust permitted him to distribute the entire capital gain of the trust to the life tenant. Id. at 958. The court acknowledged that the distribution of the trust's assets was tangentially related to administration of the estate, but the court held that the action was not barred by the probate exception because it did not require the court "to disturb possession of an estate properly in the hands of a state probate court. Presumably, after thirty years, the estate has already been administrated and closed." Id. at 959. In this case, by contrast, the probate estate remains open and its assets are subject to the jurisdiction of the Shelby County Probate Court. (Mem. in Supp. of Mot. to Remand at 5.) Considering the facts of this case and the case law applying the probate exception, the court finds that the exception applies here and warrants remand of the action to the Shelby County Probate Court.

2. **Application of Step-Transaction Doctrine to Gift Tax Payments**. In Betty R. Brown v. United States, 329 F.3d 664 (9th Cir. 2003) the decedent gave his wife money which she contributed to an insurance trust thereby making a taxable gift. He then gave her the money to pay the gift taxes. Husband died within three years, but wife survived. The District Court and Ninth Circuit treated the gift tax as being paid by the husband via the step-transaction doctrine:

> The Step Transaction
>
> The "step-transaction" doctrine collapses "formally distinct steps in an integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction." Commissioner v. Clark, 489 U.S. 726, 738 (1989); accord Custom Chrome, 217 F.3d at 1127. As such, the doctrine is part of the "broader tax concept that substance should prevail over form." Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1521 (10th Cir. 1991). Under these principles, the IRS argues, the two transactions which resulted in the payment of gift taxes (gift from Willett to Betty, payment by Betty) should be collapsed into one (payment by Willet).
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> The substance-over-form doctrines are, however, bound by, and in some tension with, the principle, equally lauded in tax law, that "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury." Grove v. Commissioner, 490 F.2d 241, 242 (2d Cir. 1973). We look to two principles to reconcile these competing concerns.
>
> First, we attempt to distinguish between legitimate "tax avoidance" -- actions which, although motivated in part by tax considerations, also have an independent purpose or effect -- and illegitimate "tax evasion" -- actions which have no, or minimal, purpose or effect beyond tax liabilities. See Stewart v. Commissioner, 714 F.2d 977, 987-988 (9th Cir. 1983)(citing Bittker, Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code, 21 How. L.J. 693, 695 (1978)).
>
> Second, we scrutinize whether the facts presented "fall within the intended scope of the Internal Revenue provision at issue." Stewart, 714 F.2d at 988. This second step is crucial in areas, such as estate planning, in which it is common for Congress to create, and taxpayers to exploit, various tax planning incentives. See Jay A. Soled, Use of Judicial Doctrines in Resolving Transfer Tax Controversies, 42 B.C.L. Rev. 587, 599, 603-04, 615-16 (2001). For example, § 2513 allowed Willet and Betty, by exercising certain elections, to treat the underlying $3,100,000 gift from Willet to the life insurance trust as if made by both of them, when in reality Willet supplied the entirety of the funds. The IRS has never argued that the substance-over-form doctrine invalidated that election, for obvious reasons: That approach would deny taxpayers the tax benefits intentionally created by the plain language of the Code.
>
> Applying these two principles with appropriate caution, we conclude that the two-step transaction between Willet, Betty, and the IRS, was properly treated as if Willet had paid the gift taxes directly.

1. Betty As A Mere Conduit of Funds

Navigating the murky distinction between "tax avoidance" and "tax evasion" requires careful stewardship. In the context of the step transaction doctrine, however, we have identified a class of cases in which the form of the transaction is particularly suspect. Where a party acts as a "mere conduit" of funds -- a fleeting stop in a predetermined voyage toward a particular result -- we have readily ignored the role of the intermediary in order appropriately to characterize the transaction. Robino Inc. Pension Trust v. Commissioner, 894 F.2d 342, 344 (9th Cir. 1990) (where taxpayers sold options on land to two trusts but the trusts acted as mere "conduits" for the ultimate sale to a third party, role of trust disregarded under step transaction doctrine); Stewart, 714 F.2d at 991 (where corporation acted as "merely a conduit" for the sale of appreciated securities by the taxpayer, several steps collapsed into one under the substance-over-form principle). See also Estate of Sachs v. Commissioner, 856 F.2d 1158, 1163 (8th Cir. 1988) (because donor of net gift used donee as a "conduit" to pay taxes, donor deemed to have paid the gift tax).

Viewing the historical facts in the light most favorable to the Estate, it is nonetheless clear that Betty was a "mere conduit" of Willet's funds. The Browns do not advance any argument that the payment to Betty had any purpose or effect other than as a step towards facilitating Willet's payment of the gift tax liability and Betty owned Willet's funds for exactly one day. Betty's fleeting ownership can therefore be disregarded under the principles of Robino and Stewart.

True, Betty was under no binding commitment to complete the prearranged plan. "Despite intimations to the contrary in the early cases," however, "there is ample authority for linking several prearranged or contemplated steps, even in the absence of a contractual obligation or financial compulsion to follow through." Boris I. Bittker, Fed. Inc. Tax'n of Indiv. §1.03[5] (2d. ed.). See, e.g., Kornfeld v. Commissioner, 137 F.3d 1231, 1235-1236 (10th Cir. 1998); McDonald's Restaurants v. Commissioner, 688 F.2d 520, 525 (7th Cir. 1982); Blake v. Commissioner, 697 F.2d 473, 481 (2d Cir. 1982). Where the two parties to the transaction were sufficiently related or commonly controlled, we have twice applied the step transaction analysis without any finding that the intermediary was legally bound to complete the prearranged plan. See Robino, 894 F.2d at 345 (transactions between two taxpayers and trust controlled by taxpayers and spouse of one taxpayer); Stewart, 714 F.2d at 984 (transaction between taxpayer and corporation he controlled).

Particularly apt is the Tenth Circuit's analysis in Kornfeld, applying the step transaction doctrine where, as here, family members colluded to accomplish a prearranged plan. In Kornfeld, the taxpayer, an experienced tax attorney, gave cash payments to his daughters and secretary. 137 F.3d at 1232-33. The gift recipients then immediately used those funds to purchase remainder interests in bonds. Id. The Tenth Circuit determined that the series of transactions should be treated as if the taxpayer had purchased the bonds in fee simple and given the remainder interests to his daughters and secretary (a determination which had negative tax consequences for the taxpayer). Id. In so determining, the Tenth Circuit applied a heightened level of skepticism to transactions between related parties. Id. at 1235. In addition, the court was swayed by the facts that the "taxpayer [had] stipulated that his intention in making gifts was to enable the donees to make the purchases," and that the donees would be unlikely to flout the taxpayer's intention. Id. at 1236. As the court noted, "one does not look a gift horse in the mouth." Id.

The same factors which applied in Kornfeld apply here: The parties are related, so heightened scrutiny is appropriate. Willet's admitted intention in giving the funds to Betty was to enable her to make the gift tax payments. Finally, Betty was unlikely to flout the desires of her husband because it was she, as the initial beneficiary of the Estate, who stood to gain if the gift tax wager was successful. The two transactions culminating in gift tax payments should therefore be treated as one integrated whole despite the lack of a legally binding commitment.

2. The End Run Around § 2035

Our conclusion is reinforced by a consideration of the statute here at issue, § 2035(c)(1993). We begin, in considering that statute, with the Eighth Circuit's analysis of a quite similar situation in Estate of Sachs v. Commissioner, 856 F.2d 1158 (8th Cir. 1988). In Sachs, Samuel Sachs gave stock in trust to his grandchildren within three years of his death. Id. at 1159. The gift was structured as a "net gift," meaning that the donees were legally bound to pay the gift taxes otherwise chargeable to the donor. Id. Relying in part on the plain language of § 2035, and in part on the substance-over-form doctrine, the Eighth Circuit held that "the gift tax paid under this arrangement is a 'tax paid . . . by the decedent or his estate' under § 2035." Id. at 1164.

The instant case differs from Sachs, however, in that Betty was jointly liable under § 2513(d) to pay the gift tax liability. In comparison, no matter how the beneficiaries in Sachs received funds to pay the gift taxes, the gift tax payment was attributable to the donor, if for no other reason than because only the donor was liable for the debt owed to the IRS. Id. at 1163-64.

The question then is whether the Willet-Betty-IRS transaction, though on its face an end-run around § 2035(c)(1993), is nonetheless authorized by § 2513. Had Betty truly paid the gift tax from her own funds, § 2035 would not apply to Betty's payments of the gift tax, because of § 2513. Id. at 1165. The Estate argues that because § 2513 authorizes the very "actuarial bet" the couple made, the source of Betty's funds is irrelevant.

The source of the funds is pertinent. Sachs, 856 F.2d at 1165 (because the gift tax was paid with funds from decedent's estate, fact that gift was split between decedent and his wife under § 2513 did not alter application of § 2035(c)). The language and the history of § 2035(c)(1993) emphasize that this section applies to actual gift tax payments, regardless of the relative gift tax liability among spouses.

First, § 2035(c)(1993) requires that the decedent include in his estate gift taxes " paid . . . on any gift made by the decedent or his spouse ." (Emphasis added). Second, the legislative history states:

> The amount of the gift tax subject to this rule would include tax paid by the decedent or his estate on any gift made by the donor . . . It would not, however, include any gift tax paid by the spouse on a gift made by the decedent within three years of death which is treated as made one-half by the spouse [e.g., under § 2513], since the spouse's payment of such tax would not reduce the decedent's estate at the time of death.

H. Rep. No. 94-1380, *14, 94th Cong., 2d. Sess. (1976) (emphasis added).

The reason the source of funds matters is that § 2035(c)(1993) was designed to reverse the effect of funds transferred out of an estate within three years of death. If Willet pays the gift tax, it is his net worth that is reduced and therefore his estate that will escape estate tax liability on the funds if he outlives the three-year reach of § 2035(c)(1993). Accordingly, it is his estate that must reverse the effect of the transfer if he dies within the three-year period. Only if Betty pays the gift tax by using her own financial resources is her estate reduced, such that her estate should bear the risk that the payment be included in her estate via § 2035(c)(1993).

By channeling Willet's funds through Betty's estate, the Browns created a transaction sequence in which the tax risk diverged from the economics of the payment. Where one spouse has significantly fewer assets than the other spouse, shifting the risk of § 2035- inclusion onto the estate of the less wealthy spouse, while actually transferring the assets out of the estate of the more wealthy spouse, could have tax evasion advantages for the couple beyond the effect of divergent mortality probabilities: The smaller estate may be subject to lower tax rates, see § 2001(c), or to no tax at all, see § 2010, so that the inclusion risk does not adequately reverse the effect of the reduction in the larger estate. We do not know whether this was the case in the Brown estate. We note the effect, however, to demonstrate that requiring, as the text and legislative history plainly do, that the § 2035 inclusion risk follow the economics of the gift tax payment is not a pointless formality. Thus, the fact that the "actuarial bet" the Browns attempted may have been proper under § 2035 and § 2513 had Betty actually paid the gift taxes does not imply that the Browns' maneuvering here was similarly appropriate.

* * *

3. Impact of Lack of Certainty of Tax Benefit

In a variant of its assertion that the actuarial bet was entirely proper, the Estate, noting that the end result of the machinations did not create a certain tax advantage, contends that the transaction sequence is therefore immune from the step transaction doctrine. That the tax advantages flowing from Willet's plan were uncertain does not, as the Estate contends, distinguish this case from other instances in which the step transaction or substance over form doctrine has been applied.

For example, in Sachs, Samuel Sachs' decision to route gift tax payments through his grandchildren's trust created a tax advantage only because he died within three years of the gift, such that § 2035 would apply if the gift tax payment were attributed to him. Just as Willet's actuarial bet had an uncertain payoff, Sachs' attempt to evade § 2035 could have been rendered useless by subsequent events.

Similarly, in Robino, we looked through the form of a transaction even though the choice of form did not create a certain tax advantage. In Robino, individuals devised a complicated cross-option scheme, using two trusts as conduits to hold, and ultimately sell, real property. This arrangement "let the taxpayers keep the parcel if it did not appreciate in value but shift the gain on the parcel to the trusts if it did increase in value." 894 F.2d at 345 . The real estate market was "volatile" during the relevant time period, id. at 343, so a gain on the real property, and therefore the tax advantage of the scheme, was by no means

> assured. As both Robino and Sachs therefore demonstrate, a certain tax advantage is not a prerequisite to application of the step transaction doctrine.
>
> Tax consequences aside, the nature of the Browns' transaction sequence (ultimately, a transfer of funds from Willet to the IRS) was fixed the moment Betty wrote out the check to the IRS. Focusing only on Betty's role within that predetermined result, it is clear that her participation had no significance beyond the attempt to alter tax liabilities. Unlike a situation in which Betty paid the gift taxes by reducing her own net worth, a decision with independent economic effect on Betty's estate, Betty's role as a conduit altered the economics of the transaction only by shifting the risk of § 2035 inclusion from Willet's estate to Betty's estate. Where, as here, that risk shift did not reflect the reality of the underlying transaction sequence, application of the step transaction is appropriate.
>
> The final component of the Estate's uncertainty argument relates to its complaint that the step transaction doctrine can be, and often is, applied asymmetrically: Had Betty died within three years of the gift tax payments, it is quite unlikely that the IRS would adamantly advocate in favor of treating the funds as if paid by Willet, so as to relieve Betty of the estate tax liability. The IRS's lawyer so indicated at oral argument.
>
> The possibility of a one-way rachet does give us pause. We are not alone: Both courts and commentators have struggled with whether the substance over form principle is a one-or two-way street, and whether, even if a two-way street, it nonetheless "run[s] downhill for the Commissioner and uphill for the taxpayer." Bittker & McMahon, Fed. Inc. Tax'n of Indiv., § 1.03 (quoting Rogers' Estate v. CIR, 70,192 P-H Memo. TC (1970), aff'd 445 F.2d 1020 (2d Cir. 1971)) but see Clark, 489 U.S. at 737 (invoking the doctrine in favor of the taxpayer). See generally, William S. Blatt, Lost On A One-Way Street: The Taxpayers's Ability to Disavow Form, 70 Or. L. Rev 381 (1991).
>
> Had Betty indeed died first, we would be faced with the difficult question of whether symmetry required application of the step transaction doctrine, or whether the taxpayer, having complete control over the form of the transaction, must bear the consequences of the chosen form without recourse to the step transaction doctrine. Whether the doctrine must be applied symmetrically is not, however, the issue now before us, and we do not reach it.

I. SECTION 2040 — JOINT INTERESTS

1. Adequate Consideration Test Met. In Estate of Marie L. Concordia, et al. v. Commissioner, T.C.Memo. 2002-216, the decedent died owning half of a house called "Western." The other half had been deeded by the decedent to her niece in exchange for (1) being able to live with and be cared for by the niece, and (2) the niece's husband managing certain rental property ("Bradley property"). The opinion described other facts as follows:

> Around that same time decedent conferred with Mr. McReady [niece's husband] about other alternatives. Decedent inquired whether she could live at Primrose [niece's home] with her dogs and pay rent that she could finance by either renting or selling Western. The McReadys were not willing to board her dogs, because they already had two dogs of their own. Further discussions and negotiations resulted in an agreement under which decedent agreed to deed

> Western to the McReadys, and Mr. McReady would manage the rental activity at Bradley for decedent. It was also understood that decedent would live with the McReadys at Primrose, that decedent's dogs could remain at Western, and that the McReadys' daughters would reside at Western during breaks from college and after their graduations. It was also expressly understood that as long as the McReady children used Western, decedent would have access to visit and care for her dogs.
>
> Decedent did not execute a deed to Western until November 1990, when she deeded Western to herself and her niece Mrs. McReady as joint tenants. The transfer by deed did not take place until almost 4 years after the agreement because of Mr. McReady's request for a delay. He was the subject of a lawsuit and did not wish to have additional property in his name. Mr. McReady was not made a joint tenant of Western. At the time of the transfer by deed, it was agreed to make decedent a joint tenant on Western in order to continue to take advantage of homestead and senior citizen deductions available in the District of Columbia.
>
> In accord with the agreement, decedent resided at Primrose with the McReadys from February 1987 through the time of her death, June 1996. During most of that period, decedent continued to be in good health, and she took care of her own needs. Decedent was also financially self-sufficient during that period. During that period, various of the McReady children occupied Western in accord with the agreement. Also, Mr. McReady managed the Bradley rental property during the period 1987 through decedent's death, placing tenants, negotiating leases, collecting rents, and seeing to its maintenance.
>
> Mr. McReady lent decedent $95,000 to enable her to pay off an existing mortgage and refinance the Bradley mortgage to obtain more favorable interest rates.
>
> At the time of decedent's death, Western had a fair market value of $270,000, 50 percent ($135,000) of which was included in the gross estate. The remainder of the principal assets in the gross estate consisted of: Bradley ($280,000); securities ($227,913); and cash and bank accounts ($56,983). The deductions from the gross estate included: Funeral expenses ($11,736); attorney's fees ($1,481); other expenses ($1,653); financing and closing costs incurred to refinance Bradley ($10,070); and debts of decedent ($109,152, $95,000 of which was due to Mr. McReady).

The court concluded:

> We recognize that Mrs. McReady, along with her sister, was the natural object of decedent's bounty and named as the sole heir of decedent, and that fact causes us to2 more closely scrutinize their transactions. However, it does not automatically negate their agreements. See Caligiuri v. Commissioner, 549 F.2d 1155, 1157 (8th Cir. 1977), affg. T.C. Memo. 1975-319; Perry v. Commissioner, 92 T.C. 470, 481 (1989), affd. 912 F.2d 1466 (5th Cir. 1990).
>
> It is important to note that Mrs. McReady and her sister, as beneficiaries, each received a distribution of assets worth $225,800. The consideration received by the McReadys is outside of that distribution. In other words, the deeding of Western in 1990, 6 years before decedent's death, was outside of the equal division of the probate estate. Upon the death of decedent, Mrs. McReady became the sole owner of Western.

Although respondent questions whether the facts in the record support the ultimate conclusion that there was an agreement and that consideration was exchanged, the credible and uncontradicted testimony of witnesses and corroborating evidence in the record support the existence of the agreement and the exchange of consideration between the parties.

Having decided that there were an agreement and the exchange of consideration, we must now decide the amount of "adequate and full" consideration given by the McReadys in exchange for an interest in Western. The estate contends that there are two types of the consideration exchanged for Bradley — the rental value of Primrose and the value of Mr. McReady's services in managing Bradley.

With respect to the fair rental value, the estate called two expert witnesses and through their testimony was able to establish an indexed fair rental value for Primrose. We have found that the fair rental value of Primrose for the period under consideration was $408,560. With three adults sharing Primrose, we use one-third of the rental value or $136,187 as the consideration attributable to the decedent's use of Primrose. The rental value was calculated for the amount of time that decedent actually survived from the time of the 1987 agreement.6

We note that $136,187 is greater than one-half the $270,000 fair market value of Western at the time of decedent's death. However, the standard for evaluating the amount of consideration in this context is specifically set out in section 20.2040-1(a), Estate Tax Regs.7 That formulaic approach to determining the portion of the fair market value of a jointly held asset that should be excluded from the gross estate, may be expressed as follows: the fair market value of the property at the date of death is multiplied by a ratio that has the consideration furnished by the survivor as the numerator and the total consideration paid to acquire and improve the property as the denominator. See Estate of Young v. Commissioner, 110 T.C. 297, 315 (1998); Estate of Van Tine v. Commissioner, T.C. Memo. 1998-344.

The approach used in section 20.2040-1(a)(2), Estate Tax Regs., measures the survivor's contribution to the jointly owned property against the decedent's contribution. At the time of the 1987 agreement, decedent's sister had just died, and decedent had become the sole owner of Western. However, the regulation, with respect to the denominator of the exclusionary formula, uses the language "total cost of acquisition and capital additions."

It is somewhat difficult to apply the concept of cost to the circumstances of this case. In 1987, decedent had just acquired the sole ownership of the property as sole survivor of three joint tenants culminating a 36-year period. In 1987, decedent exchanged an undivided one-half interest for a place to live and for services. As it relates to decedent, it could be said that her cost might have been the amount she paid, if any, at the time (1951) she began occupying Western.

No matter which approach we use, the cost, plus improvements of Western, would not exceed its $270,000 agreed fair market value as of the time of decedent's death in 1996. Using the $270,000 in the denominator of the fraction clearly sets a higher bar for the estate's quest for exclusion of Mrs. McReady's joint interest. We are not called upon to decide whether an exclusion of more than one-half of the fair market value from decedent's gross estate may have been warranted because the McReadys may have paid more consideration than decedent; the parties have not placed these aspects in issue or addressed them.

> Our holding that $136,187 was the indexed fair rental value exchanged for the undivided one-half interest in Western satisfies the estate's burden of showing that Mrs. McReady's acquisition was for an adequate and sufficient consideration to support the estate's claim that $135,000 of the $270,000 fair market value can be excluded from the gross estate.
>
> Although the estate has satisfied its burden with respect to excluding $135,000 from the gross estate, we note that we have not decided the value of the services performed by Mr. McReady in managing the Bradley rental property. On this record, his services would likely be difficult to value, but if those services should be included in the numerator of the formula for exclusion, it is clear that additional value would be added to the numerator of the exclusionary equation because of his performance over 9 years. Because the estate has shown sufficient consideration to warrant the exclusion of one-half of the fair market value of Western (the amount claimed by the estate), we need not address the value of Mr. McReady's services in managing Bradley.

J. SECTIONS 2041 AND 2514 — GENERAL POWERS OF APPOINTMENT

1. Modification of General Power is Not a Release. PLR 200335015 dealt with a general power which was modified as part of divorce settlement. The power, and modification, were:

> Article III, Paragraph C of Trust 1 provides that Taxpayer shall have the following testamentary power of appointment with respect to all or any part of the income or principal of Trust 2:
>
> > A general power of appointment in favor of any one or more of a group consisting of any of Grantor's issue (except Taxpayer), spouses of Grantor's issue, charities, and one creditor (other than the spouse of Taxpayer, an issue of Taxpayer, or the spouse of an issue of Taxpayer) of Taxpayer, exercisable by will at the Taxpayer's death. Taxpayer may appoint outright or in trust, select the trustees, create new powers of appointment in others, establish administrative powers, create life interests or other limited interests in some with future interests in others, impose lawful conditions on such new powers of appointment, impose lawful spendthrift provisions, and in general appoint by will in any lawful manner; provided always, however, that no appointment by Taxpayer shall benefit directly or indirectly one not an object of this power and that nothing herein shall be construed as authorizing Taxpayer to appoint to himself, his estate, more than one of his creditors or more than one of the creditors of his estate. Paragraph A of this Article is subject to this power.
>
> Taxpayer proposes, as part of a divorce settlement, to enter into an agreement with regard to his exercise of the testamentary general power of appointment granted him under Trust 1, Article III, Paragraph C. Under the proposed agreement, the terms and provisions of the testamentary general power of appointment are the same as provided in Trust 1 except that if Taxpayer elects to appoint all or any portion of Trust 2 to or for the benefit of any issue of his other than Daughter or her issue, then Taxpayer agrees to make an identical or more favorable appointment to or for the benefit of Daughter or her issue; except that, if Daughter is under a severe and permanent mental or physical impairment that would prevent her enjoyment, use or possession of any property appointed pursuant to the power of appointment and Taxpayer otherwise has provided amply for her comfort, welfare, health, support, and maintenance needs, then

> Taxpayer may appoint all or any portion of Trust 2 to or for the benefit of any of his issue without limitation.

Because the taxpayer could still appoint to a creditor the power remained general. The limitation to appoint to one creditor, or one estate creditor, is an interesting approach.

2. **Inadvertent Exercise of Power of Appointment**. The danger of inadvertently exercising a power of appointment is evident in Estate of Sarah W. Grove v. Commissioner, T.C. Memo 2004-91. In 1933, Sarah S. Wright, decedent's grandmother created a general power in decedent. Decedent never knew about the power, which would have excluded the assets from her estate because the power was created before October 21, 1942, but under Pennsylvania law her residuary clause exercised it!

K. SECTIONS 61, 83, 2042 AND 7872 - LIFE INSURANCE

1. **Guidance on Split-Dollar Life Insurance**. Final regulations have been issued. T.D. 9092, IRB 2003-46 at 1055 (September 11, 2003). In general the final regulations are the same as the proposed regulations and are effective for arrangements entered into after September 17, 2003 and arrangements entered into on or before that date which are materially modified afterwards. To oversimplify, payments made by the owner of a policy through an arrangement which benefits a non-owner (commonly referred to as an endowment arrangement) are taxed looking at the economic benefit to the non-owner (i.e., as compensation, dividend, or gift); payments made by a non-owner through an arrangement that benefits the owner (commonly referred to as a collateral assignment arrangement) are taxed as loans under section 7872. The Background and Explanation of Provisions states:

> Definition of split-dollar life insurance arrangement
>
> The final regulations generally define a split-dollar life insurance arrangement as any arrangement between an owner of a life insurance contract and a non-owner of the contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract. The definition does not cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract.
>
> The final regulations also retain the special rules from the 2002 proposed regulations that treat certain arrangements entered into either in connection with the performance of services or between a corporation and another person in that person's capacity as a shareholder in the corporation as split-dollar life insurance arrangements regardless of whether the arrangements otherwise satisfy the general definition of a split-dollar life insurance arrangement. Neither the general rule nor the special rules cover so-called "key man" life insurance arrangements under which a company purchases a life insurance contract to insure the life of a "key" employee or shareholder but retains all the rights and benefits of the contract (including the rights to all death benefits and cash value).
>
> The IRS and Treasury are concerned that certain arrangements may be inappropriately structured to avoid the application of these regulations (for

example, by using separate life insurance contracts that are, in substance, one life insurance contract). The Commissioner will use existing authority to challenge any such transaction.

Mutually exclusive regimes

The final regulations retain the approach of using two mutually exclusive regimes -- an economic benefit regime and a loan regime -- for determining the tax treatment of split-dollar life insurance arrangements. As under the 2002 proposed regulations, ownership of the life insurance contract determines which regime applies. Several commentators on both the 2002 and the 2003 proposed regulations argued that the use of the two mutually exclusive regimes is an artificial and rigid approach that fails to account adequately for the economic reality of a split-dollar life insurance arrangement. However, the IRS and Treasury believe that the final regulations, like the 2002 and 2003 proposed regulations, properly account for the division of the costs and benefits of a split-dollar life insurance arrangement.

Several commentators asked that taxpayers be permitted to elect which regime would apply to their split-dollar life insurance arrangements. However, in the view of the IRS and the Treasury, taxpayers effectively have the ability to elect which regime will apply by designating one party or the other as the owner of the life insurance contract.

One commentator asserted that there is no authority under section 7872 to treat payments made pursuant to split-dollar life insurance arrangements as loans. Therefore, this commentator recommends that taxation of split-dollar life insurance arrangements under section 7872 should occur only if affirmatively elected by the parties to the arrangement. The IRS and Treasury believe there is sufficient authority to require the application of section 7872 to split-dollar life insurance arrangements. There is no legislative history indicating that Congress did not intend section 7872 to apply to payments made pursuant to these arrangements.

A number of commentators expressed concern about the possible application of section 402 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Public Law 107-204, to all or certain split-dollar life insurance arrangements entered into by companies subject to Sarbanes-Oxley. These regulations do not address this issue, as interpretation and administration of Sarbanes-Oxley fall within the jurisdiction of the Securities and Exchange Commission.

The final regulations adopt the general rule in the 2002 proposed regulations for determining which regime applies to a split- dollar life insurance arrangement. The 2002 proposed regulations provided a special rule that the economic benefit regime applied to a split-dollar life insurance arrangement if the arrangement is entered into in connection with the performance of services, and the employee or service provider is not the owner of the life insurance contract; or the arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donee is not the owner of the life insurance contract. The final regulations adopt this special rule, but provide that this rule applies when the employer, service recipient or donor is the owner.

The final regulations add a rule regarding the treatment of a transfer of a life insurance contract under a split-dollar life insurance arrangement from an owner to a non-owner when payments under the arrangement had been treated, prior to transfer, as split- dollar loans under §1.7872-15. Under this rule, the economic benefit regime applies to the split-dollar life insurance arrangement from the date of the transfer and the payments made (both before and after the transfer) are not treated as split-dollar loans on or after the date of the transfer. The transferor of the life insurance contract must fully take into account all economic benefits provided under the split-dollar life insurance arrangement.

Owners and non-owners

The final regulations generally retain the rules in the 2002 proposed regulations for determining the owner and the non-owner of the life insurance contract. Thus, the owner generally is the person named as the policy owner. If two or more persons are designated as the policy owners, the first-named person generally is treated as the owner of the entire contract.

Several commentators argued that determining tax ownership based on whom the parties name as the policy owner of the life insurance contract represents a departure from general tax principles. Commentators suggested that a split-dollar life insurance arrangement is like any co-ownership situation in which two or more parties agree to share in the costs and benefits of a policy such that each party will be entitled to exercise certain rights with respect to the underlying policy and will have certain responsibilities.

The IRS and Treasury disagree with that argument. Split- dollar life insurance arrangements are structured in myriad ways, some formally as loans to the employee (for example, collateral- assignment arrangements), some formally as co-ownership arrangements between the employer and the employee, and some as arrangements in which the employer is, in form, the sole owner (for example, endorsement arrangements). In addition, split-dollar life insurance arrangements ordinarily involve division of the benefits and costs of the life insurance contract, but the division of benefits ordinarily does not correspond to the division of costs. Because the division of the burdens and benefits of the life insurance contract vary widely in split-dollar life insurance arrangements, and because title ownership generally is a factor in determining tax ownership, it is reasonable to determine tax ownership based on who is the named owner of the policy. In addition, this rule provides a clear objective standard so that both taxpayers and the IRS can readily determine which regime applies under the final regulations.

If two or more persons are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, those persons are treated as owners of separate contracts for purposes of these regulations (although not for purposes of section 7702 and other rules for the taxation of life insurance contracts). An undivided interest in a life insurance contract consists of an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract. For example, if an employer and an employee own a life insurance contract and share equally in all rights, benefits and obligations under the contract, they are treated as owning two separate contracts; ordinarily neither contract would be treated as part of a split-dollar life insurance arrangement. However, if the employer and the employee agree to enter into a split-dollar life insurance arrangement with respect to what otherwise would have been treated as the employer's (or the employee's) separate contract, the purported undivided interests will be disregarded, and the entire arrangement will be treated as a split-dollar life insurance arrangement. The Commissioner will consider all of the facts and circumstances of an arrangement to determine whether the parties

> have appropriately characterized the arrangement as one involving undivided interests and, therefore, not subject to these regulations.
>
> The final regulations provide attribution rules for compensatory split-dollar life insurance arrangements. Under these rules, the employer or service recipient will be treated as the owner of the life insurance contract if the contract is owned by a member of the employer's controlled group (determined under the rules of sections 414(b) and 414(c)), a trust described in section 402(b) (sometimes referred to as a "secular trust"), a grantor trust treated as owned by the employer (including a rabbi trust), or a welfare benefit fund (within the meaning of section 419(e)(1)).
>
> The final regulations retain the special rule for non-equity split-dollar life insurance arrangements. Under this special rule, non-equity arrangements entered into in a compensatory context or a gift context will be subject to the economic benefit regime. The final regulations provide rules for determining the tax treatment of the arrangement if the parties subsequently modify the arrangement so that it is no longer a non-equity arrangement. If, immediately after the modification, the employer, service recipient, or donor is the owner of the life insurance contract (determined without regard to the special rule for non-equity arrangements), the employer, service recipient, or donor continues to be treated as the owner of the life insurance contract (such that the normal rules of the economic benefit regime for equity split-dollar life insurance arrangements will apply). If, immediately after the modification, the employer, service recipient, or donor is not the owner, the employer, service recipient, or donor is treated as having made a transfer of the contract to the employee, service provider, or donee as of the date of the modification. For purposes of these rules, the replacement of a non-equity arrangement with a successor equity arrangement will be treated as a modification of the non-equity arrangement.

2. **Correction to Life Insurance Trust for Scrivener's Error**. In PLR 200314009 the settlor of a trust intended to include restrictions that would not allow her to appoint herself or a person subordinate to he as trustee, but due to scrivener's error the restriction was omitted. The IRS approved the effectiveness of a court reformation to fix the problem.

3. **Selling Life Insurance Policies From One Trust to Another**. Suppose a life insurance policy is owned by an irrevocable trust with undesirable terms. Traditionally there have been three simple alternatives.

First, the insured could purchase the policy from the trust. That purchase is not a transfer for value because a purchase by the insured is an exception to the transfer for value rules. Recall that if an insurance policy is ever transferred for value the death proceeds become taxable under section 101. The downside to this option is that the insured now owns the policy and it is included in the insureds estate. If the insured gives the policy to a new irrevocable trust, section 2035 imposes a three year waiting period before the policy is excluded.

The second option is to create a new irrevocable trust and have the insured and the new trust form a partnership. The insured then contributes cash to the new trust and the new trust purchases the policy from the original trust. That is not a transfer for value because the new trust is a partner of the insured, and, again, that is an exception to the transfer for value rules. The downside to the second option is that a partnership has to be formed.

The upside is that there is no three year inclusion issue because the insured never owned the policy. PLR 20012007 confirmed the favorable transfer for value result using an LLC taxed as a partnership.

The third option is to create a new trust that is a grantor trust for income tax purposes. The grantor may contribute cash to the new trust which will purchase the policy from the original trust. Because the new trust is a grantor trust it is the same as the grantor for all income tax purposes, including section 101. For many years the primary authority for the application of the grantor trust rules to section 101 was Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975). In Swanson the trust was a grantor trust because the grantor had the power to partially amend the trust instrument "he had almost unlimited power to change beneficiaries, and he had complete control over the trust property" rather than for technical reasons. In principle, this distinction would make no difference but it often did in the minds of practitioners.

In PLR 200228019, the IRS accepted the Swanson rationale (without citing it). The ruling states:

> Taxpayer [the purchasing trust] has requested a ruling that section 101(a)(1) of the Code will be applicable to the proceeds of the Policies which are paid upon the deaths of Husband and Wife. Taxpayer represents that both it and Trust 2 are grantor trusts owned by Husband. Under Rev. Rul. 85-13, a transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. Husband is treated for federal income tax purposes as owning the assets of Trust 2 and Taxpayer. Therefore, the transfer of the Policies is disregarded for federal income tax purposes and will not affect the application of section 101(a)(1) to amount that the beneficiaries of the Policies will receive upon the death of Husband and Wife.

See PLR 200247006 for a similar ruling. The purchasing trust must be a grantor trust with respect to both income and principal. A trust with Crummey withdrawal powers may be such a trust but that result is not foreordained. A withdrawal right, as in a Crummey trust, makes the power-holder the grantor of that portion of the trust. What if the trust contains other provisions that would make the real grantor – the person putting money in the trust – the grantor? Do those provisions trump the withdrawal rights? Stated in Code terms, do sections 671-677 trump section 678? The IRS ruling position with respect to income is yes, and most commentators believes that is the right result with respect to principal as well. However, the authority is sparse on the issue.

Is it significant that both the buying and selling trusts be grantor trusts? The tax status of the selling trust should not effect the transaction.

If the grantor engages in this transaction may the IRS argue that the grantor has, in effect, retained the right to change the terms of the trust thus creating an incident of ownership? The IRS would have the same argument whether the transaction is engaged in or merely "could be" and such argument should fail.

L. SECTION 2053 and 2054 - DEBTS AND ADMINISTRATION EXPENSES

1. **Interest on Specific Bequest**. For the deductibility of interest for income tax purposes, see A-3.

In Turner ex rel. Estate of Jackson v. United States, 306 F. Supp. 2d 668 (N.D. Tex. 2004), the decedent's Will left $10,000,000 to a charity and the executor waited until a closing letter was received for the estate to pay the bequest. The delay required an additional payment of $1,052,054.79 in statutory interest under Texas law. The court allowed the interest to be deducted under section 2053. The opinion tries to limit the holding to cases where interest was required to be paid because of delay.

M. SECTIONS 2056, 2056A AND 2519- MARITAL DEDUCTION

1. **Disposition For Section 2519 Purposes is a Net Gift**. Final regulations issued on July 17, 2003 (T.D. 9077, IRB 2003-39 at 634) provide that a gift caused by section 2519 will be calculated as a net gift. The donee spouse will be able to recover the amount of the gift tax caused by the transfer, and that right will reduce the amount of the gift. Failure to recover the gift tax will be a gift. On this point, Treas. Reg. § 25.22070A-1 was amended to add a new paragraph:

> (b) Failure of a person to exercise the right of recovery. (1) The failure of a person to exercise a right of recovery provided by section 2207A(b) upon a lifetime transfer subject to section 2519 is treated as a transfer for Federal gift tax purposes of the unrecovered amounts to the person(s) from whom the recovery could have been obtained. See §25.2511-1. The transfer is considered to be made when the right to recovery is no longer enforceable under applicable law and is treated as a gift even if recovery is impossible. A delay in the exercise of the right of recovery without payment of sufficient interest is a below-market loan. Section 1.7872-5T of this chapter describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to imputation under section 7872 (relating to the treatment of below-market loans) is exempted from its provisions.
>
> (2) The transferor subject to section 2519 may execute a written waiver of the right of recovery arising under section 2207A before that right of recovery becomes unenforceable. If a waiver is executed, the transfer of the unrecovered amounts by the transferor is considered to be made on the later of --
>
> (i) The date of the valid and irrevocable waiver rendering the right of recovery no longer enforceable; or
>
> (ii) The date of the payment of the tax by the transferor.

This is a more "complete" regulation then the proposed regulation.

See also PLR 200319002 (widow's sale and transfer of marital trust interest a net gift).

2. **Restriction on Income**. The following clause was found not to give the surviving spouse "all the income" for purposes of section 2056 by the Tax Court in Estate of Ralph H. Davis, et al. v. Commissioner, T.C.Memo 2003-55:

> After the death of trustor survived by his spouse and during the lifetime of his surviving spouse, the trustee shall pay to or apply for the benefit of the surviving spouse, in quarter annual or more frequent installments, all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living.

The opinion states:

> Pursuant to Section Two of the amended trust, the surviving spouse's right to receive income is significantly restricted. In determining the appropriate amount of income to distribute to the surviving spouse, Section Two of the amended trust charges the trustee to consider, in the trustee's reasonable discretion, the surviving spouse's health, education, support, maintenance, comfort, and welfare, in light of her accustomed manner of living.
>
> The expression, "in accordance with the surviving spouse's accustomed manner of living" modifies and limits the expression that precedes it: "all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare". In Estate of Ellingson v. Commissioner, 964 F.2d 959, 964-965 (9th Cir. 1992), revg. 96 T.C. 760 (1991), the Court of Appeals for the Ninth Circuit, the circuit to which any appeal of the instant case would lie, stated that, the language used by the Nicholson trust [in Estate of Nicholson v. Commissioner, 94 T.C. 666 (1990)] — 'usual and customary standard of living' — is much narrower and more specific than that used in this case — 'best interests.' Interpreting the Nicholson trust as qualifying for the QTIP deduction would have required the Tax Court to 'rewrite the trust instrument.'
>
> The "usual and customary standard of living" clause under consideration in the instant case is analogous to the clause in Estate of Nicholson v. Commissioner, supra, and distinguishable from the "best interests" clause directly considered by the court in Estate of Ellingson v. Commissioner, supra. The language in the amended trust is more restrictive than the "best interests" language in the trust in Estate of Ellingson v. Commissioner, supra. The use of the word "comfort" in the amended trust is limited by the expression, "in accordance with the surviving spouse's accustomed manner of living." Accordingly, we interpret the language of the amended trust to mean that the surviving spouse does not have such "command over the income that it is virtually hers". See sec. 20.2056(b)-5(f)(8), Estate Tax Regs.[9] In the instant case, Section Four of the amended trust provides that the trustee, in exercising reasonable discretion, may consider "any other income or resources of the beneficiary known to the trustee and reasonably available."[10] In the instant case, Section Two of the amended trust limits the surviving spouse's entitlement to income without using the term "best interests". Moreover, in the instant case, the clause under consideration is much narrower and more specific than the "best interests" clause considered by the court in Estate of Nicholson v. Commissioner, supra. We conclude that the foregoing limitations prevent the surviving spouse from being entitled to the entire income from the trust.
>
> Moreover, the surviving spouse's role as sole trustee under the trust does not assure her the requisite control over the trust income for life, because, by the terms of the amended trust, decedent's daughters could become sole or cotrustees of the trust, in the event of the surviving spouse's resignation or her

> incapacity to serve as a trustee. Estate of Ellingson v. Commissioner, supra at 962 (citing Estate of Kyle v. Commissioner, 94 T.C. 829 (1990)). Additionally, unlike the "Marital Deduction Trust" in Estate of Ellingson v. Commissioner, supra, there is no language in the amended trust which explicitly refers to a marital deduction under section 2056. Accordingly, we conclude that the decedent did not intend to grant the surviving spouse the entire income interest for life from the surviving spouse's interest in the estate.

At issue in Estate of Zorn v. Zorn Farms, Inc., 62 P.3d 854 (Or. Ct. App. 2003), was the extent of a spouse's right to make unproductive property "productive" in a marital trust. The Court held that where it was clear a settlor intended for land to be retained, unproductive land could be sold only to meet "present or immediately foreseeable" income needs. Whether such a limited reading violates section 2056(b)(5) is unclear. In TAM 200339003, the IRS allowed a marital deduction for non-dividend paying stock passing to a QTIP because of the spouse's power to make the property productive.

3. **Supplemental QTIP Election**. In PLR 200323010 the IRS allowed an estate to file a supplemental estate tax return to correct the amount shown on Schedule M. The ruling states:

> In the instant case, a QTIP election under § 2056(b)(7)(B)(v) was made on Decedent's timely filed estate tax return. The property for which the election was made was described as the "Residue of Decedent's interest in the [Family Trust]." The residue of Decedent's interest in the Family Trust consisted of the assets remaining in the Husband's Separate Property Trust after the distribution of the specific pecuniary bequests plus Decedent's one- half share of the assets of the Community Property Trust. However, under Sections 3.03 and 3.04 of the Family Trust Declaration, these assets were to be distributed to Trust B, which was to be funded with the "Marital Deduction Amount," and Trust C, which was to be funded with the "Exemption Equivalent Amount." Therefore, the QTIP election was made for both the QTIP trust and the credit shelter trust. Pursuant to Rev. Proc. 2001-38, the QTIP election with respect to Trust C, the credit shelter trust, will be treated as a nullity for federal estate, gift, and generation-skipping transfer tax purposes. However, since Trust B meets the requirements for qualified terminable interest property and the election under § 2056(b)(7)(B)(v) was made on a timely filed estate tax return, the QTIP election for the property passing to Trust B, the marital trust, is valid and irrevocable.
>
> As a result of a miscalculation, the value of the property which passed to Trust B under the provisions of Section 3.03 of the Family Trust Declaration was reported incorrectly on Schedule M of Decedent's estate tax return. As a result of this miscalculation, the marital deduction claimed for Trust B was less than the amount that should have been claimed, resulting in an estate tax liability.
>
> Based on the facts submitted and the representations made, we conclude that the description of the QTIP property on Schedule M does not invalidate the QTIP election for the property passing to Trust B pursuant to Section 3.03 of the Family Trust Declaration. Similarly, we conclude that the miscalculation of the value of the property passing to Trust B under the provisions of Section 3.03 does not preclude a marital deduction for the full value of the property which will actually fund Trust B under the terms of the governing instrument.
>
> Accordingly, the personal representative of Decedent's estate should file a supplemental Form 706 with the Internal Revenue Service Center, Cincinnati,

> Ohio 45999, prior to the time prescribed by § 6511 for claiming a credit or refund. The supplemental Form 706 should supply the correct description of the trust for which the QTIP election was made and report the full value of the property subject to the QTIP election. A copy of this letter should be attached to the supplemental return. A copy is enclosed for that purpose.

4. **Effect of Administration Expenses**. In Betty R. Brown v. United States, 32d F.3d 664 (9th Cir. 2003), the estate filed the estate tax return showing about $1,700,000 in administration expenses; later it increased its claim to about $3,600,000 based on expenses incurred. The IRS agreed but reduced the marital deduction accordingly where the expenses were paid from funds earmarked for the marital trust.

5. **Obtaining Step-Up In Basis**. PLR 200403094 is important. Husband created a trust and funded it with his own assets. The trust allowed him to revoke or amend it during his lifetime and to withdraw income and principal. The trust also gave his wife a testamentary general power of appointment if she died first:

> At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.

If husband died first a traditional marital/exemption equivalent plan would be implemented with the marital share passing outright to wife, and the exemption equivalent share being held in a Family Trust for wife and for husband's descendants, subject to ascertainable standards. Wife also had a testamentary special power of appointment among husband's descendants.

The ruling states that wife intends to execute a Will which was described as follows:

> Wife plans to execute Will. Article 2.1 of Will makes gifts of Wife's tangible personality.
>
> Article 2.2 of Will provides:
>
>> I exercise in favor of my estate the power of appointment given to me by Section 4.5 of the Trust created by [Husband] dated [__], and direct that assets having a value equal to (i) the amount of my remaining applicable exclusion amount less (ii) the value of my taxable estate, determined by excluding the amount of those assets subject to this power, be distributed to my estate as soon after my death as possible.
>
> Article 2.3 of Will provides that if Husband survives Wife, Husband will receive a fraction of Wife's residuary estate, after the payment of estate taxes, debts, and expenses, determined as follows:
>
>> The numerator of the fraction will be the smallest pecuniary amount that, if given outright to [Husband], would eliminate or reduce to the

> > lowest possible sum the state and federal estate tax liability of [Wife's] estate. This amount will be calculated by taking into account [Wife's] applicable exclusion amount and all other tax credits, deductions, and other preferences allowed to [Wife's] estate.
>
> The balance of the residuary estate will be held as a separate trust (Wife's Family Trust). If Husband does not survive Wife, the entire residuary estate will be held as the Family Trust. Under Article 3 of Will, any part of the gift to Husband that he disclaims will become part of Wife's Family Trust.

The Family Trust is parallel to the Family Trust described above.

The Service granted four rulings:

> 1. On the death of Wife during Husband's lifetime, if Wife exercises the power of appointment granted her under article 4.5 of Trust, Husband will be treated as making a gift that qualifies for the federal gift tax marital deduction to Wife with respect to that portion of Trust appointed by Wife.
>
> 2. If Wife predeceases Husband, of the assets in Trust, the value of Trust assets over which Wife holds a power of appointment under article 4.5 of Trust will be included in Wife's gross estate.
>
> 3. Any assets that originated in Trust and that pass to or from Wife's Family Trust established under Will will not constitute a gift from Husband to the other beneficiaries of Wife's Family Trust.
>
> 4. Any assets that originated in Trust and that pass to Wife's Family Trust established under Will will not be included in Husband's gross estate.

Presumably the point of this exercise was for the assets in the trust passing into the Family Trust at the first death to receive a step-up in bases by reason of being included in the estate of the first to die. No income tax ruling is mentioned which suggests the Service was not prepared to rule (or to rule favorably) on the basis issue.

Assets which pass back to a donee surviving spouse from a donor deceased spouse where the gift occurred within one year are denied a basis step-up. Thus, the question is, would these assets pass from husband to wife to husband if wife died first and, of course, that depends on the status of husband and the Family Trust.

Also see PLR 200413011 where husband retained a special power of appointment over assets in an irrevocable trust, which passed into a QTIP if the power were released.

6. **Effect of Disability Clause**. In Estate of Merle A. Whiting, Jr. v. Commissioner, T.C. Memo 2004-68, the court applied Arkansas law to determine that a clause allowing trustee to accumulate income instead of distributing it to a disabled beneficiary would not apply to the marital deduction QTIP trust.

The opinion states:

> Decedent manifested his intent to qualify for the marital deduction in numerous ways. First, the trust agreement named two of the trusts in reference to the marital deduction: The "Marital Deduction Trust" and the "Non-Marital Deduction Trust". The name of a trust is evidence of decedent's intent.
>
> Second, it is evident from the trust agreement that decedent intended to minimize Federal estate taxes through the use of the marital deduction. See *Estate of Todd v. Commissioner,* 57 T.C. 288, 294 (1971) (references to the marital deduction and citations to section 2056 clearly establish that the trust's purpose was to secure the marital deduction). In valuing the assets to be placed in the marital deduction trust, the trust agreement states that decedent intended to "have the result of qualifying the marital deduction for estate tax purposes". Only assets which qualify for the marital deduction may be placed in the marital deduction trust. The amount of the distribution to the marital deduction trust is "the excess * * * of the decedent's taxable estate * * * over the exemption equivalent of the * * * unified credit". Additionally, the terms "marital deduction", "gross estate", and others are defined in the trust agreement as having the same meaning as the definitions found in the Internal Revenue Code.
>
> Third, the circumstances surrounding the drafting of the trust indicate that decedent intended to qualify for the marital deduction. Decedent knew that he was terminally ill and hired specialized tax attorneys to draft the trust: Two are Arkansas board recognized specialists in tax law, one is a certified public accountant, and two have a master of laws in taxation. The intent of the draftsman of the marital deduction trust was to create a trust which qualified for the marital deduction.

7. No Relief For Excessive QTIP Election. Rev. Rul. 2001-38, 2001-1CB1335, provides relief in certain situations where a QTIP election was unnecessary to reduce the estate tax to zero. Specifically.

> This revenue procedure applies to elections under section 2056(b)(7) to treat property as qualified terminable interest property where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. This revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero. This revenue procedure also does not apply to elections that are stated in terms of a formula designed to reduce the estate tax to zero. See, for example, section 20.2056(b)-7(h), Examples 7 and 8. In addition, this revenue procedure does not apply to protective elections under section 20.2056(b)-7(c).

In PLR 200422050 a QTIP election was made for more of a marital trust than was necessary to produce zero estate tax and the IRS held that all of the trust for which the election was made would be included in the surviving spouse's estate under section 2044. The ruling denies all relief to the taxpayer:

> In the instant case, the taxpayer is not seeking an extension of time to make the QTIP election. Rather, the taxpayer is in effect seeking to partially revoke a QTIP election previously made, that, pursuant to § 2056(b)(7)(B)(v) is irrevocable. See Estate of Cavenaugh v. Commissioner, 100 T.C. 407 at 421 (1993). Accordingly, § 301.9100 is not applicable in this case.

> Furthermore, the situation presented is not within the purview of Rev. Proc. 2001-38, 2001-1 C.B. 1335. Pursuant to this revenue procedure, under certain circumstances, the Service will treat a QTIP election as null and void for purposes of §§ 2044(a), 2056(b)(7), 2519(a) and 2652. Rev. Proc. 2001-38 applies where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero.
>
> In this case, a QTIP election was required with respect to the marital trust to reduce Decedent's estate tax liability to zero. However, the election was made for more marital trust property than was necessary in order to reduce Decedent's estate tax liability to zero. This situation is specifically excluded from the purview of Rev. Proc. 2001-38. Accordingly, the QTIP election with respect to the entire marital trust is valid and effective for estate tax purposes. Therefore, 100 percent of the value of the marital trust on the applicable valuation date will be includible in Spouse's gross estate under § 2044.

N. SECTIONS 2501 TO 2524 - GIFTS

1. **Reciprocal Gifts**. In Estate of Robert V. Schuler v. Commissioner, 282 F.3d 575 (8th Cir. 2002), the Eighth Circuit upheld the Tax Court's extension of the reciprocal gift doctrine to transfers of different assets. The facts were:

> Two brothers, Robert Schuler (Robert) and George Schuler, Jr. (George), owned interests in two family operated companies -Minn- Kota Ag Products, Inc. (Minn-Kota) and Sigco Sunplant, Inc. (Sigco). Prior to the stock transfers at issue, George's son, Jody, owned all Minn-Kota Class A voting common stock, and Robert's son, Jay, George, and Jody owned all the restricted Class B common stock. Sigco was equally owned by Robert and George.
>
> Before Robert's death, he and George had discussed with their insurance agent their desire to have their families succeed them in the businesses. The brothers told their insurance agent they wanted Robert's family to control Sigco and George's family to control Minn-Kota. Together, with assistance from the insurance agent, Robert and George devised two three-step plans to transfer divided ownership of Minn-Kota and Sigco to each other's family and to employ section 2503(b) of the Internal Revenue Code to exclude the transfers from estate taxes.
>
> The first step for gaining family control of Sigco required Robert and his wife to make joint gifts of Sigco stock equal to approximately $20,000 each to their children, their spouses and grandchildren and to Jody, his wife and son during December 1994 and January 1995. The second step required George and his wife to make joint transfers of stock equal to approximately $20,000 to each of Robert's children and their spouses. The third step required several of Robert's children to transfer their shares to four siblings, including Jay and his children.
>
> Similarly, the first step for gaining family control of Minn-Kota required George and his wife to make joint gifts of Minn- Kota stock valued at approximately $20,000 to each of their children and grandchildren in December 1994 and January 1995. The second step required Robert and his wife to transfer

> approximately $20,000 of Minn-Kota stock each to George, his wife and their children. The third step required some of George's children and their spouses to transfer stock valued at approximately $10,000 each to Jody, his wife, and their children.
>
> Between December 1994 and January 1995, Robert transferred stock valued at $440,467.20 to George's family, and George transferred stock valued at $382,140 to Robert's family. After these stock transfers, Robert's family owned nearly 80 percent of Sigco, George's family owned nearly 68 percent of Minn-Kota, and Jody retained ownership of all Minn-Kota voting common stock.
>
> Robert and George separately filed Form 709s[2] for the years 1994 and 1995. On both Form 709s Robert and his wife claimed twelve gift tax exclusions for gifts made to George's family along with additional exclusions for gifts made to their own family members. On both Form 709s George and his wife claimed nine gift tax exclusions for gifts made to Robert's family along with additional exclusions for gifts made to their own family members.
>
> In October 1995, Robert died. His sons, Jay and Thomas Schuler, filed a Form 706[3] excluding gifts of Sigco and Minn-Kota stock made in 1994 and 1995 from their deceased father's taxable gifts. Thereafter, on December 18, 1996, January 2, 1997, and January 2, 1998, George and his wife made transfers of Minn-Kota stock, each valued at $19,926, to Robert's son, Jay. The aggregate value of these three subsequent stock transfers totaled $59,778, which, when added to the value of George's 1994-95 stock transfers, amounted to $441,918, or just $1,451 more than the value of stock Robert had transferred to George's family in 1994 and 1995.

The opinion states:

> > We have jurisdiction over appeals from the tax court pursuant to 26 U. S. C. §§ 7482. We review the tax court's factual findings for clear error and its legal conclusions de novo. Bean v. Commissioner, 268 F.3d 553, 556 (8th Cir. 2001). "Whether a transaction lacks economic substance, and whether several transactions should be considered integrated steps of a single transaction, are both fact questions which we review for clear error." Sather v. Commissioner, 251 F.3d 1168, 1173 (8th Cir. 2001) (citations omitted).
>
> For purposes of this appeal, we must determine whether the gifts at issue, similar stock transfers made by Robert and George to each other's children, were reciprocal cross gifts, that is, indirect gifts to each donor's own children. In doing so, we are guided by our recent decision in Sather. *Id.* at 1173-76 (applying the reciprocal trust doctrine[4] in a gift tax context to determine the economic substance of gift transfers).
>
> > We explained in Sather that the reciprocal trust doctrine is a variation of the substance over form concept which developed in the trust context "to prevent taxpayers from transferring similar property in trust to each other as life tenants, thus removing the property from the settlor's estate and avoiding estate taxes, while receiving identical property for their lifetime enjoyment that would likewise not be included in their estate." Id. at 1173 (citing Estate of Grace, 395 U. S. at 320). The application of the reciprocal trust doctrine is not limited only to identifying the true transferor or transferee, but also applies to

> determining the nature of the property transferred. Sather, 251 F.3d at 1174. The doctrine applies to multiple transactions which are interrelated and which, "to the extent of mutual value, leave . . . the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries." Id. at 1173-74 (quoting Estate of Grace, 395 U. S. at 324).

Applying these trust principles to gifts in Sather, we ruled the gifts were part of a jointly designed and executed plan devised for the purpose of benefitting each brother's own children. Id. at 1174-75. The Sather case involved three brothers, each of whom had three children. The Sather brothers made identical gifts of stock in a family-owned corporation on the same date to each of their children and to each of their six nieces and nephews for a total of nine gifts. A fourth, unmarried brother also made identical gifts of stock on the same date to his nine nieces and nephews. *Id.* at 1170-71.

Subsequent to the stock transfers, each child (transferee) was left in the same economic position as if his father had given the stock directly to him. *Id.* at 1174-75. We deemed as immaterial the fact that the brothers circuitously routed the gifts to their own children through their nieces and nephews, and we upheld the tax court's ruling that each brother was entitled to only three annual exclusions. We also concluded that the result was not affected by the fact the fourth, unmarried brother had made gifts of stock to his nieces and nephews which resulted in a net decrease in his economic value. The effect of uncrossing the reciprocal transfers left each of the transferors (except the unmarried brother) with children in the same economic position as if he had made stock transfers only to his own children. *Id.* at 1175.

Applying the reciprocal trust doctrine to this case, we cannot say the tax court was clearly erroneous in finding the gifts of stocks were interrelated. Robert and George Schuler jointly sought the advice of their insurance agent on how to have their children succeed them in the family-owned businesses. With their insurance agent's assistance, they devised a plan whereby Robert's family would increase its interest in Sigco while George's family would increase its interest in Minn-Kota. The 1994 and 1995 reciprocal transfers of stock were identical in type and amount and occurred on the same days. Similar to the Sather brothers, the Schuler brothers received no direct economic benefit from the stock transfers, but they received an economic benefit indirectly by benefitting their children as successors to the family-controlled businesses.

The Schulers contend their case is distinguishable from Estate of Grace and Sather, inter alia, because those cases involved transfers of identical property. In contrast, Schulers argue this case involves transfers of stock in two distinct companies whose assets, businesses, and management are different. We find such distinctions immaterial. Certainly, the three-part plans jointly executed in this case were more complicated than the transfers in Sather. However, the net effect was the same -simultaneous cross transfers of stock amounting to transfers of each brother's stock to his own children.

Nor are we persuaded the tax court was clearly wrong in finding inter-relatedness when Robert and George had a business purpose in separating the ownership of the two businesses between the children of the two Schuler families. Intrafamily transfers demand close scrutiny "precisely because the genuineness of the transaction cannot reasonably be inferred" from assurances of business purpose. Kincaid v. United States, 682 F.2d 1220, 1225 (5th Cir.

> 1982) (quoting *Fehrs v.* United States, 620 F.2d 255, 260 (Ct. Cl. 1980)). In this case, the tax court flatly rejected the assertion that business purpose was the primary motivation for making the reciprocal stock transfers. Instead, the tax court reached the "inescapable conclusion that decedent and his brother made the circuitous transfers for the primary purpose of increasing the number of exclusions under section 2503(b) that otherwise would have been available to them."
>
> After uncrossing the gifts to discern the taxability of the transactions, the tax court found Robert's children received stock from George of approximately the same economic value as they would have received by direct transfers from Robert. The tax court rested its finding on the fact that the difference in the value of the 1994 and 1995 cross stock transfers, which amounted to $58,327.20, was all but eliminated by George's transfers of stock valued at $59,778 to Robert's son in the three years following Robert's death.
>
> The Schulers contend the tax court ignored the substantial changes in ownership and control that resulted from the reciprocal transfers. After the stock transfers, the Schulers claim Robert's family interest in Sigco increased from 75 percent to 80 percent.[5] In analyzing the effect of the stock transfers, the tax court recognized the stock transfers resulted in a small shift in Sigco ownership from 75 percent to almost 80 percent. Before the transfers, Robert owned 25 percent of Sigco shares outstanding and his son, Jay, owned 50 percent; together they owned a 75 percent majority. Before and after the transfers, George's son, Jody, owed 100 percent of the Minn-Kota voting stock. Thus, the tax court found that acquiring control of the family business was not the purpose of the transfers.

Husband and wife created similar Crummey trusts and asked whether they were reciprocal in PLR 200426008. The IRS said no. The ruling states:

> In the present case, Husband's Trust differs from Wife's Trust in several respects. Husband's Trust grants Wife the right to withdraw specified amounts of trust principal after Son1's death. Husband's Trust also grants Wife an inter vivos special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and their spouses or any trust created primarily for the benefit of one or more of those persons. Further, to the extent Wife does not exercise her inter vivos special power, Husband's Trust grants Wife an inter vivos or testamentary special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons. Finally, if a Marital Trust is established, Husband's Trust grants Wife a testamentary special power to appoint the assets remaining in the Marital Trust among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons.
>
> Under Wife's Trust, with respect to any trust established under Wife's Trust except a Marital Trust, Husband cannot be a beneficiary until three years after Wife's death and then will only be a beneficiary at any time when his net worth is under $a and his income from personal services is under $a. Distributions to Husband under this provision are limited to an amount equal to $b reduced by Husband's income from personal services during the calendar year of the distribution.

> Thus, we conclude that Husband's Trust and Wife's Trust are not interrelated. As in Levy, there is no need to consider the second test. Accordingly, based on the facts submitted and the representations made, we rule as follows:
>
> 1. Neither the Husband's Trust nor the Wife's Trust will be includible in the Husband's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.
>
> 2. Neither the Husband's Trust nor the Wife's Trust will be includible in the Wife's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

2. **Gift under Federal Law**. In Wells Fargo Bank New Mexico, et al. v. United States, 319 F.3d 1222 (10th Cir. 2003), the Tenth Circuit reversed the district court on the question of whether a completed gift had been made. Essentially, wife created a lifetime QTIP but the QTIP election was not made, thus creating an unwanted gift. The estate of the now deceased wife argued there was no gift under state law because her intent was foiled. The court disagreed and the opinion states:

> At this point, two propositions emerge. First, the language employed in the trust instrument concerning the finality of the transfer of funds could not be any clearer. Indeed, the architect of the trust employed virtually every word in a legal scrivner's lexicon to denote the complete abandonment by Ms. Nielsen of any interest in the transferred property. Second, had the election required by § 2325(f)(1) been made, Ms. Nielsen's intent to create a QTIP would have been achieved, and no gift tax would have attached to the transfer of the $550,000. Unfortunately for Ms. Nielsen, for the want of an election, the exemption was lost.
>
> In an attempt to recover from this loss, the Estate paid the tax and filed this refund action in the district court, contending under New Mexico law, the transfer of funds to the lifetime QTIP trust was incomplete because Ms. Nielsen's donative intent was foiled. The district court granted the Estate's motion for summary judgment predicated upon its reading of Estate of Davenport v. Commissioner, 184 F.3d 1176 (10th Cir. 1999). The court relied upon our holding "in federal taxation cases, state law controls only to the extent that certain statutory provisions of the federal revenue laws make their application dependent on state law." Id. at 1176. The district court believed Davenport mandated application of state law to determine the nature of the ownership interest before applying federal law to decide the taxability of that property. Finding donative intent, a required element of a completed gift under New Mexico law, was absent here, the court concluded the Commissioner wrongfully assessed a gift tax against the Estate. We disagree with this analysis.
>
> We believe the point at which the district court's reasoning strayed from the proper path was in not recognizing the settled principle that for federal tax purposes, the essence of a completed transfer is determined by whether there was a "passage of dominion and control over the economic benefits of property." Estate of Sanford v. Commissioner, 308 U.S. 39, 43 (1939). There is nothing within the applicable parts of the Internal Revenue Code that even suggests state law overrides this rule of federal law. The notion is buttressed by Treasury Regulation § 25.2511-1(g)(1) which states:

> Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.
>
> See also Tres. Reg. § 25.2511-2(b) (a gift is complete for federal tax purposes when "the donor has so parted with dominion and control as to leave in him no power to change its disposition.").
>
> Under the previously described language of the trust instrument, can it be any plainer that Ms. Nielsen intended to give up dominion and control of the trust property? We think not. The verbiage of the meticulous legal scrivener drove that point home.
>
> Though this analysis is sufficient for the proper disposition of the case, the obviously sincere efforts thoughtfully expended by the district court require further comment. We do not believe that Davenport points to the conclusion the district court reached. First, in that case, we looked to state law merely to determine whether the donor had an ownership interest in property she attempted to transfer to the donee. This search did not implicate a determination of whether the transfer was complete for federal tax purposes. Second, we did not hold that, for federal gift tax purposes, all essential state law elements of a valid gift must be satisfied. Indeed, whether a transfer is complete for federal tax purposes is strictly a matter of federal law.
>
> More importantly, the Supreme Court has made plain that the "elusive state of mind" involved in the formation of donative intent has been eradicated from the tax code by Congress. Commissioner v. Wemyss, 324 U.S. 303, 306 (1945). The Court has substituted the search for donative intent with the "much more workable external test, that where property is transferred for less than an adequate and full consideration in money or money's worth, the excess in such money value shall for purposes of the tax . . . be deemed a gift." Id. (internal quotes omitted) We conclude while a donor's intent to make a gift may be a helpful factor in the ultimate determination of whether a gift has been made, for federal tax purposes, that determination in no way turns upon the absence of evidence of such an intent.

3. **Self-Cancelling Installment Note**. The Sixth Circuit has upheld the general validity of SCINs and remanded to the Tax Court the question of valuation in Estate of Duilio Costanza, et al. v. Commissioner, 320 F.3d 595 (2003). The facts were simple:

> Duilio Costanza was born in Italy in 1919. He immigrated to the United States and worked as a welder for General Motors, Inc. in Flint, Michigan until 1966. Upon retiring from GM, Duilio opened an Italian restaurant on property he owned in Flint. He later built a small office plaza on nearby property that he also owned. Both properties were appraised in 1991 at a value of $830,000.
>
> In October of 1992, when he was 73 years old, Duilio wanted to return to Italy and sell his Flint properties. He accordingly sought the advice of his attorney, John Spath, who suggested that Duilio sell the restaurant and properties to Michael in exchange for a SCIN. In late December of 1992 or early January of 1993, Michael signed a SCIN in the amount of $830,000. A mortgage fully securing the obligation was recorded in February of 1993. The SCIN, which

> provided for payment in monthly installments over a period of 11 years, contained a cancellation-upon-death provision.
>
> Duilio orally told Michael that he need not make a payment every month, instead authorizing Michael to remit the payments on a quarterly basis. Accordingly, on March 8, 1993, Michael made the note payments for January, February, and March by means of three back- dated checks. Michael tendered no further payments on the SCIN prior to Duilio's death on May 12, 1993.
>
> Duitio unexpectedly died from a toxic reaction to bypass surgery performed the previous day. He had been suffering from heart disease during the final 15 years of his life. Nevertheless, Duilio's life expectancy at the time be executed the SCIN was between 5 and 13.9 years.
>
> As the executor of his father's estate, Michael filed a federal estate tax return declaring that the estate had no estate tax liability. The estate tax return identified the SCIN as an estate asset, but claimed that the note had no value to the estate due to the cancellation-upon-death provision.

The opinion states:

> Michael affirmatively testified that it was the Costanzas' intention for Michael to satisfy all of the payments due pursuant to the SCIN. Attorney Spath also testified that the Costanzas expected the note to be paid in full:
>
> > Q: Was Duilio Costanza willing to simply gift these properties to Michael?
> >
> > A: No.
> >
> > Q: Why not?
> >
> > A: Because . . . [h]e wanted payment over time so he could retire in Italy.
>
> The tax court, however, questioned the parties' sincerity, expressing concerns about the actual date the documents were signed, the date on which the three payments were made, and the fact that Michael altered the dates of the checks. But Michael satisfactorily explained all three circumstances. A brief delay in execution after the stated date of December 15, 1992 was simply due to the need of the attorney to pick a date upon which to base an amortization schedule where the documents were to be circulated by mail for signature. The fact that all of the documents were signed within several weeks thereafter is thus entirely inconsequential.
>
> As for the delay in making the first three installments, Michael testified that his father wanted to be paid "on a quarterly basis to limit the number of bank transactions." Although issuing three separate checks would not technically decrease the number of bank transactions, since the bank would need to process each check individually, this method of payment obviously served to ease the burden of having to deposit one check every month.
>
> The quarterly payment plan also explains why Michael altered the dates of the checks. As Michael explained in his brief, he re-dated the checks "so as to clearly document the months for which Note payments had been made." The

> fact that he obviously wrote a different date on top of the original dates is further evidence that he was not trying to hide anything by the alterations. Moreover, pursuant to Duilio's oral instructions concerning the payment plan, it is not surprising that Michael did not make another payment on the note after tendering the three checks in March. The next quarterly payment would not have taken place until June, which was after Duilio had died.
>
> Finally, the Commissioner argues that Michael and Duilio entered into the SCIN agreement because they presumed that Duilio would die prior to Michael fully satisfying the note. If they had thought Duilio would outlive the final payment due under the SCIN, the Commissioner reasons, there would have been no reason to have signed the SCIN, as opposed to an unconditional promissory note. This contention, however, basically questions the validity of any SCIN, an argument that the tax court has long since rejected. Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1981) (upholding the validity of a SCIN). See generally Sheldon I. Banoff & Michael O. Hartz, New Tax Court Case Expands Opportunities for Self- Cancelling Installment Notes, 76 J. Tax'n 332 (1992) (discussing the permissibility of and reasons for executing a SCIN).
>
> Moreover, despite Duilio's heart problems, there was no evidence that either Michael or Duilio presumed that Duilio would die within a few years of signing the SCIN, let alone within five months of the signing. Medical experts testified at trial that Duilio was expected to live somewhere between 5 and 13.9 years from the time that he signed the SCIN. His premature death due to complications from surgery was clearly not anticipated. In addition, the fact that the SCIN was fully secured by a mortgage on the properties further refutes any inference that the sale was not bona fide.
>
> The petitioners have thus rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. As such, we conclude that the tax court clearly erred in finding that the execution of the SCIN was not a bona fide transaction. Cf. Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995) (holding that the sale of property via a SCIN was not a bona fide transaction when the taxpayer declared that he was not likely to demand payment on the note).

Perhaps of most interest is the Circuit Court's reversal on factual findings.

4. **Restoration of Unified Credit**. In PLR 200334020 a widow assigned her interests in a marital trust but the assignment was invalid because of prohibitions in the husband's Will. The ruling restored the widow's unified credit/applicable exclusion.

5. **Tax Payments in Grantor Trust Context**. Rev. Rul. 2004-64, 2004-27, considers the gift tax consequences when a grantor pays the income tax on income attributable to assets in a grantor trust, and the estate tax consequences if the grantor may be reimbursed by the trust for such income tax payments under the instrument or applicable state law.

The fact situations contemplated are:

> During Year 1, Trust receives taxable income of $10*x*. Pursuant to § 671, *A* includes the $10*x* in *A*'s taxable income. As a result, *A*'s personal income tax liability for Year 1 increases by $2.5*x*. *A* dies in Year 3. As of the date of *A*'s death, the fair market value of Trust's assets is $150*x*.
>
> *Situation 1*: Neither State law nor the governing instrument of Trust contains any provision requiring or permitting the trustee to distribute to *A* amounts sufficient to satisfy *A*'s income tax liability attributable to the inclusion of Trust's income in *A*'s taxable income. Accordingly, *A* pays the additional $2.5*x* liability from *A*'s own funds.
>
> *Situation 2*: The governing instrument of Trust provides that if *A* is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee shall distribute to *A* for the taxable year, income or principal sufficient to satisfy *A*'s personal income tax liability attributable to the inclusion of all or part of Trust's income in *A*'s taxable income. Accordingly, the trustee distributes $2.5*x* to *A* to reimburse *A* for the $2.5*x* income tax liability.
>
> *Situation 3*: The governing instrument of Trust provides that if *A* is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to *A* for the taxable year, income or principal sufficient to satisfy *A*'s personal income tax liability attributable to the inclusion of all or part of Trust's income in *A*'s taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes $2.5*x* to *A* to reimburse *A* for the $2.5*x* income tax liability.

The Ruling is favorable as to Situation 1: no gift tax when the income tax is paid and no estate inclusion because no rights were retained.

With respect to Situation 2, the IRS was less favorable:

> In *Situation 2*, the governing instrument of Trust requires the trustee to reimburse *A* from Trust's assets for the amount of income tax *A* pays that is attributable to Trust's income. *A*'s payment of the $2.5*x* income tax liability does not constitute a gift by *A*, because *A* is liable for the tax. The trustee's distribution of $2.5*x* to *A* as reimbursement for the income tax payment by *A* is not a gift by the trust beneficiaries to *A*, because the distribution from Trust is mandated by the terms of the trust instrument.
>
> However, *A* has retained the right to have trust property expended in discharge of *A*'s legal obligation. *A*'s retained right to receive reimbursement attributable to Trust's income causes the full value of Trust's assets at *A*'s death ($150*x*) to be included in *A*'s gross estate under § 2036(a)(1). The result would be the same if, under applicable state law, the trustee must, unless the governing instrument provides otherwise, reimburse *A* for *A*'s personal income tax liability attributable to the inclusion of all or part of the Trust's income in *A*'s taxable income, and the governing instrument does not provide otherwise.

With respect to Trustee's discretion, Situation 3, the IRS was generally favorable assuming no express or implied understanding between grantor and beneficiary:

> In *Situation 3*, the governing instrument of Trust provides the trustee with the discretion to reimburse *A* from Trust's assets for the amount of income tax *A* pays that is attributable to Trust's income. As is the case in *Situation 1* and *Situation 2*, *A*'s payment of the \$2.5*x* income tax liability does not constitute a gift by *A* because *A* is liable for the income tax. Further, the \$2.5*x* paid to *A* from Trust as reimbursement for *A*'s income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to *A*. In addition, assuming there is no understanding, express or implied, between *A* and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy *A*'s obligation would not alone cause the inclusion of the trust in *A*'s gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses *A* from Trust assets for the amount of income tax *A* pays that is attributable to Trust's income. The result would be the same if the trustee's discretion to reimburse *A* for this income tax is granted under applicable state law rather than under the governing instrument. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between *A* and the trustee regarding the trustee's exercise of this discretion; a power retained by *A* to remove the trustee and name *A* as successor trustee; or applicable local law subjecting the trust assets to the claims of *A*'s creditors) may cause inclusion of Trust's assets in *A*'s gross estate for federal estate tax purposes.

Trusts created before October 4, 2004 are grandfathered for Situation 2 but not Situation 3. Suppose a Situation 3 trust exists where the trustee has reimbursed the grantor or other facts suggest an understanding? May the trust be reformed prior to October 4, 2004 to be a Situation 2 trust and thereby protected? The application of the Ruling to Crummey trusts must be considered as well.

O. SECTION 2518 - DISCLAIMERS

1. Disclaimer of Remainder Interests. In Thomas J. Walshire, et al. v. United States, 288 F.3d 342 (8th Cir. 2002), the Eighth Circuit upheld the validity of the Treasury Regulations under section 2518 which prohibit the disclaimer of a remainder interest while keeping the life interest. The opinion states:

> Walshire attempted to disclaim a portion of the property he was entitled to receive from his brother by dividing it horizontally, that is, by disclaiming the remainder interest but retaining the right to the income and use of the property during his lifetime, or the life estate. The regulation at issue in this case requires that the undivided portion "consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property and must extend over the entire term of the disclaimant's interest in such property and in other property into which such property is converted." Treas. Reg. §§ 25.2518-3(b). In other words, the regulation requires a vertical division of the property. The regulation specifically excludes the disclaimer attempted by Walshire. See *id.* ("Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimant disclaims a remainder interest in Blackacre but retains a life estate.")

The executors argue that the regulation is contrary to the plain language of §§ 2518(a), which allows the disclaimer of "any interest in property." The executors argue that a remainder interest is "any interest in property" as that phrase is used in §§ 2518(a) and that Walshire did not partition the remainder interest but disclaimed all of it, so that we need not even look at §§ 2518(c). This construction interprets subsection (a) in isolation. Congress specifically enacted subsection (c) as a limitation on subsection (a). See I.R.C. §§ 2518(c) ("For purposes of subsection (a) . . . ."). To allow the disclaimant to partition the interest bequeathed to him in any manner he chooses as "any interest in property" under §§ 2518(a) ignores the requirement in §§ 2518(c) that only an "undivided portion" of an interest may be disclaimed and violates a fundamental rule of statutory interpretation to give effect to all words and phrases used in the statute. See Herman v. Associated Elec. Co-op., Inc., 172 F.3d 1078, 1081 (8th Cir. 1999). We therefore must construe subsection (a) in light of subsection (c) since Walshire attempted to disclaim only a portion of what he was entitled to receive under his brother's will.

The executors argue that even under subsection (c), a remainder interest falls within the clear and unambiguous meaning of an "undivided portion of an interest." I.R.C. §§ 2518(c). The statute does not define "undivided portion of an interest" as that term is used in §§ 2518(c) and we find the term to be, at best, ambiguous. Because "the statute is silent . . . with respect to the specific issue" of whether a horizontal division of property could be considered an undivided portion of an interest, we must determine "whether the agency's [regulation] is based on a permissible construction of the statute." Miller, 65 F.3d 690 (internal quotations omitted) (construing the failure to define a term as "an implicit legislative delegation of authority to the Commissioner to clarify" the undefined term).

The term "undivided" in its common usage means "not separated out into parts or shares." Webster's Third New International Dictionary 2492 (1986). We are most familiar with the concept of undivided interests in the context of a tenancy in common, which is "[a] tenancy by two or more persons, in equal or unequal undivided shares, each person having an equal right to possess the whole property." Black's Law Dictionary 1478 (17th ed. 1999). "'The central characteristic of a tenancy in common is simply that each tenant is deemed to own by himself, with most of the attributes of independent ownership, a physically undivided part of the entire parcel.'" *Id.* (quoting Thomas F. Bergin & Paul G. Haskell, Preface to Estates in Land and Future Interests 54 (2d ed. 1984)). From these uses of the term "undivided," we discern that an undivided portion of an interest is a portion that does not separate out the bundle of rights associated with the interest being apportioned. Thus, if a disclaimant is bequeathed a fee interest, as was Walshire, an undivided portion of that interest would have to include all of the rights associated with the fee. Apportioning a fee into a life estate and a remainder interest does not give the remainder interest all of the rights associated with a fee because the remainderman is not entitled to immediate possession, a fundamental right of a fee holder. A remainder interest simply is not an undivided portion of the fee. See Estate of Brock v. Comm'r2, 630 F.2d 368, 369 n. 1 (5th Cir. 1980) (addressing similar terminology under I.R.C. §§ 170(f)(3)(B), which allows a charitable deduction for a contribution of "an undivided portion of the decedent's entire interest in property," and noting that "it cannot be contended seriously that the church received an undivided interest in the property" where decedent left a life estate to his wife and a remainder interest to the church). We do not believe it was unreasonable for the Secretary to determine that such a division does not meet the definition of an undivided portion when it promulgated the regulation that allows only vertical

> divisions of an interest, as opposed to horizontal divisions, to come within the purview of §§ 2518.

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

1. **Extension to Allocate GST Exemption**. Rulings have begun to be issued with respect to section 9100 relief and late allocations of GST exemptions. To date, the ruling position seems liberal. See, e.g., PLR 200227017, 2002234026, 200320006, 200320009, 200320010, 200320016, 200318005, 200318006, 200318007, 200318008, 200318009, 200318010, 200318011, 200318012, 200318013, 200318014, 200318056, 200318057, 200318063, 200317012, 200317013, 200316031, 200316033, 200316034, 200316035, 200316036, 200315006, 200315008, 200315023, 200314006, 200314010, 200313008, 200313012, 200313013, 200311009, 200311013, 200310013, 200310016, 200309005, 200309007, 200309010, 200309026, 200308037, 200307078, 200307082, 200307088, 200306015, 200306016, 200306017, 200306018, 200306020, 200306031, 200306035, 200305022, 200304024, 200303022, 200303053, 200302017, 200302033, 200302035, 200302037, 200302038, 200301027, 200301028, 200301037. The standards are:

> Section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

2. **Determination of Inclusion Ratio**. PLR 200343019 dealt with calculating a trust's inclusion ratio, specifically the effect of various expenses paid from the trust upon its termination. The ruling states:

> In this case, Trust became irrevocable upon Grantor's death on Date 2. Trust provided Spouse with the lifetime use of a residence and a monthly payment of an amount that was subject to an adjustment by the trustee. The denominator is the value of the property transferred to the trust reduced by Federal estate tax and State death actually recovered from the trust attributable to the property. Expenses that would not have been incurred but for the decedent's death and the resulting necessity of collecting assets, paying debts, and distributing property are excluded from the value of the property that passes to trust. The estate paid $F for medical expenses incurred by Grantor during his life. The estate also paid other expenses relating to the collection of Grantor's assets, paying his debts and distributing his property. Theses expenses included attorney's fees of $C; accountant's fees of $D; appraiser, expert, and other professional fees totaling $E. The amounts paid for these expenses are properly excluded from the value of the property that passes to trust for purposes of § 2642(a)(2)(B).
>
> On the other hand, expenses of maintaining the trust after the amount that passes to the trust has been established are not excluded from the value of the property that passes to trust. Such expenses include the interest expense on the underpayment of Federal estate and state death taxes. These expenses are not excluded from the value of the property that passes to trust for purposes of § 2642(a)(2)(B).
>
> Finally, the total Federal estate tax and State death tax due was $G. Section 2642(a)(2)(B) provides that the denominator is the value of the property transferred to the trust (or involved in the direct skip), reduced by (ii) the sum of (I) any Federal estate tax or state death tax actually recovered from the trust

> attributable to such property. In this case, the total Federal estate tax and State death tax of $G was paid from assets of the Trust. This amount is properly excluded from the value of the property that passes to trust for purposes of § 2642(a)(2)(B).

3. **Section 2038 Produces ETIP**. In PLR 200419011the taxpayer spouses created trusts and were advisors with the power to approve principal distributions by trustee. As originally drafted the trust lacked ascertainable standards. Subsequently:

> Donor and all other interested parties, including Child 1, Child 2, and Child 3 in their capacities as trustees and beneficiaries, and the grandchildren as beneficiaries, obtained a court order that retroactively reformed Article VII(A)(2) and Article VIII(A)(2) of each of the seven trusts to include certain language that the parties contended had been omitted from the trust documents. Pursuant to the court order, Article VII(A)(2) and Article VIII(A)(2) were each reformed to read as follows:
>
>> 2. The Trustee is authorized and empowered in the Trustee's sole and absolute discretion at any time and from time to time, during the lifetime of said beneficiary, to disburse from the principal of the trust estate created under this Article (even to the point of completely exhausting same), such amounts as the Trustee may deem advisable to provide adequately and properly for the support and maintenance of the said beneficiary thereof, including but not by way of limitation, expenses incurred by reason of illness, disability and education. In determining the amount of principal to be so disbursed, the Trustee shall take into consideration any other income or property which such beneficiary may have from any other source; and the Trustee's discretion shall be conclusive as to the advisability of any such disbursement and the same shall not be questioned by anyone. For all sums so disbursed, the Trustee shall have full acquittance. [Emphasis added].
>
> The parties contended that the italicized language was contained in early drafts of the trusts, but had been inadvertently deleted from the final versions that were executed by Spouse and Donor. In conjunction with a civil law suit, the parties involved had been deposed on issues concerning the creation of the trusts, including the deletion of the language at issue, (hereinafter referred to as ascertainable standard language). These depositions formed part of the record in the reformation action.

The IRS did not give effect to the reformation:

> Section 30-4-3-25 of Ind. Code Ann. (Michie 2002) provides:
>
>> Recission and reformation. -- Upon petition by an interested party, the court may rescind or reform a trust according to the same general rules applying to rescission or reformation of nontrust transfers of property.
>
> In Estate of Reasor v. Putnam County, Indiana, 635 N.E. 2d 153 (Ind. 1994), the Indiana Supreme Court noted that written instruments are presumed to reflect the intentions of the parties to those instruments. Accordingly, ". . . to succeed in a reformation action a party must show either mutual mistake or fraud by clear and convincing evidence . . . [and] a party seeking reformation must also show

> the original intent or agreement of the parties by clear and convincing evidence. "Estate of Reasor v. Putnam County, Indiana, 635 N.E. 2d at 160. See also, Heavenridge v. Mondy, 49 Ind. 434 (Ind. 1875) ("It is settled law, that to entitle a party to the reformation of a written instrument, it must be clearly and satisfactorily shown that there was a mistake of fact, and not of law. It must be shown that words were inserted that were intended to be left out, or that words were omitted which were intended to be inserted."); Seufert v. Mulzer, 2000 U.S. Dist. Lexis 13665 (S.D. Ind. 2000) (Indiana law is in accord with the principle enunciated in Bogert & Bogert, The Law of Trusts and Trustees, 991 (2d ed. rev. 1983) to the effect that reformation will not be granted where the mistake was as to the legal effect of the wording of the instrument.)
>
> In the instant case, we do not believe the record provides clear and convincing evidence that a mistake of fact was made, as required under Indiana law. On the contrary, in the depositions noted above, Attorney testified that he had no recollection of why the ascertainable standard language was removed. On the other hand, there is specific testimony from Accountant that Spouse intended to delete the ascertainable standard language and that Spouse and Donor intended to make the invasion power very broad, and that Attorney had to be aware of the changes. Further, as discussed above, the actions of the trustees in managing the assets of the trusts have been consistent with the absence of any limitation that would have been imposed by the ascertainable standard language. Thus, our review of the record does not indicate that there was "clear and convincing evidence" of a mutual mistake or clear and convincing evidence that the terms of the executed instrument were contrary to the original intent of the grantors, the standard for reformation under Indiana law. Estate of Reasor v. Putnam County, Indiana, cited above. Thus, we conclude the reformation should not be given retroactive effect for transfer tax purposes.

Thus, section 2038 applied to created an ETIP:

> Donor and Spouse were members of the Advisory Committee from the creation of the trusts on Date 1, until their resignations on Date 4. Article XIII requires that the trustee consult with the Advisory Committee on all important matters, including discretionary payments of principal. Under the Article, the trustee is prohibited from taking any action involving discretionary payments of income and of principal without the unanimous consent or approval of the Advisory Committee. Only if the Advisory Committee fails to act within the time prescribed, may the trustee act in its own discretion "as if no Advisory Committee had been appointed." In addition, the Advisory Committee, acting unanimously and at its own discretion, may remove and replace an acting trustee and/or select a successor trustee, at any time and upon the death, incapacity, or resignation of a current trustee.
>
> As discussed above, we have concluded that the trustee's power to distribute corpus was not limited by an ascertainable standard. Accordingly, if this power was held directly by Donor and Spouse, as trustees, the corpus of each trust would be subject to inclusion in their respective gross estates under § 2038, to the extent of their contributions to the trusts. Rev. Rul. 73-143, cited above. In this case, although neither Donor nor Spouse were trustees, as members of the Advisory Committee, their consent was required before the trustee could make any distribution. The fact that this consent or veto power could be exercised only after the trustees initiated action does not alter the nature of the power as a power exercisable by Donor or Spouse in conjunction with others, within the

> purview of § 2038. Rev. Rul. 70-513, 1970-2 C.B. 194, citing Estate of Grossman v. Commissioner, 27 T.C. 707 (1957).1
>
> Because Donor and Spouse initially retained a power over the trusts that would cause trust property to be included in their gross estates under § 2038, the transfers by Donor and Spouse to the trusts were subject to an "estate tax inclusion period" under § 2642(f)(3), for purposes of the generation-skipping transfer tax. The estate tax inclusion period did not terminate until Date 4, the date that Donor and Spouse resigned from the Advisory Committee with respect to each of the trusts.
>
> Accordingly, for purposes of the generation-skipping transfer tax, an estate tax inclusion period did exist with respect to the transfers made by Donor and Spouse to the trusts.

Q. SECTIONS 2701-2704 - SPECIAL VALUATION RULES

1. **Family Limited Partnerships**. Taxpayers have won arguments that neither section 2703 nor 2704(b) apply (but see the section 2036 discussion above).

The Tax Court allowed a combined 40% minority and marketability discount in Estate of Elma M. Dailey, et al. v. Commissioner, T.C. Memo. 2001-263, 82 T.C.M. (CCH) 710. The FLP transaction was straightforward:

> On October 20, 1992, Mrs. Dailey executed a will, a Revocable Living Trust (Trust), and an Agreement of Limited Partnership (Agreement) of Elma Middleton Dailey FLP. The will provided that Mrs. Dailey's residuary estate would pass to the Trust, from which her son would receive the corpus outright.
>
> Upon execution of the Agreement, Mrs. Dailey took a 1- percent general and a 98-percent limited partnership interest, and Mr. Dailey [her son] received a 1-percent limited partnership interest. On November 13, 1992, Mrs. Dailey contributed, to the FLP, 400 AT&T, 20,000 Exxon, and 895 Bell South Corp. shares. Mr. Dailey did not contribute any assets to the FLP. On December 4, 1992, the Texas Secretary of State filed the FLP's Certificate of Limited Partnership.
>
> On December 8, 1992, Mrs. Dailey signed a letter which stated that by "the terms of the Elma Middleton Dailey Family Limited Partnership, this letter shall be sufficient evidence of my transfer and conveyance to you of the following limited partnership interest", giving 45-, 15-, and 38-percent interests to Mr. Dailey, his wife, and the Trust, respectively.
>
> * * * * * *
>
> On March 16, 1995, Mrs. Dailey appointed Mr. Dailey as the FLP managing partner. On July 26, 1995, he replaced her as the trustee of the Trust and FLP general partner, and her 1-percent general partnership interest became a limited one.

Mrs. Dailey died on January 10, 1997.

The opinion first discusses whether the FLP should be respected for valuation purposes. The entire discussion is as follows:

> The FLP was validly formed pursuant to Texas law, and we do not disregard it for tax purposes. See Estate of Strangi v. Commissioner, 115 T.C. 478, 487 (2000); Knight v. Commissioner, 115 T.C. 506, 513-515 (2000).

The court declined to value the interests as assignee interests and went on to discuss the discount issue:

> Mrs. Dailey gave Mr. Dailey a 1-percent limited partnership interest on formation, but the FLP had no assets on that date. Mrs. Dailey made gifts of 45- and 15-percent limited partnership interests to her son and daughter-in-law, respectively, and thus retained 39 percent in the trust at death. The parties stipulated, however, that Mrs. Dailey retained 40 percent. Respondent inexplicably does not contend that the initial 1-percent limited partnership interest transferred to Mr. Dailey had gift tax consequences at formation or funding.
>
> Both parties agree that the given and retained interests were, on December 8, 1992, and January 10, 1997, worth their proportionate share of the NAV of $1,267,619 and $1,047,603 for gift and estate tax purposes, respectively. They disagree, however, about the size of the minority and marketability discounts. Both parties' experts compared the FLP to closed-end mutual funds, which trade at a discount to NAV, but disagreed on the amounts of the discounts. Petitioners' expert, citing published data, opined that the aggregate discount is 40 percent for lack of marketability, control, and liquidity and testified that he considered the significant amount of unrealized capital gains relating to the Exxon stock.
>
> Respondent's expert, on the other hand, relied in part on an unpublished study that he coauthored and, in a revised report submitted at trial, increased the marketability discount purportedly substantiated by his unpublished study from 12.5 percent to 14.1 percent. Respondent's expert opined that an aggregate discount of 15.72 percent on December 8, 1992, and 13.51 percent on January 10, 1997, should be applied. At trial, respondent's expert testified that he could not recall reviewing the Agreement and, although he believed that unrealized capital gains are "an important source of discounts", he did not review the documents to determine if the FLP had any such gains. Respondent's expert's testimony was contradictory, unsupported by the data, and inapplicable to the facts.

In Charles T. McCord v. Commissioner, 120 T.C. No. 13 (2003), the IRS presented expert testimony as did the taxpayer. The net result was a 15% minority interest discount and 20% lack of marketability discount on the marketable securities portion of the partnership. Essentially the court averaged the various studies of comparable transactions with which it was presented.

In Clarissa W. Lappo v. Commissioner, T.C. Memo 2003-258, the issue was the valuation of a limited partnership interest owning real estate and marketable securities. Mother retained the general partnership interest (1%) and gave away her 98.7% limited partnership interest. The Court allowed a minority interest discount of 8.5% for the marketable securities component and 19% for the real estate component. With respect to lack of marketability, the Court allowed 24%. The taxpayer's expert was from Management Planning, Inc.; the government expert was a professor from USC. The Court indicated a preference for private placement studies over restricted stock studies. Section 2036 was not at issue.

A similar transaction was addressed in Peter S. Peracchio v. Commissioner, T.C. Memo 2003-2809, where the partnership owned only cash and marketable securities. The Court found both experts unhelpful because neither explained how various restricted stock studies related to the facts before the court. The Court allowed a 6% minority interest discount and 25% lack of marketability discount.

2. **Qualified Personal Residence Trust Form**. Rev. Proc. 2003-42 contains a form for a Qualified Personal Residence Trust. The form is not surprising. With respect to a sale back to the grantor the form provides:

> Prohibition on Sale of Residence to Transferor or Related Parties. The Trustee is prohibited from selling transferring (as defined in § 25.2702-5(c)(9) of the regulations) the Residence, directly or indirectly, to the Transferor, the Transferor's spouse, or an entity controlled by the Transferor or the Transferor's spouse during the retained term interest of the QPRT, or an any time after the termination of the retained term interest in the QPRT while the trust is treated as owned in whole or in part by the Transferor or the Transferor's spouse under §§ 671 through 678 of the Code.

The Annotation states:

> (4) Prohibition on Sale of Residence to Transferor or Related Person (Article II, Paragraph B(5)). The governing instrument must prohibit the trust from selling or transferring the residence directly or indirectly to the transferor, the transferor's spouse, or an entity controlled by the transferor or the transferor's spouse during the retained term interest in the trust or any time after the expiration of that interest when the trust is a grantor trust. For these purposes: (A) a sale or transfer to another grantor trust of the transferor or the transferor's spouse is considered a sale or transfer to the transferor of the transferor's spouse; and (B) a "grantor trust" is a trust that is treated as owned in whole or in part by the transferor or the transferor's spouse pursuant to §§ 671 through 678, and "control" is as defined in § 25.2701-2(b)(5)(ii) and (iii).
>
> This prohibition, however, does not apply to a distribution for no consideration either to: (i) another grantor trust of the transferor or the transferor's spouse, if the distributee-grantor trust includes the same prohibition against a sale or transfer; (ii) the transferor's spouse after the term of the QPRT; or (iii) any person pursuant to the trust instrument or the exercise of the transferor's retained power of appointment, if any, if the transferor dies prior to the expiration of the retained term interest. Section 25.2703-5(c)(9).

3. **Effect on Buy-Sell Agreement**. The Tax Court disregarded a buy-sell agreement in Estate of George C. Blount v. Commissioner, T.C. Memo 2004-116, in determining the value of closely-held stock (BBC). The court found that the agreement allowed the decedent to amend it unilaterally, thus the agreement's restrictions on lifetime transfers could have been eliminated and under pre-section 2703 law the buy-sell was ineffective to set

the price of shares subject to it. Further, in 1996 the agreement was amended, thus blowing the section 2703 grandfather.

The court also addressed the effect of life insurance payable to the company and the corporate obligation to redeem stock from the decedent's estate:

> We turn next to the question of how to account for the $3,146,134 million in life insurance proceeds BCC was due to receive on decedent's death and BCC's $4 million obligation to redeem decedent's shares, as set forth in the Modified 1981 Agreement. Mr. Fodor excluded both the insurance proceeds and the redemption obligation when determining BCC's value on the theory that the insurance proceeds were offset by the redemption obligation. In contrast, Mr. Hitchner included the insurance proceeds in valuing BCC, adding their value to his $7 million "concluded" value for BCC, while disregarding the redemption obligation.
>
> Respondent argues that the insurance proceeds must be included in BCC's value as a nonoperating asset, relying on section 20.2031-2(f), Estate Tax Regs., and Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976). In contrast, the estate argues that, while insurance proceeds might be a nonoperating asset, under Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999), affg. in part and remanding in part T.C. Memo. 1996-286, they must be offset by BCC's obligation to redeem decedent's shares, and therefore do not affect BCC's value.
>
> Estate of Huntsman makes clear that insurance proceeds are treated like any other nonoperating asset when determining a closely held corporation's value. Estate of Huntsman v. Commissioner, supra at 874; see also sec. 20.2031-2(f), Estate Tax Regs. (" consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity"). Whether BCC's $4 million obligation to redeem decedent's shares offsets the life insurance proceeds, as the estate argues, is another question. In Estate of Huntsman, we reasoned that, because life insurance proceeds should be treated like any other nonoperating asset, to the extent such assets were considered in valuing a company, they were subject to offset by corporate liabilities. However, we were not presented in that case with the question of whether a corporation's obligation to redeem the very shares that are to be valued should be treated as a liability, offsetting corporate assets.34 The estate here urges that we treat BCC's enforceable $4 million obligation to redeem the shares whose value is at issue as a liability offsetting BCC's assets (i.e., the $3,146,134 life insurance proceeds plus almost $1 million in other assets) in arriving at the value of the same shares.
>
> We decline to do so for two reasons. First, we have concluded that the agreement under which BCC was obligated to redeem decedent's shares for $4 million must be disregarded under both section 20.2031-2(h), Estate Tax Regs., and section 2703. In such circumstances, the terms of the disregarded agreement are generally not taken into account in determining the fair market value of the shares subject to the agreement. Estate of True v. Commissioner, T.C. Memo. 2001-167; Estate of Lauder v. Commissioner, T.C. Memo. 1994-527; see also Estate of Godley v. Commissioner, T.C. Memo. 2000-242, affd. 286 F.3d 210 (4th Cir. 2002). As we noted in Estate of Lauder, under these circumstances, the willing buyer/seller analysis would be distorted if we disregarded the buy-sell

agreement for purposes of fixing the value of the subject stock, yet allowed provisions in the agreement to be taken into account when determining the stock's fair market value. Thus, it would be improper here to consider the redemption obligation in the disregarded buy-sell agreement when determining the fair market value of the stock covered by that agreement.

Second, even if the impact of the redemption obligation on BCC's value were not disregarded under the principles of Estate of Lauder and like cases, the redemption obligation should not be treated as a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued. To do so would be to value BCC in its postredemption configuration; namely, after decedent's shares had been redeemed and BCC's assets had been contracted by the $4 million redemption payment. Valuing decedent's 43,080 shares by means of the hypothetical willing buyer/seller construct necessarily requires that the corporation's actual obligation to redeem the shares be ignored; such a stance is inherent in the fiction that the shares are being sold to a hypothetical third-party buyer on the valuation date rather than being redeemed by the corporation. To the hypothetical willing buyer, decedent's 43,080 BCC shares constituted an 83.2-percent interest in all of the assets and income-generating potential of BCC on the valuation date, including any assets that might be used to satisfy the actual redemption obligation. To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.

By contrast, a hypothetical willing buyer of BCC shares other than decedent's would treat the redemption obligation, on the valuation date, as a corporate liability of BCC, but only in connection with a simultaneous accounting of the impact of the redemption of decedent's shares on the ownership interest inherent in the other shares not being redeemed.

A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $500,000. If, at B's death, X's $500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $500,000 ($1 million cash less a $500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $250,000 (i.e., one half of the corporation's $500,000 value35) upon B's death. Yet if B's shares are then redeemed for $500,000, A's shares are then worth $500,000 -- that is, A's 50 shares constitute 100-percent ownership of a corporation with $500,000 in cash.

It cannot be correct either that B's one-half interest in $1 million in cash is worth only $250,000 or that A's one-half interest in the remainder shifts from a value of $250,000 preredemption to a value of $500,000 postredemption.

The error with respect to B's shares in the example lies in the treatment of X's redemption obligation as a claim on corporate assets when valuing the very shares that would be redeemed with those assets. With respect to A's shares, a willing buyer would pay $500,000 upon B's death (not $250,000) because he would take account of both the liability arising from X's redemption obligation and the shift in the proportionate ownership interest of A's shares occasioned by the redemption -- but never the former without the latter.36

The estate's reliance on Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999), is misplaced, as that case is distinguishable. Estate of Cartwright involved a law firm (organized as a C corporation) that entered into a buy-sell agreement with its majority shareholder. The parties agreed that the firm would purchase from the shareholder's estate his shares and his interest in the fees for the firm's work in progress at his death. The consideration for this purchase was designated as the proceeds from two $2.5 million life insurance policies on the shareholder's life that the firm was required to obtain under the agreement.

Upon the shareholder's death, the firm paid the $5,062,02937 insurance proceeds to the shareholder's estate. The taxpayer took the position that the entire $5,062,029 was paid for the shareholder's stock, whereas the Commissioner determined that approximately $4 million was paid for the shareholder's interest in work in progress (and, therefore, was income in respect of a decedent). Concluding that the insurance proceeds were consideration for both the stock and the shareholder's interest in work in progress, this Court undertook to allocate the consideration between the two by determining the stock's fair market value at the shareholder's death, and treating the insurance proceeds in excess of that fair market value as consideration paid for the shareholder's interest in work in progress. In determining the fair market value of the stock, we rejected the taxpayer's argument that the $5 million in insurance proceeds should be treated as a nonoperating asset of the firm, augmenting the value of its stock, on the grounds that the insurance proceeds were offset by the firm's obligation to pay them over to the estate. In so concluding, we relied on Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976), as follows: "We said in Estate of Huntsman that a buyer would not pay more for stock based on the corporation's ownership of life insurance if the proceeds would be largely offset by the corporation's liabilities. That is the case here." Estate of Cartwright v. Commissioner, T.C. Memo. 1996-286 (citation omitted). The Court of Appeals for the Ninth Circuit affirmed our position that the life insurance proceeds would not be considered by a hypothetical willing buyer in these circumstances. Estate of Cartwright v. Commissioner, 183 F.3d at 1038.

Estate of Cartwright is distinguishable. The lion's share of the corporate liabilities in that case which were found to offset the insurance proceeds were not obligations of the corporation to redeem its own stock. Rather, we determined that approximately $4 million of the $5 million liability of the corporation was to compensate the decedent shareholder for services; i.e., for his interest in work in progress. Thus, a substantial portion of the liability was no different from any third-party liability of the corporation that would be netted against assets, including insurance proceeds, to ascertain net assets.

Concededly, a portion of the liability in Estate of Cartwright constituted an obligation to redeem stock being valued. Nonetheless, in contrast to the instant case, the buy-sell agreement in Estate of Cartwright had not been disregarded pursuant to section 20.2031-2(h), Estate Tax Regs., or section 2703; indeed, our principal task in Estate of Cartwright was to construe the terms of the buy-sell agreement, which was fully respected. Given the disregarded status of the buy-sell agreement at issue here, Estate of Cartwright has no application.

Accordingly, we conclude that the $3,146,134 in insurance proceeds due BCC upon decedent's death should be treated as a nonoperating asset of BCC and is not offset by BCC's $4 million obligation to redeem decedent's shares.

R. SECTION 6166 — EXTENSION OF TIME TO PAY TAX

1. **Use of Single-Member LLCs**. In PLR 200321006 the IRS determined that single member LLCs, or disregarded entities, had no effect on a section 6166 election. The ruling states:

> Decedent died on Date 1, a resident of State X. Decedent's gross estate consisted primarily of a sole proprietorship. The sole proprietorship was engaged in direct farming operations of various crops on Y acres of land owned and/or leased by Decedent. In addition, the sole proprietorship was engaged in storage and processing functions with respect to those crops. Up until his death, Decedent was actively involved in all aspects of the farming, storage, and processing operations. The interest in the sole proprietorship included in Decedent's gross estate qualified as an interest in a closely held business within the meaning of section 6166(b)(1). As a result, the personal representative of Decedent's estate elected under section 6166 to pay the portion of estate tax attributable to the value of Decedent's interest in the sole proprietorship in installments. Decedent's estate timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return on Date 2 and included a section 6166 election.
>
> Pursuant to the terms of Decedent's will, the majority of Decedent's assets were distributable to a residuary trust with three primary beneficiaries, A, B, and C. A and B are sons of Decedent. While C was raised by Decedent and changed his last name to that of Decedent's, C is not a blood relative of Decedent. Decedent's will expressed the intent that the beneficiaries continue the farming operations.
>
> Decedent's will authorized the trust to lease portions or all of the Y acres of land to the trust beneficiaries, provided that the beneficiaries personally operate the farm. Decedent's will further provided that in the event the trust beneficiaries, individually or any combination of them, are the sole owners of a farming entity, a lease to such entity is authorized. In accordance with these terms, Decedent's estate has entered into cash leases under which it has leased certain of the Y acres of farmland to LLC 1 and LLC 2. The leases are based on a fixed cash price per acre. LLC 1 and LLC 2 were formed for the purpose of conducting Decedent's farming operations.
>
> LLC 1 is a limited liability company formed under State X law with A as its sole owner. It is a disregarded entity for all federal tax purposes and its activities are treated in the same manner as a sole proprietorship of A. See Treas. Reg. § 301.7701-2(a). Similarly, LLC 2 is a limited liability company formed under State X law with C as its sole owner. Consequently, LLC 2 is treated as a sole proprietorship of C for federal tax purposes.
>
> * * *
>
> The change in this case, from operating the farm operations as a sole proprietorship to entering into cash leases with LLC 1 and LLC 2, owned and operated by A and C respectively, does not materially alter the business. LLC 1 and LLC 2 are disregarded entities for all federal tax purposes and their activities are treated in the same manner as sole proprietorships of A and C, respectively. LLC 1 and LLC 2 continue the farming operations in the manner previously performed by Decedent. Given LLC 1's status as a disregarded entity for all federal tax purposes and LLC 1's close relationship to A, leasing the land to LLC 1 should be viewed as leasing the land to A. In substance, LLC 1 is

> **merely a trade name by which A conducts the farming business. Similarly, LLC 2 is a trade name by which C conducts the farming business. Therefore, the lease transactions will not result in the acceleration of the estate tax installments.**

S. TAX ADMINISTRATION

1. **Tax-Apportionment; GST**. In Estate of Mildred Green v. Commissioner, T.C. Memo 2003-348, the decedent left one-half of her residuary estate to charity and the other half to a trust for her grandchildren. After a valuation dispute, GST tax was owed to the government. The decedent's tax clause directed GST tax on direct skips to be paid from the residuary estate, which reduced the charitable deduction.

2. **Tax Shelter, Anti-Abuse Efforts**. On December 29, 2003 Treasury issued T.D. 9108, final regulations dealing with confidential transactions; T.D. 9109, final regulations dealing with defenses to accuracy related penalties for failure to disclose reportable transactions or that a return position is contrary to a regulation; and REG-122379-02, proposed amendments to Circular 230.

3. **Duty of Consistency.** In Estate of Rose B. Posner v. Commissioner, T.C. Memo 2004-112, the court determined that a trust was not included in a surviving spouse's estate because she had no general power of appointment. However, when the first spouse had died, in 1975, the IRS had allowed a marital deduction thinking she did.

One of the issues was the duty of consistency, which the opinion described as follows:

> As developed in caselaw, the duty of consistency (sometimes called quasi-estoppel) prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the time to assess tax for the earlier year has expired. Estate of Letts v. Commissioner, 109 T.C. 290, 296 (1997), affd. without published opinion 212 F.3d 600 (11th Cir. 2000). The duty of consistency may apply if: (1) The taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations. Id. at 297; LeFever v. Commissioner, 103 T. C. 525, 543 (1994), affd. 100 F.3d 778 (10th Cir. 1996).
>
> Spouses, as well as their estates, may have sufficient identity of interests so that one may be estopped under the duty of consistency by a prior representation of the other. Estate of Letts v. Commissioner, supra at 298; Cluck v. Commissioner, 105 T.C. 324, 333-336 (1995). Respondent contends that Mr. Posner's estate and decedent's estate have sufficient identity of interests that the duty of consistency is applicable. For purposes of this discussion, we assume, without deciding, that there was privity of interest between Mr. Posner's estate and decedent's estate.
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> **On brief, respondent acknowledges that the duty of consistency applies "if the inconsistency is a question of fact or a mixed question of fact and law. It does not apply to mutual mistake on the part of a taxpayer and the Service concerning a pure question of law." See LeFever v. Commissioner, 100 F.3d at 788; Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), affg. Glass v.**

> Commissioner, 87 T.C. 1087 (1986); S. Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 560 (1980); Unvert v. Commissioner, 72 T.C. 807, 816 (1979), affd. 656 F.2d 483 (9th Cir. 1981). With little elaboration, respondent contends on brief that the inconsistency in question here is a "mixed question of fact and law", so that the duty of consistency applies. We disagree.
>
> In Crosley Corp. v. United States, 229 F.2d 376, 380 (6th Cir. 1956), the Court of Appeals for the Sixth Circuit noted that the duty of consistency "is probably applicable in cases where the factual situation is such as to justify the taxpayer in taking either of two possible positions" but generally does not apply "when the error is one of law arising out of a definite factual situation". In the instant case, the inconsistency arose because of a mutual mistake in deciding how Mr. Posner's will should be construed under Maryland law -- a purely legal issue. See McIntyre v. Byrne, 141 A. 2d 692, 695 (Md. 1958) ("The construction of a will is a matter of law for the court to determine"). Mr. Posner's estate did not misrepresent the property or type of property that Mr. Posner had devised to decedent. Respondent has not alleged any facts to show that the estate has been inconsistent with respect to any factual positions or to suggest that the inconsistency in question arose from anything other than a purely legal error in the context of "a definite factual situation". Crosley Corp. v. United States, supra at 380.

The interpretation of the Will was at issue in prolonged litigation in state court. The executor ultimately lost the argument, which the court found important:

> Moreover, the duty of consistency "does not apply where all pertinent facts are known to both the Commissioner and the taxpayer", especially if "the crucial facts are known to both parties and the erroneous deductions are due to a mutual mistake of law." S. Pac. Transp. Co. v. Commissioner, supra at 560; cf. Interlochen Co. v. Commissioner, 232 F.2d 873 (4th Cir. 1956), affg. 24 T.C. 1000 (1955); Hull v. Commissioner, 87 F.2d 260, 262 (4th Cir. 1937) (stating that "a party either knowing the facts, or in a position to know them, cannot claim the benefit of estoppel"), revg. 33 B.T.A. 178 (1935). In the instant case, respondent had reason to know all the relevant facts. When Mr. Posner's estate filed its estate tax return, it adequately disclosed the relevant facts and documents, attaching a copy of Mr. Posner's will.15 Respondent audited the estate tax return of Mr. Posner's estate and allowed the marital deduction.16 Respondent has not alleged any facts to suggest that this audit was insufficient in any regard other than in the failure to apply the law correctly. Under these circumstances, respondent cannot be viewed as justifiably relying on the legal representation on the estate tax return of Mr. Posner's estate.
>
> The executor of Mr. Posner's estate and the executor of decedent's estate, as well as respondent's agents upon audit of Mr. Posner's estate's estate tax return, all acted in accordance with the mutual mistake of law that Mr. Posner's will gave decedent a general power of appointment. Indeed, when he filed the estate tax return of decedent's estate, decedent's executor included the marital trust property in decedent's gross estate and paid the resulting estate tax. He steadfastly maintained in the State court litigation that decedent possessed a testamentary power of appointment over the marital trust property. Only after the court of special appeals rejected this position and the Maryland Court of Appeals declined to hear the appeal did he file the refund claim. Respondent has not carried his burden to show that the duty of consistency should apply in these circumstances.

The IRS applied the duty of consistency in TAM 200407018. The facts are interesting; oil paintings passed in a life estate to decedent's spouse for which no QTIP election was made, and other paintings passed into a QTIP trust. A pastel painting was allocated to the QTIP trust. The surviving spouse died and the painting was sold, and determined actually to be an oil painting. The surviving spouse's estate excluded the proceeds of the sale. The IRS disagreed, stating:

> As described above, the doctrine applies where the same taxpayer makes conflicting representations. However, the duty of consistency can also be applied to bind one person to a representation made by another where the two are deemed to be in privity. Whether there is sufficient identity of interests between the parties to warrant the application of the duty of consistency depends on the facts and circumstances of each case. Estate of Letts v. Commissioner, 109 T.C. 290 (1997); Cluck v. Commissioner, 105 T.C. at 333-336 (concluding that a husband and wife can have interests so closely aligned that one spouse may be estopped under the duty of consistency doctrine by the prior representations of the other spouse). See also, Beltzer v. United States, 495 F.2d 211 (8th Cir. 1973) (estate beneficiary was bound by representation of value made by the executor-beneficiary of the estate); Griffith v. United States, 27 AFTR 2d 754 (N.D. Tex. 1971); McMillan v. United States, 14 AFTR 2d 5704 (S.D. W. Va. 1964); Hess v. United States, 537 F.2d 457 (Ct. Cl. 1976); Ford v. United States, 276 F.2d 17 (Ct. Cl. 1960) (estate beneficiaries who were minors at the time the estate was administered were not bound by estate representations as to the value of inherited property).
>
> In Estate of Letts v. Commissioner, cited above, the decedent's husband's will created a marital trust for the benefit of the decedent that was intended to qualify as QTIP property, for purposes of the federal estate tax marital deduction. Decedent's only interests in the trust were a right to receive all trust income, a right to withdraw up to $40,000 per year and a right to receive at the trustee's discretion, distributions of principal for her comfort maintenance and support. In preparing Schedule M of the estate tax return, the executors of husband's estate checked the "no" box, utilized to signify that a QTIP election was not being made. However, the executors claimed a marital deduction for the value of the property passing to the marital trust. Upon the decedent's death, the decedent's estate contended that the marital trust was not includible in the Decedent's gross estate under section 2044, or any other Code section, on the basis that the husband's estate, by checking the "no" box, had not treated the property as QTIP property. Further, other than the power to withdraw $40,000 annually, the decedent had no general power of appointment over the property justifying inclusion under section 2041. The taxpayer further argued that a duty of consistency did not apply between the decedent's estate and the estate of her husband.
>
> However, the Tax Court disagreed and found that there was a sufficient identity of interests between the husband's estate and decedent's estate such that the duty of consistency would apply. Initially, the Tax Court noted that, "[i]t is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the gross estate of the surviving spouse." Estate of Letts v. Commissioner, 109 T.C. at 295. The court then concluded:
>
>> There is a sufficient identity of interests between the Estates of James Letts, Jr., and of decedent to trigger the duty of consistency. Decedent

> and James Letts, Jr. were married. Their estates were a single economic unit. Decedent's husband left his estate to decedent, James P. Letts III, and Joanne Magbee [husband and decedent's children]. Decedent was an executrix of her husband's estate. James P. Letts III signed both returns. JoAnne Magbee is also a co-executor of, signed the estate tax return for, decedent's estate.

Estate of Letts v. Commissioner, 109 T.C. at 298.

In the instant case, we believe that the duty of consistency does apply to bind the Decedent's estate to the representations made by H's estate regarding the qualification of Painting for the marital deduction. Initially, we note that all three elements required for application of the duty of consistency have been satisfied. For purposes of the duty of consistency, a taxpayer's treatment of an item on a return can be a representation that facts exist which are consistent with how the taxpayer reports the item on the return. Estate of Letts v. Commissioner, 109 T.C. at 299. Several representations were made by H's estate on the estate tax return, regarding the treatment of the Painting for estate tax purposes. An appraisal attached to the federal estate tax return, identified Painting as a "pastel". H's estate represented that Painting passed under Section V of H's will. Further, by identifying the property as passing under Section V and claiming a marital deduction for Painting, the estate represented that Decedent possessed a life estate coupled with a general power of appointment with respect to Painting, that qualified Painting for the marital deduction under section 2056(b)(5). Thus, the first element has been met. Estate of Letts v. Commissioner, 109 T.C. at 300.

Further, the Service relied on the representations that Painting passed under Section V of the will, that Decedent had a general power of appointment with respect to Painting, and therefore that the Painting qualified for the marital deduction. The Service relies on a fact if a taxpayer files a return that contains an inadequately disclosed item of which the Service was not otherwise aware, the Service accepts the return, and the time to assess tax expires without an audit of that return. Estate of Letts v. Commissioner, 109 T.C. at 300. In the instant case, there was nothing on the estate tax return to alert the IRS as to any issue presented regarding the treatment of Painting, nor did H's estate provide any facts to show that Painting should have passed under Section IV and was not subject to the marital deduction. Thus, based on the representations made on the estate tax return, the Service allowed the marital deduction with respect to Painting. The Service may rely on a presumption of correctness of a return that is given to the Service under the penalties of perjury. Hughes & Luce, L.L.P. v. Commissioner, T.C. Memo. 1994-559. Further, the time to make an adjustment and assess tax with respect to H's estate has expired. Thus, the second element of the duty of consistency has been satisfied.

* * *

Although H's estate and Decedent's estate are different taxpayers, there is sufficient privity between H's estate and Decedent's estate such that Decedent's estate is bound by the representations made by H's estate under the duty of consistency doctrine. Specifically, H and Decedent were married. As the court noted in Estate of Letts, the basic policy rationale underlying the allowance of the estate tax marital deduction is that the property for which a deduction is allowed in the estate of the first spouse to die will be included in the gross estate of the second spouse to die. Thus, H's estate derived a specific tax benefit, a marital deduction, presumptively conditioned on consistent treatment of the assets for which a deduction was allowed in Decedent's estate. Accordingly, for

> transfer tax purposes, the two estates are treated as a single economic unit. Next, as a practical matter, H's estate and Decedent's estate functioned as a single economic unit, pursuant to which H's estate's property was to be available to the spouse during her lifetime and then pass to Son 1 and Son 2 when she died. Son 1 and Son 2 are the remainder beneficiaries of the interests created under Section IV and Section V of H's will, and the marital trust created under the residuary clause of H's will. The Section V property and the residuary marital trust are also included in Decedent's gross estate. Moreover, Decedent was a co-executor of H's estate. As co-executor, Decedent signed the Form 706 declaring, under the penalties of perjury, that she had examined the return, including accompanying schedules and statements, and to the best of her knowledge and belief, the return was true, correct and complete. Thus, as was the case in Estate of Letts, H's estate and Decedent's estate were in privity, both for purposes of disposing of H's property and for transfer tax purposes.
>
> However, Decedent's estate contends that H's estate and Decedent's estate were not in privity, and therefore, the duty of consistency does not apply. In this regard, the estate notes that Decedent had little involvement with the preparation of H's estate's Form 706, and relied on the other co-executors to make all decisions regarding the Form 706, including the decision to characterize Painting as Section V property.
>
> It has been clearly established by several courts that a co-executor's lack of participation does not preclude the application of the duty of consistency. In Beltzer v. United States, the taxpayer, a co-executor of his father's estate, inherited stock that had been reported on the estate tax return as having a fair market value of $59,713. After the statute of limitations on assessments against the estate expired, the taxpayer sold his shares for $140,000. For purposes of determining gain on the sale of the stock, the taxpayer asserted that the stock had a fair market value of $118,020 on the date of his father's death, despite the fact that he had signed the estate tax return and had received the benefit of the lower reported estate tax value. The taxpayer argued that he should not be bound by the estate's representation of value, because he relied on his co-executor to prepare the estate tax return. The court rejected this argument stating: "A taxpayer, in this situation, innocent or otherwise, who has already had the advantages of a past alleged misstatement -- such advantage now beyond recoupment -- may not change his posture, and by claiming he should have properly paid more tax before, avoid the present levy." Beltzer v. United States, 495 F.2d at 212-13. See also, Estate of Letts v. Commissioner, 109 T.C. at 298-299; McMillan v. United States, 14 AFTR 2d at 5704.

In Conrad Janis, et ux. et al. v. Commissioner, T.C. Memo. 2004-117, the issue was whether the taxpayer could calculate a gallery's cost of goods sold using the undiscounted value of the gallery's collection of artwork rather than the discounted value used for federal estate tax purposes. The court applied the duty of consistency:

> Respondent has established that all three elements of the duty of consistency are present in this case. Conrad and Carroll agreed that the discounted value of the collection was $14,500,000, and the Commissioner relied upon that value in assessing the estate tax owed by Sidney's estate. Once the period for assessment against Sidney's estate had closed, however, petitioners claimed that the collection's undiscounted value should be used to calculate the gallery's COGS. Because all three elements of the duty of consistency are satisfied, we hold that petitioners are bound to use the collection's discounted value as their basis for purposes of calculating the gallery's COGS for 1990 through 1997.

4. **Effect of Probate Order**. In Estate of McDonald v. United States, 302 F.Supp.2d 1285 N.D. Ala. 2003) the court rejected an IRS attempt to ignore the holdings of an Alabama probate court that the decedent appointed attorneys-in-fact to act severally, not jointly, and the decedent intended to forgive a debt in her Will. The case is interesting because it involved a District Court deciding directly issues of state law.

KENTUCKY PRINCIPAL AND INCOME ACT

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SECTION B

KENTUCKY PRINCIPAL AND INCOME ACT

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KENTUCKY PRINCIPAL AND INCOME ACT

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I. Legislative History

A. National Conference of Commissioners on Uniform State Laws

B. 1931 Uniform Principal and Income Act

C. 1962 Uniform Principal and Income Act

1. Adopted by Kentucky in 1992

2. KRS 386.191 et seq.

D. 1997 Uniform Principal and Income Act ("Uniform Act")

1. Revision of 1931 and 1962 Uniform Acts had two general purposes[1]

a. Support widespread use of the revocable living trust as a will substitute, and to establish rules for new financial instruments.

b. Provide means for implementing transition to an investment regime based on principals embodied in Uniform Prudent Investor Act -- e.g., principal of investing for total return rather than a certain level of "income" as traditionally defined as interest, dividends and rents.

[1] Prefatory Notes and Comments to Uniform Principal and Income Act (1997) prepared by National Conference of Commissioners on Uniform State Laws and approved and recommended for enactment in all states at its annual conference on July 25-August 1, 1997, Sacramento, California ("Notes and Comments").

2. Uniform Act deals with four questions affecting the rights of beneficiaries[2]

   a. How is income earned during administration of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts and the residue?

   b. When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

   c. When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

   d. After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

3. Significant Issues Addressed[3]

   a. The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3 of the Uniform Act. Sections 4 through 8 of the Kentucky Act [KRS 386.456 - 464].

   b. The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 201(3) of the Uniform Act. Section 4(3) of the Kentucky Act [KRS 386.456].

   c. The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Uniform Acts deal only with partnership interests acquired from a decedent). Section 401 of the Uniform Act. Section 9 of the Kentucky Act [KRS 386.466].

[2] Id.

[3] Id.

d. The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b) of the Uniform Act. Section 13(2) of the Kentucky Act [KRS 386.474].

e. The allocation of net income from harvesting and selling timber between principal and income. Section 412 of the Uniform Act. Section 19 of the Kentucky Act [KRS 386.486].

f. The allocation between principal and income of receipts from derivatives, options and asset-backed securities. Sections 414 and 415 of the Uniform Act. Section 11(6) of the Kentucky Act [KRS 386.470] deals with options, but provisions of Uniform Act relating to derivatives and asset-backed securities not included in the Kentucky Act.

g. Disbursements made because of environmental laws. Section 502(a)(7) of the Uniform Act. Section 22(1)(h) of the Kentucky Act [KRS 386.492].

h. Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505 of the Uniform Act. Section 25 of the Kentucky Act [KRS 386.498].

i. The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506 of the Uniform Act. Section 26 of the Kentucky Act [KRS 386.500].

4. A number of matters in prior Uniform Acts have been changed or clarified[4]

a. An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income. Section 303 of the Uniform Act. Section 8 of the Kentucky Act [KRS 386.464].

b. Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401 of the Uniform Act. Section 9 of the Kentucky Act [KRS 386.466].

c. Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by

[4] Id.

the entity to be a partial liquidation. Section 401(d)(2) of the Uniform Act. Section 9(4)(b) of the Kentucky Act [KRS 386.466].

d. Deferred compensation is dealt with in greater detail in a separate section. Section 409 of the Uniform Act. Section 16 of the Kentucky Act [KRS 386.480].

e. The 1962 Act rule for "property subject to depletion" (patents, copyrights, royalties and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income. Section 410 of the Uniform Act. Section 17 of the Kentucky Act [KRS 386.482].

f. The percentage used to allocate amounts received from oil and gas has been changed -- 90% of those receipts are allocated to principal and the balance to income. Section 411 of the Uniform Act. Section 18 of the Kentucky Act [KRS 386.484].

g. The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 413 of the Uniform Act. Section 20 of the Kentucky Act [KRS 386.488].

h. Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503 of the Uniform Act. Section 23 of the Kentucky Act [KRS 386.494].

E. Kentucky Principal and Income Act ("Kentucky Act")

1. Effective January 1, 2005.

2. KRS 386.450 through 386.504 [statute with subsections as will appear in Michie (official Publisher) will be available on line at Legislative Research Commission website on or about July 15, 2004].

3. Repeals the Kentucky Revised Uniform Principal and Income Act enacted in 1992 and found at KRS 386.191 to 386.349.

4. Applicable to all trusts administered under Kentucky law, except as otherwise specifically provided in the instrument creating the trust, regardless of when created.

5. Modeled on 1997 Uniform Principal and Income Act.

F. Cross Reference Chart for Uniform Act, Kentucky Act in House Bill 517 Format and Kentucky Act in KRS format (to be available on or about July 15, 2004) - See Exhibit A.

II. Uniform Prudent Investor Act (1994)

A. Has been enacted in 35 states and the District of Columbia

B. Kentucky has not adopted the Uniform Prudent Investor Act

C. Kentucky has adopted a prudent investor rule. KRS 287.277

1. The "prudent investor rule" repeals the "prudent man rule."

2. Enacted in 1996.

3. Applies to banks (with trust powers) and trust companies.

4. Does not apply to individual fiduciaries.

5. But, under Kentucky Act, individual Kentucky fiduciary can elect to have KRS 287.277 prudent investor rule apply, with Court approval. Section 3(1) of the Kentucky Act [KRS 386.454].

D. Purposes of Uniform Prudent Investor Act (1994)[5]

1. Removes much of the common law restriction upon the investment authority of fiduciaries.

2. Allows fiduciaries to utilize modern portfolio theory to guide investment decisions.

a. Damage to trust assets from inflation.

b. If trustees cannot invest in way that achieves a return in excess of rate of inflation, the result is diminution of the corpus passing to remainder beneficiaries.

[5] Prefatory Notes and Comments to Uniform Prudent Investor Act (1994) prepared by National Conference of Commissioners on Uniform State Laws.

c. Income and principal beneficiaries lose if investment approach restricted.

3. Fiduciary's performance is measured on the performance of the entire portfolio, not upon the performance of each individual asset.

4. Allows the fiduciary to delegate investment decisions to qualified and supervised agents.

E. Advantages of Uniform Prudent Investor Act (1994)[6] and the Kentucky Act[7]

1. Trusts are likely to achieve a higher return for beneficiaries.

2. Trustees can protect the trust corpus better through diversification of assets.

3. Trustees can invest to counter the effects of inflation.

4. Trustee no longer forced to rely upon his own knowledge and expertise, but can acquire investment services to enhance his knowledge and skill.

5. Trustees can take into account the changing character and kinds of assets available for investment, free of restrictions.

6. Trustees are judged on overall performance of the assets in the trust, rather than performance of single assets.

7. Specific needs of each trust can be taken into account in devising investment strategy, rather than having to subordinate to generic investment rules treating all trusts the same.

III. Coordination between the Uniform Prudent Investor Act (1994) and Uniform Principal and Income Act (1997) [8]

A. Law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts; Prudent Investor Rule (1992).

[6] Id.

[7] Noted advantages true for corporate trustees under existing Kentucky law and will be true for trusts with individual fiduciaries if prudent investor rule elected (with Court approval) under Section 3(1) of the Kentucky Act [KRS 386.464].

[8] Notes and Comments

B. Need to update principal and income allocation rules so the two bodies of doctrine can work well together.

C. Reconciling modern investment theory and traditional income allocation.

1. Starting point is to use traditional system -- i.e.., if prudent investing of all the assets in a trust, viewed as a portfolio, and traditional allocation effectuate the intent of the Settlor, then nothing needs to be done.
2. But the Uniform Act helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries.

3. The Uniform Act gives the trustee a power to reallocate the portfolio return appropriately.

IV. Final Regulations under Section 643 of the Internal Revenue Code of 1986, as amended ("Code")

A. Issued by the IRS on December 30, 2003.

B. Background

1. Decline in dividend yields on common stocks and long period of low interest rates make it difficult for trustees to achieve reasonable income levels and reasonable growth in the same portfolio.

2. Modern portfolio theory suggests that (i) investments should be made as a part of a total portfolio which is balanced with respect to potential risk and potential return, (ii) investments should be diversified to reduce risks, and (iii) judging investments individually is no longer appropriate.

3. A "total return" (interest/dividend income plus capital appreciation) is a more appropriate measure of performance.

4. Federal fiduciary income tax rules based on traditional state law concepts of "income" and "principal."

5. Historically, trustees were required to distribute only the income to the income beneficiaries, retaining the principal and all capital gains realized by the trust for the ultimate benefit of the trust's remaindermen.

6. Even where trustees are granted discretion to distribute principal to the income beneficiary, income tax rules severely restrict the ability of the

trustee to include distributed capital gains in distributable net income ("DNI") taxable to the income beneficiaries.

C. The purpose of the regulations is to insure that the amount paid out to an income beneficiary, where the income beneficiary is entitled to all of the income from the trust, is adequate for the trust to receive any special tax benefits accorded to the trust under any new non-traditional state law definition of income (e.g., adjustment power under Section 3 of the Kentucky Act; KRS 386.454).

D. Definition of "income" under the final regulations

1. Section 643(b) of the Code and Treas. Reg. §1.643(b-1).

2. If state law permits a non-traditional allocation between income and principal (e.g., under Section 3 of the Kentucky Act), trust provisions following that law will be respected for tax purposes.

3. Final regulations provide a safe harbor by providing that a unitrust amount which is no less than 3% and no more than 5% of the annual fair market value of the trust is held to be a reasonable apportionment.

4. Final regulations authorize a "smoothing rule" that allows the amount to be distributed as a unitrust percentage to be determined using the value of the assets averaged on a multiple year basis.

5. The trustee has the ability to include realized capital gain in trust accounting income if the allocation is made pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the trustee by local law or by the governing instrument, if not prohibited by local law. Treas. Reg. §1.643(b)-1.

E. The intent of the regulation is to permit a trustee to invest in a manner that will maximize investment performance without shortchanging the income or remainder beneficiaries.

V. Kentucky Principal and Income Act ("Kentucky Act") -- Selected Provisions

A. Copy of the Kentucky Act in the format of House Bill 517, where the new statute originated, is attached as Exhibit B.

B. Article I (Definitions and Fiduciary Duties)

1. Definitions (Section 1 of the Kentucky Act) (KRS 386.450]

a. "District Court Approval" -- the consent of:

(1) All current beneficiaries;

(2) All remainder beneficiaries in the oldest generation, and

(3) District Court.

2. Fiduciary Duties; General Principles (Section 2 of the Kentucky Act) [KRS 386.452]

a. A fiduciary must administer a trust or estate in accordance with terms of instrument, even if there is a different provision in Kentucky Act.

b. A fiduciary must administer a trust or estate in accordance with the Kentucky Act if the instrument does not contain a different provision or does not give the fiduciary a discretionary power of administration.

c. A receipt or disbursement is allocated to principal if there is no provision for a different allocation in the terms of the instrument or the Kentucky Act.

d. When there are two or more beneficiaries, a fiduciary is under a duty to deal impartially with them, except to the extent the terms of the instrument manifest a contrary intent.

3. Trustee's Power to Adjust (Section 3 of the Kentucky Act) [KRS 386.454]

a. An individual trustee may elect to have the Kentucky prudent investor rule found at KRS 287.277 apply to a trust with approval of the District Court.

b. Permits the trustee to adjust between principal and income to the extent the trustee considers necessary if:

(1) KRS 287.277 applies by law or by election -- i.e., trustee must be managing the trust assets under the prudent investor rule;

(2) The terms of the trust describe the income beneficiary's distribution rights in terms of the right to receive "income" in the traditional trust accounting sense;

(3) The adjustment is necessary for the fiduciary to administer the trust or estate impartially, based on what is fair and reasonable to all beneficiaries, and

(4) The adjustment is approved by the District Court.

c. This includes an adjustment method such as an annual percentage distribution of between 3% and 5% of the fair market value of the trust assets determined annually.

d. The Kentucky Act does not contain a list of factors included in the Uniform Act that the fiduciary must consider in deciding whether and to what extent the power to adjust should be exercised:

(1) Nature, purpose and expected duration of the trust;

(2) Intent of the Settlor;

(3) Identity and circumstances of the beneficiaries;

(4) Needs for liquidity, regularity of income and preservation and appreciation of capital;

(5) The assets held in the trust; the extent to which they consist of financial assets, interests in closely-held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset is purchased by the trustee or received from the Settlor;

(6) The net amount allocated to income under the other sections of the Uniform Act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) The anticipated tax consequences of an adjustment.

e. Rules can apply to the personal representative of an estate with approval of the District Court.

f. Adjustment is prohibited under the Kentucky Act if:

(1) The adjustment diminishes the income interest in a trust that requires that all income be paid at least annually to a spouse and for which any estate tax or gift tax marital deduction would be allowed;

(2) The adjustment reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) The adjustment changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets -- applies to annuity trusts and unitrusts with no charitable beneficiaries as well as trusts with charitable income or remainder beneficiaries. The purpose is to make clear that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of the trust's assets is not subject to adjustment;

(4) If the adjustment is from any amount that is permanently set aside for charitable purposes under a will or the terms of the trust, unless both income and principal are so set aside;

(5) Possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or any part of the trust for estate or income tax purposes, and the individual would not otherwise be treated as the owner;

(6) Possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not otherwise be included in the estate of the individual;

(7) The fiduciary is a beneficiary of the trust or estate; or

(8) The adjustment would benefit a non-beneficiary fiduciary directly or indirectly; except that any effect on the fiduciary's compensation does not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with applicable law.

g. Examples from Notes and Comments illustrate the application of the adjustment rules -- See Exhibit C.

C. Article 2 (Decedent's Estate or Terminating Income Interest)

1. General

a. A simple trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends.

b. A complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends.

c. For that reason, the Kentucky Acts speaks in terms of "income interests" ending and beginning rather than trusts ending and beginning.

d. A terminating income interest is one that has ended but whose administration is not necessarily complete.

e. The fact that a trust may or may not end when an income interest ends is not significant for purposes of the Kentucky Act.

2. Determination and Distribution of Net Income (Section 4 of the Kentucky Act) [KRS 386.456]

a. A fiduciary may pay administration expenses and interest on death taxes from either income or principal. Section 4(2)(b) of the Kentucky Act. If the fiduciary decision regarding source of payment is consistent with the decision to deduct these expenses for income for estate taxes purposes, permitting the fiduciary to choose the source of payment (i.e., income or principal first) eliminates the need to adjust between principal and interest that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense is paid from income is deducted for estate tax purposes.

b. The beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. See Section 4(3) of the Kentucky Act. Many states, including Kentucky, have no applicable law that provides for interest or some other method to be treated on an outright pecuniary gift under an inter vivos trust. In this case, this section provides that the interest or other amount to be paid shall be the same as the interest or the other amount required to be paid on testamentary pecuniary gifts. This provision gives some inter vivos instruments the same treatment as testamentary gifts. See KRS 394.520 which requires the payment of interest on pecuniary gifts unpaid after one year from probate of will if the will contains no fixed time for payment.

3. Distribution to Residuary and Remainder Beneficiaries (Section 5 of the Kentucky Act) [KRS 386.458]

a. Residuary legatees of estates receive the net income earned during the period of administration on the basis of their proportionate interest in the undistributed assets when distributions are made. This rule applies to the gain or loss realized from the disposition of assets during administration.

b. Determination of proportionate interest is based on asset values as of the date reasonably near the time of distribution, rather than "inventory" (e.g., date of death, cost) values. This rule applies to distributions from terminating trusts as well as estates.

D. Article 3 (Apportionment at Beginning and End of Income Interest)

1. When Right to Income Begins and Ends (Section 6 of the Kentucky Act) [KRS 386.460]

a. An income beneficiary is entitled to net income from the date on which the income interest begins. The income interest begins on:

(1) The date specified in the terms of the trust; or

(2) If no date is specified, on the date an asset becomes subject to a trust or successive income interest.

b. In the case of a testamentary trust, an asset becomes "subject to a trust" on the date of a testator's death, even if there is an intervening period of administration of the testator's estate.

c. An income interest ends on the date before an income beneficiary dies or another determining event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

(1) The purpose of the last phrase is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same proportionate rule that applies when a mandatory period ends.

(2) For example, what happens if a settlor creates a trust for grandchildren before any grandchildren are born? When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the proportionate rules in Section 7 and 8 (described below) apply accordingly if the terms of the trusts do not contain different provisions.

2. Apportionment of Receipts and Disbursements When Decedent Dies or Income Ends (Section 7 of the Kentucky Act) [KRS 386.462]

a. To simplify trust administration, Section 7 applies the same rules to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest (e.g., pour over will to unfunded inter vivos trust).

b. Periodic Payments. A periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities and disbursements such as the interest portion of a mortgage payment, are not apportioned.

c. Non-Period Payments. Interest on an obligation that does not provide a due date for the interest payment (e.g., interest on income tax refund) is apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on an obligation (e.g., zero coupon bond) and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 13 of the Kentucky Act.

3. Apportionment when Income Interest Ends (Section 8 of the Kentucky Act) [KRS 386.464]

   a. "Undistributed income" (i.e., income received before the date on which an income interest ends) is paid to the income beneficiary or his estate.

   b. Accrued periodic payments.

      (1) Under the prior Uniform Act, an income beneficiary or his estate was entitled to receive a portion of any payments (other than dividends), that were due or that accrued when the income interest terminated.

      (2) Section 8 changes old rules by providing that accrued items, such as periodic payments of interest, rents and dividends, are not included in undistributed income. The rule also applies to expenses that are due or accrued.

      (3) Example:[9] Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30. The successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 7(1) of the Kentucky Act, the July payment is added to the principal of the successive income interest when received. Under Section 7(2) of the Kentucky Act, the entire periodic payment of rent that is due August 20 is income when received by the successive income interest. Under Section 8 of the Kentucky Act, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20th or the August 30th payment because neither one was

[9] Taken from Notes and Comments to Section 303 of the Uniform Act.

received before the income interest ended on July 30. The same principal is applied to expenses of the trust.

c. The last sentence of Section 8(3) of the Kentucky Act is in addition to the Uniform Act and it permits a settlor to change the charitable beneficiary of a trust by will or through written notice to the trustee, so long as the change does not alter the income, gift, estate or other tax benefits available under the terms of the trust. For example, this will permit the settlor of a charitable remainder trust to change the charitable remainder beneficiary(ies) where the terms of the trust do not give anyone the power to do so.

E. Article 4 (Allocation of Receipts During Administration of Trust)

1. Character of Receipts (Section 9 of the Kentucky Act) [KRS 386.466]

a. Deals with receipts from "entities," but does not apply to receipts from tenancy-in-common property.

b. Receipts from an entity that are allocated to principal include, but are not limited to:

(1) Partial liquidations.

(a) Any distribution designated by the entity as a partial liquidating distribution, regardless of the percentage of total assets that it represents.

(b) If a distribution exceeds 20% of the entity's gross assets, the entire distribution is considered a partial liquidation whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

2. Distribution from Trust or Estate (Section 10 of the Kentucky Act) [KRS 386.468]

a. Amounts received as a distribution of income from a trust or estate are allocated to income of the recipient trust, and amounts received as a distribution of principal from a trust or estate are allocated to principal of the recipient trust.

b. If a trustee purchases an interest in a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purposes of receiving capital contributed by investors, investing that capital and managing investment assets, Section 10 of the Kentucky Act applies to receipts from such trust.

3. Principal Receipts (Section 11 of the Kentucky Act) [KRS 386.470]

a. Even though the award in an eminent domain proceeding may include an amount for a loss of future rent on a lease, the entire award is principal if that amount is not separately stated. Amounts paid or received for the granting of an option is allocated to principal.

b. Any gain or loss realized upon the exercise of an option is allocated to principal

4. Rental Property (Section 12 of the Kentucky Act) [KRS 386.472]

a. An amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease, is allocated to income.

b. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods, must be added to principal, and held subject to terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

c. Receipts that are capital in nature

(1) A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for non-payment.

(2) Transfer from income to reimburse principal may be appropriate under Section 24 of the Kentucky Act (Transfers from Income to Reimburse Principal) to the extent that some of the "rent" is really a reimbursement for improvements.

5. Obligation to Pay Money (Section 13 of the Kentucky Act) [KRS 386.474]

a. An amount received as interest on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, is allocated to income without any provision for amortization of premium.

b. Discount Obligations

(1) Subsection (2) of Section 13 the Kentucky Act applies to all obligations acquired at a discount, including short-term obligations such as U. S. Treasury bills, long-term obligations such as U.S. Savings Bond, zero-coupon bonds and discount bonds that pay interest during part, but not all, of the period before maturity.

(2) The entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year.

6. Insurance Policies and Similar Contracts (Section 14 of the Kentucky Act) [KRS 386.476]

a. Proceeds from a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or loss of profits from a business, are allocated to income.

b. Proceeds from a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset (except as otherwise provided), are allocated to principal.

7. Unsubstantial Allocations Not Required (Section 15 of the Kentucky Act) [KRS 386.478]

a. This section relieves a trustee from making relatively small allocations to income while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars.

b. Example: [10]Assume that a trust's assets, which include a working interest in an oil well, have a value of $1,000,000; the net income

[10] Taken from Notes and Comments to Section 408 of the Uniform Act.

from the assets other than the working interest is $40,000; and the net receipts from the working interest are $400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or $40, to income under Section 18 of the Kentucky Act (Minerals, Water and Other Natural Resources). If the net receipts from the working interest are $35,000, so that the amount allocated to income under Section 18 of the Kentucky Act would be $3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 18 of the Kentucky Act should be made, even though the trustee is still permitted under Section 15 of the Kentucky Act (Unsubstantial Allocations) to allocate all of the net receipts to principal because the $3,500 would increase the net income of $40,000, as determined before making an allocation under Section 18 of the Kentucky Act, by less than 10%.

c. This section also relieves a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

d. Allocations are not permitted under this section in circumstances described in Section 3(4) (prohibited adjustments) of the Kentucky Act [KRS 386.454] to eliminate claims that the power in this section has adverse tax consequences.

8. Deferred Compensation, Annuities and Similar Payments (Section 16 of the Kentucky Act) [KRS 386.480]

a. This section applies to:

(1) Fees from all forms of annuities and deferred compensation arrangements, where the payment will be received by the trust in a lump sum or in installments over a period of years;

(2) Payments that may be received over two or three years;

(3) Payments that may last for much longer periods, including payments from an IRA, deferred compensation plan (whether qualified or non-qualified), and insurance renewal commissions;

(4) Retirement plan to which the settlor has made contributions, and an annuity policy that the settlor purchased individually;

(5) Variable annuities, deferred annuities, annuities issued by a commercial insurance companies and private annuities;

b. The focus of Section 16, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made.

c. Required minimum distributions (RMD) from a qualified plan or IRA

(1) To the extent that a payment is required to be made, 10% of the amount received is allocated to income and the balance is allocated to principal;

(2) All other payments are allocated to principal because they represent a change in the form of a principal asset;

(3) This rule holds true in Section 7(2) of the Kentucky Act (Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Ends), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

d. Marital deduction requirements

(1) When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it.

(2) To qualify for QTIP treatment, the spouse must be entitled for life to all the income earned on the assets in the IRA payable at least annually.

(3) An IRS ruling states that if the terms of the QTIP marital deduction trust provide that all of the trust income must be distributed to the spouse and the spouse is given the power, exercisable at least annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to the spouse, then the IRA will qualify for QTIP treatment even if the IRA in fact distributes less than all of its income to the marital deduction trust and the spouse does not in fact exercise such power. Rev. Rul. 2000-2, 2000-1 C.B. 305.

(4) If the allocation to income under this section of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, subsection (4) of Section 16 of the Kentucky Act requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction.

(5) If the terms of the marital deduction trust do not permit the spouse to require the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and distribute such amount to the spouse, a distribution under subsection (4) may be necessary.

9. Liquidating Assets (Section 17 of the Kentucky Act) [KRS 386.482]

a. "Liquidating asset" means that an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration, including leasehold, patent, copyright, royalty rights, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance (e.g., lottery payments);

b. The term does not include a payment subject to Section 16 of the Kentucky Act (Deferred Compensation, Annuities and Similar Payments) or any asset for which the trustee establishes a reserve for depreciation under Section 23 of the Kentucky Act [KRS 386.494];

c. The trustee shall allocate to income 10% of the receipts from a liquidating asset and the balance to principal.

10. Minerals, Water, and Other Natural Resources (Section 18 of the Kentucky Act) [KRS 386.484]

a. This section applies to the extent that the trustee does not allocate all of the receipts to principal under Section 15 of the Kentucky Act [KRS 386.478] (Unsubstantial Allocations Not Required). If applicable:

(1) Royalty, shut-in-well-payment, take-or-pay payment, bonus delay rental. Allocate 90% of net receipts to principal and 10% to income if receipt is more than nominal. If nominal, allocate to income;

(2) Production payment income. A receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance is allocated to principal;

(3) Subsection (3) of Section 18 provides that the Kentucky Act applies whether or not a decedent or donor is extracting minerals, water, or other natural resources before the interest became subject to the trust. The purpose of this subsection is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Such receipts are to be allocated to or between principal and income in accordance with the provisions of the Kentucky Act.

b. Proceeds from the disposition of mineral interest is allocated in the same manner as receipts from that interest.

11. Timber (Section 19 of the Kentucky Act) [KRS 386.486]

a. Applicability

(1) Applies to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth;

(2) Applies to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulp wood, and Christmas and other ornamental trees;

(3) Subsection (1) of Section 19 of the Kentucky Act applies to net receipts from property owned or leased by the trustee;

(4) Provisions are not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, non-commercial purposes -- e.g., Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property;

b. Net receipts from the sale of timber are allocated:

(1) To income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;

(2) To principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

(3) To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the above rules; or

(4) To principal to the extent that advance payments, bonuses and other payments are not allocated pursuant to the above provisions.

12. Property Not Productive of Income (Section 20 of the Kentucky Act) [KRS 386.488]

a. If a marital deduction is allowed for all or part of a trust that is not producing income, the spouse may require the trustee to make the trust income productive.

b. In all other cases, proceeds from the sale or disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.

(1) Existing KRS 386.295 gives the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as "delayed income."

(2) Subsection (2) of Section 20 of the Kentucky Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income.

c. The provision does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive of income.

F. Article 5 (Allocation of Disbursements During Administration of Trust)

1. Disbursements from Income (Section 21 of the Kentucky Act) [KRS 386.490]

a. 50% of the regular compensation of the trustee and any person providing investment advisory or custodial services to the trustee, except as provided in KRS 386.180 (testamentary trustee entitled to 6% of the income plus .3% of principal, or 6% of principal at the time of principal distribution);

b. 50% of all expenses for accountings, judicial proceedings or other matters involving both income and remainder interests;

c. All other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest;

d. Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset. "Recurring" intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 22 of the Kentucky Act [KRS 386.492].

2. Disbursements from Principal (Section 22 of the Kentucky Act) [KRS 386.492]

a. That portion of the regular compensation of a trustee, investment advisor and custodian not paid from income under Section 21 of the Kentucky Act [KRS 386.490] described above;

b. 50% of the disbursements for accountings, judicial proceedings or other matters involving both income and remainder interests;

c. All of the trustee's compensation calculated on principal as a fee for acceptance, distribution or termination, and disbursements made to prepare a property for sale;

d. Payments on the principal of a trust debt;

e. Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

f. Premiums paid on an insurance policy not described in Section 21(4) of the Kentucky Act [KRS 386.490] -- e.g., title insurance;

g. Estate, inheritance and other transfer taxes (e.g., generation-skipping transfer taxes), including penalties, apportioned to the trust;

h. Disbursements related to environmental matters.

3. Transfers from Income to Principal for Depreciation (Section 23 of the Kentucky Act) [KRS 386.494]

a. A trustee has discretion to transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but the trustee may not transfer any amount for depreciation:

(1) Of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for personal use or enjoyment for a beneficiary;

(2) During the administration of a decedent's estate.

b. Background[11]

(1) KRS 386.305(1)(b) provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting practices,..." Such provisions in multiple jurisdictions have been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One theory is that depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principals may not require depreciation to be taken if the property is not part of a business;

[11] Notes and Comments.

(2) The drafting committee of the Uniform Act concluded that the decision to provide for depreciation should be discretionary with the trustee;

(3) The power to transfer funds from income to principal that is granted by this section is a discretionary part of the adjustment referred in Section 2(2) of the Kentucky Act, and in exercising the power a trustee must comply with Section 2(2) of the Kentucky Act [KRS 386.452].

(a) One purpose served by transferring cash from income to principal for depreciation is to be provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 24(2)(d) of the Kentucky Act [KRS 386.496] permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

4. Transfers from Income to Reimburse Principal (Section 24 of the Kentucky Act) [KRS 386.496]

a. The trustee may transfer income to principal for certain principal disbursements:

(1) Extraordinary repairs;

(2) Capital improvements and special assessments;

(3) Expenses to prepare a property for rental, including tenant allowances, leaseholder improvements and broker's commission;

(4) Principal payment on a mortgage if the depreciation charged against the income is less than the principal payments on the mortgage.

5. Income Taxes (Section 25 of the Kentucky Act) [KRS 386.498]

a. Tax required to be paid by a trustee on the trust's share of an entity's taxable income shall be paid proportionately:

(1) From income to the extent that receipts from the entity are allocated to income; and

(2) From principal to the extent that:

(a) Receipts from the entity are allocated to principal; and

(b) The trust's share of the entity's taxable income exceeds the total receipts described in (1) above and (2)(a) above.

b. Electing Small Business Trusts ("ESBT")

(1) An ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries.

(2) The portion of an ESBT that consists of the S corporation's stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.

(3) A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (4) of Section 25 of the Kentucky Act provides that receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax. Thus, this section takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries.

6. Adjustments Between Principal and Income Because of Taxes (Section 26 of the Kentucky Act) [KRS 386.500]

a. Permits the fiduciary to make adjustments between income and principal because of tax law provisions, with district court approval.

b. Examples of situations meriting a discretionary adjustment:

(1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return;

(2) A distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who received the income of any obligation to pay income tax on the income; or

(3) A trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain.

c. Subsection 1(c) of Section 26 of the Kentucky Act applies to a Qualified Subchapter S Trust ("QSST") whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If a QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary.

d. Subsection (2) of Section 26 of the Kentucky Act mandates an adjustment from income to principal to preserve an estate tax marital deduction or charitable contribution deduction where such deduction is reduced by the payment of additional estate taxes because of the fiduciary's election to deduct certain expenses on income tax returns.

EXHIBIT A

HOUSE BILL 517

AN ACT relating to the administration of trusts and estates.

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

ARTICLE 1

DEFINITIONS AND FIDUCIARY DUTIES

SECTION 1. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) "Accounting period" means a calendar year unless another twelve (12) month period is selected by a fiduciary. The term includes a portion of a calendar year or other twelve (12) month period that begins when an income interest begins or ends when an income interest ends;

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir, legatee, and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary;

(3) "District Court approval" means the consent of:

(a) All current beneficiaries;

(b) All remainder beneficiaries in the oldest generation; and

(c) The court;

(4) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, and public administrator;

(5) "Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Articles 4 and 5 of the Kentucky Principal and Income Act;

(6) "Income beneficiary" means a person to whom net income of a trust is or may be payable;

(7) "Income interest" means the right of an income beneficiary to receive all or part

of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion;

(8) "Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute;

(9) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under Sections 1 to 27 of this Act to or from income during the period;

(10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates;

(11) "Remainder beneficiary" means a person entitled to receive principal when an income interest ends;

(12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct; and

(13) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

SECTION 2. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of Articles 2 and 3 of the Kentucky Principal and Income Act, a fiduciary:

(a) Shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in Sections 1 to 27 of this Act;

(b) May administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will,

even if the exercise of the power produces a result different from a result required or permitted by Sections 1 to 27 of this Act;

(c) Shall administer a trust or estate in accordance with Sections 1 to 27 of this Act if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(d) Shall add a receipt or charge a disbursement to principal to the extent that neither the terms of the trust nor Sections 1 to 27 of this Act provide a rule for allocating the receipt or disbursement to or between principal and income.

(2) In exercising the power to adjust under subsection (2) or (3) of Section 3 of this Act or a discretionary power of administration regarding a matter within the scope of Sections 1 to 27 of this Act, whether granted by the terms of a trust, a will, or Sections 1 to 27 of this Act, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest a contrary intention. Except as provided in this subsection, determination in accordance with Sections 1 to 27 of this Act shall be presumed to be fair and reasonable to all of the beneficiaries.

SECTION 3. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) Notwithstanding any provision of Kentucky law to the contrary, the trustee of a trust to which by law KRS 287.277 does not apply may elect to have such provisions apply to the administration of the trust with approval of the District Court.

(2) A trustee may adjust between principal and income to the extent the trustee considers necessary if KRS 287.277 applies by law or by election made and approved under subsection (1) of this Act, the terms of the trust describe the

amount that may or shall be distributed to a beneficiary by referring to the trust's income, the trustee determines, after applying the rules in subsection (1) of Section 2 of this Act, that the trustee is unable to comply with subsection (2) of Section 2 of this Act and the adjustment, including an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, is approved by the District Court.

(3) (a) A personal representative may adjust between principal and income in the same manner as a trustee if KRS 287.277 applies to the personal representative by law or if the personal representative elects to have KRS 287.277 apply to the administration of the estate, upon approval of the District Court, which approval may be an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, and:

1. The amount distributable to a beneficiary of the estate is determined by reference to the income of the estate; and

2. The personal representative determines, and after applying the rules of subsection (1) of Section 2 of this Act, that the personal representative is unable to comply with subsection (2) of Section 2 of this Act.

(4) A fiduciary shall not make an adjustment:

(a) That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment;

(b) That reduces the actuarial value of the income interest in a trust to which a *person transfers property with the intent to qualify for a gift tax exclusion;*

(c) That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(d) From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(e) If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust or estate for income tax purposes, and the individual would not be treated as the owner if the fiduciary did not possess the power to make an adjustment;

(f) If possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not be included in the estate of the individual if the fiduciary did not possess the power to make an adjustment;

(g) If the fiduciary is a beneficiary of the trust or estate; or

(h) If the fiduciary is not a beneficiary, but the adjustment would benefit the fiduciary directly or indirectly; except that any effect on the fiduciary's compensation shall not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with the applicable law.

(5) If paragraph (e), (f), (g), or (h) of subsection (4) of this section applies to a fiduciary and there is more than one (1) fiduciary, a cofiduciary to whom the provision shall not apply may make the adjustment unless the exercise of the power by the remaining fiduciary or fiduciaries is not permitted by the terms of the trust.

(6) A fiduciary may release the entire power conferred by subsection (2) or (3) of this section or may release only the power to adjust from income to principal or the

power to adjust from principal to income if the fiduciary is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (a) to (f) of subsection (4) of this section or paragraph (h) of subsection (4) of this section, or if the fiduciary determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (4) of this section. The release may be permanent or for a specified period, including a period measured by the life of an individual. Such release shall require approval of the District Court. Further, with approval of the District Court, a fiduciary may divide a trust into one (1) or more fractional shares if the division does not change the beneficial interests.

(7) Terms of a trust or will that limit the power of a fiduciary to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust or will that the terms are intended to deny the fiduciary the power of adjustment conferred by subsection (2) or (3) of this section.

ARTICLE 2

DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 4. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the following rules apply.

(1) A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in Articles 3, 4, and 5 of the Kentucky Principal and Income Act that apply to trustees and the rules in subsection (5) of this section. The fiduciary shall distribute the net income and

net principal receipts to the beneficiary who is to receive the specific property.

(2) A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the rules in Articles 3, 4, and 5 of the Kentucky Principal and Income Act that apply to trustees and by:

(a) Including in net income all income from property used to discharge liabilities;

(b) Paying from income or principal, in the fiduciary's discretion, fees to attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and

(c) Paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under subsection (2) of this section, or from principal to the extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary would be entitled under applicable law if the pecuniary

amount were required to be paid under a will.

(4) A fiduciary shall distribute the net income remaining after distributions required by subsection (3) of this section in the manner described in Section 5 of this Act to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust.

(5) A fiduciary shall not reduce principal or income receipts from property described in subsection (1) of this section because of a payment described in Section 21 of this Act to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

SECTION 5. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) Each beneficiary described in subsection (4) of Section 4 of this Act is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one (1) distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one (1) who shall not receive part of the distribution, is entitled, as of each distribution date, to the net income the

fiduciary has received after the date of the death or terminating event or earlier distribution date but has not distributed as of the current distribution date.

(2) In determining a beneficiary's share of net income, the following rules apply.

(a) The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations.

(b) The beneficiary's fractional interest in the undistributed principal assets shall be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.

(c) The beneficiary's fractional interest in the undistributed principal assets shall be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by an unpaid principal obligation.

(d) The distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(3) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(4) A fiduciary may apply the rules in this section, to the extent that the fiduciary considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

ARTICLE 3

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 6. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(2) An asset becomes subject to a trust:

(a) On the date it is transferred to the trust in the case of an asset that is transferred to a trust during the transferor's life;

(b) On the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or

(c) On the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.

(3) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined under subjection (4) of this section, even if there is an intervening period of administration to wind up the preceding income interest.

(4) An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

SECTION 7. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) A trustee shall allocate an income receipt or disbursement other than one to which subsection (1) of Section 4 of this Act applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.

(2) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement shall be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins shall be allocated to principal and the balance shall be allocated to income.

(3) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of Sections 1 to 27 of this Act. Distributions to shareholders or other owners from an entity to which Section 9 of this Act applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that shall be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

SECTION 8. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) In this section, "undistributed income" means net income received before the date on which an income interest ends. The term shall not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

(2) When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust unless the beneficiary has an unqualified power to revoke more than five percent

(5%) of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked shall be added to principal.

(3) When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee shall prorate the final payment if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements. The settlor may change the charitable beneficiary of a trust by Will or through written notice to trustee, or may decline to make a change in like manner, so long as the change does not alter the income, gift, estate, or other tax benefits available under the terms of the trust.

ARTICLE 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

SECTION 9. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 10 of this Act applies.

(2) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(3) A trustee shall allocate the following receipts from an entity to principal:

(a) Property other than money;

(b) Money received in one (1) distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(c) Money received in total or partial liquidation of the entity; and

(d) Money received from an entity that is a regulated investment company or a real estate investment trust, if the money distributed is a capital gain dividend for federal income tax purposes.

(4) Money is received in partial liquidation:

(a) To extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

(b) If the total amount of money and property received in a distribution or series of related distributions is greater than twenty percent (20%) of the entity's gross assets, as shown by the entity's year end financial statements immediately preceding the initial receipt.

(5) Money is not received in partial liquidation, nor may it be taken into account under paragraph (b) of subsection (4) of this section to the extent that it does not exceed the amount of income that a trustee or beneficiary shall pay on taxable income of the entity that distributes the money.

(6) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

SECTION 10. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 9 of this Act applies to a receipt from the trust.

SECTION 11. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

A trustee shall allocate to principal:

(1) To the extent not allocated to income under Sections 1 to 27 of this Act, assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;

(2) Money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including stock splits and realized profit, subject to this article;

(3) Amounts recovered from third parties to reimburse the trust because of disbursements described in subsection (1)(g) of Section 22 of this Act or for other reasons to the extent not based on the loss of income;

(4) Proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;

(5) Net income received in an accounting period during which there is no beneficiary to whom a trustee may or shall distribute income;

(6) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option shall be allocated to principal. An amount paid to acquire the option shall be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, shall be allocated to principal; and

(7) Other receipts as provided in Sections 15, 16, 17, 18, 19, and 20 of this Act.

SECTION 12. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

To the extent that a trustee accounts for receipts from rental property under this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is applied as rent for future periods, shall be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

SECTION 13. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, shall be allocated to income without any provision for amortization of premium.

(2) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one (1) year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one (1) year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust shall be allocated to income.

(3) This section shall not apply to an obligation to which Section 12, 16, 17, 18, or 19 of this Act applies.

SECTION 14. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) Except as otherwise provided in subsection (2) of this section, a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.

(2) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or loss of profits from a business.

(3) This section shall not apply to a contract to which Section 16 of this Act applies.

SECTION 15. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

If a trustee determines that an allocation between principal and income required by Section 16, 17, 18, or 19 of this Act is unsubstantial, the trustee may allocate the entire amount to principal unless one (1) of the circumstances described in subsection (4) of Section 3 of this Act applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in subsection (4) of Section 3 of this Act and may be released for the reasons and in the manner described in subsection (6) of Section 3 of this Act. An allocation is presumed to be insubstantial if:

(1) The amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than ten percent (10%); or

(2) The value of the asset producing the receipt for which the allocation would be made is less than ten percent (10%) of the total value of the trust's assets at the beginning of the accounting period.

SECTION 16. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO

READ AS FOLLOWS:

(1) In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one (1) or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(2) To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(3) If no part of a payment is characterized as interest, a dividend, or an equivalent payment and all or part of the payment is required to be made, a trustee shall allocate to income ten percent (10%) of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(4) If, to obtain an estate tax marital deduction for a trust, a trustee shall allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(5) This section shall not apply to payments to which Section 17 of this Act applies.

SECTION 17. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) In this section, "liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one (1) year under an arrangement that shall not provide for the payment of interest on the unpaid balance. The term shall not include an activity subject to Section 11(6) of this Act, payment subject to Section 16 of this Act, resources subject to Section 18 of this Act, timber subject to Section 19 of this Act, or any asset for which the trustee establishes a reserve for depreciation under Section 23 of this Act.

(2) A trustee shall allocate to income ten percent (10%) of the receipts from a liquidating asset and the balance to principal.

SECTION 18. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(a) If received as nominal delay rental or nominal annual rent on a lease, a receipt shall be allocated to income;

(b) If received from a production payment, a receipt shall be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance shall be allocated to principal;

(c) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, ninety percent (90%) shall be allocated to principal and the balance to income; or

(d) If an amount is received from a working interest or any other interest not provided for in paragraph (a), (b), or (c) of this subsection, ninety percent (90%) of the net amount received shall be allocated to principal and the balance to income.

(2) An amount received on account of an interest in water that is renewable shall be allocated to income. If the water is not renewable, ninety percent (90%) of the amount shall be allocated to principal and the balance to income.

(3) Sections 1 to 27 of this Act apply whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(4) If a trust owns an interest in minerals, water, or other natural resources on the effective date of this Act, the trustee may allocate receipts from the interest as provided in Sections 1 to 27 of this Act or in the manner used by the trustee before the effective date of this Act. If the trust acquires an interest in minerals, water, or other natural resources after the effective date of this Act, the trustee shall allocate receipts from the interest as provided in Sections 1 to 27 of this Act.

(5) The proceeds from any disposition of an interest specified in this section shall be allocated in the same manner as receipts from the interest.

SECTION 19. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

(a) To income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;

(b) To principal to the extent that the amount of timber removed from the land

exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

(c) To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (a) and (b) of this subsection; or

(d) To principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraphs (a), (b), or (c) of this subsection.

(2) In determining net receipts allocated under subsection (1) of this section, a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(3) Sections 1 to 27 of this Act apply whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.

(4) If a trust owns an interest in timberland on the effective date of this Act, the trustee may allocate net receipts from the sale of timber and related products as provided in Sections 1 to 27 of this Act or in the manner used by the trustee before the effective date of this Act. If the trust acquires an interest in timberland after the effective date of this Act, the trustee shall allocate net receipts from the sale of timber and related products as provided in Sections 1 to 27 of this Act.

SECTION 20. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) If a marital deduction is allowed for all or part of a trust, the spouse may require the trustee to make the trust income productive.

(2) In cases not governed by subsection (1) of this section, proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.

ARTICLE 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 21. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

A trustee shall make the following disbursements from income to the extent that they are not disbursements to which subsection (2)(b) or (2)(c) of Section 4 of this Act applies:

(1) One-half (1/2) of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, except as provided in KRS 386.180;

(2) One-half (1/2) of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

(3) All of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and

(4) Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

SECTION 22. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) A trustee shall make the following disbursements from principal:

(a) That portion of the regular compensation of the trustee and any person providing investment advisory or custodial services to the trustee not paid from income under subsection (1) of Section 21 of this Act;

(b) The remaining one-half (1/2) of the disbursements described in subsection

(2) of Section 21 of this Act;

(c) All of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;

(d) Payments on the principal of a trust debt;

(e) Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

(f) Premiums paid on a policy of insurance not described in subsection (4) of Section 21 of this Act of which the trust is the owner and beneficiary;

(g) Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and

(h) Disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

(2) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

SECTION 23. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) In this section, "depreciation" means a reduction in value due to wear, tear,

decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one (1) year.

(2) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but shall not transfer any amount for depreciation:

(a) Of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary; or

(b) During the administration of a decedent's estate.

(3) An amount transferred to principal need not be held as a separate fund.

SECTION 24. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one (1) or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements.

(2) Principal disbursements to which subsection (1) of this section applies include the following, but only to the extent that the trustee has not been and does not expect to be reimbursed by a third party:

(a) An amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;

(b) A capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;

(c) Disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions;

(d) Periodic payments on an obligation secured by a principal asset to the

extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and

(e) Disbursements described in subsection (1)(g) of Section 22 of this Act.

(3) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (1) of this section.

SECTION 25. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) A tax required to be paid by a trustee based on receipts allocated to income shall be paid from income.

(2) A tax required to be paid by a trustee based on receipts allocated to principal shall be paid from principal, even if the tax is called an income tax by the taxing authority.

(3) A tax required to be paid by a trustee on the trust's share of an entity's taxable income shall be paid proportionately:

(a) From income to the extent that receipts from the entity are allocated to income; and

(b) From principal to the extent that:

1. Receipts from the entity are allocated to principal; and

2. The trust's share of the entity's taxable income exceeds the total receipts described in paragraph (a) of this subsection and paragraph (b)1. of this subsection.

(4) For purposes of this section, receipts allocated to principal or income shall be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

SECTION 26. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO

READ AS FOLLOWS:

(1) A fiduciary may, with District Court approval, make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(a) Elections and decisions, other than those described in subsection (2) of this section, that the fiduciary makes from time to time regarding tax matters;

(b) An income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving, or a distribution from, the estate or trust; or

(c) The ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(2) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes and, as a result, estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement shall equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced shall be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

SECTION 27. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

(1) The provisions of Section 3 of this Act that allow a trustee to adopt the prudent investor rule and make allocations to income shall not apply to any trust without District Court approval.

(2) The provisions of Sections 1 to 27 of this Act, other than Section 3 of this Act, shall apply to all trusts administered under Kentucky law, except as otherwise specifically provided in the instrument creating the trust, regardless of when created.

ARTICLE 6

MISCELLANEOUS PROVISION

SECTION 28. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

Sections 1 to 27 of this Act may be cited as the " Kentucky Principal and Income Act."

SECTION 29. The following KRS sections are repealed:

386.191 Definitions for KRS 386.191 to 386.349.

386.195 Rules of trust administration.

386.205 Definition of income and principal.

386.215 Income interest -- Income beneficiary.

386.225 Determination and distribution of income.

386.235 Corporate distribution of shares.

386.245 Corporate securities.

386.255 Net profits of business.

386.265 Royalties and other receipts from disposition of natural resources.

386.275 Timber.

386.285 Other depletable property.

386.295 Delayed income from sale of underproductive property.

386.305 Charges against income.

386.315 Apportionment of expenses.

386.325 Application of KRS 386.191 to 386.459.

386.335 Construction of KRS 386.191 to 386.349.

386.345 Effective date -- Application on receipts and expenses.

386.349 Short title.

Section 30. This Act takes effect January 1, 2005.

EXHIBIT B

UNIFORM PRINCIPAL AND INCOME ACT ("UNIFORM ACT")

V.

KENTUCKY PRINCIPAL AND INCOME ACT ("KENTUCKY ACT")

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Definitions and Fiduciary Duties	Article 1		Article 1	
Short Title	Section 101			
Definitions	Section 102	386.450	Section 1	Adds at Subsection (3) a definition of "District Court Approval" to mean the consent of: (a) All current beneficiaries (b) All remainder beneficiaries in the oldest generation, and (c) The court Deleted from definition of a "fiduciary" in Subsection (4) "a person performing substantially the same function."
Fiduciary Duties; General Principles	Section 103	386.452	Section 2	

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Trustee's Power to Adjust	Section 104	386.454	Section 3	Adds Subsection (1) which allows an individual trustee to elect to have the Kentucky prudent investor rule at KRS 287.277 apply to trust with approval of the District Court. Deletes the "factors" to consider found in Section 104 (b) of the Uniform Act. Subsection (2) of the Ky Act permits an adjustment method such as an annual percentage distribution of not less than 3% nor more than 5% of FMV with approval of the District Court. Subsection (3) extends provisions to personal representative of estate. Added Subsection (4)(h) which provides that effect on compensation of a non-beneficiary fiduciary does not preclude an adjustment. Subsection (6) provides that release of power to adjust requires District Court approval.

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Decedent's Estate or Terminating Income Interest	Article 2		Article 2	
Determination and Distribution of Net Income	Section 201	386.456	Section 4	
Distribution to Residuary and Remainder Beneficiaries	Section 202	386.458	Section 5	
Apportionment At Beginning and End of Income Interest	Article 3		Article 3	
When Right to Income Begins and Ends	Section 301	386.460	Section 6	
Apportionment of Receipts and Disbursements when Decedent Dies or Income Interest Ends	Section 302	386.462	Section 7	
Apportionment when Income Interest Ends	Section 303	386.464	Section 8	Added last sentence of Subsection (3) [Section 303(c) of Uniform Act] to make clear a settlor can change charitable beneficiary of a trust by will or written notice to trustee, if does not change tax consequences even if trust agreement does not expressly allow.

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Allocation of Receipts During Administration of Trust	Article 4		Article 4	
Part 1. Receipts from Entities				
Character of Receipts	Section 401	386.466	Section 9	
Distribution from Trust or Estate	Section 402	386.468	Section 10	
Business and Other Activities Conducted by Trustee	Section 403			Deleted in entirety.
Part 2. Receipts Not Normally Apportioned				
Principal Receipts	Section 404	386.470	Section 11	Added "stock splits" to Subsection (2) Moved provisions dealing with options from Uniform Act Section 414 to here because balance of Section 414 dealing with derivatives deleted in entirety.
Rental Property	Section 405	386.472	Section 12	
Obligation to Pay Money	Section 406	386.474	Section 13	

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Insurance Policies and Similar Contracts	Section 407	386.476	Section 14	
Part 3. Receipts Normally Apportioned				
Insubstantial Allocations not Required	Section 408	386.478	Section 15	Statute uses word "unsubstantial" rather than "insubstantial."
Deferred Compensation Annuities and Similar Payments	Section 409	386.480	Section 16	
Liquidating Asset	Section 410	386.482	Section 17	
Minerals, Water, and Other Natural Resources	Section 411	386.484	Section 18	Added a new Subsection (5) [or Section 411(e) under Uniform Act], which provides that proceeds from disposition of mineral interest is allocated in same manner as receipts from the interest.
Timber	Section 412	386.486	Section 19	
Property Not Productive of Income	Section 413	386.488	Section 20	First subsection in Ky Act tracks the QTIP marital deduction rules – ... "spouse may require the trustee to make the trust income productive."

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Derivatives and Options	Section 414			Deleted derivatives portion of Section 414 of the Uniform Act in entirety and moved the option provision to Section 11(6) of the Ky Act.
Asset-Backed Securities	Section 415			Deleted in entirety.
Allocation of Disbursements During Administration of Trust	Article 5		Article 5	
Disbursements from Income	Section 501	386.490	Section 21	
Disbursements from Principal	Section 502	386.492	Section 22	Added Subsection (1) providing that portion of regular compensation of trustee/investment advisor/custodian not paid from income under Section 12 [Section 501(1) of Uniform Act] is paid from principal.
Transfers from Income to Principal for Depreciation	Section 503	386.494	Section 23	Section 503(b)(3) of Uniform Act deleted because Ky Act deleted Uniform Act Section 403 (Allocation of Receipts from Business and Other Activities).
Transfers from Income to Reimburse Principal	Section 504	386.496	Section 24	

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Income Taxes	Section 505	386.498	Section 25	
Adjustments Between Principal and Income Because of Taxes	Section 506	389.500	Section 26	Ky Act requires court approval for adjustments between principal and income for tax effects.
		386.502	Section 27	Subsection (1) provides that adoption of prudent investor rule and making allocations to income requires District Court approval. Subsection (2) provides that Ky Act Sections 1-27 (other than 3) apply to all trusts administered under Ky law, except as specifically provided in the instrument creating the trust, regardless of when created.
Miscellaneous Provisions	Article 6		Article 6	
		386.504	Section 28	Names the legislation the "Kentucky Principal and Income Act."
Uniformity of Application and Construction	Section 601			
Severability Clause	Section 602			

Subject Matter	Uniform Act	New KRS Chapter/Section	Kentucky Act Section of House Bill 517[1]	Changes in Kentucky Act from Uniform Act[2]
Repeal	Section 603		Section 29	
Effective Date	Section 604		Section 30	Ky Act effective January 1, 2005
Application of Act to Existing Trusts and Estates	Section 605			

LEX:649156.1

1. The Kentucky Act originated in House Bill 517.

2. Sections referred to in this column are the sections of House Bill 517 because KRS subsections not yet issued by Legislative Research Commission.

EXHIBIT C

Examples of Adjustments to Principal and Income[1]

Example (1) -- T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 104(b) [of the Uniform Act; but not included in of the Kentucky Act], T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

Example (2) -- T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 [of the Uniform Act; Section 13 of the Kentucky Act; KRS 386.474], is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

Example (3) -- T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's income from her social security, pension and saving exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) -- T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives

[1] These examples are taken from the Prefatory Notes and Comments to the Uniform Principal and Income Act (1997) prepared by the National Conference of Commissioners on Uniform State Laws and approved and recommended for enactment in all states at its annual conference on July 25-August 1, 1997, Sacramento, California.

for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 104(a) [of the Uniform Act; Section 3 of the Kentucky Act; KRS 386.454] to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Example (5) -- T is the trustee of a trust for the Settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of $600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of $900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under Section 409(c) [of the Uniform Act; Section 16(3) of the Kentucky Act; KRS 386.480] . The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) [of the Uniform Act; Section 2(2) of the Kentucky Act; KRS 386.452] include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary.

Example (6) -- T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to Section 501(3) [of the Uniform Act; Section 21(3) of the Kentucky Act; KRS 386.490]. After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 104(b) [of the Uniform Act; not included in the Kentucky Act], T may exercise the power to adjust under Section 104(a) [of the Uniform Act; Section 3 of the Kentucky Act; KRS 386.454] to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with Section 103(b) [of the Uniform Act; Section 2(2) of the Kentucky Act; KRS 386.452].

Example (7) -- T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 501(1) [of the Uniform Act; Section 21(1) of the Kentucky Act; KRS 386.490] and the other one-half would have been paid from principal under Section 502(a)(1) [of the Uniform Act; Section 22(1)(a) of the Kentucky Act; KRS 386.492]. After considering the total return from the portfolio as a whole and other relevant factors described in Section 104(b) [of the Uniform Act; not included in the Kentucky Act], T may exercise its power to adjust under Section 104(a) [of the Uniform Act; Section 3 of the

Kentucky Act; KRS 386.454] by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

WHAT THE TRUST AND ESTATE LAWYER MUST KNOW ABOUT HIPAA

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SECTION C

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WHAT THE TRUST AND ESTATE LAWYER MUST KNOW ABOUT HIPAA

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A. AN OVERVIEW OF HIPAA.

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), Public Law 104-191, was enacted on August 21, 1996. Sections 261 through 264 of HIPAA required the Secretary of HHS to publicize standards for the electronic exchange, privacy and security of health information.

HIPAA required the Secretary to issue privacy regulations governing individually identifiable health information, if Congress did not enact privacy legislation within three years of the passage of HIPAA. Because Congress did not enact privacy legislation, HHS developed a proposed rule and released it for public comment on November 3, 1999. The final regulation, the *Standards for Privacy of Individually Identifiable Health Information* ("Privacy Rule"), was published December 28, 2000.

In March 2002, the Department proposed and released for public comment modifications to the Privacy Rule. The final modifications were published in final form on August 14, 2002. A text combining the final regulation and the modifications can be found at 45 CFR Part 160 and Part 164, Subparts A and E on the HHS Office of Civil Rights ("OCR") website: http://www.hhs.gov/ocr/hipaa.

The Privacy Rule establishes, for the first time, a set of national standards for the protection of certain health information. The Privacy Rule standards address the use and disclosure of individuals' health information—called "protected health information" or "PHI" by organizations subject to the Privacy Rule—called "Covered Entities," as well as standards for individuals' privacy rights to understand and control how their health information is used. Within HHS, the OCR has responsibility for implementing and enforcing the Privacy Rule with respect to voluntary compliance activities and civil money penalties.

The Privacy Rule became effective, for all but small providers and small health plans, on April 14, 2003. Small providers and small health plans now are also subject to HIPAA's Privacy Rule. The Privacy Rule applies to "Covered Entities" -- health plans[1], health clearing houses[2], and to health care providers[3] who transmit health information electronically in connection with a transaction subject to HIPAA. [4] Thus, some health care providers have managed to avoid being subject to the Privacy Rule by refusing to transact their business electronically; as a practical matter this means accepting no patients whose charges would be paid by insurance, including from Medicare or Medicaid, and not transferring or accepting PHI from another provider in an electronic format. Once a provider becomes subject to HIPAA, all PHI in its possession or control is subject to the HIPAA Privacy Rule's requirements. [5]

[1] A health plan is defined as an individual or group plan providing, or paying for medical care, including health insurers, HMOs, Medicare, Medicaid, Medicare supplement and long term care insurers, employee benefit welfare plans, MEWAs, state high risk pools, other federal health care insurance programs and any other individual or group plan which provides or pays for health care.

[2] Clearing Houses are public or private entities that either process or facilitate the processing of standard data to nonstandard data [or vice-versa]. This includes billing and repricing companies, certain health management information systems and networks that facilitate the processing of health information received from another entity.

[3] Any provider of services identified in 42 USC 1395x(u) of medical or health services and any other person or organization who furnishes, bills or is paid for health care in the normal course of business.

[4] A fourth category of Covered Entity has recently been designated by HHS – sponsors of the new Medicare prescription drug card benefit...

[5] The Privacy Rule speaks of two types of health information: IIHI or Individually Identifiable Health Information which is information collected from an individual and related to past, present or future treatment, payment or provision of health care services and which could identify the individual; and PHI or Protected Health Information, which is IIHI that is transmitted or maintained by a Covered Entity in any format, not just electronically

The Privacy Rule also applies to certain persons who work with or provide services to Covered Entities and who are known as "Business Associates". In addition to persons more directly involved in providing services necessary for the day-to-day operation of a Covered Entity's business, Business Associates also include persons who provide legal, actuarial, accounting and financial management services to a Covered Entity. When providing services to a Covered Entity which relate to that Entity's health care business [treatment, payment or operations] and which involves the use or disclosure of PHI, a Business Associate is required to execute a contract binding it to comply with the requirements of the HIPAA Privacy Rule.

For more on the background and general provisions of HIPAA, see the "Summary of the HIPAA Privacy Rule" at the OCR website at the address listed hereinabove.

B. HIPAA DISCLOSURE RULES.

As attorneys, we may provide Business Associate services to a Covered Entity or we may simply need access to PHI in order to provide services to our own trust and estate (or other) clients. In either event we need to have a basic understanding of many of the provisions of the Privacy Rule, most particularly those that relate to the ability to obtain PHI from a Covered Entity.

Under HIPAA, a Covered Entity may use or disclose PHI only:

- To the individual whose PHI it is or his/her duly authorized personal representative;
- In accordance with a valid authorization under 45 CFR 164.508 (5);

- As otherwise permitted or required under HIPAA, without written authorization, but with advance notice and opportunity to object (limited to circumstances such as inclusion in a hospital's phone directory of patients or to discussing health condition in front of family member accompanying the patient] 45 CFR 164.510);
- As otherwise permitted or required under HIPAA without written authorization or notice;
- When required by law;
- For public health activities;
- When abuse, neglect or domestic violence is suspected;
- For health oversight activities;
- In connection with judicial & administrative actions;
- For law enforcement activities;
- About decedents to coroners, medical examiners and funeral directors;
- To avert a serious threat to health or safety;
- For specialized government purposes; or
- For workers' compensation obligations.

Thus under HIPAA, a Covered Entity ***may, but is not required to,*** provide PHI to others involved in the treatment of his/her patients. Because such disclosure is merely permissive, and in view of HIPAA's potential fines and criminal sanctions, many providers have elected to disclose PHI only when required under the Privacy Rules. This is increasingly the case where a provider does not have a long-term relationship with a patient and is, therefore, uncertain regarding the patient's circumstances or desires. Also, some providers are reporting that an increasing number of patients are requesting that their health status NOT be shared with their families. Anecdotally, this appears to be particularly true in the case of elderly patients fearing loss of independence if the true state of their health is disclosed to family members.

In the context of estate planning and trust documents, the health of an individual can be critical to the legal effectiveness of some or all of the terms of the client's planning. The client's Power of Attorney may only take effect upon a physician-certified disability, by its terms. If the client wants to use a funded Revocable Trust to provide for asset management upon disability, but serve as his or her own trustee until disability commences, the determination of the client's disability is crucial to the transition of the Trust Agreement from the client's management to the successor trustee's management. Further, in Trust Agreements, successor trustees' service may be expressly contingent upon the successor trustee not being disabled either. Finally, a client's Living Will Directive prepared in accordance with Kentucky law only takes effect under KRS 311.621 and 311.625, when the client lacks "decisional capacity". In all these instances, the attorney and family of the client must turn to the client's physician for assistance in determining whether or not the client is disabled, before the disability or estate planning can move ahead.

To provide the necessary cooperation of the client's physician when the need for a disability determination will arise, there are two avenues available to the drafter. The first is to assure that the relevant documents create a legally enforceable "personal representative status" for a party named in the document as a matter of applicable state law; the second is to obtain a HIPAA compliant authorization at the time the documents are drafted. It must be noted that neither approach is completely foolproof. There is a wealth of writing and speaking on the subject, but a noted dearth of consensus on how best to proceed. The presenters will give you a number of the concepts and forms being advocated by various proponents, but with no assurance as to what may be best or effective for your practice. However, lest you decide to abandon all hope, one fact should be considered: failure to attempt compliance with HIPAA's privacy requirements virtually assures that health information will not be available when needed.

C. THE "PERSONAL REPRESENTATIVE" APPROACH.

HIPAA's Privacy Rule outlines when a person will be treated as a "personal representative" of another and thus be entitled to assert the rights of that other person in a matter related to the patient's health care needs. These provisions are found in 45 CFR 164.502. Its provisions are applicable to adults [both competent and incompetent], minors and deceased persons.

First, personal representative capacity is determined by reference to applicable state law. If that law would designate an individual as a personal representative authorized to act with respect to the matter at hand (e.g. making health care decisions or administering an estate), then a Covered Entity must honor that person's personal entity status. ***See*** 45 CFR 164.502 (g)(2) & 164.502 (g) (4), respectively. Similarly, with respect to an unemancipated minor, a parent or guardian, or other person having ***in loco parentis*** status under state law ***and*** granted the right under that law to make health care decisions for the minor, must be treated as the minor's personal representative. 45 CFR 164.502 (g)(3)(i). From the Covered Entity's perspective, the only exceptions to these rules occurs when the provider, acting in good faith, suspects abuse, neglect or domestic violence or where a more specific state law limits the personal representative's rights.

The specific language of the Privacy Rule addressing personal representative capacity sets forth the main limitation which must be considered in drafting powers of attorney, trust documents or in obtaining a court order granting personal representative status:

> If under applicable law a person has authority to act on behalf of an individual who is an adult or an emancipated minor in making decisions related to health care, a Covered Entity must treat such person as a personal representative under this subchapter, with respect to protected health information relevant to such personal representative.
>
> 45 CFR 164.502 (g)(2).

OCR has addressed the limitations and requirements of his section of the Privacy Rule in a series of answers to Frequently Asked Questions (hereinafter "OCR FAQ #"), posted on its website cited in Section A hereinabove. These are paraphrased below.

- The personal representative must - by reference to applicable state law – be entitled to make health care decisions for the individual. In OCR FAQ # 220, OCR has advised Covered Entities that a person holding a non-health care power of attorney does not have the right to access the medical records of the grantor unless the grantor has died and applicable state law qualifies the POA as the personal representative of the decedent. This approach may be virtually useless to the planner; the Power of Attorney dies with the client under most states' laws, and a personal representative must be named under the decedent's Will.

- If the right to make health care decisions is limited by state law, the personal representative cannot obtain more general information. OCR FAQ # 221 discusses this, stating, "If a personal representative's authority is limited to authorizing artificial life support, then the personal information is limited to that information which may be relevant to decisions about artificial life support."
- A personal representative under a health care POA will have the right to access the medical records of the individual for whom he/she serves as POA to the same extent as that individual himself. OCR FAQ # 220.
- A Covered Entity is required to verify a personal representative's authority in accordance with 45 CFR 164.514(h). See OCR FAQ # 226.
- "A Covered Entity does not have to treat a personal representative as the individual's representative if it reasonably believes, in the exercise of professional judgment, the individual is subject to domestic violence, abuse or neglect by the personal representative, or doing so would otherwise endanger the individual." OCR FAQ # 223.
- Nothing in the Privacy Rule changes the way in which state law determines the authority of, or authorizes, one person to make health care decisions for another. OCR FAQ # 219.

- Because Covered Entities are required to verify that a person claiming personal representative status does, in fact, hold that status, many are requiring a copy of any POA or similar document before releasing any information to a personal representative. Assuming the POA is sufficiently broad in its reference to health care decisions, a Covered Entity will still limit any information produced to the "minimum necessary" for the intended purpose. If the PHI is needed for treatment by another provider, the entire file may be sent; if it is needed to decide whether a patient may safely travel, the information provided may be much less detailed. Obviously, some Covered Entities will feel comfortable producing more information than others. If the PHI is requested for a reason other than to make a health care decision, a Covered Entity is well within its rights to refuse to disclose the PHI absent a broadly worded document making clear the representative's right to PHI under the circumstances at hand.

In Kentucky, there are a number of different fiduciary roles created or recognized by statute. These include health care surrogates designated pursuant to KRS 311.623, durable powers of attorney under KRS 386.093, guardians, limited guardians and conservators under KRS 387.010-.280 as well as personal representatives [executors, administrators or curators] under KRS 395.015. Additionally there are statutes addressing who may make a medical decision when an advance directive does not exist or address the issue [KRS 311.631], who makes certain health care decisions when there is both a court appointed fiduciary and a health care surrogate [KRS 311.6231], and statutes allowing an estate to be processed without administration [KRS 395.455 & .470].

Each of these statutes raises interesting questions under HIPAA both for an attorney providing advice to the individual or his family and to Covered Entities with respect to who is entitled to access the individual's PHI. The job of the planner is to coordinate these roles in any documents drafted, subject to the limits imposed by state law. The goal should be to have at least one person who is clearly the client's "personal representative" for HIPAA purposes. That person should then be authorized to share PHI with others in the overall plan who need the PHI to act properly under their governing document.

The question presented in Kentucky, as in many other jurisdictions, is whether the "surrogate" named in the client's Living Will Directive will be recognized as the client's "personal representative" entitled to receive the client's PHI. KRS 311.621(15) defines "surrogate" to mean an adult who has been designated to make health care decisions in accordance with KRS 311.621 to 311.643. However, under KRS 311.629, a surrogate designated pursuant to an advance directive may not make a health care decision for a grantor in any situation in which the grantor's attending physician has determined in good faith that the grantor has decisional capacity. In effect, then, the legal authority of the surrogate only arises when the physician determines that the grantor lacks decisional capacity. The question presented is whether the grantor's physician, who presumably is a "Covered Entity" under HIPAA in most cases, will recognize the surrogate as the "personal representative" of the grantor of the Living Will Directive entitled to receive the information that the grantor lacks decisional capacity. Or, will the physician, in an abundance of caution, fear that the disclosure of the grantor's lack of decisional capacity to the surrogate will constitute a violation of HIPAA, since the authority of the surrogate does not arise until the absence of decisional authority has been determined? This potentially is a classic "Catch-22" situation which has been generally noted in the literature, with no resolution yet offered by the OCR. In online dialog with other estate planners, at least one has noted that the hospitals in his area take a practical view, and will make the disclosure. However, as planners, we do not like to rely upon techniques which may be practical if we are not certain that they are also a clearly valid legal approach.

Cautious planners will want to take further steps to secure the "personal representative" status of an individual on behalf of their client. For many years before the Living Will statute was first enacted in 1990, Kentucky recognized the concept of the Power of Attorney as a matter of the common law of agency. Further, under KRS 386.093, there is a statutory provision enabling a Power of Attorney to survive the disability of the principal, if so stated in the Power of Attorney with the proper terminology. This suggests that a Power of Attorney which is presently effective and which includes express health care decisional authority should be effective as a matter of Kentucky law. If so, then the person named in that instrument should qualify as the "personal representative" of the client, with the right to access the necessary health care information. The broader the scope of health care authority set forth in the health care Power of Attorney, arguably the broader the scope of medical information which the client's physician and other health care entities will agree to provide. If the same person is named in the Health Care Power of Attorney and as Surrogate in the client's Living Will Directive, there should be no issue about "dueling personal representatives." However, some provisions in the Power of Attorney to coordinate it with the Living Will Directive may still be helpful. A sample Limited Power of Attorney for health care decisional authority which is presently effective is attached as part of the "Personal Representative Forms" in Exhibit A at the end of these materials.

Also attached at the end of these materials are other forms of "personal representative" language advocated by a variety of other authors. All of these are offered in the hopes that one or more of them may be useful to you in your practice.

D. THE "AUTHORIZATION" APPROACH.

A second possible solution to the issue created by the HIPAA Privacy Rules is to use a HIPAA compliant authorization from the client, allowing a named individual to obtain the client's health information.

As originally proposed, the Privacy Rule had two separate concepts – consent and authorization. Consent was required before a provider could use or disclose PHI for treatment, payment or operations, while authorization was required for other uses or disclosures of PHI. Comments received after HHS proposed this approach consistently noted the adverse impact this consent requirement would have on timely and appropriate care – inability to consult with a specialist or order lab tests without prior written consent. The comments also noted problems with payment – how does a provider get paid if a patient refuses to allow him/her to provide information to the health insurance company? As a result, the concept of consent was dropped from the Rule, except as a voluntary act by the provider or when required under applicable state law. [***See*** OCR FAQ # 360] A provider may now use or disclose PHI as necessary and appropriate for his or her own treatment, payment and operations rights and obligations. Any other use or disclosure of PHI must be specifically permitted or required under the Privacy Rule, as discussed at the beginning of this outline. Outside of government public health and safety activities, this generally means that an authorization to release medical information will be required.

An authorization is essentially a medical release form, but HIPAA requires that a number of provisions be satisfied before such a form is deemed 'compliant'. Specifically, these include:

- A specific and meaningful description of the PHI to be used or disclosed,
- The specific identity of the person, persons or class of persons authorized to make the requested use or disclosure,
- The specific identity of the person, persons or class of persons to whom the Covered Entity may make the requested use or disclosure,
- An expiration date which relates to the individual or specific purpose of the use or disclosure,
- A statement of the individual's right to revoke the authorization in writing, the exceptions to that right [set forth in 45 CFR 164.508(b)(5)] and the details of how the individual may revoke the authorization,
- A statement that once disclosed pursuant to the authorization the information may be subject to redisclosure by the recipient and no longer be protected under HIPAA, and
- The signature of the individual and the date.

As is the case with questions relating to personal representative status, OCR has issued answers to a number of frequently asked questions related to the scope and use of authorizations. These address the following areas:

- An Authorization must contain either an expiration date or an expiration event that relates to the individual or the purpose of the use or disclosure; e.g., "one year from date this Authorization is signed" or "upon the minor's age of majority." The fact that the expiration date is longer than established by applicable state law does not invalidate the Authorization under the Privacy Rule, but a more restrictive state law would control how long it would be effective. OCR FAQ # 476.
- A Covered Entity may disclose PHI as specified in a valid Authorization [one that means the requirements of 45 CFR 164.508, set forth above], that has been prepared by a third party such as an attorney or insurance company. OCR FAQ # 472.
- An Authorization form may be used to authorize uses and disclosures by classes or categories of persons or entities without naming the particular persons or entities. [45 CFR 164.508 (C) (1)]. A valid Authorization may also specifically identify the person or class of persons entitled to PHI. [45 CFR 164.508 (C) (1)(iii)] OCR FAQ # 473.
- An authorization is not required to be notarized or witnessed. OCR FAQ # 478.
- An individual may revoke his or her Authorization in writing and a HIPAA compliant authorization must state this fact. Revocation is not effective until received by the Covered Entity. Authorization forms created by third parties should not imply that revocation is effective when the third party receives it. OCR FAQ # 474.

A problem with the authorization approach is the duration limit. As noted above, a state law limitation on the duration of an authorization will, effectively, end the authorization even before its stated date of expiration. Under Kentucky law, the practice has certainly been to limit the use of medical authorizations to a period of two years, in the pre-HIPAA practice era. Therefore, use of the release approach for long term disability planning may not be effective. If the physician or other health care provider that is a "Covered Entity" will not accept an authorization more than two years old, then the only safe approach to use of the authorization approach is to have the client execute a new one every two years.

As for addressing the ability to access the PHI of successor trustees, various approaches have been suggested. Among them include the inclusion of a requirement in the trust or Will that a successor trustee, by agreeing to serve thereas, must also consent to the release of his PHI for purposes of determining whether or not he has become disabled from serving as trustee, or a requirement that the successor trustee sign an authorization for the same purpose at the time that the successor trustee assumes office. Others have simply suggested adding such personal representative or authorization language in the trust instrument itself, although this may be problematic where the successor trustee has not signed the document. Another approach is to give a non-physician the ability to make the disability determination with respect to successor trustees. Form language is included in Exhibit A addressing the trustee disability issue.

Attached at Exhibit B to these materials you will find a release form from a leading New York estate planning attorney, for your consideration. Again, the presenters make no promises or guarantees as to efficacy, but provide the form in the hope it may be useful to you in your practice.

E. **CONCLUSION.**

The Privacy Rule of HIPAA was enacted in order to protect a client's medical records of privacy. The medical information arena is not necessarily an area familiar to estate planners. The challenge facing us is to address these rules in our disability and estate planning for our clients, so that the legal rights of privacy do not frustrate the client's desire for information to be disclosed to their designated agents so that these agents can act for the client's best interests. Because the Privacy Rules were not promulgated with the disability and estate planning process in mind, and because the regulators who control the regulations and implementation are not estate planners, the challenge is even greater. Unfortunately, there is as yet no true consensus as to the best approach to addressing HIPAA for the estate planner. Nonetheless, it is incumbent upon us all to take the best known steps to address these issues with our clients, in view of the enactment and implementation of HIPAA and the penalties placed upon care providers if they breach the HIPAA Privacy Rule.

For those interested in further reading, in addition to the OCR website cited in Section A hereinabove, please see the attached Selected Bibliography.

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1. Paul L. Basile, Jr., "HIPAA PRIVACY RULES: WHAT'S AN ESTATE PLANNER TO DO?", California Trusts and Estates Quarterly (Spring 2004).

2. Michael L. Graham and Jonathan G. Blattmachr, "Planning For the HIPAA Privacy Rule," 29 ACTEC Journal 307 (2004).

3. Thomas J. Murphy, "Drafting Health Care Proxies to Comply With the New HIPAA Regs," 30 Estate Planning 559 (November 2003).

EXHIBIT A–SAMPLE AUTHORIZATION FORMS

POWER OF ATTORNEY

I, ***, of Jefferson County, Kentucky, hereby make, constitute and appoint my spouse, ***, or if my spouse shall die or cease to serve thereas for any reason, my children, *** and ***, either of whom may act independently and without the consent or joinder of the other, as my true and lawful Attorney-in-Fact, with full power of substitution, hereby revoking any and all powers of attorney that may have been heretofore executed by me, with full power and authority for me in my name, place and stead, to act in, manage, and conduct all my affairs, as I could do if acting personally, effective immediately. For purposes of acting as my Attorney-in-Fact, I hereby authorize my said Attorney-in-Fact, for me and in my name, place and stead, and for my use and benefit, and as my act and deed, to do, and execute, or to concur with persons and/or other legal entities jointly interested with myself therein in the doing or executing of, all or any necessary acts, deeds and things including, but not limited to, the following:

(1) **HIPAA PERSONAL REPRESENTATIVE.** TO ACT AS MY HEALTH CARE SURROGATE to make any health care decisions for me, and to act for me and in my name (in any way I could act in person) to make any and all decisions for me concerning my personal care, medical treatment, hospitalization and health care and to require, withhold or withdraw any type of medical treatment or procedure, even though my death may ensue. My Attorney-in-Fact/Health Care Surrogate shall have the same access and rights with respect to my medical records that I have, including the right to disclose the contents to others. I designate my current Attorney-in-Fact as my limited attorney-in-fact and personal representative to have access to my medical records, and to disclose the contents to others, for the purposes of acting as my health care surrogate hereunder and for the purpose of aiding others (e.g. persons named in my Living Will Directive, my Trust Agreement or otherwise) to assist me in case of my disability, incapacity, terminal illness or persistent vegetative state whenever they are legally authorized to do so. THIS DESIGNATION OF MY PERSONAL REPRESENTATIVE IS MADE IN ACCORDANCE WITH THE PROVISIONS OF 45CFR 164.502(g)(1), AND AS SUCH AUTHORIZES EACH OF MY ATTENDING PHYSICIANS AND MY OTHER HEALTH CARE PROVIDERS OF ANY KIND TO PROVIDE MY PERSONAL REPRESENTATIVE WITH ALL RIGHTS THAT I POSSESS IN AND TO MY MEDICAL AND OTHER PROTECTED HEALTH INFORMATION UNDER THE HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 ("HIPAA"). I hereby indemnify my said physicians and other health care providers from any liability for providing my medical and other protected health information as so authorized. My Attorney-in-Fact/Health Care Surrogate shall also have full power to dispose of any part or all of my body for medical purposes, authorize an autopsy and direct the disposition of my remains. Subject to any Living Will Directive I may have to the contrary, I do not want my life to be prolonged nor do I want life-sustaining treatment to be provided or continued if my Attorney-in-Fact/Health Care Surrogate believes the burdens of the treatment outweigh the expected benefits. Subject to any Living Will Directive I may have to the contrary, I want my Attorney-in-Fact/Health Care Surrogate to consider the relief of suffering, the expense involved and the quality as well as the possible extension of my life in making decisions concerning life-sustaining treatment. Without limiting the generality of the foregoing, but subject to the foregoing direction, my Attorney-in-Fact/Health Care Surrogate shall have the following powers:

(a) To give consent to and authorize or refuse, or to withhold or withdraw consent to, any and all types of medical care, treatment or procedures relating to my physical and mental health, including any medication program, surgical procedures, life-sustaining treatment or provision of food and water.

(b) To admit to or discharge me from any and all types of hospitals, institutions, homes, residential or nursing facilities, treatment centers and other health care institutions providing personal care or treatment for any type of physical or mental condition.

(c) To contract for any and all types of health care services and facilities in the name of and on my behalf and to bind me to pay for all such services and facilities; and my Attorney-in-Fact/Health Care Surrogate shall not be personally liable for any services or care contracted for on my behalf.

(d) At my expense and subject to reasonable rules of a health care provider to prevent disruption of my health care, to examine and copy and consent to disclosure of all my medical records that my Attorney-in-Fact/Health Care Surrogate deems relevant to the exercise of my Attorney-in-Fact/Health Care Surrogate's powers, whether the records relate to mental health or any other medical condition and whether they are in the possession of or maintained by any physician, psychiatrist, psychologist, therapist, hospital, nursing home or other health care provider.

(e) To direct that an autopsy be made; to make a disposition of any part or all of my body pursuant to the Uniform Anatomical Gift Act, as now or hereafter amended; and to direct the disposition of my remains.

If I have executed a Living Will Directive, (i) the language contained in this Paragraph 1 shall be in addition to, and not in lieu of, any health care proxy authority which I may have granted in such Living Will Directive; and (ii) any binding directive set forth in such Living Will Directive shall bind my Health Care Surrogate hereunder and shall supersede the authority of my Health Care Surrogate as to the matters expressly covered thereby.

(2) TO BUY, ACQUIRE, OBTAIN, TAKE OR HOLD POSSESSION of any property or property rights of mine or for me whatsoever, whether real, personal or mixed; and to retain such property as long as said Attorney-in-Fact shall deem it wise; and without limiting the generality of the foregoing, to take possession of, and to order the removal and shipment of, any property from any post, warehouse, depot, dock, or other place of storage or safekeeping, governmental or private; and to execute and deliver any release, voucher, receipt, shipping ticket, certificate or other instrument necessary or convenient for such purposes;

(3) TO SELL, CONVEY (either with or without covenants of warranty), LEASE, MANAGE, CARE FOR, PRESERVE, PROTECT INSURE, IMPROVE, CONTROL, STORE, TRANSPORT, MAINTAIN, REPAIR, REMODEL, REBUILD, and in every way deal in and with any property or property rights of mine, real, personal or mixed, now or hereafter owned by me, and to set up and carry reserves for repairs, improvements, upkeep and obsolescence of real and personal

property; to eject, remove, or relieve tenants or other persons from, and to recover possession of such property, real, personal or mixed; and to deal with the United States government, or agencies thereof, in the negotiating and executing of any contract;

(4) TO BORROW MONEY, MORTGAGE MY REAL AND PERSONAL PROPERTY OR COMPLETE, EXTEND, MODIFY OR RENEW ANY OBLIGATIONS, GIVING EITHER SECURED (including but not restricted to real estate mortgages, stock certificates and/or insurance policies as collateral) or unsecured, negotiable or nonnegotiable obligations of the undersigned, at a rate of interest and upon terms satisfactory to my said Attorney-in-Fact; to likewise LEND MONEY, either with or without collateral; to EXTEND OR SECURE CREDIT; and to GUARANTEE AND INSURE THE PERFORMANCE AND PAYMENT OF OBLIGATIONS OF ANOTHER PERSON, firm or corporation in the furtherance of any business of mine;

(5) TO OPEN, MAINTAIN, OR CLOSE BANK, BROKERAGE OR OTHER FINANCIAL INSTITUTION ACCOUNTS, or to do any business with any banking, lending, brokerage or other financial institution, in regard to any account of mine, to make deposits and withdrawals, obtain statements and passbooks, to collect or receive funds, to sign, endorse or execute checks, drafts, money orders, warrants, certificates or vouchers payable to me by any person, firm or corporation, including political corporations, and including the United States of America; to purchase and sell assets in and for my account, to pledge or margin my account, to write checks or otherwise direct the withdrawal or payment of my funds from any such account in any amount for my benefit or for any purpose herein provided; and TO HAVE FULL ACCESS TO ANY SAFETY DEPOSIT BOX, AND CONTENTS OF MINE, IN ANY BANK OR BANKING INSTITUTIONS;

(6) TO PAY ALL TAXES, city, county, State or Federal, including, but not restricted to, real estate taxes, special assessments, personal property taxes, monies and credit taxes, gift taxes, and income taxes, and to receive appropriate receipts thereof; to prepare, execute, file and obtain from the Government, income and other tax returns, State and Federal, and other governmental reports, applications, requests and documents; to take any appropriate action to minimize, reduce or establish nonliability for taxes whether now or hereafter unlawfully or illegally assessed against me; to receive or sue or take appropriate action for refunds of same; to appear for me and to represent me before the Internal Revenue Service and/or United States Department of the Treasury and/or any state tax commission, or any unit, division, agent or employee thereof, in connection with any matter involving Federal or State taxes in which I may be a party; to do everything whatsoever requisite and necessary to be done in the premises and to receive refund checks; and to execute waivers of the statute of limitations and to execute closing agreements as fully as I might do if done in my own capacity (and I hereby request and direct that all correspondence, documents and other communications regarding any tax matters with respect to which my said Attorney-in-Fact is hereby authorized to act be addressed to the said Attorney-in-Fact at the address said Attorney-in-Fact directs);

(7) TO ACT AS PROXY, with full power of substitution, at any corporate meeting, and to initiate corporate meetings for my benefit as stockholder, in respect of any stocks, stock rights, shares, bonds, debentures, or other investments, right or interest I may now or hereafter

hold, as fully as I might do if personally present and acting in my own behalf, including, but not restricted to, the right to join in or oppose any plans for changes in organization;

(8) TO INVEST AND REINVEST, or exchange any existing assets, including but not restricted to common and preferred stocks, annuities, and life insurance, in any income-producing contracts or property or securities, real or personal; and, not limited by the generality of the foregoing, to take out life insurance upon my life or upon the life of anyone else in whom I have an insurable beneficial interest, naming as beneficiary either me or the insured or the estate of any insured; and to pay the premiums, assessments and proper charges for such investments or to continue any existing plan of insurance or investment;

(9) TO REASONABLY DELAY, DEFEND, BEGIN, PROSECUTE, SETTLE, ARBITRATE, OR DISPOSE OF ANY LAWSUIT, or administrative hearings, claims, actions, attachments, injunctions, arrests or other proceedings, or otherwise engage in or participate in litigation in connection with the premises;

(10) TO CARRY ON A BUSINESS, or businesses of mine, in the discretion of the Attorney-in-Fact, and for that purpose to retain and employ or increase therein the capital which as of this date shall be employed therein; and to use fresh capital for any new enterprises; and to incorporate, or to operate as a general partnership, or limited partnership, or sole proprietorship under a trade name; to borrow on behalf of such business and to pledge business and/or personal assets of mine for such debt; to extend, modify, renegotiate or otherwise deal with any business debt; to buy and sell business assets; to liquidate, merge or reorganize any business; to make ordinary or extraordinary distributions of profits; to serve individually as employee, officer or director of such business at reasonable compensation for each service rendered;

(11) TO EMPLOY professional and business assistants of all kinds, including, but not restricted to, attorneys, accountants, realtors, appraisers, salesmen, and agents;

(12) TO ACT IN THE SETTLEMENT OF ANY ESTATE, in which I have or may have some interest or property due me and to protect, prosecute, and defend such interests; to petition, apply for, or otherwise obtain original or ancillary letters of administration, or letters testamentary; to receive and give acquittance for all sums of money, debts and accounts whatsoever, which are or shall become due, owing and payable to me; to appear, waive a bond or other security, and to deduct reasonable expenses from any share due me;

(13) TO PURCHASE with the same effect as I could such United States Treasury Bonds and securities as may be redeemed, at par value (and accrued interest) in payment of Federal estate taxes which I or my estate may owe (commonly called "Flower Bonds"), as well as any other bonds available at a discount and redeemable at par at my death, and for the purposes thereof, to do any and all things (including the borrowing of funds) which I could do if acting personally, in order to effect the purchase and ownership of such bonds and securities for the purposes aforesaid;

(14) TO MAKE GIFTS outright, in trust, in a section 529 Plan or in custodianship of any amount or amounts, of any real or personal property, or both (within the amount of the gift

tax annual exclusion, including the full amount which can be given if my spouse consents to split such gifts for gift tax purposes under section 2513 of the Internal Revenue Code, as amended) to the natural objects of my bounty, including, without limitation, my spouse, my issue and the spouses of my issue, so as to reduce the Federal estate taxes and state inheritance taxes payable at my death and at my spouse's subsequent death, with full power of substitution of judgment in this regard; and

(15) TO CLAIM OR DISCLAIM any power, property or interest in property (present or future) to be given, bequeathed, devised, passed by intestacy or distributed in any way to me or any trust for my benefit, including without limitation homestead, renunciation or elective share, dower or curtesy, in whole or in part, with full power of substitution of judgment in this regard;

(16) TO WITHDRAW any and all amounts in any life insurance policy, annuity, qualified or non-qualified retirement pension, profit-sharing or deferred compensation plan, benefit or account of any kind, to the full extent of my ability to do so personally, and the insurance or annuity company, trustee, fiduciary or other holder of such policy, annuity, plan, benefit or account shall be released from all liability for complying with the instructions of my Attorney-in-Fact as to such matters. To make any election available, in my Attorney-in-Fact's sole discretion, to take 5-year averaging, 10-year averaging and/or capital gain treatment of any distribution from any qualified plan.

(17) In the sole discretion of my Attorney-in-Fact, TO MAKE any election or allocation of any exemption available against or under the generation-skipping tax imposed by Chapter 13 of the Code, and to file such return or returns as shall be necessary to make such election or allocation.

(18) (a) TO CREATE AND FUND one or more revocable trusts for my benefit and payable to my estate after death, with such trustee(s) and on such terms as my Attorney-in-Fact shall deem appropriate, and to revoke, amend or withdraw from, any such trust. TO FUND the *** **REVOCABLE TRUST** with any or all of my assets at any time and from time to time.

(b) To exercise any rights I have retained under any revocable or irrevocable trust on my behalf.

(c) To alter, amend or revoke the *** **REVOCABLE TRUST**, and any other trust under which either I or my Attorney-in-Fact holds such powers under the express trust terms or applicable law (or under both).

(19) TO INDEMNIFY any third party and hold such third party harmless from liability for accepting the authority of my Attorney-in-Fact, and to sue or otherwise charge any third party which fails, declines or refuses to accept the authority of my Attorney-in-Fact.

(20) TO ESTABLISH AND FUND, in such amounts as my Attorney-in-Fact shall deem advisable, one or more prepaid tuition plans and qualified tax-deferred tuition savings plans (under Code section 529 or otherwise) for any of the natural objects of my bounty, including, without

limitation, my issue; to designate the custodian of any such plans, and to change such custodian from time to time, to the extent permitted by such plans; to designate the beneficiary of any such plans, and to change such beneficiary from time to time, to the extent permitted by such plans; to select the state for establishment of any such plans, and to rollover any such plans from one state to another state; and to withdraw the funds from any such plans from time to time, to the extent permitted by such plans.

I hereby give and grant said Attorney-in-Fact full power and authority to do and perform each and every act, deed, matter and thing whatsoever in and about my property, person and affairs as fully and effectually to all intents and purposes as I might or could do in my own proper person if personally present, and hereby ratify all that said Attorney-in-Fact shall lawfully do or cause to be done by virtue thereof; PROVIDED, HOWEVER, that nothing herein shall give or grant the power to execute or change my Last Will and Testament.

I hereby waive any conflict of interest which my Attorney-in-Fact may have in exercising any or all of the foregoing powers, and acknowledge and agree that my Attorney-in-Fact may deal with himself or herself (including making gifts) without limitation, absent bad faith or willful misconduct. No third party need inquire as to whether any act of self-dealing by my Attorney-in-Fact is duly authorized, and I indemnify all third parties from liability for allowing or facilitating any act of self-dealing by my Attorney-in-Fact.

I further direct that this Power of Attorney shall take effect as below provided and shall be irrevocable except as hereinafter otherwise expressly stated, and if real estate of mine is involved and this instrument has been recorded in a public office, this instrument, as to such real estate, shall not be revocable, unless and until such time as there is filed of record a duly acknowledged revocation of this instrument in the same public office in which the instrument containing this power is recorded.

I hereby nominate my said Attorney-in-Fact as the conservator or guardian of my estate and person if protective proceedings for either my estate or person (or both) are hereafter commenced.

This Power of Attorney shall become effective on the date of execution hereof, and shall continue effective until it is revoked by me in writing. This power, as between said Attorney-in-Fact and me, may be revoked at any time by prior written notice to said Attorney-in-Fact stating the date on which such revocation shall be effective; BUT, as regards any revocation by me or by operation of law, including death, anyone else in good faith relying upon the exercise of these powers by said Attorney-in-Fact may rely upon this instrument for its continuing validity. This instrument may be recorded in a public office but need not necessarily be so recorded.

THIS POWER OF ATTORNEY SHALL NOT BE AFFECTED BY THE DISABILITY OF THE PRINCIPAL.

EXCULPATION. My said Attorney-in-Fact shall not be liable for any loss sustained through error of judgment made in good faith, but said Attorney-in-Fact shall be liable for willful misconduct or breach of good faith.

IN WITNESS WHEREOF, I have hereunto set my hand and seal the ______ day of ________________, 2004, at Louisville, Jefferson County, Kentucky.

____
***

___________________________________ ___________________________________
Witness Witness

___________________________________ ___________________________________
Address Address

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

I, the undersigned, a Notary Public in and for the State and County aforesaid, certify that on the _____ day of ______________, 2004, there appeared before me in said State and County, ***, ____________________ and ________________________, witnesses, who subscribed their names to the above and foregoing Power of Attorney and acknowledged and delivered it to be and constitute their voluntary act and deed.

IN WITNESS WHEREOF, witness my signature and Notarial Seal hereunto affixed this ______ day of __________________, 2004.

My commission expires: _____________________.

(SEAL)

____
Notary Public

I certify that I prepared the
foregoing Power of Attorney.

____
John R. Cummins, Esq.
Greenebaum Doll & McDonald, PLLC
3500 National City Tower
Louisville, KY 40202
(502) 587-3602

HIPAA Language for POA (M. Douglas Deitchler)

Language for POA: Regardless of the time of commencement of the other powers granted my agent by this document, I authorize and request any physician, health care professional, health care provider, and medical care facility to provide to any designated agent in this document information relating to my physical and mental condition and the diagnosis, prognosis, care, and treatment thereof upon the request of any agent I have designated in this document. It is my intent by this authorization for my designated agent to be considered a personal representative under privacy regulations related to protected health information and for my designated agent to be entitled to all health information in the same manner as if I personally were making the request. This authorization and request shall also be considered a consent to the release of such information under current laws, rules, and regulations as well as under future laws, rules, and regulations and amendments to such laws, rules, and regulations to include but not be limited to the express grant of authority to personal representatives as provided by Regulation Section 164.502(g) of Title 45 of the Code of Federal Regulations and the medical information privacy law and regulations generally referred to as HIPAA.

HIPAA –Trust Provisions (Pete Donahoe)

Authority to Release Certain Medical Information. Any trustee or successor trustee who accepts their appointment as such with respect to any trust created under this Will, hereby authorizes the release by any health care provider of medical information needed to make any medical determination required by any such trust created under this instrument, including but not limited to, a determination concerning such trustee's or successor trustee's capacity to serve as a trustee.

Definitions: "Incapacity" shall mean that a Trustee is so mentally or so physically incapacitated that he or she is either unable or it is impractical to give prompt and intelligent consideration to business affairs. The successor trustee shall determine whether the acting trustee lacks the capacity to serve as Trustee and in making such determination the successor trustee may rely upon the acting trustee's written request for the successor trustee to serve. If the acting trustee has not made such a request or is incapable of doing so, the successor trustee shall consult with the acting trustee's doctor when making such determination. In determining to serve or not, the successor trustee shall regard a written medical opinion issued by the acting trustee's doctor that he or she is incapable of serving as trustee as constituting conclusive proof of such fact.

HIPAA Authorization Language to be added to a Healthcare POA (Bob Wolf, March 2004)

Effective immediately and continuously until my death or revocation by a writing signed by me or someone authorized to make health care treatment decisions for me, I authorize all healthcare providers or other covered entities to disclose to my agent, upon my agent's request, any information, oral or written, regarding my physical or mental health, including, but not limited to, medical and hospital records, including what is otherwise private, privileged, protected or personal health information, including but not limited to, health information as defined and described in the Health Insurance Portability and Accountability Act of 1996 (Public Law 104-191, 110 Stat. 2024), the regulations promulgated thereunder and any other state or local laws and rules. Information disclosed by a healthcare provider or other covered entity may be redisclosed and may no longer be subject to the privacy rules provided by 45 CFR § 164.

This power of attorney authorizes my attorney-in-fact to make various property related decisions on my behalf, some of which relate to my health care. Accordingly, I confirm that in connection therewith, my attorney-in-fact shall be treated as my personal representative for all purposes relating to my PHI, as provided in 45 CFR 164.502(g)(2).

Paul L. Basile, Jr., Los Angeles, California

Excerpted with permission from his article "HIPAA Privacy Rules: What's An Estate Planner To Do?", California Trusts and Estates Quarterly (Spring 2004). Mr. Basile indicates that there is some specific language in the document addressing California law issues, which would not be germane outside California.

AUTHORIZATION FOR RELEASE OF PROTECTED HEALTH INFORMATION

I hereby appoint __[Name]__[1] as my Personal Representative for health care disclosure under the Standards for Privacy of Individually Identifiable Health Care Information (45 CFR Parts 160 and 164) under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") and the California Confidentiality of Medical Information Act ("CMIA"). In the event that __[Name]__ is not reasonably available to act as my Personal Representative, I hereby appoint __[Alternate 1]__ as my Personal Representative. In the event that __[Alternate 1]__ is not reasonably available to act as my Personal Representative, I hereby appoint __[Alternate 2]__ as my Personal Representative.

My Personal Representative shall have the same access to Protected Health Information as I would. In accordance with California Probate Code § § 4235, 4682 and 4690, the authority granted to my Personal Representative in this paragraph shall be effective immediately and shall not be dependent on a determination of whether or not I lack capacity.

I authorize the disclosure of all Protected Health Information, whether now existing or hereafter created, related to my physical or mental ability to (a) perform the duties of a trustee of a trust or administer a trust, (b) understand or be able to make or communicate decisions about my property or financial or business affairs or the property or financial or business affairs of any other person for whom I am an agent under a durable power of attorney, or (c) make informed health care decisions regarding myself or any other person for whom I am an agent under an advance health care directive or similar instrument.

This authorization shall apply to any physician or other health care provider who is providing health care services to me at the time such Protected Health Information is sought by my Personal Representative.

[1] I prefer to name an individual as the person holding the power because I think the physician or hospital will feel more comfortable in disclosing Protected Health Information to a named individual without having to refer to another document in which the Personal Representative may be named. Civil Code § 56.11(f) allows the naming of a person or the "functions of the persons or entities authorized to receive the medical information." One could, therefore, refer to the successor trustees of a trust or agents under a durable power of attorney or advance health care directive executed by the principal instead of a named individual.

Such Protected Health Information shall be provided to my spouse, my lineal ancestors and descendants, my Personal Representative, my and my Personal Representative's respective attorneys, and any court or other governmental agency which may require such information in connection with any proceeding before such court or governmental agency. My Personal Representative may disclose such Protected Health Information to such other persons or entities, such as trustees of trusts of which I am or have been a trustee or agents under durable powers of attorney or advance health care directives executed by me.

This authorization shall remain in full force and effect until the earlier of (1) my written revocation hereof __[list any exceptions to the right of revocation]__ or (2) my death. Any written revocation of this authorization shall be delivered to my Personal Representative.

I understand that I have the right to receive a copy of this authorization. I also understand that I have the right to revoke this authorization and that any such revocation must be in writing.

Dated: ____________________

____
Signature of Principal

EXHIBIT B – SAMPLE RELEASE FORMS

Thomas J. Murphy

HIPAA Release Authority. I intend for my agent to be treated as I would be with respect to my rights regarding the use and disclosure of my individually identifiable health information or other medical records. This release authority applies to any information governed by the Health Insurance Portability and Accountability Act of 1996 (aka HIPAA), 42 USC 1320d and 45 CFR 160-164. I authorize:

any physician, health-care professional, dentist, health plan, hospital, clinic, laboratory, pharmacy or other covered health-care provider, any insurance company and the Medical Information Bureau Inc. or other health-care clearinghouse that has provided treatment or services to me, or that has paid for or is seeking payment from me for such services,

to give, disclose and release to my agent, without restriction,

all of my individually identifiable health information and medical records regarding any past, present or future medical or mental health condition, including all information relating to the diagnosis and treatment of HIV/AIDS, sexually transmitted diseases, mental illness, and drug or alcohol abuse.

The authority given my agent shall supersede any prior agreement that I may have made with my health-care providers to restrict access to or disclosure of my individually identifiable health information. The authority given my agent has no expiration date and shall expire only in the event that I revoke the authority in writing and deliver it to my health-care provider.

Larry J. Ferguson

AUTHORIZATION TO RELEASE MEDICAL RECORDS AND INFORMATION WAIVER OF PRIVACY

The undersigned, ___________________, whose address is _________________________ states:

1. Authorization. You are authorized to do the following:

   a. Disclose any and all information regarding my past and current medical treatment and care;

   b. Provide copies of all documents and records in your possession regarding my medical condition and treatment, at any time, including medical history and findings, consultations, prescriptions, treatments, x-rays, radiology reports, special consultation reports, diagnosis and prognosis, copies of all hospital, medical and billing records.

2. Provide Information To. The information identified in this document may be released, provided to, or discussed with any of the following persons:

3. When to Provide Information. You are authorized to provide the information identified in this document at the request of the individual or individuals identified in paragraph 2 above.

4. Expiration. This Authorization contains no expiration date.

5. Authority to Revoke. The undersigned reserves the right to revoke this authorization. In order to revoke this authorization, the notification must be written, signed by the undersigned, and dated. The revocation will then become effective upon delivery to you.

6. Redisclosure. I understand that the information disclosed by reason of this document may be subject to re-disclosure by the recipient and therefore may no longer be protected under state or federal law.

7. Photostatic Copies. A photostatic copy of this Authorization shall be considered as effective and valid as the original.

8. Voluntary Action. I understand that I am not required to sign this document and I am signing this document voluntarily.

9. Privacy Waiver. With regard to the disclosure of information authorized in this document, I waive any right of privacy that I may have under the authority of the Health Insurance Portability and Accountability Act of 1996, Public Law 104-191 (HIPAA), any amendment or successor to that Act, or any similar state or federal act, rule or regulation that might otherwise prevent any health care provider from providing access to my medical records under this document, and I hold harmless from any claim of liability under such act, rule or regulation, any medical provider who provides access to my medical information and records under this document.

10. Durable Power. This power of attorney shall not be affected by my disability. The authority of my agent shall be exercisable notwithstanding my later disability or incapacity or later uncertainty as to whether I am alive.

Dated: ______________________________

____
Signature

PREPARED BY FERGUSON & WIDMAYER, P.C.
538 North Division
Ann Arbor, Michigan 48104
Print Name
734-662-0222

HIPAA Form – Authorization for Release of Protected Health Information
(Moses & Singer)

I hereby authorize the use and/or disclosure of my individually identifiable health information as described below. I understand that this authorization is voluntary and that if the individual entity authorized to receive this information is not a covered entity under federal privacy regulations, the release of such information may no longer be protected by federal privacy regulations. I also understand that once this information is used/and or disclosed pursuant to this authorization it may be subject to re-disclosure by the recipient(s) and may no longer be protected by federal privacy regulations.

Name of (Trustee) (Attorney in Fact): ______________________________
Address: ______________________________
Phone Number: ______________________________
Soc. Sec. I.D. #: ______________________________

Person(s) or class of persons authorized to use and/or disclose the information:

Any physician, healthcare professional, dentist, health plan, hospital, clinic, laboratory, pharmacy or other covered health care provider, any insurance company, and the Medical Information Bureau Inc. or other health care clearinghouse that has provided treatment or services to me.

Person(s) or class of persons authorized to receive the information:

Any and all (Successor Trustees/Attorneys in Fact) under ______________ (Trust Name) (Power of Attorney dated ______________) and the attorneys of Moses & Singer, LLP, 1301 Avenue of the Americas, New York, NY 10019.

Description of the information that may be used and/or disclosed: (*please state clearly*)

My medical records and all other individually identifiable health information about me, whether or not contained in my medical records, regarding any past or present medical or mental health conditions, including but not limited to information relating to a physical or mental disability and information relating to the diagnosis and treatment of mental illness, excluding psychotherapy notes.

The information will be used and/or disclosed for the following purpose(s):

To determine whether I am under a disability, mentally or physically incapacitated or lack competency to act as Trustee under the above named Trust.

The Trustee must read and initial the following:

1.	I understand that this authorization will expire on the earlier of the date of termination of the _____________ (Trust Name) under the Trust agreement or revocation of this authorization as stated below.	**Initials** _______
2.	I understand that I may revoke this authorization at any time in writing by delivering it to the attorneys for the __________ (Trust Name), Moses & Singer LLP, 1301 Avenue of the Americas, New York, NY, 10019, except to the extent that action has been taken in reliance on this authorization.	**Initials** _______
3.	I also understand that in the event I do revoke this authorization, it will not have any effect on actions taken by any Successor Trustee prior to receipt of the revocation.	**Initials** _______

____

____

Name of (Trustee) (Attorney in Fact) Date

____

Signature of (Trustee) (Attorney in Fact)

CURRENT VALUATION ISSUES

John W. Porter
Baker Botts L.L.P.
Houston, Texas

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SECTION D

CURRENT VALUATION ISSUES

31ST ANNUAL MIDWEST/MIDSOUTH ESTATE PLANNING INSTITUTE

JULY 15-17, 2004

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I. OVERVIEW.

The determination of the fair market value of an interest in property which is being transferred, either by gift or at death, is the foundation upon which our federal estate and gift tax system is built. The United States Supreme Court has often held that succession taxes, inheritance taxes and estate taxes are constitutional levies by the federal government only if they are applied in a manner that merely is an excise tax at the transfer of property at death. *See, e.g.*, *Knowlton v. Moore*, 178 U.S. 41 (1900); *New York Trust v. Eisner*, 256 U.S. 345 (1921). Therefore, only that property which is transferred as a result of a taxpayer's death or by gift during the taxpayer's life can be subjected to taxation under the federal estate and gift tax system. The tax cannot be a "wealth tax" or "property tax" on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax on the value of the asset transferred. *See* I.R.C. §§ 2033, 2035-38, 2040(c), 2044 and 2501.

II. BASIC VALUATION PRINCIPLES.

In determining the value of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, federal tax law takes over to determine how such rights and interests will be taxed. *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940); *Estate of Nowell v. Commissioner*, 77 T.C.M. (CCH) 1239 (1999) (Cohen, C.J.). The valuation of property for transfer tax purposes is based upon the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b); Treas. Reg. § 20.2512-1. "The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is a not personalized one which envisions a particular buyer and seller." *LeFrak v. Commissioner*, 66 T.C.M. 1297, 1299 (1993). "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case." Treas. Reg. § 20.2031-1(b).

Because of this test, there are two primary components of federal estate and gift tax valuation: (1) understanding the state law rights being transferred from the hypothetical willing seller to the hypothetical willing buyer, and (2) determining the fair market value of the transferred rights.

III. FAMILY LIMITED PARTNERSHIP ISSUES.

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See, e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 973004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); and PLR 9723009 (February 24, 1997).

A. Dealing with the IRS's Arguments Regarding Family Limited Partnerships.

1. The Murphy Argument.

The principal support for the National Office's position in each of its pronouncements comes from the Tax Court's memorandum decision in *Estate of Murphy v. Commissioner*, 60 T.C.M. (CCH) 645 (1986), in which the Court valued a decedent's 49.65% common stock interest in a closely held corporation as a controlling interest because the decedent had given her children a 1.76% block of stock only 18 days before her death. The Court specifically found that "all concerned intended nothing of substance to change between the time of transfer and the time of [the decedent's] death, and that nothing of substance did change." *Id.* at 659. The Court stated that its position was "consistent with the established principle that transactions with no purpose or effect other than to reduce taxes are disregarded for federal tax purposes." *Id.* (emphasis added) Relying on this language in Murphy, the IRS argues that if the primary purpose for creating the partnership was to reduce transfer taxes, the IRS can ignore it for tax purposes.

The IRS relies on the *Estate of Murphy v. Commissioner*, 160 T.C.M. (CCH) 645 (1990) for the proposition that should the formation of the entity (FLP) be intended primarily for tax reduction purposes, then the entity can be ignored for Federal tax purposes. Murphy says no such thing. The question in *Murphy* was whether a gift of corporate stock 18 days before Mrs. Murphy's death should be recognized for estate tax purposes when the undisputed facts demonstrated that the "sole motive" for the transaction was to obtain the minority interest discount for the remaining 49% stock owned by Mrs. Murphy at the time of her death. The Court in *Murphy* said because the "sole motive" for the transaction was to tax reduction, and that nothing of substance changed in connection with the transaction, it could be ignored for a transfer in tax purposes.[1] Even if *Estate of Murphy* can be characterized to allow the IRS to disregard the existence of an entity (there is substantial doubt that the holding can be extended that far in light of the fundamental principles of transfer tax law discussed above and the Fifth Circuit's holding in *Wheeler* discussed below), *Murphy* does not allow the IRS to disregard the existence of a validity created entity under state law for transfer tax purposes where valid non-tax reasons for creating the entity exist. In other words, *Murphy* is a case where the sole motive for the transaction was transfer tax savings. Contrary to the Service's position, "taxpayers generally are free to structure a business transaction as they please, even if motivated by tax avoidance considerations." *Kerr v. Commissioner*, 113 T.C. 449, 464 (1999).

Established judicial authority holds that the Service cannot disregard the existence of a partnership if the partnership was formed for a business, financial, *or* investment reason or

[1] Ironically, the National Office pronouncements virtually ignore the Tax Court's memorandum decision in *Estate of Frank v. Commissioner*, 69 T.C.M. (CCH) 2255 (1995), which involved facts substantially similar to *Murphy*. In addressing a fact situation similar to that in *Murphy*, the Tax Court held that "as a general rule, we will respect the form of the transaction. We will not apply substance over form principles unless the circumstances so warrant." *Id.* at 2259.

in fact did engage in a business, financial, or investment activity.[2] Where any of these tests has been met, the courts have not ignored the effect of partnership agreements on valuation, even when valuation discounts approach 85%.[3] Moreover, the "intent" based argument asserted by the IRS under its *Murphy* analysis is similar to the argument expressly rejected by the Fifth Circuit in *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997). In *Wheeler*, the Government argued, in connection with a purchase of a remainder interest in a trust, that "because the purpose of § 2036(a) is to reach intrafamily interest transfers that amount to testamentary substitutes and include the underlying asset's value in the gross estate, the adequate and full consideration for intrafamily transfers—which are generally testamentary in nature because the interest passes 'to the natural objects of one's bounty in the next generation'—must be measured against the entire value of the underlying asset in order to accomplish § 2036(a)'s purpose." The Fifth Circuit rejected the Government's argument, stating that "[i]t is safe to say that, with the possible exception of gifts causa mortis, the present transfer tax scheme eschews subjective intent determination in favor of the objective requirements set forth in the statutes . . . Unless and until Congress declares that intrafamily transfers are to be treated differently, *see* I.R.C. §§ 2701-2704 (West Supp. 1996) discussed below, we must rely on the objective criteria set forth in the statute and Treasury Regulations to determine whether a sale comes within the ambit of the exception § 2036(a)." *Id.* at 765-766. *See also Estate of Strangi v. Commissioner*, 115 T.C. No. 35 (November 30, 2000) (Ignoring the subjective intent of the parties in creating the partnership, the Court stated that "the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we will not do so in this case.").

B. I.R.C. § 2703 Argument.

1. I.R.C. § 2703 Cannot Be Used to Completely Ignore the Existence of a Partnership Validly Created and Existing Under State Law.

In each of the National Office pronouncements, the Service took the position that I.R.C. § 2703 allows the IRS to disregard the existence of a partnership under the theory that the partnership agreement is a "restriction on the right to sell or use" the property of the partnership which can be ignored under I.R.C. § 2703 unless it meets the safe harbor provisions of I.R.C. § 2703(b). In essence, the Service interprets the word "property" in I.R.C. § 2703 to mean the assets transferred to the partnership -- not the partnership interest transferred.

The Service has stated that I.R.C. § 2703 can be used to completely disregard the existence of a partnership validly created and existing under state law. This argument ignores the fact, however, that the transfer tax is a tax on the "transfer of property." In essence, the Service claims that the property "transferred" is the transferor's interest in the property of the

[2] *See Frank G. Lyon Co. v. U.S.*, 435 U.S. 561, 583-584 (1978); *Estate of McLendon v. Commissioner*, 66 T.C.M. (CCH) 946,962 (1993); *Sparks Farm, Inc. v. Commissioner*, 56 T.C.M. (CCH) 464, 472-473 (1988); *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306, 1309 (1987); *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39-41 (1977).

[3] *See Estate of Watts v. Commissioner*, 51 T.C.M. (CCH) 60 (1985), *aff'd*, 823 F.2d 483 (11th Cir. 1987); *John R. Moore v. Commissioner*, 62 T.C.M. (CCH) 1128 (1991); *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987); *Harwood v. Commissioner*, 82 United States Tax Court Reports 239 (1984).

partnership, and that the value of the "interest" for transfer tax purposes is the transferor's proportionate share of the assets of the partnership. In the context of a decedent's estate, the question of law is whether the term "property," as it is used in I.R.C. § 2033, Treas. Reg. § 20.2031-1(b), and I.R.C. § 2703, refers to the property owned and transferred by a decedent as a result of his death (an interest in a partnership validly created and existing under state law and federal tax law) or, as the Service contends, to property that was not owned or transferred by the decedent as a result of his death (the property owned by the Partnership)? To determine this issue, the fact-finder will need to determine (1) whether the term "property," as it is used in I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b), means the decedent's partnership interest; and (2) whether the term "property," as it is used in I.R.C. § 2703, has the same meaning as the term "property" as it is used in I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b).[4]

A partnership interest is included in a decedent's estate for estate tax purposes because of I.R.C. § 2033. Under that section, "[t]he value of the gross estate shall include the value of all *property to extent of the interest therein of the decedent* at the time of his death." I.R.C. § 2033 (emphasis added). As a general rule, "the value of *every item of property* includable in a decedent's gross estate under §§ 2031 through 2044 [of the Code] is its fair market value at the time of a decedent's death . . . The fair market value is the price at which *the property* would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (emphasis added).

I.R.C. § 2703 addresses the value of certain property included in a decedent's estate under I.R.C. § 2033; it does not attempt to change the property interest being included. In certain instances, however, I.R.C. § 2703 can exclude from consideration for valuation purposes what would otherwise be relevant facts under the "willing buyer-willing seller" test for valuing that property by allowing certain restrictions against the transfer or use of that property, which a hypothetical buyer and seller would otherwise take into account in valuing that property. In no event does I.R.C. § 2703 permit the Service to completely ignore what property is being transferred by the decedent under I.R.C. § 2033. Specifically, I.R.C. § 2703 provides that:

> **Sec. 2703. Certain Rights and Restrictions Disregarded.**
>
> (a) GENERAL RULE--For purposes of this subtitle, the value of *any property* shall be determined without regard to--
>
> (1) any option, agreement, or other right to acquire or use *the property* at a price less than the fair market value of *the property* (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use *such property*.

[4] The question is similar in the context of a gift. I.R.C. § 2501, 2512 and Treas. Reg. § 2512-1 are simply substituted for I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b). For simplicity, the discussion below will relate to a decedent's estate, except where noted.

> (b) EXCEPTIONS--Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

I.R.C. § 2703 (emphasis added).

In its pronouncements, the Service appears to read the word "property" in I.R.C. § 2033, Treas. Reg. § 2031-1(b), and I.R.C. § 2703 to mean the proportionate share of the property owned by the partnership that an owner of the partnership interest would receive if the partnership liquidated. This interpretation ignores not only all terms of the partnership agreement, but the very existence of the partnership under state and federal tax law. The Service's interpretation is incorrect, for under state law a decedent generally has no right to property of the partnership and no ability to transfer property owned by the partnership. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 6132a-1 sec. 7.01 (Vernon Supp. 1997) ("A partner has no interest in specific limited partnership property."). In other words, the "property" being transferred by the decedent as a result of his death is not and cannot be the property of the Partnership; rather, the property being transferred as a result of death is the decedent's partnership interest. *Id.* Accordingly, the "property" to be valued in the decedent's gross estate is his interest in the Partnership. That is precisely what the Tax Court held in *Estate of Strangi v. Commissioner*, 115 T.C. No. 35 (November 30, 2000) (where the legal interest transferred by the decedent is an interest in a partnership, and not the assets of the partnership, I.R.C. § 2703 cannot be used to disregard the existence of the entity). *See also Church v. United States*, 2000-1 U. S. Tax Cas. (CCH) ¶ 60, 369; 85 A.F.T.R.2d (RIA) 804 (January 18, 2000).[5]

2. The Service's "New" I.R.C. § 2703(a) Position.

Since the IRS's attempt to disregard the existence of the entity using § 2703 has been rejected, the IRS has raised a new argument using § 2703 in several cases in which I am involved. Under the IRS's theory, all provisions in the partnership agreement are considered provisions related to the "use" of a partnership interest. Similarly, any provision which requires any level of consent of the other partners (*i.e.*, does not allow a partner to act unilaterally) is a "restriction" on the "use" of the partnership interest.[6] The IRS has erroneously asserted that the

[5] An examination of the other estate tax "inclusion" provisions of the Code also demonstrates that the term "property" as used in I.R.C. § 2703 means the property owned by the decedent. *See, e.g.* I.R.C. § 2034 ("The value of the gross estate shall include the value of all property to the extent of any interest therein of the surviving spouse . . ."); I.R.C. § 2035 ("[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer . . .").

[6] Under this theory, the very existence of the Partnership is a restriction on the right to use the Partnership interest, since a partnership by its nature implies joint action. But the IRS's attempt to use I.R.C. § 2703 to disregard the existence of a validly created entity was rejected by the Tax Court in *Estate of Strangi*, 115 T.C. at 35.

restrictions on the use of a partnership interest under I.R.C. § 2703(a) include provisions regarding the liquidation of the partnership, provisions regarding a partner's withdrawal, provisions regarding the admission of new partners, provisions regarding a general partner's discretion to make distributions, the term of the Partnership, the purposes of the partnership, and even the existence of other partners.

The answer to the issue turns on what is meant by "any restriction on the right to sell or use such property." I.R.C. § 2703(a)(2) (emphasis added). It is a question of statutory construction.

The Court's function in the interpretation of the Code is to construe the statutory language so as to give effect to the intent of Congress. *Carlson v. Comm'r*, 116 T.C. 87 (2001); *Merkel v. Comm'r*, 109 T.C. 463 (1997). When interpreting a statute, the court ordinarily first looks to the plain meaning of the language used by Congress. *Carlson*, 116 T.C. 87. When a statute does not define a term, the court generally interprets that term by employing the ordinary, contemporary, and common meaning of the words that Congress used. *Id.* If the plain meaning of the statute only supports one interpretation, the statute is not ambiguous. *Id.* However, where the ordinary and common meaning of the statutory language supports more than one interpretation, the statutory language is ambiguous, and the court will consult legislative history and the reason for the statute's enactment to assist the court in interpreting the language in question. *Merkel*, 109 T.C. 463; *Carlson*, 116 T.C. 87. When "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters . . . the intention of the drafters, rather than the strict language, controls." *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564 (1982).

Similarly, "use" is undefined in the Code for purposes of I.R.C. § 2703. Black's Law Dictionary defines the term as (1) "[t]o make use of, to convert to one's service, to avail one's self of, to employ;" and (2) "to leave no capacity with force or use in." Black's Law Dictionary (5th ed. 1979). In the context of an interest in an entity, such as an LLC or a partnership, the word "use" is highly ambiguous. I.R.C. § 2703 applies to "property" transferred by death or by gift. *See Estate of Strangi v. Comm'r*, 115 T.C. 35 (2000). With respect to the Partnership, the transferred interest is an interest in the Partnership. Under Texas law, "partnership interest" means a partner's interest in a partnership, including the right to receive distributions of partnership assets and the right to receive allocations of income, gain, loss, deduction, or credit of the partnership. TEX. REV. CIV. STAT. ANN. art. 6132a-1 sec. 1.02(11). A partner, however, has no specific rights in partnership property, so the "use" to which I.R.C. § 2703(a) refers cannot be the use of property of the Partnership. *See* TEX. REV. CIV. STAT. ANN. art 6132a-1 sec. 7.01 ("A partnership interest is personal property. A partner has no interest in specific limited partnership property.")

How does a partner "use" his interest in the partnership? It might be argued that the "use" of a partnership interest could consist of pledging the partnership interest as collateral for a loan, or assigning the partnership interest to a third party (*i.e.*, a buy-sell restriction). But the IRS's interpretation of the word "use" stretches the definition beyond both its plain meaning and Congressional intent.

Congress never intended for the definition of "use" to be extended as far as the IRS is trying to take it. A review of the legislative history of I.R.C. § 2703 demonstrates that by passing this bill, Congress was focused on options and buy-sell agreements that Congress believed to be abusive. It was never intended to be broadly interpreted to cover voting rights, management rights, liquidation rights, or the term of the partnership agreement or LLC regulations.

I.R.C. § 2703 is included in Chapter 14 of the Internal Revenue Code, which Congress passed in 1990. Chapter 14 was intended as a replacement to the estate tax freeze rules under I.R.C. § 2036(c) (repealed). Congress believed that because I.R.C. § 2036(c) had become unworkable, an across-the-board estate and gift tax inclusion rule was an inappropriate and an unnecessary approach to the valuation problems associated with the estate freezes. Thus, the 1990 Senate Report on the proposed revisions to the estate freeze rules, which is found at 136 Congressional Record S 15679-15683 (Daily Ed. October 18, 1990), states that "the Committee bill generally substitutes for Section 2036(c), ***a series of targeted rules*** generally designed to assure a more accurate determination of the value of the property subject to transfer tax." 136 Congressional Record at 15680 (emphasis added).

The first portion of the Senate Report discusses the areas targeted by Chapter 14. The analysis of the then "Present Law and Background" specifically addresses the estate tax freeze concerns of Congress when it passed Chapter 14. *Id.* at 15679. Those areas of concern included (1) preferred interests in corporations and partnerships, (2) trusts and term interests in property, (3) options and buy-sell agreements, and (4) lapsing rights. With respect to options and buy-sell agreements, the Senate Report discussed the Senate's concerns as follows:

> Description: Under another common freeze device, a member of an older generation grants a member of a younger generation an option to purchase property at a fixed or formula price. Such an option may be part of a buy-sell agreement under which the survivor (or the corporation) has the right to purchase stock from the estate of the first to die. An option may freeze the value of property at the strike price which in turn may be below the fair market value of the property at the date of death.
>
> Estate tax consequences: A restriction upon the sale or transfer of property may reduce its fair market value. Treasury regulations issued in 1958 acknowledge that the existence of an option or contract to purchase may affect the estate tax value of stock. Those regulations provide that the restriction is to be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass the decedent's stock to natural objects of his bounty for less than full and adequate consideration.
>
> Some courts have gone beyond the Treasury regulations and held that the price contained in a buy-sell agreement will limit fair market value for estate tax purposes if the price is fixed or determinable, the estate is obligated to sell, the agreement contains

> restrictions on lifetime transfers, and there is a valid business purpose for the agreement.
>
> In applying this standard, a number of courts have held that maintenance of family control and ownership is a business purpose that precludes the possibility that the agreement serves as a testamentary device. Continuation of family ownership and control has been found sufficient even when the "control" being preserved is only the right to participate as a limited partner. It also has been held sufficient when one party to the agreement has already contracted a terminal illness.
>
> In *Saint Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982), the Eighth Circuit held that the maintenance of family ownership and control of the business standing alone to be an insufficient ground for giving effect to a buy-sell agreement. Conceding that such purpose established the existence of a business purpose, the court went on to consider whether the agreement was a tax avoidance device. In finding evidence that might establish a tax avoidance motive notwithstanding a business purpose, the court considered the health of the decedent when the agreement was made, the disparity of the sale price from fair market value, and the enforcement of the agreement against other parties.

Id. at 15680.

Under the heading "Reasons For Change – Repeal of section 2036 (c)," the Senate Report discusses the reasons for the repeal of § 2036(c) and its replacement with Chapter 14. The Senate Report states that

> The committee believes that an across the board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes . . . Moreover, the committee is concerned that the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses.

The Report goes on to state that "the committee bill generally substitutes for section 2036(c) ***a series of targeted rules*** generally designed to assure a more accurate determination of the value of the property subject to transfer tax." *Id.* (emphasis added). The Report states that "in developing a replacement for current section 2036(c), the committee sought to accomplish several goals: (1) to provide a well defined and administrable set of rules; (2) to allow business owners who are not abusing the transfer tax system to freely engage in standard intrafamily transactions without being subject to severe transfer tax consequences; and (3) to deter abuse by making unfavorable assumptions regarding certain retained rights." *Id.*

With those stated goals in mind, the Senate Report discusses the concerns regarding each affected area. Included among these concerns are options and buy-sell agreements. Thus, under the heading of "Options and buy-sell agreements," the Senate Report provides that

> Options and buy-sell agreements
>
> The Committee believes that buy-sell agreements are common business planning arrangements and that buy-sell agreements are generally are entered into for legitimate business reasons that are not related to transfer tax consequences. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance. However, the Committee is aware of the potential of buy-sell agreements for distorting transfer tax value. Therefore, the Committee establishes rules that attempt to distinguish between agreements designed to avoid estate taxes and those with legitimate business agreements. These rules generally disregard a buy-sell agreement that would not have been entered into by unrelated parties acting at arm's length.

Id. at 15681. After discussing the reasons the Senate felt the need to adopt Chapter 14, the Senate Report includes an "Explanation of the Provisions" of Chapter 14. The "general explanation" in the Senate Report for Chapter 14 provides that:

> The bill repeals § 2036(c) retroactively and provides in its place rules generally intended to assure more accurate gift tax valuation of the initial transfer. These rules modify the valuation of specific retained rights in corporations and partnerships, the valuation of split temporal interests in property, the effect of buy-sell agreements and options upon value, the transfer tax consequences of lapsing rights, and the gift tax statute of limitations.

Id. (emphasis added).

This general explanation of the purpose of Chapter 14 can be traced specifically to each section of the Code enacted in the Bill. The rules that "modify the valuation of specific retained rights in corporations and partnerships" are contained in I.R.C. § 2701, which is entitled "Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships." The rules modifying "the valuation of split temporal interests in property" are contained in I.R.C. § 2702, which is entitled "Special Valuation Rules in Case of Transfers of Interests in Trusts." The rules modifying "the transfer tax consequences of lapsing rights" are contained in I.R.C. § 2704, which is entitled "Treatment of Certain Lapsing Rights and Restrictions." The provision modifying the "gift tax statute of limitations" is contained in I.R.C. § 6501(c)(9). Finally, the rules modifying "the effect of buy-sell agreements and options upon value: are contained in I.R.C. § 2703, entitled "Certain Rights and Restrictions Disregarded." With respect to that provision, the Senate Report states:

> Buy-sell agreements
>
> The bill provides that the value of property for transfer tax purposes is determined without regard to any option, agreement or other right to acquire or use the property at less than fair market value or any restriction on the rights to sell or use such property, unless the option, agreement, right or restriction meets three requirements. These requirements apply to any restriction, however created. For example, they apply to restrictions implicit in the capital structure of the partnership or contained in the partnership agreement, articles of incorporation, or corporate by-laws or a shareholder's agreement.
>
> The first two requirements are that the option, agreement, right or restriction (1) be a bona fide business arrangement, and (2) not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. These requirements are similar to those contained in the present Treasury regulations, except that the bill clarifies that the business arrangement and device requirements are independent tests. The mere showing that the agreement is a bona fide business arrangement would not give the agreement estate tax effect if other facts indicate that the agreement is a device to transfer property to members of the decedent's family for less than full and adequate consideration. In making this clarification, it adopts the reasoning of Saint Louis County Bank and rejects the suggestion of other cases that the maintenance of family control standing alone assures the absence of a device to transfer wealth.
>
> In addition, the bills adds a third requirement, not found in present law, that the terms of the option, agreement, right or restrictions be comparable to similar arrangements entered into by persons in an arm's length transaction. This requires that the taxpayer show that the agreement was one that could have been contained in an arm's length bargain. Such determination would entail consideration of such factors as the expected term of the agreement, the present value of the property, its expected value of the time of exercise, and the consideration offered for the option. It is not met simply by showing isolated comparables but requires a demonstration of the general practice of unrelated parties. Expert testimony would be evidence of such practice. In unusual cases where comparables are difficult to find because the taxpayer owns a unique business, the taxpayer can use comparables from similar businesses.

> The bill does not otherwise alter the requirements for giving weight to a buy-sell agreement. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to be binding on death.

Id. at 15683.

The Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, also makes clear that I.R.C. § 2703 was intended to deal with only options and buy-sell agreements. Specifically, the discussion of the then present law focuses on six areas, (1) estate tax inclusion related to estate freezes, (2) preferred interest in corporations and partnerships, (3) gift tax statute of limitations, (4) trusts and term interests in property, (5) options and buy-sell agreements, and (6) lapsing rights. H.R. Rep. 101-964. Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, 101st Cong., 2d Sess. 1130-1138 (1990). Under the heading "Buy-sell agreements," the Conference Report states that

> The Senate amendment provides that the value of property is determined without regard to any option, agreement, right or restriction, unless (1) the option, agreement, right or restriction is a bona fide business arrangement, (2) the option, agreement, right or restriction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration, and (3) the terms of the option, agreement, right or restriction are comparable to those obtained in similar arrangements entered into by persons in an arm's length transaction.

Id. at 1133. This is the identical language of I.R.C. § 2703(b).

The Conferees' agreement followed the Senate Amendment, with a few exceptions. With respect to "buy-sell agreements and options," the Conference Report provided that

> The conferees do not intend ***the provision governing buy-sell agreements*** to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the Conference Report.

Id. at 1137 (emphasis added).

The legislative history of Chapter 14 demonstrates that I.R.C. § 2703 was never intended to allow the IRS to seek to disregard provisions other than buy-sell agreements or similar options in valuing property. The IRS has interpreted the provisions of I.R.C. § 2703 without regard to its literal meaning or Congressional intent.

The IRS may argue that the "right to sell or use" the interest in a partnership includes the right to vote the interests (*i.e.*, management rights) or liquidation rights associated with the interests. As a practical matter, that is the only way the IRS can justify its position. But the IRS's interpretation of I.R.C. § 2703 is inconsistent with the clear legislative history set forth above and statutory structure of Chapter 14. *See Shwarz v. United States*, 234 F.3d 428, 433 (9th Cir. 2000) (looking to "plain language of the statute, as well as its legislative history" to interpret I.R.C. § 7431); *Merkel v. Comm'r*, 192 F.3d 844, 848 (9th Cir. 1999) (turning to legislative history for guidance on meaning of word "liabilities," given that term was not defined in Code). The IRS's view of § 2703 would totally supplant the need for I.R.C. § 2704 (which provides that certain voting rights and liquidation rights in an agreement may be disregarded under certain circumstances). If I.R.C. § 2703 was intended by Congress to allow the IRS to ignore voting rights and liquidation provisions in an entity for transfer tax purposes, there would be no need to enact I.R.C. § 2704. *See* H.R. Rep. No. 101-964 at 1137-38. Stated differently, the natural conclusion of the IRS's position is that Congress passed a meaningless statute when it enacted I.R.C. § 2704.

The IRS has argued that the regulations under I.R.C. § 2704 explicitly exclude transactions to which I.R.C. § 2703 applies, Treas. Reg. § 25.2704-2(b), and that Congress recognized that in a given case I.R.C. § 2703 and § 2704 may overlap. However, the IRS's argument is meaningless, considering the fact that the Treasury Regulations were written by the Department of Treasury, and not by Congress. Nowhere in the legislative history or the Code, both written by Congress, is there any indication that Congress meant to explicitly exclude from I.R.C. § 2704 transactions to which I.R.C. § 2703 applied. Our position is consistent with Congress' stated intent for Chapter 14 to be a series of ***targeted*** rules intended to deal with specific issues of concern to Congress.

In addition, the IRS has argued that testimony from Michael Graetz ("Graetz"), Deputy Assistant Secretary (Tax Policy), Department of Treasury, is somehow persuasive to support its position that I.R.C. § 2703 was intended to apply to more than options and buy-sell agreements. Estate Freezes—Hearing on "Discussion Draft" Before the Subcomm. on Energy and Agricultural Taxation and Subcomm. on Taxation and Debt Management, 101st Cong. 153 (June 27, 1990) (statement of Michael Graetz, Deputy Assistant Secretary (Tax Policy), Department of Treasury). At the Senate Finance Committee June 27, 1990 hearing, Graetz testified that he was of the opinion that I.R.C. § 2703 should apply to more than just contractual arrangements and options. In support of his argument, he cited three cases: *Estate of Harrison v. Comm'r*, 52 T.C.M. 1306 (1987); *Estate of Hall v. Comm'r*, 92 T.C. 312 (1989); and *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990). However, none of the cases cited by Graetz appear in the legislative history for I.R.C. § 2703, which came out after Graetz testified at the hearing. 136 Congressional Record 15679–15680 (Daily Ed. Oct. 18, 1990). Harrison is cited in the legislative history under I.R.C. § 2704 (and not § 2703), and neither of the other cases is addressed under I.R.C. § 2703. The omission of Graetz's citations from the legislative history demonstrates that Congress did not intend to expand the scope of the statute as broadly as Treasury had requested, and supports our argument that I.R.C. § 2703 is not intended to be applied as broadly as the IRS seeks to apply the statute.

3. I.R.C. § 2704(b).

Under I.R.C. § 2704(b), certain "applicable restrictions" must be disregarded in determining the value of a transferred ownership interest if: (1) the transfer is made to a member of the transferor's family; (2) the transferor's family controls the entity; and (3) there is an "applicable restriction" which either: (a) lapses after the transfer; or (b) may be removed wholly or partially after the transfer by the transferor or any member of his or her family, individually or jointly.

If an applicable restriction is disregarded, the transferred interest which formerly was subject to the restriction is valued as if the restriction does not exist and as if the rights of the transferor are determined under state law.

The Treasury regulations define "applicable restriction" as a restriction which: (a) is a limitation on the ability to liquidate the entity (in whole or in part); and (b) "is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction."[7] Treas. Reg. § 25.2704-2(b).

Even if an applicable restriction exists, that restriction will not be affected by I.R.C. § 2704(b) if: (1) it arises as part of any financing or equity participation entered into by the corporation or partnership with a person who is unrelated, as long as the restriction is commercially reasonable; (2) it is imposed or required to be imposed by any federal or state law; or (3) it is a restriction that is also subject to I.R.C. § 2703. *See* I.R.C. § 2704(b)(3) and Treas. Reg. § 25.2704-2(b).

a. When There Is a Restriction Against a Limited Partnership Continuing Beyond Either a Certain Point in Time or the Accomplishment of a Particular Undertaking, Is That an "Applicable Restriction" Under I.R.C. § 2704(b)?

If the partnership with a fixed term instead were required to be treated as a partnership at will because its required termination after a period of years is disregarded, then a limited partner would be deemed under state law to have a right to withdraw and be paid "fair value" after six-month's notice. As mentioned throughout this outline, however, the estate tax and gift tax are excise taxes on the *transfer* of property, not direct taxes on what a transferor could have derived from his interest in the partnership. Given that principle, there are five separate methods of analyzing I.R.C. § 2704(b) under which it is clear that a substantial "discount" from liquidation value is appropriate in measuring the transfer value of a transferor's limited partnership interest.

(1) A Fixed Term Is a Restriction on Not Liquidating.

Restrictions which require the consent of all partners before the limited partnership may terminate before the end of its term and prohibiting an assignee or limited partner's withdrawal before the definite time for dissolution are consistent with the restrictions

[7] Treas. Reg. § 25.2704-2(b).

that exist under the Uniform Revised Limited Partnership Act. *See* § 6.03 and 8.01 of the Uniform Revised Limited Partnership Act. Thus, these restrictions are not "applicable restrictions" since they are no more restrictive than state law. Of course, the restriction on the partnership continuing beyond its fixed term is not an "applicable restriction," and cannot be disregarded, because it is only a restriction on *not* liquidating.

b. The Nature of an Assignee's Interest.

Even if I.R.C. § 2704(b) applies to these restrictions with respect to a limited partnership interest, it does not cause the assigned limited partnership interest to be valued at its liquidation value. Under Revenue Ruling 93-12, 1993-2 C.B. 202, fair market value is determined by examining the rights transferred to the assignee, not the rights formerly held by the assignor. In other words, even if the partnership agreement's restrictions on a limited partner's ability to liquidate his limited partnership interest did not exist, any person buying the transferred limited partnership interest would purchase it at a price based on the income value approach or net asset value approach, not its liquidation value, because that person would only be an assignee, not a partner. If the partnership agreement were silent on these matters, a hypothetical buyer still would be concerned with the restrictions on an assignee under state law. The mechanics of I.R.C. § 2704(b) do not require that the valuation be determined as if the transferee's interest has a "put" right. It only requires that the valuation be determined as if the applicable partnership agreement is silent with respect to liquidation restrictions. If the governing investment is silent as to liquidation rights, one then must look to state law to determine the result. Under state law, assignees do not have the right to force a liquidation of the partnership or even the right to petition a court to force a liquidation.

(1) Limited Partners Receive Only "Fair Value" on Withdrawal.

Section 6.04 of the Texas Revised Limited Partnership Act makes it clear that under State law, even if I.R.C. § 2704(b) applies, a limited partner on withdrawal receives in cash only "the fair value of that limited partner's interest in the limited partnership as of the date of withdrawal." (emphasis added). The Act does not define "fair value," but the use of that particular terminology is significant, especially when contrasted to the language used to define what a limited partner receives when the partnership is wound up and liquidated. What is the fair value of a limited partnership interest on the date of a limited partner's death under state law? It should be what a willing buyer would pay to assume the rights inherent in that limited partnership interest. The meaning a state legislature gives to the term "fair value" may be well developed because of its use under the Model Business Corporation Act. *See* TEX. BUS. CORP.

ACT art. 5.12 (Vernon Supp. 1994). It is clear under relevant case law that "fair value" is not liquidation value.[8]

(2) Legislative History Contemplates Normal Discounting.

The legislative history of I.R.C. § 2704(b) makes it clear that normal minority interest discounts and other discounts are not to be disregarded. The general discussion portion of the Conference Committee Report dealing with I.R.C. § 2704 states as follows: "These rules do not affect minority discounts or other discounts available under present law." Thus, if the transferee owns only a minority interest in a corporation, or owns only a limited partnership interest as in the above example, and if under state law the minority corporate or limited partnership interest does not have a "put" right or automatic liquidation right, then fractionalization discounts will be applied. In other words, as the legislative history makes clear, if a minority interest in a corporation or a limited partnership interest normally is valued on a income approach or net asset value approach basis, then I.R.C. § 2704(b) will not affect that result. Stated differently, if an entity having a limited term is interpreted as per se containing an "applicable restriction," then the only entities that are not subject to I.R.C. § 2704(b) would be perpetual corporations. No one can argue seriously that such a proposition represents Congressional intent.

(3) *Kerr v. Commissioner.*

The Tax Court's opinion in *Kerr v. Commissioner*, 113 T.C. 449 (1999) is the first opinion addressing the IRS's broad interpretation of the provisions of Chapter 14 of the Internal Revenue Code and Congress' intent with respect to those statutes. The Court held that I.R.C. § 2704(b) did not affect the valuation of limited partnership interests transferred by the taxpayers because the restrictions on liquidation in the partnership agreements at issue were not "applicable restrictions" under § 2704(b).

In 1993, the taxpayers and their children formed two family limited partnerships in 1993 (KIL and KFLP). Mr. and Mrs. Kerr simultaneously, with the creation of KFLP, transferred part of their general partnership in KFLP to their four children. Over one year later, the taxpayers created separate grantor retained annuity trusts ("GRATs"), and each transferred 44.535% Class B interests in KFLP to the GRATs. The remainder interests in the GRATs passed to generation skipping trusts pursuant to a formula. The trustees of the GRATs were not formally admitted as limited partners -- no general partner other than the taxpayers consented to the admission of the GRAT trustees as limited partners. The taxpayers also made gifts of interests in KIL to their children. However, under the KIL partnership agreement, the children

[8] *See In Re Glosser Bros*, 555 A.2d 129 (Pa. Super. 1989) (a court may consider any method of stock valuation generally considered acceptable in the financial community); *Independence Tube Corp. v. Levine*, 535 N.E.2d 927 (1st Dist. Ill. 1988) (in determining fair value, the court is allowed to exercise its judgment after considering all relevant factors such as investment value, dividend history, projected dividend policy, selling prices of stock of like character, and the minority or illiquidity of the stock), and *Blake v. Blake Agency, Inc.*, 486 N.Y.S.2d 341 (2d Dept. 1985), (the trier of fact may use three principal methods of stock valuation to determine fair value, including: (1) net asset value; (2) investment value; or (3) market value. The value should be determined on the basis of what a willing purchaser, in an arm's-length transaction, would offer for an interest in an operating, rather than liquidating, business.).

automatically received partnership interests because they were already partners in the partnership.

In filing their federal gift tax returns for 1994 and 1995, the taxpayers computed the fair market value of the interests transferred by applying valuation adjustments for minority interest and lack of marketability. The IRS, however, determined that § 2704(b) barred any adjustment for minority interest and lack of marketability in computing the fair market value of the partnership interests. The IRS claimed that the provisions of the partnership agreements which restricted the right of a limited partner to liquidate his limited partnership interest were "applicable restrictions" which should be disregarded in determining the fair market value of the interests transferred.

The IRS's argument had two components. First, the IRS claimed that the provisions of the partnership agreements which stated that the partnership shall liquidate upon the earlier of December 31, 2043, or the consent of all the partners, were restrictions on the liquidation of the partnerships that constitute "applicable restrictions" within the meaning of § 2704(b) which must be disregarded in valuing the interests transferred. Second, the IRS claimed that the provisions of the partnership which restricted a limited partner's right to withdraw from the entity were "applicable restrictions" which must be disregarded in valuing the interests transferred. The IRS thus claimed that because a limited partner in a partnership that did not have a fixed term (*i.e.*, December 31, 2043) had the right to withdraw his interest under state law upon six months notice, that the fair market value of the interest is equal to the proportionate pro rata net asset value of the partnership interest transferred.

After the case was put at issue in the Tax Court, the taxpayers filed a motion for partial summary judgment arguing that § 2704(b) did not apply to the valuation of the transferred interests because (1) the taxpayers could only unilaterally transfer assignee interests in KFLP, as opposed to limited partnership interests (the IRS conceded in its brief that if the assigned interest was an assignee interest § 2704(b) did not apply); (2) the restrictions on liquidation and withdrawal in the partnership agreements are not "applicable restrictions" within the meaning of § 2704(b) because a limited partner under Texas law cannot withdraw until the end of a fixed term; (3) the restrictions on withdrawal in the partnership agreements are not "applicable restrictions" because under Texas law a limited partner can only withdraw in accordance with the terms of the partnership agreement; and (4) the family did not have the unilateral right to remove any restriction on liquidation or withdrawal because the University of Texas (who had been given interests in the partnership), as either a limited partner or as an assignee under the terms of each of the partnership agreements, had the right to block that withdrawal or the removal of any such restriction.

As an initial matter, the Court found that the transferred interests transferred to the GRAT trustees were limited partnership interests, and not assignee interests (regardless of the fact that no general partner of KFLP other than the taxpayers consented to the trustees admission as limited partners). Despite this finding, the Court held that § 2704(b) did not apply to the valuation of the transferred interests. The Court's analysis focused on whether the partnership agreements imposed greater restrictions on the liquidation of the partnerships than the limitations that generally would apply under Texas law.

Comparing the liquidation provisions in § 10.01 of the partnership agreements with § 8.01 of the Texas Revised Limited Partnership Act (TRLPA),[9] the Court concluded that § 10.01 did not contain restrictions on liquidation that constitute "applicable restrictions" within the meaning of § 2704(b). The Court reasoned that Texas law provided 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 the partners. As such, the restrictions contained in the partnership agreements were no more restrictive than the limitations that generally would apply to the partnerships under Texas law. Stated differently, providing for a fixed term when the partnership must liquidate, according to the Court, is not an "applicable restriction."

Importantly, the Court rejected the IRS's argument that the restrictions in the partnership agreements on withdrawal of a limited partner should be compared with § 6.03 of the TRLPA, which deals with a limited partner's right of withdrawal.[10] The Court found the IRS's reliance on TRLPA § 6.03 was erroneous, stating that TRLPA § 6.03 sets forth limitations on a limited partner's withdrawal from a partnership. The Court noted, however, that "a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. In this regard, the Court concluded that TRLPA § 6.03 is not a 'limitation on the ability to liquidate the entity' within the meaning of § 25.2704-2(b)."

On June 10, 2002, the Fifth Circuit affirmed the Tax Court's decision that I.R.C. § 2704(b) does not apply, but on different grounds than the Tax Court. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to constitute "applicable restriction." Because the University of Texas was a partner in the partnership, the Court held that the Kerr family did not have the right to remove any restriction unilaterally. The Court rejected the IRS's argument that the University of Texas would not oppose the removal of liquidation restrictions if requested by the family because the University wanted to convert its interest to cash as soon as possible. The Court noted that "the Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction." The probable consent of the University "cannot fulfill the requirement that the family be able to remove the restrictions on its own." Because the Court affirmed the Tax Court's decision on other grounds, it did not to address the basis for the Tax Court's holding that I.R.C. § 2704(b) did not apply.

[9] Under § 8.01 of the TRLPA, a partnership shall be dissolved on the earlier of: (1) the currents 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) the entry of a decree of judicial dissolution.

[10] Under § 6.03 of the TRLPA which was in existence in 1994 and 1995, a limited partner could "withdraw from a limited partnership at the time or on the occurrence of events specified in a written partnership agreement and in accordance with that written partnership agreement. ***If the partnership agreement does not specify such a time*** or event or define a time for the dissolution and winding up of the limited partnership, a limited partner may withdraw on giving written notice not less than six months before the date of withdrawal to each general partner." (emphasis added).

(4) Drafting Around I.R.C. § 2704(b).

First, a family limited partnership should be designed to terminate after fixed term of years or after a specific undertaking is accomplished. Under the default state law rules, if a partnership is so worded, a limited partner cannot withdraw until the partnership terminates. Second, there should be more than one general partner. If there is only one general partner, however, the general partner's estate should not be given the power to liquidate the partnership or the decedent's interest in the partnership.

4. The Gift on Formation Argument.

The IRS's argument that a gift occurs when a partnership is created is based on the notion that if the value of the partnership interest received by a partner is less than the value of the assets contributed by the partner (under the fair market value definition of Treas. Reg. § 20.2031-1(b)), a gift has been made because someone must have received a gratuitous transfer of the difference. In support of this argument, the IRS commonly relies on *Commissioner v. Wemyss*, 324 U.S. 303 (1945), in which the Supreme Court stated that "[The gift tax statute by] taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate." 324 U.S. at 307-308.

A donative transfer, by definition, requires the presence of a donor, a donee, and a transfer having the quality of a gift. *Commissioner v. Hogle*, 165 F.2d 352, 353 (10th Cir. 1947) ("[T]he [gift] tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift."). If any one of those three elements is missing, a taxable transfer has not occurred. As the Supreme Court stated in *Dickman v. Commissioner*, 465 U.S. 330, 334 (1984):

> The words "transfer . . . by gift" and whether . . . "direct or indirect" are designed to cover and comprehend all transactions . . . whereby, and to the extent . . . that, property or a property right ***is donatively passed to or conferred upon another***, regardless of the means or device employed in its accomplishment.

465 U.S. at 334 (emphasis added), *quoting* H.R. Rep. No. 708, 72d Cong., 1st Sess., 27-28 (1932); S. Rep. No. 665, 72d Cong., 1st Sess., 39 (1932).

The IRS's claim that a transfer occurred when a pro-rata partnership was created ignores the fact that partnership interests in a pro-rata partnership are divided on a pro rata basis between the partners based upon their contribution of assets. The creation of the partnership does not confer a financial benefit on or increase the wealth of any partner. A gift does not occur, and never can in the formation of a business entity in which each investor's interest is proportional to the capital contributed. *See Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369; 85 F.T.R.2d (RIA) 804 (W.D. Tex. January 18, 2000).

The Court of Claims' decision in *Chanin v. United States*, 393 F.2d 972 (Ct. Cl. 1968), is instructive on this point. In *Chanin*, shareholders of a corporation made transfers to the corporation on a pro-rata basis. The IRS claimed that a gift occurred because the increase in the value of each donor's shares was less than the value of the assets transferred by the donor. The Court rejected the IRS's position, holding as follows:

> Certainly when the gifts to the donee stockholders are to be evaluated on this basis, it is fair and reasonable to determine the related interest in the same manner. At least that is true, as here, in the absence of any real fair market value, adequately ascertained. The whole is thus made equal to the sum of its parts. Otherwise, different standards would be applied on the "transferred" and "received" sides of the equation. The donors were in a sense also donees, except that it is illogical to say that a person can give property to himself. But in lieu of being a donee, the donor has "received" in the same sense that he had retained his proportionate share of the overall gifts.

Id. at 980 (emphasis added). *See also Heringer v. Commissioner*, 235 F.2d 149 (9th Cir. 1956).

5. A Gift Does Not Occur Where the Creation of the Partnership Was a Bona Fide Arm's-Length Transaction That Was Free from Donative Intent.

The "ordinary course of business" provision under Treas. Reg. § 25.2512-8 deems a transaction to be for "adequate and full consideration" under I.R.C. § 2512(b), even if the purported transferor receives less consideration than a hypothetical willing seller would receive. A transfer is deemed to be for adequate and full consideration, and not subject to tax, if made "in the ordinary course of business (a transaction which is bona fide, at arm's-length, and free from donative intent)." Treas. Reg. § 25.2512-8.

The creation of a mechanism to ensure family ownership and control of a family enterprise has long been held by the Tax Court to constitute a bona fide and valid business purpose. *See Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39-41 (1977); *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 194 (1970), *acq.*, 1971-2 C.B. 3; *Estate of Littick v. Commissioner*, 31 T.C. 181, 187 (1958), *acq. in result*, 1984-2 C.B. 1; *Estate of Harrison*, 52 T.C.M. (CCH) at 1309 (holding that "[w]ith respect to business purpose, petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of decedent's properties and that the partnership was advantageous to and in the best interests of decedent"). Finally, the creation of a pro rata partnership for a valid business purpose where the interests of each partner are based upon the value of the assets contributed to the entity has been held as arm's-length and free from donative intent. *See, e.g., Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369; 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. January 18, 2000).

6. A Partner Cannot Make a Gift to Herself.

The IRS's claim that a gift on formation of the Partnership occurred also suffers from another fatal flaw -- a partner cannot not make a gift to herself. Assume that at formation, Mrs. Jones owned a 90% partnership interest in the partnership, and other family members own the rest. The partnership is pro rata and each family member received an interest in the partnership equal to the value of the assets contributed. The IRS would argue that because the value of Mrs. Jones' interest in the partnership was worth less than the assets she contributed, she has made a gift equal to the difference between the value of the assets received and the value of the assets transferred. If a gift was made by Mrs. Jones, she was the recipient of 90% of that gift. *See Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) (noting that the taxpayer could not make a gift to herself when she transferred her ranch to a newly formed corporation that she and her two sons owned all of the voting stock, the Court held that she had made a gift to each of her sons of one-third of the total gift amount); *Estate of Hitchon v. Commissioner*, 45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder sons).

7. *Shepherd v. Commissioner.*

On the other hand, in a case where a father and his two sons created a partnership and the father, at creation, transferred all of the assets to the partnership, and the sons made no individual capital contribution, the Tax Court held that the father had made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent those properties were attributed to his sons capital accounts. *Shepherd v. Commissioner*, 115 T.C. No. 30 (October 26, 2000). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. In language which should give some level of comfort to creators of pro rata partnerships, the Tax Court stated that "obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of the contribution, thus entitling him to recoup the same amount upon liquidation of the partnership." The Court also held, however, that the transfer should be treated as separate transfers of 25% to each son, and applied undivided interest discounts in determining the value of the gifts.

8. *Estate of Strangi v. Commissioner.*

In *Estate of Strangi*, 115 T.C. No. 35 (November 30, 2000), decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99% limited partnership interest. The IRS argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Tax Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of the contribution. Although the *Strangi* court rejected the IRS's gift on formation argument, it appeared to do so because the Tax Court did not believe that the decedent gave up control of his assets. As the Court stated, "in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a miniscule proportion of the value that would be 'lost' on the conveyance of his assets for the partnership in exchange for a partnership interest."

9. *Estate of Jones v. Commissioner.*

The Tax Court dealt the IRS's gift on formation a significant blow in *Estate of Jones v. Commissioner*, 116 T.C. No. 11 (March 6, 2001). In that case, Mr. Jones formed a family limited partnership with his son and transferred assets including real property in exchange for a 95.5389% limited partnership interest. He also formed a family limited partnership with his four daughters and transferred real property to it in exchange for an 88.178% limited partnership interest. The son contributed real property in exchange for general and limited partnership interests in the first partnership, and the daughters contributed real property in exchange for general and limited partnership interests in the second partnership. All of the contributions were properly reflected in the capital accounts of the contributing partners. The IRS argued that Mr. Jones made taxable gifts upon contributing his property to the partnerships. "Using the value reported by decedent on his gift tax return, the IRS argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value." *Id.* at p. 11.

The Tax Court held that the contributions of property were similar to the contributions in *Estate of Strangi* and distinguishable from the gifts in Shepherd. "Decedent contributed property to the partnerships and received continuing limited partnership interests in return. Although the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts." Thus, even though Mr. Jones contributed most of the assets to the partnerships and received noncontrolling limited partnership interests in return, the Court held that he did not make a taxable gift on the formation of the partnerships because his contributions were properly reflected in his capital accounts when the entity was created and the value of the other partners' interests was not enhanced by his contributions.

C. I.R.C. § 2036(a).

The primary area in which the IRS has experienced success in connection with its challenges to family limited partnerships involved situations where the taxpayers failed to respect the integrity of the entity. In these cases, the Tax Court has used I.R.C. § 2036(a) to bring a value of the assets of the partnership back into the decedent's estate as a retained life interest. Section 2036(a) provides as follows:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

In *Estate of Reichardt v. Commissioner*, 114 T.C. No. 9 (March 1, 2000), Judge Colvin agreed with the IRS that the substance of the partnership transaction was that Mr. Reichardt and his children had an implied agreement to allow Mr. Reichardt to continue to substantively enjoy the property contributed to the partnership and retain the right to income from the partnership assets during his lifetime in the same manner he had before the creation of the partnership. The Court found that the transfers to the partnership did not affect Mr. Reichardt's enjoyment of the property. Mr. Reichardt also continued to manage the property in the same fashion that he had before. The Court also found that Mr. Reichardt commingled partnership and personal funds, enjoyed the use of the personal residence, which was contributed to the partnership, without paying rent, and that Mr. Reichardt was solely responsible for the partnership's business activities.

In *Estate of Schauerhamer v. Commissioner*, 73 T.C.M. (CCH) 2855 (1997), the Tax Court held that the value of assets transferred by decedent to three family limited partnerships were included in the decedent's estate under I.R.C. § 2036 because she deposited the income produced by the partnership assets in her personal checking account and did not maintain separate records for partnership and non-partnership funds.

See also Estate of Harper, 83 T.C.M. (CCH) 1641 (2002); Estate of Thompson, 84 T.C.M. (CCH) 374 (2002); *Estate of Stone v. Commission*, 86 T.C.M. (CCH) 551 (2003), discussed at pp. 41, *supra*. Factors examined by the courts in deciding whether § 2036 applies are case specific and continue to be developed through litigation and in the appeals of decisions such as *Strangi* and *Thompson.* "Formation" facts looked at by the courts have included: (1) whether the other partners made real contributions of property or services; (2) whether the decedent had sufficient assets outside of the partnership to live on; (3) whether personal use assets were placed in the partnership; (4) whether fiduciary obligations were negated in the partnership agreement; (5) whether partners other than the decedent had the opportunity to comment on and provide input with respect to the terms of the partnership agreement; (6) whether partners other than the decedent had the opportunity to decide what assets would be contributed to the partnership; and (7) the discretion regarding distributions provided to the decedent general partner. "Operational" facts looked at by the courts include (1) whether partnership assets were commingled with the decedent's personal assets; (2) whether distributions were made in accordance with the terms of the partnership agreement; (3) whether the entity was treated and respected as a separate entity; and (4) whether personal expenses of the decedent were paid from the partnership or whether distributions were made for personal needs; (5) whether estate taxes and administration expenses were paid from the partnership.

1. The Partners Must Respect the Entity.

In order to facilitate the substance of the partnership formation being recognized, the partners need to act like partners. Partnership bank accounts should maintained, which only pay partnership expenses and do not pay personal expenses. When partnership distributions are made, they should follow the partnership agreement. For instance, if the partnership is a pro rata partnership, all distributions should be made on a pro rata basis. The partnership agreement should make it clear that all partners are subject to normal partnership fiduciary duties. The partnership agreement should also make it clear that an "ascertainable" standard exists for making distributions based on a standard of reasonableness.

IV. RECENT CASE LAW.

A. *Estate of Strangi v. Commissioner.*

In 1993, Mr. Strangi experienced health problems, and his son-in-law, an attorney with an estate planning background, took over his affairs under a power of attorney. In 1994, the decedent's son-in-law formed a family limited partnership with an LLC as its corporate general partner. A certificate of limited partnership was filed with the Texas Secretary of State and Mr. Strangi's assets were transferred under the power of attorney to the partnership in exchange for a 99% limited partnership interest. All of the contributed property was reflected in Strangi's capital account and had a fair market value of $9,876,929. Mr. Strangi's four children (who were the residuary beneficiaries of his estate) acquired an interest in the corporate general partner. Mr. Strangi owned 47% of the corporate general partner, and his children collectively owned the remaining 53%. The son-in-law managed the day-to-day affairs of the entities. Mr. Strangi died two months after the creation of the partnership. The estate valued the decedent's interest in the entities at $6.5 million, applying combined discounts for lack of control and lack of marketability of 43%.

The Estate claimed that the partnership was formed to (1) reduce executor and attorney's fees payable at the death of decedent; (2) insulate decedent from an anticipated tort claim and the estate from a will contest; and (3) to provide a joint investment vehicle for management of decedent's estate. In the majority opinion,[11] the Tax Court noted its skepticism, based upon the facts of the case, of the Estate's claims of business purposes relating to the creation of the partnership and noted that no active business was conducted by the partnership following its formation. However, the Court specifically found that the partnership was validly formed under Texas law and as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. The Court explicitly found that all partnership formalities were followed, and the proverbial "i's were dotted" and "t's were crossed." *Strangi v. Comm'r*, 115 T.C. No. 35 (2000) ("*Strangi I*"). Ignoring the subjective intentions of the parties in creating the partnership (*i.e.* the Tax Court's implied conclusion that the partnership was formed primarily to reduce estate taxes), the Court held that "the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case." 115 T.C. No. 35 at 16.

The majority also disregarded the IRS's claim that I.R.C. § 2703(a)(2) could be used to completely disregard the existence of the entity. Section 2703(a) provides as follows:

> Sec. 2703(a) General Rule -- for purposes of this subtitle, the value
> of any property shall be determined without regard to –

[11] Seven of the fifteen Tax Court judges agreed with the majority opinion (Judges Cohen, Chabot, Whalen, Colvin, Halpen, Chiechi and Thornton). The concurrences and dissents in *Strangi* include the repudiation of the economic substance test of entities in the transfer tax context (Judges Foley and Wells), a request for a more stringent application of the economic substance doctrine (Judges Parr, Beghe, and Marvel), an argument that the presence of an estate tax valuation discount virtually compels a finding of a gift on creation (Judges Reue, Parr, Beghe, Gale, and Marvel), and an estate depletion theory (Judges Beghe, and Parr). Although Judge Laro concurred in the majority opinion, he did not sign on to any of the concurring opinions.

> (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use such property.

The IRS argued that § 2703(a)(2) can be used to disregard the partnership for transfer tax purposes because it is a "restriction on the right to sell or use the property of the partnership." The majority, citing *Kerr v. Commissioner* (113 T.C. 449 (1999)), noted that Congress did not intend, by the enactment of § 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest.[12] In essence, the Tax Court found that because the legal interest transferred by Mr. Strangi at the moment of death was an interest in the partnership, and not the assets of the partnership, I.R.C. § 2703 could not be used to disregard the existence of the entity.

The Tax Court also rejected the IRS's claim that the decedent made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Court noted that using the value reported on the estate tax return, if the decedent gave up property worth in excess of $10 million and received a limited partnership interest worth approximately $6.5 million in return, he appears to have made a gift equal to the loss in value. But the Court held that no taxable gift occurred when the partnership was formed, stating that "[i]n view of decedent's continuing interest in [the partnership] and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be 'loss' on the conveyance of his assets to the partnership in exchange for a partnership interest." 115 T.C. No. 35 at 21.

In fact, the Tax Court signaled to the IRS that it would be receptive to an argument that the partnership property should be included in Mr. Strangi's estate under I.R.C. § 2036 because of the level of control retained by Mr. Strangi's son-in-law as attorney-in-fact (who held a 99% limited partnership interest and 47% stock ownership in the corporate general partner). However, given the Court's holding that no donative transfer occurred upon creation of the partnership, it is hard for this writer to see how I.R.C. § 2036 could apply with respect to the creation of the partnership, since I.R.C. § 2036(a) requires "property . . . of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth)."

The taxpayer's valuation expert applied a total discount of 43.75% in valuing the decedent's partnership interest, but disregarded the relationship between the decedent's 99% limited partnership interest and his 47% interest in the stock of the corporate general partner. The Tax Court was of the view that Mr. Strangi's interests must be examined together in determining fair market value, and rejected the taxpayer's valuation.

The IRS's appraiser applied total discounts of 31% in valuing Mr. Strangi's partnership interest (consisting of an 8% lack of control discount and a 25% lack of marketability

[12] Citing *Estate of Church v. United States*, 85 AFTR2d 2000, 804, 2001-U.S.T.C. Par. 60,369 (W.D. Tex. 2000).

discount). The Court accepted the IRS's appraiser's determination of value, stating that it felt "constrained to accept the evidence concerning discounts applicable to decedent's interest in the partnership and in Stanco as of the date of death." The Court also stated that "we believe that the result of the IRS's expert's discounts may be still be overgenerous to petitioner, but that result is one that we must reach under the evidence and under the applicable statutes."

On June 17, 2002, the Fifth Circuit Court of Appeals affirmed in part, and reversed in part, the Tax Court's decision. *Estate of Strangi v. Commissioner*, 293 F.3d 279 (5th Cir. 2002). The Court affirmed the Tax Court's findings that the partnership had a valid business purpose and economic substance, as well as the Tax Court's holdings under I.R.C. § 2703 and gift on formation. The Court reversed the Tax Court's denial of the IRS's motion to amend to add a claim alleging that under I.R.C. § 2036, the gross estate should include the value of the partnership's assets. The Tax Court denied the motion to amend, which was made 52 days before trial, because it considered the motion untimely. However, the Court held that because the denial of the motion to amend was not based upon on any stated reason (such as prejudice or delay), the Tax Court abused its discretion in denying leave to amend. The Court remanded the case to the Tax Court for consideration of the I.R.C. § 2036 issue.

On remand, the Judge Cohen addressed the application of I.R.C. §§ 2036(a)(1) and (a)(2) to the partnership in a memorandum decision. *Estate of Strangi v. Comm'r*, T.C. Memo 2003-145 (May 20, 2003)("*Strangi II*"). The Court found that both applied. Relying on the Court's prior decisions in *Harper*, *Thompson*, and other cases, Judge Cohen found that § 2036(a)(1) applied because Mr. Strangi had impliedly retained the right to the assets from any income from the assets transferred to the partnership. The "bad facts" relied upon by Judge Cohen included the fact that Mr. Strangi transferred a majority of his assets to the partnership, leaving him with little assets to pay for his personal needs, his rent-free occupancy of the home following its transfer to the partnership, and the payment of partnership funds to cover his personal expenses, including medical expenses and taxes.

Judge Cohen also addressed the application of I.R.C. § 2036(a)(2). This provision requires inclusion of transferred property in which a decedent retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." The taxpayer argued that I.R.C. § 2036(a)(2) did not apply, primarily relying on *United States v. Byrum*, 408 U.S. 125 (1972) for the proposition that Mr. Strangi retained no legally enforceable rights and that his management powers were limited by fiduciary obligation which did not cause estate inclusion. Judge Cohen found that *Byrum* did not provide any basis for "presuming the fiduciary obligations would be enforced in circumstances divorced from the safeguards of business operations in meaningful independent interests or oversights." There were three primary reasons for the Court's opinion. First, there was no third party control. Mr. Strangi, in Judge Cohen's view, retained control either through his son-in-law's attorney-in-fact or alone. Second, Mr. Strangi was not constrained by any business reality (that had been the case in *Byrum*) that would dictate decision-making. Third, Strangi was not constrained in the exercise of control by any unrelated independent parties who would be expected to enforce Strangi's fiduciary duties.

B. *Knight v. Commissioner.*

On December 28, 1998, Herbert and Ina Knight established a management trust, a family limited partnership of which the management trust was the general partner, and trusts for the benefit of each of their two adult children. The Knights transferred to the partnership three parcels of real estate, including a ranch and two homes in which their two children lived rent free, and financial assets. Petitioners each transferred a 22.3% interest in the partnership to each of the children's trusts, retaining a 4.9% interest in the partnership as limited partners.

The IRS contended that the partnership should be disregarded for gift tax valuation purposes, arguing that the fair market value of each of the gifts was equal to the pro rata percentage of the real property and financial assets of the partnership, discounted for selling expenses and built in gains. The taxpayer claimed that the partnership must be recognized for federal gift tax purposes, and that the portfolio, minority and lack of marketability discounts totaling 44% should apply.

The Tax Court rejected the IRS's argument that the partnership lacked economic substance and failed to qualify as a partnership under federal law, holding that "[s]tate law determines the nature of property rights, and federal law determines the appropriate tax treatment of those rights." 115 T.C. No. 36 at 13, citing *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985); *United States v. Rodgers*, 461 U.S. 677, 683 (1983). The Court found that the parties stipulated that the steps followed in the creation of the partnership satisfied all requirements under Texas law, and that the partnership has been a limited partnership under Texas law since it was created. The Court also rejected the IRS's claim that the form over substance doctrine should be applied to the case, stating that "[w]e believe that the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuations. The IRS agrees that Petitioners created and operated a partnership as required under Texas law and gave interests in that partnership to their children's trusts. Those rights are apparently enforceable under Texas law." 115 T.C. No. 36 at 14-15. The Court also held that I.R.C. § 2704(b) did not apply to the partnership agreement restrictions regarding (1) the 50-year term of the partnership or dissolution by agreement of all the partners; and (2) the lack of withdrawal rights of limited partners. The Court opined that the provisions contained in the partnership agreement were not more restrictive than the limitations that generally would apply under Texas law.

As to valuation, the Tax Court concluded that the fair market value of the partnership interest transferred should be determined based upon a 15% combined discount for lack of control and lack of marketability. The Tax Court rejected the aggregate 44% discount sought by the taxpayer (which consisted of a 10% portfolio discount [based on the thought that no single buyer would be interested in all of the partnership's varying assets], a 10% minority interest discount, and a 30% lack of marketability discount). The Court pointed out that the taxpayer's experts' conclusions were unexplained or contrary to the evidence and that his erroneous factual assumptions cast doubt on his objectivity.

C. *Estate of Jones v. Commissioner.*

On January 1, 1995, WW Jones, II formed two family limited partnerships. The first family partnership ("JBLP") was formed between Mr. Jones and his son. Mr. Jones contributed 100% of the surface rights in one ranch, along with cattle and certain personal property. His son contributed a 20% undivided interest in another ranch. Mr. Jones received a 95.5% limited partnership interest for his contribution. His son received a 1% general partner interest and a 3.5% limited partner interest. On the same day that JBLP was formed, Mr. Jones gave his son an 83.1% general partner interest and a 3.5% limited partner interest.

On the same day he created JBLP, Mr. Jones and his four daughters formed AVLP, a Texas limited partnership. Mr. Jones contributed a ranch to the partnership, and each of his daughters contributed a 25% undivided interest in another ranch. Mr. Jones held an 88.18% limited partnership interest, two of his daughters received a 2.95% limited partnership interest, and the other two daughters received a 1% general partner interest and a 1.96% limited partnership interest. As with JBLP, Mr. Jones' immediately gave 16.9% limited partnership interests in AVLP to his daughters.

The IRS made two basic legal arguments: (1) that a gift on formation occurred when Mr. Jones created partnerships with his son and daughters because the value of the interests he received in each partnership were worth less, based upon the appraisals submitted by the taxpayer, 66% less than the value of the property transferred to the partnerships; and (2) that restrictions prohibiting the withdrawal of the partner before the end of the 35 year term of each partnership should be disregarded for transfer tax purposes under I.R.C. § 2704(b).

The Tax Court rejected the IRS's gift on formation argument, holding that Mr. Jones' contributions of property to partnerships were similar to the contributions in *Estate of Strangi*. The Court noted that "decedent contributed property to the partnerships and received continuing limited partnership interests in return. All the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interest was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts." 116 T.C. at 11-12.

As to the I.R.C. § 2704(b) argument, the IRS argued that the fact that limited partners were prohibited from withdrawing from the partnership during the partners' 35 year term was an "applicable restriction" on liquidation that should be disregarded under I.R.C. § 2704(b). Although the argument is the same as the Tax Court specifically rejected in *Kerr v. Commissioner*, 113 T.C. 449 (1999), the IRS made the argument as the basis of its claim that *Kerr* was wrongly decided. Refusing to reconsider its decision in *Kerr*, the Tax Court ruled that under Texas law the exercise of a limited partner's right to withdraw does not cause the dissolution or liquidation of the partnership. Therefore, restrictions on withdrawal are not applicable restrictions under § 2704(b).

The next question addressed by the Tax Court was whether Mr. Jones transferred "limited partnership interests" or "assignee interests" in JBLP and AVLP. The Tax Court held that limited partnership interests were in fact transferred, even though it was undisputed that the consent required under both partnership agreements to have the transferees admitted as limited partners was not obtained. The Tax Court based its decision on the following facts, among others: (1) the transfer documents were titled "Gift Assignment of Limited Partnership Interests;" (2) the transfer documents stated that after the transfers were complete, each newly held interest would be a "limited partnership interest;" (3) the gift tax returns referred to the gifts as gifts of "limited partnership interests;" and (4) an affidavit filed by Mr. Jones' son described the interest received as "limited partnership interests." Thus the Court held that, in substance and in form, limited partnership interests were transferred.

The Tax Court's characterization of the transferred interests as limited partnership interests, and not assignee interests, was very important in the Court's determination of the fair market value of the JBLP partnership interest transferred. The taxpayer argued that the fair market value of the 83.1% limited partnership interest transferred should be determined using a 66% combined discount from net asset value. The discount was based on a 55% secondary market discount, a 20% lack of marketability discount, and a 5% discount for built in capital gains. But the IRS successfully argued that the holder of an 83.1% limited partnership interest had the right to liquidate the entity under the specific terms of the JBLP partnership agreement. Because of this liquidation right, the Tax Court rejected the valuation evidence submitted by the taxpayers' expert and applied only an 8% lack of marketability discount in valuing the JBLP interest. The Court held that the 8% discount was sufficient to take into account the lack of marketability imposed by any legal issues regarding the power to force liquidation.[13]

In valuing the four gifts of AVLP in limited partnership interests, the IRS's expert applied a 38% secondary market discount and a 7.5% discount for lack of marketability for each 16.9% interest. The taxpayer contended that the gifts should be valued by taking a 58% combined discount from net asset value, based upon a 45% secondary market discount, a 20% lack of marketability discount and a 5% built in capital gains discount. In determining value, the Court applied a 40% secondary market discount and a lack of marketability discount of 8%, for a combined 44% discount. However, the Tax Court rejected the application of the discount for built in capital gains exposure under the theory that a buyer could avoid the built in gains situation in a partnership context by somehow causing the partnership to make an I.R.C. § 754 election.

D. *Church v. Commissioner.*

On January 18, 2000, the United States District Court for the Western District of Texas released its Findings of Fact and Conclusions of Law in this case. Mrs. Church died on October 24, 1993. Two days prior to her death, Mrs. Church and two other persons signed an agreement entitled "Agreement of Sturnberg Ranch Partners, Ltd." Testimony established that the purpose of the partnership was twofold: (1) the partners wished to consolidate their undivided interests in a 23,000 acre family ranch to provide for centralized management of their interests and preserve the ranch as an ongoing enterprise for future generations; and (2) Mrs. Church had become concerned about protecting her substantial assets from judgment creditors in the event of a catastrophic tort claim against her. In addition to her contribution of her undivided interest in the ranch, Mrs. Church also contributed approximately $1 million in securities to the partnership. The Certificate of Limited Partnership was not filed in the Office of the Texas Secretary of State until October 26, 1993, two days after Mrs. Church's death. The corporate general partner of the

[13] The IRS's liquidation argument could have been avoided by the transfer of less than 50% or less of the limited partnership interests, for the Tax Court found that under the terms of the Partnership Agreement, partners holding 51% or more of the partnership interests had the power to liquidate the entity.

partnership was not actually organized until March of 1994, several months after Mrs. Church's death.

At the time that the partnership was formed, Mrs. Church had been previously diagnosed with breast cancer. However, the Court factually concluded that Mrs. Church died "suddenly and unexpectedly of cardiopulmonary collapse" and that the cause and timing of Mrs. Church's death "is largely irrelevant to this case" and "unrelated to her cancer." (emphasis added). The District Court specifically observed 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 and "evidence of this motivation is concrete and persuasive." The District Court also specifically found the following:

> (i) that the partnership had bona fide business purposes . . .
>
> (ii) The partnership was not formed solely to reduce estate taxes.
>
> (iii) There was no express 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 the partnership property . . .
>
> (iv) The partnership was a bona fide business arrangement and not a devise to transfer property to Mrs. Church's family for less than full and adequate consideration . . .
>
> (v) The terms and restrictions in the partnership agreement were comparable to similar arrangements entered into by persons in arm's-length transactions.

The District Court also made specific findings as to valuation matters. The Court determined that assets contributed by Mrs. Church to the partnership were valued at $1,467,748 and that the fair market value of her limited partnership interest in the partnership was $617,591, a discount in excess of 50%. The District Court noted that the "government chose not to present any valuation evidence of its own."

The District Court made the following Conclusions of Law:

> (i) That the formation of the partnership was "in substantial compliance in good faith with the Texas Revised Limited Partnership Act."
>
> (ii) That the partnership was a "valid Texas limited partnership as of October 22, 1993."
>
> (iii) Under well established principles of Texas law, ownership of property intended to be partnership property is not determined by legal title, but rather by the intention of the parties.

> (iv) That no taxable gift had been made in this case since "a taxable gift must involve a gratuitous transfer, which by definition requires a donee" and there was no donee in this case.

The District Court also rejected the government's allegations under I.R.C. §§ 2036 and 2038, finding that there had been no gratuitous transfer and further rejected the government's assertions that I.R.C. § 2703 could be interpreted to disregard the existence of the partnership. The Justice Department appealed *Church* the issues regarding partnership formation to the United States Court of Appeals for the Fifth Circuit. It did not appeal the tax issues. The Fifth Circuit's per curium opinion, which was filed on July 18, 2001, was very brief:

> The judgement of the district court is affirmed for the following reasons:
>
> The only issue of the estate's valuation is whether the transfer of the assets was restricted at the time of Church's death. Different legal theories have been argued during the course of this proceeding, but that has always been the dispositive question - as it was the basis for the different valuations given the assets by the appraiser (not now questioned). Regardless of the status of the limited partnership due to the certificate not being filed on that date, the documents that Church had signed imposed restrictions on the assets that necessarily caused their value to be discounted even if no limited partnership was then formed.
>
> We reject the government's argument that the 1999 revision of the Texas statute made the filing of the certificate an absolute prerequisite to the creation of a limited partnership and rendered an agreement between the parties unenforceable until the time of filing. A Texas court has held that a written partnership agreement constitutes an enforceable contract and governs the rights of the parties. *Hoagland v. Finholt*, 773 S.W.2d 740, 742-43 (Tex.App.—Dallas, 1989, no writ). Further, the Bar Committee's commentary to the 1999 revision of section 2.01 states that the revision was not meant to overturn *Garrett v. Koepke*, 569 S.W.2d 568 (Tex.Civ.App.—Dallas, 1978, writ ref'd n.r.e.), which held that an entity could operate as a limited partnership before filing a certificate. Tex. Rev. Civ. Stat. Ann. art. 6132a-1 2.01, Source and Comment - Bar Committee (Vernon Supp. 2001).
>
> The estate stated in its pleadings that the discounts for lack of control applied without the formation of a limited partnership, and in its refund claim it stated that it was entitled to a "discount for lack of control and marketability." The IRS was apprised of the nature of the refund action.
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> AFFIRMED

E. *Adams v. Commissioner.*

In *Adams v. Commissioner*, 170 F.3d 1173 (5th Cir. 2000), the decedent died owning a 25% general partnership interest in a Texas general partnership. The other 75% of the partnership was owned equally by three of decedent's siblings. The partnership held and managed several items of property inherited from the children's father, including ranch land, marketable securities, mineral royalties and working interests. The government filed a motion for partial summary judgment seeking a determination that the proper interest to be valued for federal estate tax purposes is an assignee interest in a liquidating partnership. The estate did not dispute that the relevant interest for federal estate tax purposes was an assignee interest, but asserted that because "dissolution" of the partnership would not necessarily result in a "winding up" or liquidation of that partnership, the government was wrong in contending that liquidation of the partnership was inevitable. The district court agreed with the Estate finding that "[a]s an alternative to liquidation, the remaining partners can continue the business of a dissolved partnership provided they pay the deceased partner's Estate the value of her [assignee] interests as of the date of the dissolution." But the court concluded that the relevant interests for estate tax purposes is "most accurately described as an assignee interest in a dissolved, rather than liquidating, partnership." Following a bench trial, the district court entered a memorandum opinion in favor of the government, disregarding the discounts relied upon by the Estate and accepting the government's expert appraisal.

The Fifth Circuit initially stated that while valuation of property for federal tax purposes is a question of fact that the Court reviews for clear error, a different standard should be applied in this case because "there is a pure question of law imbedded in the valuation calculus: to arrive at a reasonable conclusion regarding the value of the property at issue in this case, one must first determine the rights afforded to the owner of such property by the applicable state law. More specifically, to appraise the value of a fractional assignee interest in a dissolved Texas general partnership, one must consider whether, under Texas partnership law, the holder of such an assignee interest has the right to force liquidation of the partnership or, alternatively, the right to force the remaining partners to buy out his interest and, if so, for what value, *i.e.*, for a pro rata share of NAV undiscounted except for liquidation-related brokerage costs or for a fully discounted share." The Court thus concluded that the *legal conclusion* regarding the rights inherent in the property is a subject for the Fifth Circuit to review *de novo*. The Fifth Circuit found that although it was likely that an assignee's interest in a partnership would be subject to discounts in determining the fair market value, "we are firmly convinced that it is anything but 'well-established' that a partner's assignee has the right to receive a 25% share of NAV." The court stated that

> [We discern] a very real possibility that, as a matter of law, the holder of an assignee interest in the partnership could be stuck with an unmarketable interest in a partnership that owns a poorly diversified mix of assets and over which the assignee has no legal control. If this proved to be the case, the fair market value of the 25% assignee interest would be substantially less than a straight, ratable 25% share of the partnership's NAV, thereby reflecting these undesirable characteristics. More to the point, the legal uncertainty that obscures the extent, if any, to which an assignee

> has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interests, suggests that any effort to exercise such punitive rights would be met with strong resistance from the remaining partners. This legal uncertainty -- which raises the specter of costly litigation in addition to an adverse result -- is itself a factor that must be taken into account when appraising the fair market value of assignee's interest for estate tax purposes.

Therefore, the Fifth Circuit reversed the district court's judgment in favor of the government and remanded the case to the district court for further proceedings consistent with the opinion.

On remand, the Federal District Court in the Northern District of Texas determined that in valuing a 25% assignee interest in a Texas general partnership where the rights of the assignee were not clearly defined under Texas law, discounts for lack of control (20%), portfolio (10%), and lack of marketability (35%) should be applied. These combined discounts resulted in an aggregate discount of approximately 54%. The assets of the partnership consisted of ranch land, mineral royalties, working interests, and securities. Interestingly, the taxpayers' expert in *Adams* was the same expert who testified for the taxpayer in *Knight*. The results were substantially different. *Adams v. Commissioner*, 2001-2 U.S.T.C. (CCH) ¶ 60,418 (August 24, 2001).

F. *Estate of Dailey v. Commissioner.*

In *Estate of Dailey v. Commissioner*, 82 T.C.M. (CCH) 710 (2001), the Tax Court addressed the fair market value of limited partnership interests in Dailey Family Limited Partnership transferred by Mrs. Dailey during her life and at her death. The assets of the partnership consisted of $1,047,603 of marketable securities, primarily Exxon stock. The Tax Court found the testimony of the IRS's expert, who applied discounts ranging from 13.51% to 15.72%, contradictory and unsupported. The Court concluded that an aggregate combined lack of control and lack of marketability discount of 40%, as espoused by the Taxpayer's expert, was warranted.

G. *Hackl v. Commissioner.*

On March 27, 2002, the Tax Court issued its opinion in *Hackl v. Commissioner*, 118 T.C. No. 14 (2002) in which it held that interests transferred by gift in a closely-held limited liability company that owned and operated tree farming property did not qualify for the gift tax annual exclusion. The Tax Court based its decision on the restrictive nature of the LLC interests transferred and its holding that the interests did not confer, in the court's opinion, substantial presently realizable economic rights on the donees. Although this case is subject to review on appeal, practitioners should anticipate that the IRS will attempt to apply *Hackl* to other transfers of closely-held interests in LLCs and family limited partnerships.

1. The Facts.

In 1995, A.J. Hackl created Treeco, LLC (the "LLC"), a limited liability company designed to own and operated two tree farms with approximately 10,000 acres of property.

Mr. Hackl's investment goal with respect to the tree farming business was long-term growth. The tree farms had little or no existing merchantable timber. Mr. Hackl created a separate entity to conduct his tree farming operations to shield his assets not related to the tree farming business from potential liability associated with that business, to create a separate enterprise in which family members could participate and to facilitate the transfer of ownership interests in the tree farming business to his children, their spouses and his grandchildren. He selected an LLC to obtain liability protection for members, to provide protection of assets inside the LLC from members' creditors, to provide passthrough tax treatment and to provide for centralized management for the operation of the family tree farming business.

The LLC operating agreement provided that the management of the company's business was vested exclusively in the manager, and required the manager to perform his duties under a fiduciary standard. Mr. Hackl was designated as the initial manager to serve for life, or until his resignation, removal or incapacity. He also had the authority to name a successor manager during his lifetime or by will.

With respect to distributions, the LLC agreement stated that the manager "*may direct* that the Available Cash, if any, be distributed to the members, pro rata in accordance with their respective percentage interests." Available Cash was defined as cash funds on hand after payment of or provision for all operating expenses, all outstanding and unpaid current obligations and a working capital reserve.

Prior to dissolution, no member had the right to withdraw his or her capital contribution, except as approved by the manager. No member was entitled to transfer his or her interest except with the prior written consent of the manager, and the manager's consent could be withheld in the manager's sole discretion. However, if a transfer was made in violation of the LLC agreement, the transferee would have no opportunity to participate in the business affairs of the LLC or to become a member. Instead, the transferee would only be entitled to receive the share of profits or distributions that otherwise would have been paid to the transferor.[14] The entity was to be dissolved when the first of the following occurred: (1) while Mr. Hackl was the manager, by his written determination that the company should be dissolved; (2) following his tenure as manager, by a written determination by voting members owning not less than 80-percent of the voting units of the LLC; (3) a dissolution event such as the resignation, expulsion, bankruptcy, death, insanity, retirement or dissolution of the manager if the company is not continued by majority vote of the members within 90 days; or (4) or at such earlier time as may be provided by applicable law.

In 1995, Mr. and Mrs. Hackl began giving interests in the LLC to family members. They each transferred voting and nonvoting units to their eight children and to the spouse of each child. In 1996, Mr. and Mrs. Hackl gave additional units to each of their children and to their spouses. They also gave interests in trust for each of their 25 minor grandchildren. Mr. and Mrs. Hackl timely filed gift tax returns for the 1995 and 1996 gifts, reporting these transfers and electing to treat the gifts as being made one-half by each spouse under I.R.C. § 2513. In 1995, Mr. and Mrs. Hackl each sought to use 16 annual exclusions. In 1996, Mr. and Mrs. Hackl each sought to use 41 annual exclusions.

[14] The rights are similar to those possessed by an assignee of a partnership interest.

The IRS disallowed the annual exclusions for the gifts.

2. The Law.

I.R.C. § 2501 imposes a tax for each calendar year "on the transfer of property by gift" by any taxpayer. However, I.R.C. § 2503(b) excludes from taxable gifts the first $10,000 "of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year." In other words, the donor is entitled to an annual exclusion of $10,000 per donee for present interest gifts.

The Treasury Regulations under I.R.C. § 2503 state that a "'future interest' is a legal term, and includes reversions, remainders and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." The Regulations further state that "an unrestricted right to the immediate use, possession or enjoyment of property or the income from property [such as a life estate or term certain] is a present interest in property." Treas. Reg. § 25.2503-3(b).

3. The Positions of the Parties.

Mr. and Mrs. Hackl argued that they made direct, outright transfers of the LLC units, which are personal property separate and distinct under state law from the assets of the LLC. They further argued that the units had a substantial and stipulated value (the IRS and the taxpayers had stipulated to the fair market value of the interests before trial), that they placed no restrictions on the donees' interests in the units and that the donees acquired all rights in and to the transferred units, which were identical to those Mr. and Mrs. Hackl had in the units they retained. Thus, the taxpayers claimed that the transfers involved no postponement of rights, powers or privileges that would cause the gifts to constitute future interests.

The IRS argued that Mr. and Mrs. Hackl's transfers of units were gifts of future interests in property and failed to qualify as gifts of present interests under I.R.C. § 2503. The IRS argued that because of the restrictions contained in the LLC operating agreement, the transfers did not confer on the donees immediate and unconditional rights to the use, possession or enjoyment of the LLC units or the income from the LLC units. The IRS emphasized the requirement of "present economic benefit," and contended that inability of the donees to freely transfer the units or to compel distributions from the entity prevented them from receiving any such benefit.

4. The Court's Opinion.

The Tax Court stated that a taxpayer claiming an annual exclusion must establish that the transfer in dispute conferred on the donee "an unrestricted and a noncontingent right to the immediate, use, possession or enjoyment (1) of property or (2) of income from the property, both of which alternatives in turn demand that such immediate use, possession or enjoyment be of a nature that substantial economic benefit is derived therefrom."

The Tax Court initially and correctly stated that the property interests transferred were ownership interests in the LLC itself, rather than indirect gifts of property contributed to the entity. In analyzing whether or not the gifts of LLC units constituted present interests in property, the court focused on the rights and restrictions related to the LLC units contained in the LLC operating agreement. The Tax Court found that the restrictive nature of the operating agreement "foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the units." The court based its opinion primarily on the inability of an interest owner to withdraw and receive value for his interest and on the court's view that the interest owner had no practical ability to unilaterally transfer his or her interest for value. Although the court noted that a transfer of an interest could take place without the manager's consent, "transfers subject to the contingency of manager approval cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a sufficient source of substantial economic benefit." *Id.* Thus, based on its analysis of the provisions of the LLC agreement, the court concluded that the actual receipt of the LLC interests themselves did not confer upon the donees the "use, possession or enjoyment" of that property within the meaning of I.R.C. § 2503(b) so as to qualify for the annual exclusion.

The next issue addressed by the court was whether the LLC units afforded the donees the right to the use, possession or enjoyment of the income therefrom so as to qualify the transfers as present interest. Relying on cases involving trusts, the court applied a three-part test for ascertaining whether the rights to income satisfy the present interest requirement. The court stated that the taxpayer must prove that: "(1) the trust will receive income, (2) some portion of that income will flow steadily to the beneficiary, and (3) the portion of income flowing out to the beneficiary can be ascertained." *Id.*, citing *L.J. Calder*, 85 T.C. 713, Dec. 42,467 (1985). The court opined that the first prong was not met because the parties had stipulated that the primary business purpose of the LLC was to acquire and manage timberland for long-term income and appreciation, that the entity would operate at a loss for a number of years and that none of the members anticipated that the entity would make any distributions for a number of years after the gifts. The court also noted that even if the first two prongs had been met, there was no showing that any "ascertainable portion" of the income would flow to the donees since distributions were to be made in the manager's discretion, thus making the timing and amount of distributions a matter of speculation.

5. Analysis.

The Tax Court's decision is troubling. Although the court correctly concluded that the interests transferred were ownership interests in the LLC, the court relied primarily on cases involving transfers of property by a donor to either a trust or a corporate entity in determining that the transfer of LLC units did not convey a present interest. But where the transfer of property is to a trust or an entity, the use, possession or enjoyment of the transferred property is clearly postponed because that property is in the hands of either a trustee or the corporation itself, and not the beneficiary or shareholder. *See, e.g., E.F. Fondren*, 45-1 USTC ¶ 10,164, 324 US 18, 65 SCt 499; *L.J. Stinson Est.*, CA-7, 2000-1 USTC ¶ 60,377, 214 F3d 846. The *Hackl* donees had both the immediate possession and the use of the LLC interests transferred to them.

The LLC interests may not be the most desirable of assets, but the court acknowledged that they could be sold to a third party. The court just believed that no one would be interested in acquiring the property. As to the stipulated value of the LLC units, the Tax Court stated that "entity interest values can be based, as the facts and circumstances indicate is the case here, on the worth of underlying assets and the future income potential they represent, neither of which maybe presently reachable." Although a buyer could base his purchase price on the present value of future cash flows, fair market value is demonstrative of the price at which the interest would trade ***on the valuation date***.[15] By definition, the stipulated value was a current realizable benefit, which should have, in this author's opinion, qualified for the annual exclusion.

Hackl was affirmed by the Seventh Circuit Court of Appeals. *See Hackl v. Comm'r*, 7th Cir. No. 02-3093 (July 11, 2003). The Seventh Circuit stated, relying on *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000), that "the sole statutory distinction between present and future interests lies in the question of whether there is a postponement of enjoyment of specific rights, powers, or privileges which would be forthwith existent if the interests were present." The Court noted that Treeco's operating agreement foreclosed the donees' ability to realize any substantial present economic benefit, and the fact Treeco might be set up like any other limited liability corporation and that its restrictions on the alienability of its shares are common in closely-held companies "does not mean that shares in such companies should automatically be considered present interests for purposes of the gift tax exclusions."

6. Avoiding the *Hackl* Problem.

In holding that the transfer of LLC units did not confer an immediate substantial economic benefit, the court seemed particularly concerned with the inability of a donee to withdraw from the entity, the restrictions upon sale and the lack of regular distributions. If any of these three "defects" were not currently present, it is likely that the court would have held that the LLC units qualified as present interests.

As to the right of withdrawal, the entity agreement could include the right to withdraw from the entity at "fair market value" (the same definition as used in the Treasury Regulations). Fair market value could be defined to require the interest to be valued as though the put right did not exist. The donee in that circumstance has the ability to realize immediate value through withdrawal much like a beneficiary of a trust with a *Crummey* withdrawal provision, and the annual exclusion should be allowed.

As to transfer restrictions, a provision allowing a family member the unrestricted right of transfer of an interest in the entity to an outsider might not be palatable to most clients. The desire to keep the assets in the family is one of the primary reasons many closely-held entities are created. Rather than completely restricting the transfer, however, the entity or other family owners could be given a right of first refusal so that if a family member desires to transfer the interests for cash, the holder could exercise the right to purchase that interest before it is transferred to the outsider, keeping the interest in the family.

[15] But fair market value is determined at the date of the gift based on "the price at which such property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1.

As to the lack of distributions, the court's requirement that the portion of income flowing to the interest holder be "ascertainable" poses difficult problems. Clearly, a required annual distribution of a specified amount should meet this requirement. However, many clients may be reluctant to do so, preferring, as Mr. Hackl did, to allow the assets of the entity to grow in value.

H. *Estate of Harper v. Commissioner.*

In *Harper*, 83 T.C.M. (CCH) 1641 (2002), the Tax Court held that property contributed by an individual to a family limited partnership was includable in his gross estate under I.R.C. § 2036(a) because he retained the enjoyment of the property during his lifetime.

Harper set up a living trust with a portfolio of assets which constituted the vast majority of his net worth. During 1994, Harper formed a family limited partnership. His children received a 1% general partnership interest, and the trust received a 99% limited partnership interest. On July 1, 1994, the trust assigned a 24% interest to one child and a 36% interest to another child and reported the transaction as a gift. Harper died on February 1, 1995.

The IRS argued that the full fair market value of the assets contributed to the partnership by the trust should be included in his estate under I.R.C. § 2036(a) because the facts of the case demonstrated that although the assets were contributed to the partnership, Mr. Harper retained the economic benefit of the assets and the right to use those assets during his lifetime. The taxpayer argued that § 2036(a) should not apply because the trust transferred the assets to the partnership and what was owned by Mr. Harper at the time of his death were interests in the partnership, that the trust received full and adequate consideration for the transfer under I.R.C § 2036(a), and there was no agreement that Mr. Harper would retain the right to the control of, or the income generated by, the property.

The Tax Court concluded that I.R.C. § 2036(a) applied to bring all of the assets contributed by the trust into Mr. Harper's taxable estate. The Tax Court's analysis was centered on the taxpayer's failure to respect the partnership as a separate entity. Specifically, the Court noted that the partnership had a history of disproportionate distributions, funds of the partnership were commingled with Mr. Harper's personal funds, and that a significant delay existed between the date the partnership was formed and the date that the assets of the partnership were transferred to it. In sum, the Court found "compelling indicia of an implied understanding or agreement that the partnership would not curtail the decedent's ability to enjoy the economic benefit of asserts contributed to the" partnership.

The Tax Court also rejected the estate's argument that § 2036(a) did not apply because the trust received full and adequate consideration for the transfer. The Court held that 2036(a) does not apply "in the case of a bona fide sale for an adequate and full consideration in money or money's worth." The Court held that because the children did not transfer any assets to the partnership upon formation, the decedent alone determined how the partnership would be structured and operated, so there was no arm's length agreement. The Court referred to this as a "pure recycling" of interests. The Court thus noted that the transfer was not an arm's length transaction but rather a transaction within the context of § 2036 which was "testamentary" in nature.

I. *Estate of Thompson v. Commissioner*.

In *Estate of Tompson*, 84 T.C.M. (CCH) 374 (2002), Mr. Thompson formed a family limited partnership with his daughter and son-in-law and a second partnership with his son two years before his death. The partners also created two corporations to serve as the general partners for each of the partnerships. Mr. Thompson contributed over $1.4 million in securities and notes receivable to each of the partnerships, receiving a 95.4% and 62.27% limited partnership interest in each partnership in return. During the two years before Mr. Thompson's death, the partnerships collectively distributed nearly $100,000 to Mr. Thompson, which he used to make gifts to family members and pay personal expenses. At trial one of the children testified that she wanted to make sure that despite the creation of the partnership, Mr. Thompson could in fact obtain funds from the partnership to make gifts to his children.

The IRS argued that under I.R.C. § 2036, the total value of the decedent's interest in the partnership was equal to its pro rata net asset value. The Tax Court held that while the partnerships had sufficient substance to be recognized for estate and gift tax purposes (observing that the partnerships were validly created under state law), it found an implied agreement that the decedent would retain the economic benefit of the contributed property, thereby requiring an inclusion of those assets in his gross estate under I.R.C. § 2036(a)(1). The Court noted that because the decedent transferred assets to the partnerships that would have been required for his support, there had been an implied understanding this his children would agree to his request for money from the property that he contributed and that the partnerships were created primarily as an alternative vehicle for implementing the decedent's estate plan. The Court further noted that the decedent's transfer of assets to the partnerships was not a bona fide sale for adequate and full consideration because the decedent's receipt of partnership interests was merely a "recycling of value" and the contribution was not motivated by legitimate business concerns.

J. *Kimbell v. United States*.

In *Kimbell*, 244 F.Supp. 700 (N.D. Tex 2003), the IRS successfully argued at the district court level that a family limited partnership should be ignored under I.R.C. § 2036. In this case, a family limited partnership was created when the principal contributor (Mrs. Kimbell) was 96 years old. Before the partnership was created, the bulk of Mrs. Kimbell's assets were held in a living trust of which she and her son served as trustees. The trust transferred the most of its assets to the partnership in exchange for a 50% interest in the LLC (which was the 1% general partner of the partnership) and a 99% limited partnership interest in the partnership. Mrs. Kimbell's son was a co-trustee of the trust and owned the other 50% interest in the LLC. The son was also the manager of the LLC.

Mrs. Kimbell died within 2½ months after the partnership was created. The IRS took the position during the audit that I.R.C. § 2036 operated to bring the assets contributed by the trust into Mrs. Kimbell's gross estate. The estate paid the tax, and filed a claim for refund. When the refund claim was denied, the estate filed suit in the United States District Court for the Northern District of Texas (Dallas Division).

Both the estate and the IRS filed cross motions for summary judgment regarding the applicability of I.R.C. § 2036 to the case. Citing *Harper v. Commissioner*, the district court held that I.R.C. § 2036 did apply to the case. Like the court in *Harper*, the district court found that the "bona-fide sale for an adequate and full consideration" exception under § 2036 had not been met because "Plaintiff has produced no credible evidence that the formation of the Partnership was the product of an arm's length transaction, *i.e.* a transaction 'between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power' . . . Indeed, one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a bona fide sale." The court further found that this partnership creation was nothing other than mere "value recycling" similar to that found in *Harper*.

The district court then addressed the question of whether Mrs. Kimbell "retained the enjoyment of the property transferred to the partnership." The court, focusing on the terms of the limited partnership agreement, noted that Mrs. Kimbell, as a 99% limited partner, could at any time remove the general partner and appoint herself or someone of her choosing to be the general partner. Moreover, the court also found that the general partner had "sole discretion" to decide on distributions of income from the partnership. The court thus found that Mrs. Kimbell "retained the power to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership, and thus runs afoul of both I.R.C. § 2036 (a)(1) and (2)." The court rejected the estate's claim that the fiduciary duties owed by the general partner prevented Mrs. Kimbell from having § 2036 retained rights, holding that (1) *U.S. v. Byrum* was "distinguishable on its facts" and was "expressly overruled by Congressional enactment of § 2036(b), and (2) regardless, the partnership agreement specifically provided that the General Partner will not owe a fiduciary duty to the Partnership or to any Partner."

In *Kimbell v. United States*, _ F.3d _, 2004 WL 1119598 (5th Cir. May 20, 2004) (No. 03-10529), *rev'g* 244 F.Supp. 700 (N.D. Tex. 2003), the Fifth Circuit reversed the district court's conclusion that § 2036 applied to the assets transferred by Mrs. Kimbell's trust to the partnership, holding that the bona fide sale for adequate and full consideration exception precluded the application of § 2036. In its opinion, the Fifth Circuit set forth an excellent analysis of both the "bona fide sale" and the "adequate and full consideration" language of § 2036.

As to what constitutes a "bona fide sale" in the context of the creation of an entity, the court held that "what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale where the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest in exchange." *Id.* at *6. The Fifth Circuit noted several "objective facts" that supported the taxpayer's position that the transfer to the partnership was a bona fide sale. Those facts included:

> (1) Mrs. Kimbell retained sufficient assets outside the partnership for her support and there was no commingling of Partnership and her personal assets;
>
> (2) Partnership formalities were satisfied and the assets contributed to the partnership were actually assigned to the partnership;

> (3) The assets contributed to the partnership included working interests in oil and gas properties which require active management;
>
> (4) Other credible non-tax reasons for the formation of the partnership that could not be accomplished via Mrs. Kimbell's trust, which included protection from creditors, centralized management, keeping the assets in an entity that would preserve the property as separate property for descendents, establishing a vehicle to manage the assets if something should happen to Mrs. Kimbell's son, and providing a dispute resolution mechanism.

Id. at *8.

As to what constitutes full and adequate consideration in connection with the creation of an entity, the court held that the proper focus is:

> (1) Whether the interests credited to each of the partners was proportionate to the fair market value of the assets partner contributed to the partnership;
>
> (2) Whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and
>
> (3) Whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

Id. at *7.

K. *Lappo v. Commissioner*.

In *Lappo v Commissioner*, 86 T.C.M. (CCH) 333 (2003), taxpayer made three gifts of limited partnership interests in a partnership holding marketable securities (primarily municipal bonds) and real estate. The April, 1996 gifts consisted of a 66.80917% limited partnership interest to a trust, and four .6680917% limited partnership interests to grandchildren. The July, 1996 gift was a 29.2184632% limited partnership interest to taxpayer's daughter.

The experts and the Court used the net asset value approach to determine the fair market value of the transferred interests, and reduced the proportionate net asset value by discounts for lack of control and lack of marketability. The parties disagreed as to the appropriate size of the lack of control and lack of marketability discounts.

The lack of control discount was determined by the Court using a weighted average of the individual discount factors for each category of assets owned by the partnership (*i.e.*, marketable securities and real estate). In determining the appropriate lack of control discount, both parties' experts applied the closed-end fund analysis in determining the marketable securities component of the lack of control discount. The parties agreed to use the IRS's slightly higher net asset values for the marketable securities. The IRS's expert determined a 9.5% lack of control discount for this component. The taxpayer's expert determined a 7.5% discount for this component. The Tax Court (Judge Thornton) stated that "fairness" dictated that since the parties agreed to use the IRS's slightly higher NAVs for marketable securities, that the IRS's 8.5% minority interest discount should be using in valuing in determining the lack of control discount for this component.

In determining the lack of control discount for the real estate component of the partnership portfolio, the taxpayer's expert relied on the discounts observed in the sales of interests in real estate limited partnerships. The Court noted that none of the real estate partnerships were comparable to the partnership's portfolio of real estate. Therefore, the Court focused on the lack of control discount by reference to comparable real estate investment trusts. Taking guidance from academic studies on private placement discounts, the Court concluded that a 17.6% liquidity premium would be warranted in connection with real estate investment trusts, resulting in a 19% minority interest discount for the partnership's real estate component. Applying the weighted averages of the lack of control discount factors, the Court held that an overall lack of control discount of 15% was appropriate in determining the value of the transferred limited partnership interests.

In determining the appropriate lack of marketability discount, the Court relied on private placement analyses prepared by Mukesh Bajaj and Hertzel & Smith (which the median discount observed was 21%) and concluded, based on partnership specific factors, that a 24% lack of marketability discount should be used to value the transferred interests. Applying the lack of control and lack of marketability discount sequentially, the Court reduced the proportionate net asset value by combined discounts for lack of control and lack of marketability of approximately 35.4%.

L. *Peracchio v. Commissioner.*

In *Peracchio v Commissioner*, 86 T.C.M. (CCH) 412 (2003) Taxpayer transferred limited partnership interests in a family limited partnership to a family trust in two separate transactions. In the first transaction, the taxpayer transferred a 45.47% limited partnership interest by gift. In the second transaction, the taxpayer transferred a 53.48% limited partnership interest to the trust in exchange for a promissory note in the amount of $646,764 (which taxpayer believed was the fair market value of the transferred interest). The transactions occurred on the same day. The taxpayer reported the fair market value of the transfers based upon a combined 40% discount from net asset value for lack of control and lack of marketability.

In the notice of deficiency, the IRS argued that the partnership lacked economic substance and should be disregarded for gift tax purposes, the partnership agreement should be treated as a restriction on the right to sell or use the property of the partnership which should be disregarded under § 2703, that the provision in the partnership agreement restricting a limited partner's ability to liquidate his interest should be treated as an applicable restriction under § 2704(b) which must be disregarded in determining the gift tax value of the transferred interests, and that no discounts for lack of control and lack of marketability were warranted. At trial, the

IRS abandoned the first three arguments and modified its position with respect to the valuation argument to "allow" for a 4.4% discount for lack of control and a 15% discount for lack of marketability based upon the IRS's experts' valuation opinion.

The Tax Court (Judge Halpern) found that the parties use of publicly traded, closed-end mutual funds was an appropriate method by which to determine the lack of control discount. The Court used the weighted mean discount from a representative sample of closed-end funds and determined that a 6% lack of control discount was appropriate. The Court also concluded that a 25% lack of marketability discount was warranted in valuing the interest transferred, which represented the upper limit of the IRS's range of justifiable discounts. The combined discount for lack of control and lack of marketability applied was 29.5%.

M. *Estate of Stone v. Commissioner.*

In *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003), the Tax Court (Judge Chiechi) held that § 2036 did not apply to two partnerships created by Mr. and Mrs. Stone and their four children several months before Mr. and Mrs. Stone died. In *Stone*, five separate limited partnerships were funded in April of 1997. The purpose of the partnerships was to create a vehicle for managing Mr. and Mrs. Stone's assets, as well as help resolve ongoing disputes and litigation among Mr. and Mrs. Stone's four children. Each child was a co-general partner of one of four partnership holdings certain assets. A fifth partnership was also created with additional assets. The children funded their capital contribution to the partnerships through assets given to them by Mr. and Mrs. Stone. The gifts were disclosed on timely filed gift tax returns. Mr. Stone died in May of 1997. Mrs. Stone died in 1998.

The IRS originally asserted various alternative arguments to essentially ignore the existence of the partnerships. Those arguments included substance over form, lack of economic substance, gift on formation and § 2036(a)(1). The arguments other than § 2036(a)(1) were dropped before trial. In addressing the IRS's § 2036 argument, the Court opined that three elements were required: (1) a transfer of property by the decedent; (2) the transfer was other than a bona fide sale for an adequate and full consideration in money or money's worth; and (3) decedent retained possession or enjoyment of, or the right to the income from, the property transferred.

The Court's analysis focused on the second element of § 2036; that is, whether the transfers of assets to the partnerships were other than a bona fide sales for an adequate and full consideration. The Court distinguished this case from the prior decisions in *Harper*, *Reichardt, Thompson* and *Strangi.* The Court noted that the Stone partnerships were created as a results of arms-length negotiations in which each member of the Stone family (including the parents) was represented by his or her independent counsel. The Court found that the transfers to the partnerships "were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Mrs. Stone during their lives and thereafter and the resolution of the litigation among the children." The Court noted that each of the partnerships had economic substance and operated as joint enterprises for profit though which the children actively participated in the management. The Court thus held that transfers of assets to the partnerships by Mr. and Ms. Stone did not constitute a circuitous "recycling of value".

In addition, the Court found that the initial transfers to the partnerships by Mr. and Mrs. Stone did not result in gifts to the other partners. The Court noted that the partnership interests received were proportionate to the assets contributed, the assets transferred by each partner were properly credited to the partner's capital accounts, and upon termination or dissolution, the partners were entitled to distributions equal to their respective capital accounts. The IRS, on the other hand, argued that the partnership interests received by Mr. and Mrs. Stone did not constitute adequate or full consideration after taking into account appropriate discounts in the values of the partnership interest. The Court rejected this argument, stating:

> Respondent's argument in effect reads out of section 2036(a) the exception for a 'bona fide sale for an adequate and full consideration in money or money's worth' in any case where there is bona fide, arms'-length transfer of property to a business entity (*e.g.*, a partnership or a corporation) for which the transferor receives an interest in such entity (*e.g.*, a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) with the exception that Congress expressly rejected when it enacted the statute. . . . Respondent's argument about the discounted value of the partnership interest at issue also ignores the fact that each of the five partnerships were created, funded, and operate as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services.

Thus, the Court held that IRC § 2036 did not apply because the bona fide sale for a full and adequate consideration exception was met.

V. DEFINED VALUE OR FORMULA TRANSFERS.

In an environment where the continued long-term existence of the federal estate tax has become uncertain, estate planners are discovering that clients are becoming hesitant to engage in transfer tax planning transactions that trigger a substantial gift tax. One of the techniques increasingly used by planners to attempt to cap gift tax exposure with respect to a gift or sale transaction involving a hard to value asset is a formula clause. These clauses are designed to limit the transferor's gift exposure by either adjusting the value of the interest transferred to the extent a different value is "finally determined for gift tax purposes" (a "value adjustment clause") or specifying the dollar value of the interest transferred (a "defined value clause").[16]

[16] *See, e.g.*, Moore, *Attempting to Achieve Finality in Potentially "Open" Transactions*, U. OF MIAMI INST. ON EST. PLANNING 13 EST., GIFTS & TR. J. 83 (1988); Moore and Buchanan, *Valuation and Readjustment Clauses: What's Possible?*, 45TH NYU TAX INST. (1987); McCaffrey and Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 TRUSTS AND ESTATES 47 (Oct. 1986).

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax.

A. Value Adjustment Clauses.

There are generally two types of value adjustment clauses. The first type of clause provides that if it is finally determined for transfer tax purposes that the value of the property transferred exceeds a specified dollar amount (*e.g.*, by agreement with the IRS or by a court decision), the size of the transferred interest is reduced so that the value of the property transferred equals the specified dollar amount. The second type of clause, rather than adjusting the size of the transferred interest, requires the transferor to give additional consideration to the transferor equal to the difference between the value of the interest as finally determined for transfer tax purposes and the specified dollar amount.

The IRS has taken the position that such clauses should be ignored for transfer tax purposes, asserting that the clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS's and the court's time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the formula clause kicks in to adjust the transaction so that no gift tax is owed. Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS. Over the years, several value adjustment clauses have been tested in the courts, with the results generally favoring the IRS's position that the gift tax consequences of the transfer should be determined without regard to the clause.

The validity of value adjustment clauses was first addressed in *Comm'r v. Procter*, 142 F.2d 284 (4th Cir. 1944). In *Procter*, the taxpayer transferred property and provided in the transfer document that if it were determined by a final judgment of a court of last resort that any part of the transfer was subject to gift tax, the property subject to gift tax would be deemed excluded from the transfer and would remain the transferor's property. The Fourth Circuit Court of Appeals held that the provision did not eliminate the taxable gift because it imposed a condition subsequent that violated public policy. The court determined that the provision would be "trifling with the judicial process" and would inhibit tax collection since attempts to enforce the tax would defeat the gift. Moreover, the court held that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot once the decision was rendered.

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for federal gift tax purposes . . ." to exceed $2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McClendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

Taxpayers, however, are not without a court victory upholding a value adjustment clause. In *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the taxpayer sold stock to trusts for his children for $1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales agreements provided that "if the fair market value . . . as of the date of . . . [the agreement] is ever determined by the Internal Revenue Service to be greater than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." The IRS took the position that the shares were worth more than $1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

> Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction.

Id. at 705. The Tenth Circuit found that the *King* clause had a proper purpose; that is, "an attempt to avoid valuation disputes with the Internal Revenue Service agents by removing incentive to pursue such questions is not contrary to public policy in the absence of a showing of abuse."

B. Value Definition Clauses.

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a $1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of $1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011, the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter*, *Ward*, and their progeny.

The application of *Procter* and *Ward* to value definition clauses is directly at issue in *McCord v. Comm'r*, 120 T.C. No. 13 (May 14, 2003). In *McCord*, the taxpayers made a gift of their 82% limited partnership interests to a group consisting of their sons, generation-skipping trusts for the benefit of each son's family line, and two charities. The gift was made using a value definition clause in which the taxpayers specified that their sons and the trusts, collectively, had the right to receive that portion of the transferred interest having a fair market value of $6.9 million with the remainder of the interests passing to the charities. The taxpayers left it up to the donees to determine what portion of the 82% interest passed to the sons and the trusts (*i.e.* what portion of the interest had a fair market value of $6.9 million), and what portion passed to the charities. After the gift was made and after an appraisal was obtained, the donees entered into an arm's length agreement as to the percentage interest each received in a document entitled "Confirmation Agreement." The partnership redeemed the charities' interests approximately seven months after the gifts.

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51 (1958).), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of $6.9 million. Thus, the value of the gift to the sons and the trusts was equal to $6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS. Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See, e.g.*, Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the treasury regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt frqm GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Reg. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount passing to charity under a charitable trust. Treas. Reg. § 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes); Treas. Reg. § 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made). *See also* Rev. Rul. 72-392, 1972-2 C.B. 340, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

The taxpayer also distinguished *Procter* and its progeny because the cases involved formula clauses that attempted to adjust the terms of a gift *after the gift was made.* In those cases, assets were purported to be transferred in such a way that, if it was determined by the IRS or the court that a portion of the transfer would be subject to gift tax, the transaction was adjusted after-the-fact such that those portions were no longer subject to gift tax. *See, e.g., Procter*, 142 F.2d at 827; *Ward*, 87 T.C. at 114. Contrasting the case with *Procter*, the value of the interests transferred under the *McCord* defined value clause to the sons and the trusts were readily determinable, and were not subject to change. The sons and the trusts were entitled, collectively, to the first $6.9 million of transferred interests. The value of the transfer to the sons and the trusts was unaffected by any determination by the court or by the IRS. The taxpayers were simply trying to determine and establish with certainty, through the use of a formula clause specifying the dollar value of the interest in the partnership passing to each donee, the amount of gift tax that would result from the transfers. The taxpayers argued that the property rights transferred by the taxpayers to the sons and the trusts -- the right to receive assignee interests in the partnership with a fair market value of $6.9 million -- were clearly set forth in the assignment agreement and should be given effect for purposes of calculating the taxpayers' gift tax. *See Morgan v. Comm'r*, 309 U.S. 78, 80-81 (1940).

As noted above, a formula clause will provide the taxpayer additional arguments against the IRS in a valuation dispute involving a hard-to-value asset. In *McCord*, the value definition clause provided the taxpayers with two arguments in addition to asserting that the appraisal value was correct: namely, that (i) the fair market value of the gift was fixed by the valuation adjustment clause; and (ii) since the best evidence of value is the price at which an interest in the entity would change hands between a buyer and a seller in an arm's-length transaction, the value agreed upon by the donee's when determining the interests each were entitled to receive is the best evidence of value. Of course, the taxpayers argued that the value determined by the taxpayers' appraiser was correct.

On May 14, 2003, the Tax Court issued its opinion in *McCord v. Comm'r*, 120 T.C. No. 13 (May 14, 2003). The Tax Court rejected the IRS's claim that the charitable deduction should be limited by the amount that the charity received because either the substance over form doctrine, public policy considerations, or the integrated transaction doctrine. However, a majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred.

The majority's decision interpreted the assignment agreement under Texas law. Specifically, the Court stated that

> Whenever the concept of "property" is relevant for Federal tax purposes, it is State law that defines the property interest to which Federal tax consequences attach. *E.g., United States v. Craft*, 535 U.S. 274, 278-279 (2002) (Federal tax lien attaches to property held, under State law, as tenants by the entireties). Thus, in order to determine the Federal gift tax consequences that attach to petitioners' assignment of the gifted interest, we look to applicable State law to determine the extent of the rights transferred. Because petitioners transferred interests in a Texas limited partnership, Texas law governs our determination in that regard.
>
> . . .

. . . In essence, petitioners [donors] contend that because (1) they transferred to CFT [the residual charity] a portion of the gifted interest corresponding to the excess of the fair market value of that interest over $7,044,933, and (2) we have determined the fair market value of the gifted interest to be $9,883,832, it follows from the maxim beginning this paragraph that they are entitled to a charitable contribution deduction in the amount of $2,838,899 for their gift to CFT. Because the assignment agreement does not equate the term "fair market value" with the term "fair market value as finally determined for Federal gift tax purposes," petitioners' [property law] argument must fail.

. . .

By way of the assignment agreement, petitioners transferred to CFT the right to a portion of the gifted interest. That portion was not expressed as a specific fraction of the gifted interest (*e.g.*, one-twentieth), nor did petitioners transfer to CFT a specific assignee interest in MIL (*e.g.*, a 3-percent assignee interest). Rather, CFT was to receive a fraction of the gifted interest to be determined pursuant to the formula clause contained in the assignment agreement. The formula clause provides that CFT is to receive that portion of the gifted interest having a fair market value equal to the excess of (1) the total fair market value of the gifted interest, over (2) $7,044,933. The formula clause is not self-effectuating, and the assignment agreement leaves to the assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT.

. . .

. . . The assignment agreement provides a formula to determine not only CFT's fraction of the gifted interest but also the symphony's and the children's (including their trusts') fractions. Each of the assignees had the right to a fraction of the gifted interest based on the value of that interest as determined under Federal gift tax valuation principles. If the assignees did not agree on that value, then such value would be determined (again based on Federal gift tax principles) by an arbitrator pursuant to the binding arbitration procedure set forth in the partnership agreement. There is simply no provision in the assignment agreement that contemplates the allocation of the gifted interest among the assignees based on some fixed value that might not be determined for several years. Rather, the assignment agreement contemplates the allocation of the gifted interest based on the assignees' best estimation of that value. Moreover, each of the

> assignees' percentage interests was determined exactly as contemplated in the assignment agreement (without recourse to arbitration), and none can complain that they got any less or more than petitioners [donors] intended them to get. Had petitioners [donors] provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes, we might have reached a different result. However, that is not what the assignment agreement provides.
>
> Of course, the assignees' determination of the fair market value of the gifted interest, while binding among themselves for purposes of determining their respective assignee interests, has no bearing on our determination of the Federal gift tax value of the assignee interests so allocated. . .

The majority thus concluded that the donor was entitled to a charitable deduction equal to $594,743. This amount was higher than the dollar figure the charities received when their interests were redeemed six months after the assignment.

Judges Laro and Vasquez dissented, finding that under the IRS's common law arguments they would have allowed a deduction for only the amount actually received by the charity in the redemption.

Judges Chiechi and Foley concurred in part and dissented in part. They rejected the majority's interpretation of the assignment agreement under Texas law. Both also found, in separate concurring opinions, that the assignment agreement should govern the property rights transferred to the donees and that under Texas property law, the value of the gift to the taxable donees was $6,910,933 -- the amount specified in the assignment agreement.

McCord is now on appeal to the Fifth Circuit Court of Appeals.

VI. IRS ATTACKS ON SALES TO DEFECTIVE GRANTOR TRUSTS.

A favorite technique of estate planners in recent years involves the sale of interests in a partnership or LLC to an intentionally defective grantor trust. A "defective" grantor trust is not a poorly drafted trust agreement, but rather is an irrevocable trust in which the trust income is taxed to the grantor instead of to the trust or its beneficiaries. See IRC The trust assets, however, are not included in the grantor's taxable estate upon the grantor's death.

A gift to a defective grantor trust is subject to gift taxes. To avoid the payment of gift taxes, many practitioners advise the grantor to sell closely-held interest to the defective grantor trust for either a demand note or a term note. Most practitioners believe that if the transaction is 90% leveraged by the note (*e.g.*, the trust has $1 million in assets after the sale, but owes the grantor $900,000 in the form of a note), there is an informal "safe harbor" and the sale transaction and the notes will not be ignored. The note is often secured by the assets of the trust, including the partnership interests sold. Since the grantor is considered to be the owner of the assets of the trust, the sale is not considered an exchange, sale or disposition between separate taxpayers for federal income tax purposes and the grantor is not required to recognize gain or loss on the sale. *See* Rev. Rul. 85-13, 1985-1 C.B. 184 (transfer of trust assets to the grantor in exchange for the grantor's unsecured promissory note is not recognized as a sale for federal income tax purposes).

There are two primary benefits to "defective grantor trust" treatment. First, since the grantor is treated as the owner of the trust for income tax purposes, the grantor will be taxed on the trust income. Although no one likes to pay income taxes, the technique allows the grantor to transfer substantial value to the trust and its beneficiaries in the form of income tax payments that would otherwise be borne by either the trust or its beneficiaries.[17] Second, to the extent that the grantor makes a sale to the defective grantor trust, the grantor has essentially frozen the transfer tax value of the assets transferred, except to the extent that the interest paid on a note received in the sale transaction exceeds the income taxes the grantor pays on the trust income.

In conjunction with its recent attacks on the use of family limited partnerships and LLCs for estate planning purposes, the I.R.S. has taken a closer look at transactions involving sales to defective grantor trusts. In the recently filed Tax Court case of *Karmazin v. Comm'r*, Tax Court Docket No. 002127-03, the I.R.S. has challenged a 1999 sale of interests in a family limited partnership under a defined value formula clause to two defective grantor trusts in exchange for promissory notes. The promissory notes were secured by the partnership interests owned by the trust.

The I.R.S. challenged the existence of the partnership for transfer tax purposes (and thus the lack of control and lack of marketability discounts used to value the interests in the partnership) under a number of theories. First, the I.R.S. sought to disregard the partnership under a lack of economic substance theory, alleging that there were no "legitimate negotiations among the parties before the execution of the limited partnership agreement." Second, the I.R.S. also claimed that the partnership lacked a valid business purpose, asserting that there was no history of business activity and no "tax independent motivation." Third, the I.R.S. asserted that the partnership should be disregarded under applicable state law because it lacked the business purpose required under the law of the state in which the partnership was organized. Fourth, the I.R.S. argued that I.R.C. § 2703(a)(2) could be applied to ignore the partnership. With the exception of the state law argument, the Tax Court has rejected similar attempts to disregard the existence of the entity in its decisions in *Strangi I* and *Knight v. Comm'r.*

As to the promissory notes, the I.R.S. asserted that the debt was, in reality, equity in the partnership and should be treated as such, resulting in the imposition of additional gift taxes. The I.R.S. based its argument on its claim that (1) there was no personal guaranty from

[17] The I.R.S. has taken the position in at least of one its pronouncements that the grantor trust treatment can result in gift tax liability to the grantor if the trust does not contain a provision requiring the trustee to reimburse the grantor for income taxes paid on the trust income that exceeded the income actually received by the grantor. *See* PLR 9444033 (August 5, 1994). Most practitioners, however, do not believe that this position is consistent with the law in this area because there is strong authority against it. *See, e.g., Comm'r v. Hogle*, 165 F.3d 352 (10th Cir. 1947) (trust income attributable to the grantor cannot be the basis for gift tax liability, noting that there can only be a gift when there is a transfer). *See also, Comm'r v. Beck*, 129 F.2d 243 (2nd Cir. 1941) (grantor could not reduce the value of transfer to trust for gift tax purposes by the amount of income taxes he was required to pay on the trust's income).

the beneficiaries of the trust on the 100% financing, (2) the partnership's cash flow was incapable of servicing the debt obligation, and (3) the partnership agreement provided preferential distribution rights to the trusts to service the promissory note payments.

The I.R.S. also argued that as a result of the sale transaction, the taxpayer kept "applicable retained interests" as defined under I.R.C. § 2701[18] in the form of promissory notes that should be reclassified as equity. *But see* PLR 9535026 (Service determined that notes issued by defective grantor trusts were debt and retained interests). The I.R.S. claimed that the notes had special preferential "distribution rights" under the partnership agreement that were not a "qualified payment right" under § 2701 and the distribution right was in fact "an extraordinary payment right" which constituted a right to receive preferential distribution rights in cash flow and liquidation under I.R.C. § 2701. Finally, the I.R.S. argued that the sale of partnership interests for a note was in essence a gift with a retained life estate which was not a "qualified interest" under I.R.C. § 2702.[19] The taxpayer challenged the I.R.S.'s position by filing a petition in the Tax Court on February 10, 2003. Shortly before trial, the IRS conceded the issues regarding the valuation of the partnership and the notes, and settled the valuation at less than 5% of the original asserted deficiency.

The attacks to the sale transactions are not limited to the *Karmazan* case. In several cases I have currently pending at I.R.S. Appeals, the Service has sought to ignore the existence of promissory notes issued by defective grantor trusts in exchange for interests in a partnership. In those cases, the I.R.S. has asserted that the "economic realities of the arrangement . . . do not support a part sale," and that a gift occurred equal to the value of the interests in the partnership transferred, unreduced by the consideration received by the grantor in the form of a fully secured promissory note. Of course, the I.R.S. ignored Treas. Reg. § 25.2512-a, which provides that the federal gift tax only applies to "sales, exchanges and other dispositions of property for consideration to the extent that the value of the property transferred by the donor *exceeds* the value in money or money's worth of the consideration given therefor."

In several cases the Tax Court has outlined the factors to be considered in determining whether a promissory note will be considered a bona fide transaction and, thus, respected for tax purposes. In *Estate of Deal v. Comm'r*, 29 T.C. 730 (1958), the Court found that whether the transfer of properties was a gift or sale depends upon whether, as part of

[18] Under I.R.C. § 2701, an "applicable retained interests" is any interest in a corporation or partnership if the interest provides the holder with either (1) a distribution right, but only if the transferor and the transferor's applicable family members control the entity immediately before the transfer, or (2) a liquidation, put, call, or conversion right, whether or not the transferor and applicable family members hold control of the entity. A "distribution right" is (a) a right to distributions from a corporation with respect to its stock, or (b) a right to distributions from a partnership with respect to a partner's interest in the partnership, in each case other than a right to distributions with respect to an interest of an equity class that is the same or subordinate to the transferred interests, and other than a right to receive a guaranteed payment within the meaning of I.R.C. § 707(c) of a fixed amount. Debt is not included as an applicable retained interest.

[19] Section 2702 provides the method for valuing a gift in trust when a gift is to or for the benefit of a member of the transferor's family and the donor or an applicable family members retains an interest in the gifted property. Section 2702(a)(2) provides that, in general, the value of any retained interest that is not a qualified interest shall be treated as being zero. Thus, since the note was deemed not to be a qualified interest, the value of the gift was equal to the fair market value of the partnership interests transferred, less zero.

prearranged or preconceived plan, the donor intended to forgive the notes that were received at the time of the transfer. *See also* FSA 1355722 (1992) (a finding of preconceived intent to forgive the notes relates to whether valuable consideration was received and, thus, whether the transaction was in reality a bona fide sale or disguised gift. In *Estate of Holland v. Comm'r*, 73 T.C. (CCH) 3236 (1997), the Tax Court stated that the determination of whether a transfer was made with the real expectation of repayment and an intention to enforce the debt depends on "all facts and circumstances including whether: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax is consistent with the loan." The factors are not exclusive, and no one factor controls. The courts look to the various factors to provide a legal basis upon which it makes its factual determination of whether a bona fide indebtedness existed.

Although the positions taken by the I.R.S. in *Karmazin* and in my cases involve, in my opinion, a real stretch of the facts and the law, these cases illustrate the fact that the I.R.S. is beginning to challenge sales of closely-held interests to defective grantor trusts under a number of alternative theories. Despite these I.R.S. challenges, the sale of closely-held interests to a defective grantor trust continues to be an effective estate planning tool. However, to avoid any attempt by the I.R.S. to challenge the sales and recharacterize the notes issued by the trust in the transaction, practitioners should keep the following thoughts in mind: (1) the trust should have sufficient assets to make principal and interest payments when due; (2) although the cash flow to be received from the interest can be a source of principal and interest payments, greater expected distribution can effect the value of the interests transferred; (3) make sure that the client understands that the existence of the notes should be reflected on financial statements and that interest income and expense must be properly reported; (4) although not necessary, I prefer to see the notes fully secured; (5) make sure that there is no agreement, explicit or otherwise, that the taxpayer and the trustee have any intention of treating the notes as anything other than binding obligations. In sum, the more the transaction mirrors those entered into by parties in arm's-length deals, the more likely the transaction is to be respected by the I.R.S. and the courts.

VII. VARIOUS VALUATION ADJUSTMENTS.

A. Minority Interest and Lack of Marketability.

Most individuals involved in the valuation process are familiar with the standard minority interest and lack of marketability adjustments which are applied when valuing partial interests in property. A minority interest discount reflects the fact that the shareholder or owner of a partial interest who owns less than a majority cannot control managerial decisions, impact future earnings, control efforts for growth, or establish executive compensation. A lack of marketability discount is influenced by the speed and efficiency with which an investor can buy and sell an investment. The value of an interest in a privately held company is not directly comparable to the value of a similar publicly traded interest because privately held companies and minority interests in those companies are not actively traded on a stock exchange as are shares of publicly traded companies. Therefore, the fair market value of an interest in a private company is adjusted to reflect its lack of liquidity and lack of a ready market. *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 217 (1990).

Both the minority interest discount and the lack of marketability discount are factual determinations. Critical to this determination is an appreciation of "the fundamental elements of value that are used by the investor in making his or her investment decision." *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852, 2864 (1995), *aff'd without opinion*, 91 F.3d 124 (1996).

In *Estate of Brown v. Commissioner* (Tax Court Docket Nos. 7492-95 and 14899-96), I asked the IRS to admit through discovery that certain factors the IRS utilized in a partnership valuation case (*Robertson v. Commissioner*, Tax Court Docket Nos. 26090-95, 26091-95, and 12782-96) were appropriate for determining the amount of a discount for minority interest and lack of marketability in determining the value of a limited partnership interest in another tax court valuation case. In *Robertson*, the IRS used a 70% combined discount for the minority interest and lack of marketability in valuing a limited partnership interest which was purchased by parents from one of their children. The primary asset of the partnership was non-income producing ranch land. Because the parents paid an amount equal to pro rata net asset value for the interest, the IRS claimed the parents had made a gift. The case settled shortly after trial for no deficiency, the IRS apparently deciding that it was not in its best interest to have a published decision in which it claimed that such a steep discount should be applied. However, in response to informal discovery in *Robertson*, the District Counsel of the IRS identified the following factors which should be considered in determining the fair market value of a minority interest in a partnership:

> The IRS admits that a discount of 70% was used in valuing the 6% limited partnership interest. The IRS believes that there are many considerations that enter into evaluation of a partnership interest. Those consideration (sic) include lack of lack of (sic) marketability and minority interest. The IRS also believes that in valuing interest in family limited partnerships, such as the 6% interest in [Robertson family partnership], considerations must be given to other additional factors, including, but not limited to: management risk, asset risk that arise due to concentration of asset in one class/or geographic region, limited cash distributions to partners, limited liquid assets for making distributions, expected returns, lack of an active organized secondary market for interest, restrictions on the transfer of interest by partners, concentration of control over the partnership, the economic outlook for the business or geographic area the partnership operates in, the partnership's position in the industry, the partnership's historical profitability, and expectation of future profitability, values of comparable interest traded on secondary markets and restrictions on transferability.

In *Brown*, I requested that the IRS admit that the considerations set forth above were proper factors for an appraiser to consider in determining the fair market value of the partnership interests owned by Mrs. Brown at the time of her death. The Service responded to my request as follows:

> Admits, but denies any implication that such a listing encompasses
> the universe of appropriate factors to consider.

B. Discounts Applied to Majority Ownership Interests.

Discounts can and do exist in the context of controlling interests. The existence of the discount for a controlling interest depends upon the facts and circumstances of each particular case. *See Estate of Trenchard v. Commissioner*, 69 T.C.M. (CCH) 2164 (1995) (discount applied to interest in a corporation in which decedent owned 60.92% of voting power); *Estate of Luton v. Commissioner*, 68 T.C.M. (CCH) 1044 (1994) (lack of marketability discount of 20% for stock of a corporation owned 78% by the decedent); *Estate of Bennett v. Commissioner*, 65 T.C.M. (CCH) 1816 (1993) (15% lack of marketability discount for real estate management company with varied, illiquid assets held in a corporate shell); *Estate of Dougherty v. Commissioner*, 59 T.C.M. (CCH) 772 (1990) (25% discount applied to a 100% interest in corporation that owned real estate, securities, fixed assets and other long term investments).

Various factors may be relevant in determining whether a valuation adjustment is applicable to controlling interest in a closely held entity. For example, a buy/sell agreement contained in the corporate charter may restrict the ability of a shareholder to transfer her interests, creating "a chilling effect on prospective investors." *Mandelbaum*, 69 T.C.M. (CCH) at 2866 (1995). Furthermore, the presence of environmental problems may impact marketability. *See Estate of Desmond v. Commissioner*, 77 T.C.M. 1529 (1999); *but see Estate of Pillsbury v. Commissioner*, 64 T.C.M. (CCH) 294 (1992).

A diverse asset mix of assets owned within the controlled entity may affect marketability (whether it is called a lack of marketability or portfolio discount), since the entire entity would not likely interest any one particular buyer. *See, e.g., Estate of Bennett v. Commissioner*, 65 T.C.M. (CCH) 1816, 1826 (1993) ("We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties."); *Estate of Dougherty*, 59 T.C.M. (CCH) at 780-81 (Court applied a 10% discount for incremental management costs and 25% discount for lack of marketability because the assets of the Corporation were so varied, consisting of real estate and other non-liquid assets); *Estate of Luton v. Commissioner*, 68 T.C.M. (CCH) 1044 (1994) (decedent owned 78% of a passive real estate corporation, yet the court still allowed a 20% marketability discount); *Estate of Simpson v. Commissioner*, 67 T.C.M. (CCH) 2938 (1994) (decedent owned 100% of an investment holding corporation and the court allowed a 30% marketability discount).

Finally, the existence of the corporate shell itself may affect value (when the corporation is valued on a net asset basis), since purchasers as a general rule would prefer to purchase the corporation's assets directly rather than the stock. Such a direct purchase would avoid hidden corporate liabilities, tax issues involving the corporation, and the need to deal with the minority interest holders. *See, e.g., Bennett*, 65 T.C.M. at 1825 ("The corporate form cannot simply be ignored as the IRS would have us do. The benefits and burdens of corporate form are often the very reasons upon which the decision to apply or to not apply a discount for lack of marketability is based."); *Gallun v. Commissioner*, 33 T.C.M. (CCH) 1316 (1974) ("[W]e believe that the IRS's witness erred in refusing to discount the value of the stock to account for a corporate entity intervening between the investment assets and the owner of Gallun stock.").

C. Unrealized Capital Gains.

In *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998), the Tax Court recognized the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation for the first time since the repeal of the General Utilities doctrine. At issue in *Davis* was the gift tax value of two 25 share blocks of stock (of the total of 97 shares) of A.D.D. Investment & Cattle Company ("ADDIC") to each of two sons. ADDIC was a family owned holding company, the assets of which included over 1% of the issued and outstanding common stock of Winn-Dixie, listed on the New York Stock Exchange, and assets related to ADDIC's cattle operations. ADDIC assets had a total built-in capital gains tax liability of $26.7 million, about 96% of the gain being attributable to its Winn-Dixie stock. The Court allowed a $9 million adjustment for built-in capital gains tax, representing approximately 1/3 of the total capital gains tax liability on all of the corporate assets. The petitioner's two experts and the IRS's expert (but not the IRS) believe that an adjustment was warranted -- that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock. The dispute was over the amount of the adjustment. The Court found that the full amount of built-in tax liability could not be taken as a discount when there was no evidence that ADDIC planned to liquidate or sell its assets. The Court concluded that a $9 million discount was properly included as a part of the lack of marketability discount to be applied in value in the two blocks of stock.

Following quickly on the heels of the Davis decision was the Second Circuit's decision in *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998), reversing a memorandum decision of the Tax Court. The Appeals Court found that the Tax Court erred in not considering the built-in capital gains tax as a liability and remanded the case back to the Tax Court to decide on the amount of the liability. This reversal is the last nail in the coffin of the notion that built-in capital gains taxes should not be considered in valuing C corporations. The IRS has acquiesced in Eisenberg "to the extent that it holds that there is no legal prohibition against such a discount." AOD 1999-001.

In *Estate of Jameson v. Commissioner*, 77 T.C.M. (CCH) 1383 (1999), the Tax Court again allowed a discount for unrealized capital gains. In *Jameson*, the decedent owned a 97% interest in a closely held corporation which had as its primary asset 5,405 acres of timberland in Louisiana. The fair market value of the timber property was $6 million. Its tax basis was approximately $200,000. Citing *Estate of Davis*, the Court allowed a built-in capital gains discount. In discussing this opinion, Judge Gayle stated

> We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built in capital gains

> over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built in capital gains in valuing decedent's Johnco stock.

The Court concluded that since capital gains taxes would be incurred as Johnco's timber was cut and sold, recognition of the gain was certain to occur independently of any liquidation that a hypothetical willing buyer of decedent's Johnco stock "would take into account Johnco's built in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However the court limited the discount "an amount reflecting the rate at which they [the capital gains taxes] will be recognized, measured as the net present value of the built in capital gains tax liability that will be incurred over time as timber is cut."

The Fifth Circuit Court of Appeals reversed the Tax Court's decision. *Estate of Jameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001). The Court noted that the Tax Court had "deviated from several criteria of fair market value analysis, including assuming that a buyer was a strategic buyer who would continue to operate the corporation for timber production, peremptorily denying a full discount for the accrued capital gains liability based upon the erroneous assumption that the purchaser would engage in long range timber production." The Court also noted that the Tax Court had internally inconsistent assumptions, assuming that a hypothetical purchaser of the stock would engage in long range timber production earning a 14% gross annual rate of return while requiring a 20% rate of return. Since the buyer would be earning less than his required rate of return, the buyer would either lower the purchase price or sell the interest quickly and re-deploy the proceeds elsewhere. The Fifth Circuit remanded the case back to the Tax Court for valuation analysis consistent with its opinion.

In *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002) the Fifth Circuit applied a dollar-for-dollar discount for unrealized capital gains when determining the value of a 63.96% interest in a closely-held Texas corporation under an asset-based approach.

At her death, Mrs. Dunn owned 62.96% of Dunn Equipment was family-owned and operated company in the business of renting heavy equipment to refinery and petrochemical businesses. Reversing the Tax Court, the Fifth Circuit held, as a matter of law, the $7.1 million built-in capital gains tax liability of Dunn Equipment's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of Dunn Equipment.[20] The Court opined that the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in capital gains tax. The holding makes rational sense, and should be applied in any asset-based valuation of a C corporation since the asset-based approach assumes that the buyer is paying for the stock of the entity based upon the price the buyer could realize for the assets of such entity. Before the buyer can realize such value, however, the corporate level capital gains tax must be incurred.

D. Blockage/Market Absorption.

The blockage discount applies to large blocks of property which cannot be placed on the market at the valuation date without depressing the price. The adjustment would apply to

[2020] It did not apply the same reduction when determining value under the income-based approach.

any large number of a particular type of asset being valued and which cannot be disposed of in a short period of time without depressing the market price. The discount has been applied to real estate, stock, and artwork. The basis for the discount was summarized in the Tax Court Memorandum decision in *Estate of Grootemaat v. Commissioner*, 38 T.C.M. (CCH) 198 (1979):

> Absorption is a price depressant caused by the disposition of the parcels of land in a short period of time creating competition among the parcels that might not otherwise exist. . .
>
> The record is clear that the 302 acres owned by GLC in November of 1971, if valued as a whole, would have a different value than if the values of the individual parcels were totaled. The disposition of all of the parcels of land owned by GLC within a reasonably short period of time would result in the different parcels (or their subdivisions) being in direct competition with each other. An abrupt increase in supply would, assuming demand remains constant, reduce the price for which these parcels or subdivisions would sell. This element of competition, a price depressant, is not taken into account in valuing the parcels individually. We therefore believe the discount for absorption is appropriate.

38 T.C.M. (CCH) at 203. *See also Carr v. Commissioner*, 49 T.C.M. (CCH) 507, 513 (1985) ("We agree with Petitioners that a discount [for market absorption] is necessary in order to reflect the absence of time within which to make an orderly disposition of the property"), and *Estate of Grootemaat v. Commissioner*, 38 T.C.M. (CCH) 198 (1979). Treas. Reg. § 20.2031-2(e).

The discount for market absorption is well recognized in the context of real estate. *Estate of Rogers v. Commissioner*, 77 T.C.M. (CCH) 1831 (1999) ("In the case of real estate, the principles of supply and demand may warrant application of an absorption discount. That is because the disposition within a reasonable period of time of similar real properties would result in those being in direct competition with each other and other similar real properties in the marketplace."); *Estate of Folks v. Commissioner*, 43 T.C.M. (CCH) 427, 434 (1982) ("In simplistic terms, blockage refers to an immediate oversupply of goods which demand (the market) will not absorb at optimum prices. It is not unreasonable that placing 5 lumberyards on the market simultaneously in a limited geographical area would depress prices 20 percent"); *Brocato v. Commissioner*, T.C.M. 1999-424 (December 29, 1999) (20% fractional interest and 11% blockage discount applied in valuing undivided interest in apartment projects).

A discount for blockage has long been recognized in the valuation of publicly traded securities. *See DuPont v. Commissioner*, 2 T.C. 246, 253, 257 (1943) (finding that blockage discount of approximately 12% applied for block of 52,900 shares of stock representing 8.48% in the company where average trading volume was 2,323 shares for the month before the valuation date); *Adair v. Commissioner*, 54 T.C.M. (CCH) 705, 711 (1987) (finding that increasing the market trading by 20% over a six-month period "would certainly have some effect upon the market").

E. Undivided Interests in Real Estate.

The IRS has often asserted that the only discount which should be applied when determining the fair market value of undivided interests in real property are the costs and expenses associated with a partition of that property. *See* PLR 9336002 (May 28, 1993). The Tax Court has consistently recognized, however, that IRS reliance on partition costs as the sole basis for the discount is misplaced.

In *Estate of van Loben Sels v. Commissioner*, 52 T.C.M. (CCH) 731 (1986), the Tax Court addressed the question of whether a fractional interest discount should be applied in valuing the decedent's undivided interests in 79,755 acres of timberland in California. The IRS contended that no discount was warranted. *Id.* at 740. Rejecting the IRS's contention, the Court held that "a discount from the value determined by reference to the fee value is warranted because of the disabilities associated with decedent's undivided interest. The disabilities include lack of marketability, lack of management, lack of general control, lack of liquidity, and potential partitionment expenses." *Id.* at 742. The Court held that because of the disability associated with owning an undivided interest in the properties, "a minority discount of 60% is reasonable in this case." *Id.* at 743. *See also Estate of Forbes v. Commissioner*, T.C.M. 2001-72 (March 23, 2001) (30% discount allowed for undivided 42% interest in 5,354 acres of real property); *Williams v. Commissioner*, 75 T.C.M. (CCH) 1758 (1998) (44% discount for undivided interest applied to a one-half undivided interest in approximately 4,600 acres of timber property in Florida); *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297, 1308-10 (1993) (holding that a 20% minority interest and 10% lack of marketability discount applied for undivided interest in New York apartment and office buildings).

In *Estate of Baird v. Commissioner*, 82 T.C.M. (CCH) 666 (2001), the Tax Court applied a 60% discount in valuing undivided interests in 16 non-contiguous tracts of Louisiana timber property. In Mr. Baird's estate tax return, the estate claimed a 25% fractional interest discount. The return was later amended to assert a 50% undivided interest discount. Mrs. Baird's estate tax return included a 50% undivided interest discount, and was later amended to assert a 60% discount. At trial, both estates claimed discounts of 60%. One expert of the taxpayer based his discount upon comparable sales and concluded that a discount of "at least 50% was appropriate." The second expert also relied on comparable sales and concluded that a 55% discount was appropriate. The third expert, James Steel of Monroe, Louisiana, made a living through buying and selling fractional interests. His report asserted that the discount should be at least 55%. At trial, he opined that the subject interest should be discounted by 90%. The Tax Court opined that a 60% discount was appropriate. The Tax Court primarily relied upon Mr. Steel's "personal knowledge and experience in the marketplace under consideration."

F. Control Premium.

The rationale for a control premium is that a controlling shareholder has the power to elect the board of directors, influence corporate policy and directly affect corporate decision-making. The controlling shareholder may be able to unilaterally direct corporate action, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge or sell assets. *Estate of Newhouse v. Commissioner*, 94 T.C.M.

(CCH) 193, 217 (1990). For these reasons, a control premium is usually warranted in evaluating controlling interests.

In *Estate of Salsbury v. Commissioner*, 34 T.C.M. (CCH) 1441 (1975), the court identified the following powers that an owner has in a controlling stock interest: (1) the owner could elect the entire board of directors; and (2) the owner could, through the power to control the board, control the business and affairs of the corporation, elect and remove all of the officers, fix their salaries and control the declaration of dividends. Accordingly, the Court applied a 38.1% control premium to the value of the decedent's shares which constituted a 51.8% voting interest.

The Ninth Circuit Court of Appeals recently reversed the Tax Court's decision in *Estate of Simplot v. Commissioner*. In *Estate of Simplot v. Commissioner*, 112 T.C. 130 (1999), the Tax Court applied a control premium to the valuation of Class A voting stock in J.R. Simplot Co., a closely held corporation. At the time of the decedent's death, he owned 23% of the outstanding shares of voting stock and approximately 2.8% of the non-voting stock. The ratio of voting shares to non-voting shares was 1 to 1,848. The Tax Court applied a control premium equal to 3% of Simplot's equity value to the transferred voting shares on the theory 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 other family members' "shares" to form a control group."

The Ninth Circuit Court of Appeals reversed the Tax Court's decision on the grounds that the Tax Court's swing vote theory erroneously applied the willing buyer, willing seller test. *Estate of Simplot v. Commissioner*, 249 F.3d 1191 (9th Cir. 2001). The Ninth Circuit determined that "the facts applied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful an outside purchaser might suggest. 'All of these factors,' *i.e.*, all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers." The Ninth Circuit also found that the Tax Court erred by (1) proportionately applying a control premium to the estate's minority interest in voting stock based upon a premium applied to all of the voting stock, and (2) failing to show that a purchaser of the voting stock would be able to use control to an increased economic advantage. The Court stated "in Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share."

G. Tax Affecting S Corporation Earnings.

In *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001), the Sixth Circuit Court of Appeals affirmed the Tax Court's valuation a minority interest in the stock of a Pepsi Cola bottling company, an S corporation, which made substantial distributions to its shareholders. In determining the fair market value of the transferred shares, the Tax Court agreed with the IRS expert's opinion that no tax should be imputed on the earnings of the S corporation under the discounted cash flow method applied by the expert. The Tax Court also applied the 25% discount for lack of marketability determined by the IRS's expert.

The Sixth Circuit Court of Appeals, in a 2-1 decision, affirmed the Tax Court's opinion. The majority held that the Tax Court did not commit clear error when it valued the stock in a manner consistent with the opinion of the IRS expert. The Court opined that the Tax Court weighed the testimony of the two competing experts and did not clearly err in accepting one expert's opinion over the other. The majority determined that tax affecting the stream of income under the facts of the *Gross* case was not required because of the disagreement among professional appraisers as to the propriety of employing such a procedure. The Court also opined that the Tax Court's refusal to tax affect the stock was not unfair to the donors, because (1) the donors were not justified in relying on internal IRS policy manuals concerning S corporation stock valuation; (2) there was no evidence that the corporation would lose its sub-chapter S status; and (3) the IRS was not precluded from taking the approach it did even if tax affecting had been used in previously approved returns.

The dissent believed that it was error not to tax affect the corporation's stream of income in determining the fair market value. The dissent focused on the fact that the IRS's appraiser did not know whether or not (1) real buyers and sellers, and (2) appraisers tax affected S corporation earnings in 1992 (the year in which the transfer occurred). The dissent also found persuasive the IRS's pronouncements regarding tax affecting of S corporation earnings and the treatment of prior gifts made by the donor.

In *Estate of Adams v. Commissioner*, 83 T.C.M. (CCH) 1421 (2002), the Tax Court did not allow of the income stream computed under a discounted cash flow approach to be adjusted for imputed income taxes on the S corporation's income when determining the fair market value of a 61.59% interest in a closely-held insurance agency. The Tax Court stated that "we disagree that [the taxpayer's expert's] estimates of WSA's perspective net cash flows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cash flows when the stock being valued is stock of an S corporation."

H. Tiered Discounts.

The IRS often takes the position that successive or tiered discounts should not be applied in determining the value of an interest in an entity which in turns owns an interest in another entity. But both the Tax Court and other courts have recognized the existence of "tiered discounts" when valuing an interest in a closely held entity. *See, e.g., Gow v. Commissioner*, 79 T.C.M. (CCH) 1680 (2000) (the court applied combined discounts for lack of control and lack of marketability in valuing the stock of the top tier entity for 1989 and 1990, respectively, of 44% and 51%, and 41% in valuing the interest in the second tier entity); *Kosman v. Commissioner*, 71 T.C.M. (CCH) 2356 (1996); *Dean v. Commissioner*, 19 T.C.M. (CCH) 281 (1960); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

VIII. PRIVILEGES IN THE ESTATE PLANNING CONTEXT

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity could be completely disregarded for estate and gift tax purposes under the Service's interpretation of the Tax Court's memorandum decision in *Estate of Murphy v. Comm'r*, T.C. Memo. 1990-472 and I.R.C. § 2703. *See, e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 973004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); PLR 9723009 (February 24, 1997). In each of these pronouncements, the Service took the position that it could completely disregard the existence of the applicable entity – whether or not that entity was validly created and existing under state law. In other words, the Service claims that because, in its opinion, the entity at issue was formed primarily for estate planning purposes, the Service can completely disregard for federal estate and gift tax purposes the existence of a legal entity in determining the fair market value of the assets subject to the transfer taxes – regardless of the fact that the asset transferred was an interest in a closely held entity validly created and existing under state law.

Because of these attacks, IRS requests for documents at the audit level and in estate tax litigation increasingly include requests for communications with counsel and other persons involved in the estate planning process seeking to determine the motives for creating the entity. This is particularly true in the area of buy-sell agreements, family limited partnerships, and closely-held corporations, where the IRS has become more aggressive in seeking to have entities ignored for estate tax purposes on the grounds that the entity lacks "business purpose" or was created solely as a "device" to avoid estate taxes. Attached as Exhibits 1 through 4 are examples of IRS document requests that have been served on taxpayers over the last several years in audits involving closely held entities. The requests are extremely intrusive and cover every aspect of the estate planning and entity administration process.

A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience.

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their correspondence and their files may also be subject to production in a tax audit or in litigation.

B. Understand the IRS's Broad Subpoena Power.

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

Subject to any applicable privileges, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the estate planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

1. Enforcement of Summons.

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. Understand and Preserve All Privileges.

As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffe v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney-client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to medical records, the doctor/patient privilege and psychotherapist/patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

1. The Attorney-Client Privilege.

a. What the Privilege Covers.

The attorney-client privilege generally protects the disclosure of confidential communications between estate planning counsel and the client made for the purpose of facilitating the rendition of legal advice. The attorney-client privilege also protects "an attorney's advice in response to such disclosures." *In Re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). In addition, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when the lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Communications with third parties, such as accountants or financial advisors, that are made to "assist the attorney in rendering advice to the client" are also generally protected. *See United States. v. Adlman*, 68 F.3d 1495, 1499 (2^{d}Cir. 1995). ("The privilege would extend to an accountant hired by the attorney to assist the attorney in understanding the client's financial information.")

A privileged communication is "any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression." *See, e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass'n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) ("[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege."); *New York Underwriters Ins. Co. v. Union Constr. Co.*, 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney's billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir. 1982) (holding that bills, ledgers, statements, time records, and the like that reveal "the nature of the services provided" should be privileged).

Courts generally define "client" broadly, even extending the privilege to include prospective clients who reasonably believe that they are seeking legal advice. The Supreme Court has also extended the privilege to all corporate employees of a represented taxpayer if the communications at issue were made by corporate employees to counsel for the corporation acting as such, at the direction of corporate superiors in order to secure legal advice from counsel and the "employees . . . were aware that they were being questioned so that the corporation could obtain legal advice." *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

The attorney-client privilege survives the death of the client. *Swindler & Berlin v. United States*, 1998 U.S. LEXIS 4214 (June 5, 1998).

b. What the Privilege Does Not Cover.

Communications with nonclient family members, stock brokers, accountants, or other third parties that are *not* made to "assist the attorney in rendering advice to the client" are generally not privileged. *Adlman*, 68 F.3d at 1499. "What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer.* If what is sought is not legal advice but only accounting service . . . or the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Id.* at 1499, citing *United States v. Kovel,* 296 F.2d 918 (2^d Cir. 1961).

Work papers of the attorney that do not constitute or contain communications from the client, drafts of documents, and correspondence with third parties do not fall within the attorney-client privilege. *See Hickman v. Taylor,* 329 U.S. 495, 508 (1947) (holding that the privilege did not attach to "memoranda, briefs, communications and other writings prepared by counsel for his own use in prosecuting his client's case; and it is equally unrelated to writings which reflect an attorney's material impressions, conclusions, opinions or legal theories").

In addition, advice rendered in connection with tax return preparation is generally not privileged. *See United States v. Frederick,* 182 F.3d 496, 500 (1999). The *Frederick* Court's refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is "accountant's work," whether performed by an accountant or a lawyer. For lawyers who prepare estate and gift tax returns for estate planning clients, *Frederick* is a must read case.

In *Frederick,* an attorney/accountant claimed the attorney-client privilege for work papers prepared in the process of preparing tax returns for his individual clients and their closely held corporations. The Court held that the lawyer's "legal cogitations borne out of his legal representation" that appeared in the work sheets for the preparation of the tax return would not be privileged, because of their use in tax return preparation. *Id.* at 501. Under the Seventh Circuit's analysis, disclosures made by a client during tax planning might lose their privileged status if incorporated in any way in work papers leading to the preparation of a tax return by the same representative.

The situation in *Frederick* was particularly complex because the attorney knew that the IRS was investigating the taxpayers and their company with regard to other tax years, and the attorney was representing the taxpayers' interests in connection with the investigation as well as preparing their current tax returns. *Id.* at 501. The tax return work papers could contain privileged information related to the years under investigation and could have dual purposes – litigation preparation and return preparation. The Court held that the "dual purpose" documents prepared for both tax return preparation and litigation were not privileged because of their relationship to the tax return.

In addition, the Court dealt with the question of whether documents prepared in connection with a tax audit are privileged. The Court viewed the audit as "both a stage in the determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation." *Id.* at 502. In its original opinion, the Court treated all audit representation the same way – as not qualifying for the privilege. However, the Court amended its opinion to provide that if the audit primarily concerns "verifying the accuracy of a return," then the audit representation is "accountant's work" whether done by an accountant or a lawyer. If the taxpayer's lawyer attends the audit "to deal with issues of statutory interpretation or case law that the revenue agent may have raised" in the audit, then the "lawyer is doing lawyer's work and the attorney-client privilege may attach." *Id.*

If the client retains an accountant to deal with verification and an attorney to do the "lawyer's work," then separating privileged communications from unprivileged communications during the audit is easy. Such separate representation is rarely practical. Any tax practitioner or court trying to separate privileged communications from unprivileged ones in a tax audit may face a very difficult process of sorting matters out after *Frederick.*

c. Waiver.

Beware: even if a document is privileged, that privilege can be waived. Disclosing otherwise privileged communications between a lawyer and client to third parties may cause those communications to lose their privileged status. *See, e.g., United States v. Brown*, 478 F.2d 1038 (7th Cir. 1973).

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made "to assist the attorney in rendering advice to the client," are protected under the attorney-client privilege. *See, e.g., Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney's direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) ("Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation."). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made "in confidence for the purpose of obtain legal advice." *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir, 1973).

In a dispute we handled over whether the Service's summonses were enforceable in light of privilege issues, a taxpayer argued that a holding of waiver in the context of communications to and from the client's financial advisors for the purpose of rendering legal advice to the client in forming a business entity would be contrary to the logic of the principle of the attorney-client privilege. *Segerstrom v. U.S.*, 2001 WL 263449 (N.D. Cal. 2001). In a rare decision, the Court granted the taxpayer's request to quash summonses, given the facts - disclosure to third parties was shown to meet standard if privilege/disclosure.

Olender v. United States, 210 F.2d 795 (9th Cir. 1954), would appear to stand for the contrary proposition. However, such a conclusion ignores the factual setting of *Olender*, where the Court found that the only purpose for which the attorney in question there was hired was to prepare net worth statements and tax returns. *Id.* at 806. In the estate planning context, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when the lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). According to the Ninth Circuit, "[c]alling the lawyer's advice 'legal' or 'business' advice does not help in reaching a conclusion [as to whether the communication is protected by the attorney-client privilege] . . . What matters is whether the lawyer was employed with or without 'reference to his knowledge and discretion in the law' to give his advice." *Id.* at 1502.

d. The IRS's View on the Privilege.

In a recent speech at the Texas Federal Tax Institute, B. John Williams, Jr., former Chief Counsel of the Internal Revenue Service, offered his thoughts on the attorney-client privilege and what the Service considers that the privilege does not cover. B. John Williams, Jr., Speech to Texas Federal Tax Institute, 2002 TNT 110-29 (June 6, 2002). In the Service's view, the attorney-client privilege does not cover communications from the advisor unless the communications from the advisor would reveal confidential client communications.

In addition, the Service considers that any information communicated to an attorney that will be incorporated into a tax return is not privileged, given that it is intended to be disclosed to the IRS. According to Mr. Williams, in this regard the privilege does not cover, for instance, information appearing on a K-1.

Finally, the Service posits that the attorney-client privilege does not protect preexisting facts, documents, or intra-corporate communications unrelated to the seeking of legal or tax advice. In this regard, the Service believes that the privilege does not protect the existence of an attorney-client or practitioner-client relationship or the fees paid, communications made in connection with providing non-legal services such as accounting or tax preparation activities or for non-legal advice such as business or accounting advice.

D. The Attorney Work Product Privilege.

Many lawyers believe that the attorney work product privilege absolutely protects their file from disclosure to third parties. The work product privilege is actually much narrower; it only shields from disclosure materials prepared "in anticipation of litigation" by a party or the party's representative, absent a showing of substantial need. Fed. R. Civ. P. 26(b)(3). The purpose of the doctrine is to establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary's preparation. *See United States v. Nobles*, 422 U.S. 225, 238 (1975).

There is no bright line test to determine whether a document has been prepared "in anticipation of litigation." In the estate planning process, however, it will be difficult to argue that an estate planning attorney's internal memos or work papers were prepared "in anticipation of subsequent litigation" with the IRS. *See United States v. Adleman*, 96-2 U.S.T.C. 85,682 (S.D.N.Y. 1996) (refusing to apply the work product privilege to an accountant's memorandum analyzing the "legal ramification of a proposed transaction to determine whether, despite a likely challenge, the legal risk was acceptable," and holding that "[t]he primary purpose of these documents was not to prepare for litigation; the primary purpose was to decide whether or not to go through with a multimillion dollar transaction"). *But see, e.g., Adlman*, 68 F.3d at 1500-02 (nothing that there is no bar to "application of work product protection to documents created prior to the event giving rise to litigation").

One court has even held that the power of the IRS to investigate the records of taxpayers makes doubtful the relevancy of the work product privilege enunciated in *Hickman* to a proceeding for the enforcement of an IRS summons. *United States v. McKay*, 372 F.2d 174, 176 (5th Cir. 1967) (reasoning that the IRS summons power is broad because all facts are in the taxpayer's hands).

1. The Tax Practitioner's Privilege.

In the Internal Revenue Restructuring Act of 1998, Congress added I.R.C. § 7525, which extends the attorney-client privilege to confidential communications between taxpayers and practitioners that would protect the same "communication[s] between a taxpayer and an attorney." The privilege, however, is limited to (1) "non-criminal tax matters before the Internal Revenue Service" and (2) "non-criminal tax proceedings in federal court brought by or against the United States." I.R.C. § 7525. Because the work product doctrine is separate from the attorney-client privilege, the new privilege provision does not grant the work product privilege to non-attorney advisors.

Frederick was the first case to address the tax practitioner privilege. The *Frederick* court took I.R.C. § 7525 into account in reaching its decision in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. *Frederick*, 182 F.3d at 502. Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

The First Circuit recently reinforced the *Frederick* court's construction of I.R.C. § 7525 in *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Cavallaro*, the First Circuit upheld the granting of enforcement of summonses issued by the IRS given that information was disclosed to accountants in a merger deal, and the accountants were providing accounting services, not facilitating communication of legal advice. The First Circuit reasoned that an attorney does not render client communications to an accountant privileged merely by engaging the accountant.

a. The IRS's View.

According to Mr. Williams, the tax practitioner privilege does not protect details about a transaction necessary for the IRS to determine whether a significant tax avoidance purpose exists. Nor does it cover a tax opinion that is marketed to more than one client, particularly if the opinion is not based on facts supplied by a client, or where hypothetical facts not used by the client are used to formulate the tax opinion. The Service's rationale is that because the facts in such an opinion are hypothetical, there is no client communication to be protected.

2. The Physician-Patient Privilege.

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United*

States v. Moore, 970 F.2d 48, 50 (5th Cir. 1992).[21] The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

However, in *Jaffee v. Redmond*, 518 U.S. 1 (1996), the Supreme Court addressed the question of whether federal courts should recognize a psychotherapist-patient privilege under Rule 501. In *Jaffee*, the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501. In reaching its holding, the Court noted that:

> Like the spousal and attorney-client privileges, the psychotherapist-patient privilege is "rooted in the imperative need for confidence and trust." *Trammel*, 445 U.S. at 51, 63 L. Ed. 2nd 186, 100 S.C. 906. Treatment by a physician for physical illness can often proceed successfully on basis of a physical examination, objective information supplied by the patient, and the results of diagnostic tests. Effective psychotherapy, by contrast, depends upon an atmosphere of confidence and trust in which the patient is willing to make a frank and complete disclosure of facts, emotions, memories and fears. Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace.

Id. at 9. While the *Jaffee* Court did not rule on the applicability of a physician-patient privilege, the cited language shows that medical records based primarily upon physical examination and other objective information supplied by the patient or that result from diagnostic tests may not be considered privileged.

E. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So.

The assertion of the privileges at the audit or tax court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

[21] When Congress adopted the final version of the new Federal Rules Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (which included a physician-patient privilege) in favor of a single rule authorizing federal courts to apply "common law principles – in the light of reason and experience" in determining whether a privilege exists under the common law. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 "should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined as a case by case basis." S. Rep. No. 93-1277, p. 13 (1974).

In cases where the IRS has questioned the motive of a decedent, the best evidence often comes from the correspondence prepared in connection with the transaction at issue. Well-drafted contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as "a device solely to avoid estate taxes" or lacks "business purpose." *See, e.g., John J. Wells, Inc. v. Comm'r*, 47 T.C.M. (CCH) 1114, 1116 (1984). ("While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.").

1. The IRS's View.

Interestingly, it is the Service's view that asserting a reasonable cause and good faith defense under Section 6664 waives the attorney-client privilege with respect to any opinion used to establish reasonable cause, as well as for communications and other tax advice relating to the transaction. In the Service's opinion, the taxpayer has put at issue his mental state or knowledge regarding the transaction and thus the privilege is waived with regard to all information in that regard.

Unfortunately, the Service's approach in this regard was bolstered by the Tax Court's decision in *Johnston v. Comm'r*, 119 T.C. No. 3 (August 8, 2002). In *Johnston*, the Tax Court held that the taxpayer impliedly waived the attorney-client privilege by raising a claim that could be effectively disproven only through discovery of privileged information. The Johnstons rebutted fraud penalties with the defense of reasonable reliance on qualified experts in preparing income tax returns. Relying on *Hearn v. Ray*, 68 F.R.D. 574, 581 (E.D. Wash. 1975), the *Johnston* court acknowledged four approaches[22] to implied waiver analysis, and focused on the three factors of the *Hearn* test to determine whether the privilege had been impliedly waived: (1) assertion of the privilege must be the result of an affirmative act – in other words, the privilege is implicated in the context of an affirmative defense; (2) as a result, the privileged information has been put at issue by the person asserting the privilege by making it relevant to the case; and (3) upholding the privilege would deny the opposing party access to information vital to his defense (sometimes termed a "sword and shield" approach). For a discussion of the "sword and shield" analysis, see *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992).

F. The Effect of Asserting the Privilege on the Burden of Proof in Disputed Cases.

In certain cases, the taxpayer can shift the burden of proof in transfer tax cases from the taxpayer to the government in the Tax Court. *See* I.R.C. § 7491. Section 7491 provides:

[22] The other three approaches were: (1) the automatic waiver rule – whereby a party automatically waives the privilege by asserting a claim or defense to which otherwise privileged material is relevant; (2) a balancing test – weighing the need for discovery against the underlying rationale for the privilege; and (3) a more protective waive theory whereby the privilege is waived only if the party directly injects an attorney communication into issue.

> (a) burden shifts where taxpayer produces credible evidence.–
>
> (1) GENERAL RULE.–If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
>
> (2) limitations.–
>
> (A) the taxpayer has complied with the requirements under this title to substantiate any item;
>
> (B) the taxpayer ***has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews***; and
>
> (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
>
> Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).
>
> (3) COORDINATION.– Paragraph (1) shall not apply to any issue if any other provisions of this title provides for a specific burden of proof with respect to such issue.

I.R.C. § 7491 (emphasis added).

To shift the burden of proof, the taxpayer must have complied with the substantiation requirements and kept the required records. In addition, the taxpayer must have cooperated with "reasonable requests" by the IRS for "witnesses, information, documents, meetings, and interviews" and must present "credible evidence" in court on the factual issue before the burden shifts. If the taxpayer asserts the privilege in response to an IRS request for information, the IRS will obviously argue that the taxpayer has not cooperated fully enough in providing information and should not be able to shift the burden of proof. The question yet to be addressed by the courts is whether a request that seeks privileged information can ever be "reasonable."

G. Privilege versus Penalty.

Ironically, the price of asserting the privilege in particular cases may be the loss of other rights that would otherwise be available to the taxpayer or to the tax preparer. For instance, claiming the privilege may prevent taxpayers from showing that they have had substantial authority for a return position to avoid an accuracy related penalty, or prevent tax preparers from protecting themselves from tax preparer penalties.

Specifically, I.R.C. § 6662(a) imposes an accuracy related penalty in an amount equal to 20% of the portion of any underpayment to which the section applies. The section applies to, among other items, the portion of an underpayment attributable to negligence or disregard of rules or regulations. I.R.C. § 6662(b)(1). Negligence has been defined as the lack of due care or failure to do what a reasonable and ordinary prudent person would do under the circumstances. *Neely v. Comm'r*, 85 T.C. 934, 947 (1985). Negligence includes the failure to make a reasonable attempt to comply with the Internal Revenue Code. I.R.C. § 6662(c).

One defense to an underpayment penalty is that the underpayment of tax was made in good faith and due to reasonable cause. Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Treas. Reg. 1.6664-4(b). However, reliance on the advice of professional accountants or attorneys in preparing tax returns constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id. See, e.g., Schauerhamer v. Comm'r*, 73 T.C.M. (CCH) 2855 (1997). In order to demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise be privileged information. Accordingly, each case should be looked at on its own merits to determine whether or not the client will benefit by disclosure.

H. Privileges in the Appraisal Process.

1. The Estate Planning Professional Should Hire the Appraiser.

Working with appraisers is an everyday event for most estate planning professionals. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of their home. In addition, many clients do not enjoy working with appraisers. Although they are necessary, they are also expensive and can slow transactions down.

In most cases, the estate planner, not the client, should hire the appraiser for an estate planning transaction. The estate planning professional can offer guidance both to the client and the appraiser as to how similar transactions have been handled in the past by the IRS and the courts. In addition, the estate planning professional often can obtain a lower fee from the appraiser because of an existing relationship and repeat business. Doing so will also provide the taxpayer with an argument that any unused reports or correspondence are privileged, as the appraisal I s intended to assist the attorney in rendering legal advice. As noted above, this argument is not as strong in the "planning" stage – but is much stronger in the litigation stage.

2. Anything Committed to Writing May Be Discoverable.

Any document in the appraiser's file, including correspondence, notes, and drafts of an appraisal can be discovered during the audit process or in subsequent litigation. Experienced appraisers should know this; however, it never hurts to remind them. Once again, consider who your audience may ultimately be and understand that the appraiser's file may be reviewed by the examining agent, appeals officer, district counsel, or the ultimate finder of fact in tax litigation.

3. Discuss the Methodology and Results of the Appraiser's Work With the Appraiser Before the Appraiser Drafts the Report.

Hiring a qualified appraiser is only the first part of the job. Examine the underlying assumptions, analysis, and conclusions of the appraiser and ensure that they are logical. Appraisers can and do make mistakes. Discuss with the appraiser his or her methodology of his or her examination *before* the appraiser commits the findings to writing. This doesn't mean you should "coach" the appraiser or tell the appraiser the answer that you want; it does mean that you should satisfy yourself that the appraiser's assumptions and analysis are correct. If you have questions or concerns regarding the appraiser's assumptions or analysis, you should discuss those concerns with the appraiser before the appraiser begins drafting the report. If your concerns cannot be satisfied, consider choosing another appraiser. If you decide to engage a second appraiser *before* the first appraiser has reduced his findings to writing, there will be no documents from that appraiser to produce in response to an examining agent's request for "copies of all appraisals."

I. Where Are We Now?

Recent opinions have dealt a significant blow to the lack of economic substance, lack of business purpose, I.R.C. § 2703, I.R.C. § 2704(b) and gift on formation positions taken by the IRS in the family limited partnership area. As a general rule, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes. Moreover, the provisions I.R.C. § 2703 and 2704(b) were never intended to allow the IRS to disregard the existence of a validly existing entity. In fact, the primary cases where the IRS has successfully disregarded the existence of an entity is where the Tax Court has found that the partners have not respected and treated the partnership as a separate legal entity for state law purposes.

In light of these decisions, the IRS is primarily left arguing over the value of the partnership interest or, in cases where the entity has not been respected or where the Decedent retained a significant amount of control, an argument that the entity should be ignored under I.R.C. § 2036. In dealing with the IRS at the audit level and in litigation, I have seen the IRS increase its focus on the actual operations of the partnership. The IRS routinely requests the opportunity to examine the books and records of the partnership, the partnership's bank statements, and the documents conveying assets into the partnership. If distributions were made, were they made in accordance with the terms of the partnership agreement? Was the partnership operated as a separate legal entity, or merely a second bank account for the decedent? The IRS is inquiring, as did Judge Cohen in the *Estate of Strangi* opinion, whether the proverbial "i's are dotted and t's are crossed?" The IRS attacks on partnership based valuation discounts can be thwarted with careful planning, documentation and operation of the entity. This includes ensuring that the partners respect the entity and that qualified, supportable, and well reasoned appraisals are obtained when valuing the transferred interests.

Valuation discounts for lack of control and lack of marketability are real. A person acquiring an interest in a family limited partnership, particularly a non-controlling interest, lacks the ability to dictate how the partnership will be run and how distributions will be made. There is no established market on which the interest can be traded.

As can be seen from the table set forth below, taxpayers have sustained substantial valuation discounts in cases where the Court found their expert's valuation testimony more persuasive than the valuation testimony presented the government. Practitioners must remember that the valuation report is the most important piece of evidence in a transfer tax dispute. Because the valuation filed with the transfer tax return constitutes an "admission" of value by the taxpayer, it is important for the taxpayer to obtain well-reasoned appraisals from a qualified appraiser ***when the return is filed***.

Case	Assets	Discount from NAV
Strangi I	securities	31%
Knight	securities/real estate	15%
Jones	real estate	8%; 44%
Dailey	securities	40%
Adams	securities/real estate/minerals	54%
Church	securities/real estate	63%
McCord	securities/real estate	32%
Lappo	securities/real estate	35.4%
Perraccio	securities	29.5%

Internal Revenue Service Department of the Treasury

Date:

In Reply Refer to:
Person to Contact:
Contact Telephone Number:
Fax Number:

Re: U.S. Gift Tax Return Form 709

Dear

The United States Gift Tax Return you filed for the year 1996 is being audited by this office. We need the information listed below furnished or made available for our inspection within the next three (3) weeks:

1. Copies of donor’s Federal Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced above.

2. Copies of all 709’s filed with with appraisals, acts of donation and other supporting documentation. This includes 709’s filed by your spouse.

3. If any assets subject to any of the above referenced gifts have been sold or agreements to sell have been entered into subsequent to date of donation please provide complete details, including contracts, deeds and closing statements.

4. A list of donations of any kind, other than customay holiday and birthday gifts of small value, made during your life time regardless of whether a Gift Tax Return Form 709 was filed.

5. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:

a) All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
b) Articles of organization and operating agreement, with any amendments.
c) All documents that were prepared to meet state law requirements on the formation and operation of the entity.
d) All financial statements and tax returns prepared and/or filed since inception.
e) All of the entities’ bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.
f) Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.

EXHIBIT 1

g) Evidence showing how the value of each entity asset was arrived at as of the date:
   1. it was contributed to the entity;
   2. of each gift of a interest in the entity;

provide all appraisals and supporting workpapers.

h) Evidence as to how the entity was valued as a whole as well as fractional interest. Provide all appraisals if not already furnished.

i) Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor.

j) For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, etc.).

k) For each entity asset, explain/provide:
   1. evidence that the entity owns the asset;
   2. when the donor acquired the asset;
   3. how the asset was used by the donor since its acquisition and how the entity has used the asset since; and
   4. who managed the asset prior to and after its contribution, explain in detail what management consisted of and how it changed after the entity was formed.

l) Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.

m) For each gift or transfer of an interest, provide:
   1. evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
   2. any assignment of any interest along with the terms of the assignment;
   3. the amount and source of any consideration paid along with an explanation as to how the amount was arrived at.

n) Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
   1. date of birth;
   2. education and occupation;
   3. experience and expertise in dealing with real estate, financial affairs and investments;
   4. extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof; and
   5. any personal financial statements and credit applications which were prepared in connection with loan applications after the LLC was created.

o) Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.

p) Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.

q) A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, in necessary.

r) A copy of the Donor's will, revocable trust, and any executed power of attorney, if not submitted with the return.

s) A statement indicating the identity of the parties recommending the use of the LLC or partnership, when the recommendations were made, and the reasons set forth in support of using such an entity.

t) Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

Each item should be responded to either by furnishing the requested documentation; a written response, if called for, under the signature of the donor or a written explanation as to why the information will not be provided.

Should you have any questions call or write to me at he above number and address. A Form 2848 is enclosed for for your execution if you wish to appoint your attorney or CPA to represent you.

Very truly yours,

Enclosures:
IRS Publication 1
Form 2848 Power of Attorney

EXHIBIT "A"

REQUEST FOR INFORMATION - ESTATE TAX EXAMINATION OF LTD PARTNERSHIP INTEREST

Except for any of the below listed items that may be deleted, please provide the following:

1. Copy of partnership agreement, with all exhibits. If the current agreement has been amended, include a complete copy of all prior agreements.

2. Partnership income statements and balance sheets for five years before the gift, or for the period of existence if less than five years.

3. Copies of all appraisals of the partnership, and of partnership interests transferred, in the year of transfer.

4. Copies of all appraisals of assets transferred into the partnership at the time of formation of the partnership.

5. List of the partners both at the time of the formation of the partnership and at the date of death, and their relationship to the decedent.

6. Copies of all trust agreements for trusts that have either received partnership interests, or have transferred assets to the partnership.

7. List of all securities owned by the partnership, and all CUSIP numbers for those that are publicly traded.

8. Copy of all community property partition agreements affecting partnership assets, with a list of the assets themselves.

9. Copy of all documents used to execute and record the transfer of the partnership units that are the subject of the gift, e.g. "assignments of gifts," or "gift directives;" include a copy of the partnership transfer record.

10. A statement regarding the health of the decedent at the time of the formation of the partnership.

11. A list of all physicians seen by the decedent in the three years prior to the formation of the partnership, and the authorizations for those physicians to release information to the Internal Revenue Service.

12. A list of all hospitals in which the decedent was hospitalized in the three years prior to the formation of the partnership, and authorizations for the hospitals to release information to the Internal Revenue Service.

13. A statement signed by the executor describing the bona fide business arrangement for the formation of the limited partnership.

14. A statement signed by the executor affirming the fact that the formation of the partnership was not a device to transfer property to the natural object of the decedent's bounty for less than full and adequate consideration in money or money's worth.

15. A statement signed by the executor affirming the fact that the partnership the decedent became part of is under the terms of the partnership agreement, comparable to similar business arrangements entered into by persons in an arm's length transaction.

EXHIBIT 2

INTERNAL REVENUE SERVICE-ESTATE & GIFT TAX
REQUEST FOR INFORMATION

Donor:
Gift Tax Year:
Name of Partnership:
Name of Trust(s)

The following information is requested in connection with the examination of the above-captioned donor. Please submitted complete information by

Provide a complete statement describing all of the facts and circumstances surrounding the creation and operation of the above captioned partnership. Include the following items:

1. A description of the purpose for establishing the partnership captioned above

A description of the purpose for establishing the two trusts captioned above

2. An explanation as to why the purpose(s) in A could not be achieved equally as well through outright gifts of the property.

What was the unique advantage of the partnership form which compelled its use in this case? What was the unique advantage of the trusts which compelled their use in this case?

3. Identify all of the parties recommending the use of the family limited partnership arrangement and trusts.

4. With regard to 3, provide documentation (letters, memos, written communications) to show when the recommendations were made and the reasons set forth to the client for the use of the family limited partnership and trust arrangement.

5. A statement with documentation (include complete return) to show where the fees for creation of the partnership and trusts were deducted.

6. Provide a copy of the Revocable Intervivos Trust and a copy of her will.

EXHIBIT 3

INTERNAL REVENUE SERVICE-ESTATE & GIFT TAX
REQUEST FOR INFORMATION

7. Provide exact dates and supporting documentation to show when the transfer of the property to the limited partnership occurred.

8. Provide exact dates and supporting documentation to show when the transfer of the partnership interests to the Family Trust occurred.

9. Provide the ages of the beneficiaries of the Family Trust at the time of the gifts. Provide the educational background of each and provision, if any.

10. Describe who managed the assets prior to the transfer of the assets to the partnership.

11. Identify , his relationship to Mrs. , and his fiduciary duties, if any, to the partnership. Provide his educational background and profession, if any.

12. Provide a copy of the certificate of limited partnership filed with the Secretary of State for the State of Florida.

13. Provide the age of Mrs. at the time of the formation of the partnership. Provide a statement as to the educational background of Mrs. and her profession, if any.

14. Provide a statement as to the expertise needed by the general partner to manage the partnership.

15. List the specific duties actually performed by the general partner.

16. Provide a statement regarding the state of health of Mrs. at the time the partnership was created. Be specific.

17. Have you or a member of your firm lectured to any group on the advantages of family limited partnerships? If so, identify the person and provide information, including dates and lecture materials regarding same.

18. Have you, your firm, or any accounting firm used by your firm marketed family limited partnership to your client through the use of general mailings? If so, provide copies of the general mailings.

INTERNAL REVENUE SERVICE
Estate Tax Group E:1105 HOU
STOP 4308 SANW

Re: United States Estate Tax Return, Form 706,

Dear

The above referenced estate has been assigned to me for examination and we need to Schedule an opening conference.

Enclosed is some literature relating to your rights, Publication 1, Your Rights as a Tax Taxpayer (12/98), and Notice 619, Privacy Act Notice (6/99).

I am dedicated to providing to you a courteous, professional examination that is completed within a reasonable period of time, six months from now. If at any time you perceive that you are not receiving those things, I invite you to bring the matter to my attention so that I may have an opportunity to consider and deal with your concerns.

Please contact me by November 16, 1999 to schedule our opening conference, and have available at that conference the documents and information requested below.

A. Re general background:
   1. Decedent's history from 1988 to 1998,
      a. describe Decedent's standard of living and where she lived;
      b. identify source and application of Decedent's
         (1) income,
         (2) funds used to purchase major assets, if any,
         (3) balances of cash on hand and in bank,
         (4) loans made or repaid, if any;
   2. identify by a family tree the natural objects of Decedent's bounty; and
   3. explain who kept and how financial records were organized 1988-1998.

B. Re administration of estate:

   1. describe any significant developments generally;
   2. indicate whether there are/were any appraisals of estate assets other than those furnished with Form 706;
   3. resolution of litigation, if any, pending at time 706 was filed; and
   4. were/are there any previously unreported assets, deductions, gifts.

EXHIBIT 4

C. Please state whether Decedent transferred any interest in titled property (e.g. real estate, securities, financial accounts) to family members since 1976.

D. Please furnish copies of:

1. Forms 1040 for 1992-98 plus all attachments/enclosures together with any examination reports;
2. checks or other evidence of payments made of Form 1040 federal income tax for the tax year 1998;
3. Forms 1041 for this estate;
4. Estate records of receipts and disbursements, starting at date of death;
5. copy of original power(s)-of-attorney granted by Decedent since 1983;
6. copy of any and all fiduciary accounting records/reports for the period 1988-1998;
7. copy of any/all applications to any court made under a POA since 1982;
7. copy of all documents related to loan, proceeds of which were used to pay federal estate and state death taxes;
8. copy of all guardianship application documents;
9. completed Power of Attorney, Form 2848, to include both United States Estate Tax Return, Form 706, and all periods for which United States Gift Tax Return, Form 709, have been filed, if any, for the period ended December 31 1997 (the year in which the family partnership was formed), and for periods ended December 31 of all years in which family partnership interests were gifted or otherwise transferred by this Decedent; and
10. furnish completed Notice of Fiduciary Relationship, Form 56.

In addition, attached are lists E-J of requested information and documents related to both the bona fides of the formation and operation of the family limited partnership, and related to its valuation.

I would appreciate written responses to my request for information because it is difficult for me to listen and reduce to writing accurately and completely mere verbal responses. For your convenience, I have spread out the questions over several pages, making them into worksheets which, if you so choose, you may use to prepare your responses. Handwritten responses are acceptable so long as they are legible. However, if, after making a reasonable attempt to respond, you find the process too burdensome, or you perceive or encounter any other problems in responding to a request for either information or documents, please contact me as soon as possible so that we can discuss alternatives, if any.

The major issue(s) identified at this time include ascertaining:

I. the federal estate and gift tax effect of a power-of-attorney holder for Decedent subjecting substantially all of her assets to a family limited partnership in 1997 for a term of 49 years in exchange for partnership interests valued by this estate at significantly less (40%) than net fair market value of those assets;

II. to what extent, if any, the amount claimed as deduction for interest expense is allowable;

III. whether there were previously unreported assets, deductions or gifts.

EXHIBIT 5

Please be aware that it may be necessary for me to contact third parties, such as the Probate Court, Clerk of Court, Central Appraisal District, or other agencies. I may also need to contact appraisers, financial, medical or other record keepers, or other persons. Please see - Notice 1219, Notification of Potential Third Party Contact (1/99). The extent to which I need to contact third parties will depend, at least in part, upon the information sought, whether you possess the information sought, and whether you can and do timely furnish that information to me.

After giving consideration to the information which I gather, and listening to any concerns you might have, I plan to discuss with you, or your representative, my proposed determination so as to identify and resolve, if possible, any differences. I will furnish a written report of proposed any adjustments, and can discuss them with you, or with your representative, as needed. In the event we are unable to reconcile any differences, then I can provide to you an explanation of both your appeal rights (Publication 5, Appeal Rights and Preparation of Protests for Unagreed Cases (1/99) and Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund (2/99)) and the collection process (Publication 594, The IRS Collection Process (01/99)). If paying an agreed amount of additional tax poses a problem, please ask and I can explain to you either installment payment (IRC 6166) or extension of payment (IRC 6161) relief provisions.

Since you or your representative possess the records and information related to this matter, only your full cooperation (as exhibited by full and timely responses to my information requests) will permit me to meet the target of completing this examination within six months from now.

If you have any questions in this matter, please feel free to call me at the number shown above.

Sincerely,

Copy:

INFORMATION re CREATION

E. Re the FLP, Please furnish the following INFORMATION related to the CREATION of the partnership:

1. state whether the partnership was created in conjunction with estate planning, if so, explain;
2. state whether creation of the partnership was a negotiated transaction, and if so, identify the parties and describe the negotiation process;
3. identify at whose suggestion the partnership was created;
4. explain why the FLP was created and why at that particular time;
5. state whether the idea of the partnership originated with the Decedent, if not, identify with whom;
6. describe the advice decedent or his/her family sought, and describe the qualifications of advisor(s);
7. describe what advice decedent and other parties to the partnership received, and identify by whom they were advised;
8. state how many meetings were held regarding the formation of the partnership before it was created, and identify who attended each meeting;
9. identify what, if any, notes were kept at such meetings, identify who took those notes, and identify where those notes are now;
10. summarize the factors discussed or considered regarding
    a. who would run the partnership,
    b. the decision as to who would be a partner,
    c. the decision as to who would be a general partner,
    d. the decision as to who would be a limited partner,
    e. responsibility of general partner,
    f. liability of general partner,
    g. whether general partner should be a corporation, trust or individual,
    h. the extent of each partner's interest in the partnership
    i. the fiduciary duty of a general partner and the impact of that on the limited partners,
    j. the ability of creditor or bankruptcy trustee to reach partnership assets,
    k. the rights and duties of limited partners,
    l. when to make gifts of limited partnership interests,
    m. the circumstances under which limited partnership interests could be sold,
    n. the circumstances under which limited partner could withdraw,
    o. what assets should be used to fund the partnership,
    p. what would be the reporting position regarding income taxation of the partnership,
    q. what would be the reporting position regarding gift and estate taxation of the partnership interests,
    r. what would be the reporting position regarding discounts for purposes of gift and estate taxation of partnership interests,
    s. how income from the partnership would be divided,
    t. family problems (such as sibling rivalry) among the partners,
    u. sources of funds to be used to buy a partner's interest in a partnership under any buy-sell provision,
    v. what was the understanding of the meaning of the term "fair value", and
    w. whether the understanding of the meaning of the term "fair market value" was before or after any discount;

11. identify Decedent's heirs using a family tree, state their years of birth, and explain how the existence of those persons affected Decedent's decision to form the partnership;
12. identify the benefits of the partnership perceived by Decedent or her POA, and by whom was she so advised;
13. identify who represented the Decedent and each of the other partners;
14. state whether the partnership was a prepackaged transaction, if so, identify the provider/vendor;
15. identify decedent's prior history of gift giving, if any;
16. identify what portion of Decedent's assets she subjected to the partnership agreement;
17. identify the origin of partnership assets by category;
18. identify what assets were retained by decedent, not subjected to the partnership agreement;
19. identify nonfamily members, if any, having independent knowledge of decedent's mental and physical state during all or part of the period 1983-1998, and furnish their names, addresses and telephone numbers;
20. identify the source of partnership contributions by partners other than decedent;
21. describe by category how the partnership assets (e.g. cash, securities, real property) were historically managed prior to being subjected to the partnership agreement, and explain why that could no longer continue;
22. identify who historically managed the assets prior to their being subjected to the partnership agreement, describe his/her qualifications to manage, the amount of time devoted to such management, and schedule of fees charged, if any;
23. state the business purposes for the creation of the partnership, and identify by what facts and documentation they are supported;.
24. explain how, if at all, management of the assets changed as a consequence of their being subjected to the partnership agreement;
25. state whether the partnership issued certificates of limited partnership;
26. identify what factors each partner considered in agreeing to each restriction on his or her interest in the partnership;
27. identify the subjective intent of the parties to the partnership other than this decedent, indicate whether they were concerned about decline in value of their property as a consequence of subjecting it to the partnership agreement, and explain their thinking either way;
28. identify who, if any, of the partners have initiated/completed divorce, filed bankruptcy, or been sued since they received their partnership interest, and, if there has been a will contest of any partner, provide the identity of the court and cause number, and furnish copies of pleadings, judgements, etc.;
29. if there has been a divorce, bankruptcy, law suit or will contest of any partner, then describe how the court treated the partnership interest in resolving the issues;
30. to the extent the partnership has been appraised other than by HFBE, indicate for what purpose, by who it was appraised, and for HFBE and others identify who each appraiser(s) contacted in connection with his appraisal;
31. state whether each partner in fact physically transferred from their own accounts to an account of the partnership the capital contribution allocated to them, if so furnish evidence of those transfers;

32. identify the extent to which, if any, each partner's capital contribution had its origin in Decedent;

33. identify the date after 1982 when Decedent executed any will or codicil and explain what prompted/motivated her to do that then;

34. explain to what extent property subjected to FLP came to rest in hands of same persons as would have received it upon Decedent's death had the property not been subjected to FLP;

35. identify the person who drafted or was responsible for drafting the Decedent's will, the partnership agreement, and documents of transfer of assets made subject to the partnership agreement;

36. state whether Decedent or her POA received counseling on the disposition of Decedent's wealth and planning for the disposition of her estate, if so, by whom;

37. briefly describe the state of decedent's mental and physical health for the period 1988-1998, especially as of date of execution of the partnership agreement;

38. furnish all detailed information/documents related to decedent's medical status for the period 1988-1998 (the period), including,

    a. statements by persons having personal knowledge of the facts wherein they describe Decedent's physical and mental health for the period, noting especially her condition as of date of formation of the FLP, and as of dates of any intervivos gifts, and identify medical conditions for which she sought/received medical treatment within that period,

    b. the name, address, telephone and dates of occupancy by Decedent in any nursing home(s) or other care facility,

    c. the identity of all medical providers (e.g. doctors, nurses, facilities, agencies), if any, from whom Decedent sought or received treatment during the period, and furnish their name, address, telephone and city,

    d. identify what, if any, medical treatment Decedent received during the period, and what was the objective of that treatment,

    e. indicate the dates, if any, when the Decedent was perceived by anyone (e.g. heir, doctor, nurse, aide, attorney) to be other than competent, and identify such perceiving person(s), if any (please do diligent inquiry),

    f. copies of the admission and dismissal summaries that show dates hospitalized during the period, the symptoms at time of admission, her medical/social history, and the final diagnosis,

    g. state whether Decedent suffered pain, whether it was progressively severe, to what extent it was ameliorated by medication, and to what extent he/she did not tolerate the pain medication,

    h. provide information regarding what was the expected probability of Decedent's survival as of date of formation of the FLP for 6mo, for 1yr, for 18mo, for more than 18mo,

    i. identify who, besides Decedent, was aware of those expectations, and

    j. furnish completed Forms 4452, Authorization to Disclose Medical Information; and

39. indicate to what extent you, , as POA for Decedent sought and or received court approval for subjecting Decedent's assets to the family limited partnership.

DOCUMENTS re CREATION

F. Re the FLP, please provide the following DOCUMENTATION related to the CREATION of the partnership:

1. a copy of the taxpayer's financial statement/net worth shortly before creation of the partnership;
2. copies of all correspondence between the taxpayer or her POA and the firm forming the partnership regarding creation of the partnership;
3. copies of any/all engagement letters with the firm that was engaged to form the partnership, and copies of that firm's time slips, and billing statements;
4. copies of any/all powers of attorney granted by the taxpayer during the formation of the partnership;
5. copies of all reports, analyses and computations prepared prior to formation of the partnership regarding the benefits of its creation;
7. if different than the one filed with Form 706, a copy of the family limited partnership (FLP) agreement as filed with the state;
8. indicate whether the written agreement represented the entire agreement between the parties, or whether there was any unwritten understanding, agreement or commitment regarding retained control of assets either by Decedent or by other partners, and if so provide copies of any such side agreements;
9. if there was a divorce of any partner after formation of the partnership, please furnish copies of any property settlements and pre-divorce agreements;
10. a copy of any amended Certificate of Partnership, showing the date it was filed with the state of Secretary of State;
11. all notes taken by Decedent's POA and other partners or their representatives regarding creation of the partnership;
12. all correspondence, including e-mail, among the partners/parties to the partnership and or Decedent's representatives regarding creation of the partnership;
13. all correspondence, meeting notes, and e-mail, among the representatives of the partners/parties regarding creation of the partnership;
14. all reports or analyses prepared prior to creation of the partnership that were generated by the partners, or their representatives;
15. copies of all appraisals of any partnership assets, including appraisals of securities, plus supporting documentation of the data, reasoning and analyses of Mr. Richard T. Hudgins regarding the realty;
16. copies of any partnership agreements of any other partnership of which the decedent is a partner;
17. documents indicating whether, when forming this family limited partnership, the parties considered the general practices of unrelated parties in forming partnerships;
18. documents or financial statements indicating decedent's financial condition and net worth shortly prior to formation of the family limited partnership;
19. documents or financial statements indicating the financial condition and net worth of parties/partners other than Decedent shortly prior to formation of the family limited partnership;
20. documentation showing transfer of assets subjected by Decedent and others to the family limited partnership;
21. copy of each partner's certificate/unit of limited partnership.
22. copies of any reports or analyses regarding the restrictions on the partners' interests in the partnership;
23. copies of each partner's calendar of records of events for the time during which formation of the partnership was under consideration;

24. copies of any powers of attorney granted by decedent that were in effect during the period that the partnership was formed;

25. copies of any assignments of partnership interest, if any, other than those filed with Form 706;

26. copies of any appraisals of partnership interests, if any, other then that by HFBE,

27. copies of all information which was furnished to any appraisers (including HFBE) to enable them to prepare their appraisals;

28. regarding the real property appraisal, copies of all of Mr. Hudgins' supporting documentation (e.g. comparable sales information, maps, etc.) retained in his files concerning the data, reasoning, and analyses of his appraisal, see his transmittal letter at page 1;

29. in regards the person who drafted or was responsible for drafting the Decedent's will or the partnership agreement, please furnish copies of each drafting person's fee bills and identify where that person's fees for creating the partnership and transferring the assets were deducted, if at all for purposes of federal income tax; and

30. copies of applications, orders, or other documents, if any, related to court approval of subjecting Decedent's assets to the FLP agreement.

INFORMATION re OPERATION

G. Re the FLP, please furnish the following INFORMATION regarding OPERATION of the partnership:

1. describe how, from an economic standpoint, the partnership operated;
2. describe how, if at all, there was a joining in the common conduct of a business by the family members;
3. describe in what trade or business transactions, if any, the partnership engaged, in particular whether the real property was leased to tenants or operated by the partnership;
4. describe how the Decedent's relationship to the property (subjected to the partnership agreement) and its income changed, if at all, as a result of the partnership;
5. state whether the partnership filed suit or was otherwise involved in litigation;
6. indicate to what extent, if any, the partnership,
   a. purchased, conveyed, leased, mortgaged or disposed of property,
   b. voted or dealt in shares of other interests or entities,
   c. subscribed or otherwise acquired notes or obligations of another entity,
   d. owned, held, sold, loaned or otherwise disposed of obligations of another entity,
   e. borrowed money or otherwise incurred debt,
   f. loaned money and received a security interest in property as security for repayment,
   g. was a promoter, partner, or manager of another entity.
   h. has an office, if so furnish address/location,
   i. hire employees or agents, define their (employees or agents) duties, fixed their compensation, or established pension plans or other employee benefit plans,
   j. made contributions, or
   k. indemnify anyone,
   l. marketed or sold any of the real property;
7. indicate the extent to which each partner was involved in or consulted in the operation of the partnership;
8. describe specific circumstances whereby, if at all, the partners held themselves out as partners to third parties;
9. describe how, if at all, the partners concealed the partnership or themselves as partners from third parties, and identify from whom and explain why;
10. indicate whether any partnership interests were sold, exchanged, or otherwise liquidated in the time since partnership agreement was executed;
11. state whether the other partners view themselves as partners;
12. describe how partnership books and records were kept;
13. identify the persons who make entries into the partnership books and records, and furnish their addresses and telephone numbers;
14. to the extent entries in the partnership books and records are not made by a partner, identify at whose direction entries are made;
15. explain how the transaction was treated for income tax purposes and for state law purposes;
16. indicate any charitable deduction taken for any partnership interests transferred to any qualified organization; and
17. identify who provided investing information and made investment decisions, both before and after creation of the partnership, and provide a copy of schedule of fees charged, if any.

DOCUMENTS re OPERATION

H. Re the FLP, please provide the following DOCUMENTATION related to OPERATION of the partnership.

1. copies (which show the date filed) of any corrected certificates partnership or cancellation filed with the Secretary of State;
2. full and complete (i.e. including depreciation schedules, K-1, etc) copies of the partnership financial statements and income tax returns, Forms 1065, for the periods 1997-1999;
3. copies of all correspondence, meeting notes, and e-mail among the partners, or their representatives, regarding partnership operation;
4. all reports or analyses prepared regarding partnership operation;
5. copies of any written waivers of any restrictions imposed on the partners with respect to their partnership interests;
6. copies of all partnership financial accounts, including account checks, account deposit tickets and related third party checks or transfer slips, and signatory cards for those accounts from 1997-1999;
7. copies of all securities account records, including copies of all correspondence with the broker or other third party record keeper from anyone (e.g. taxpayer, taxpayer's attorney, taxpayer's accountant) relating to the FLP account (please have complete and unedited correspondence file sent directly to me by the broker), all account statements, and all account transaction or transfer slips;
8. copies, if any, of partnership equivalent of corporate minutes;
9. copies of bookkeeping records, particularly capital accounts, of partnership; and
10. copies of all assignments of partnership interest other than filed with Form 706.

INFORMATION re VALUATION

I. Re the FLP, please furnish the following INFORMATION regarding VALUATION of the partnership:

1. state the fair market net asset valuation of partnership assets/liabilities (and show the computation thereof) as of
   a. the legal date of creation of partnership,
   b. the dates of any intervivos gifts, and
   c. date of death;
2. state the valuations (and show the computation thereof) of all partnership interests as of
   a. date of creation of partnership
   b. the date of any intervivos gifts by Decedent's of partnership interest, and
   c. as of date of death;
3. state the valuations (and show the computation thereof) of partnership interests if restrictions per agreement or state law on its sale or use were disregarded under IRC 2703(a)(1)
   a. as of the date of creation of partnership,
   b. the date of any intervivos gifts by Decedent's of partnership interest, and
   c. as of date of death; and-
4. state the valuations (and show the computation thereof) of partnership interests if restrictions per agreement or state law on its sale or use were disregarded under IRC 2704(b)
   a. as of the date of creation of partnership,
   b. the date of any intervivos gifts by Decedent's of partnership interest, and
   c. as of date of death.

DOCUMENTS re VALUATION

J. Re the FLP, please furnish the following DOCUMENTATION regarding VALUATION of the partnership:

1. copies of all information furnished to any appraiser to enable him to prepare his appraisal;

WORKSHEET
INFORMATION re CREATION

E. Re the FLP, Please furnish the following INFORMATION related to the CREATION of the partnership:

1. state whether the partnership was created in conjunction with estate planning, if so, explain;

2. state whether creation of the partnership was a negotiated transaction, and if so, identify the parties and describe the negotiation process;

3. identify at whose suggestion the partnership was created;

4. explain why the FLP was created and why at that particular time;

5. state whether the idea of the partnership originated with the Decedent, if not, identify with whom;

6. describe the advice decedent or his/her family sought, and describe the qualifications of advisor(s);

7. describe what advice decedent and other parties to the partnership received, and identify by whom they were advised;

8. state how many meetings were held regarding the formation of the partnership before it was created, and identify who attended each meeting;

9. identify what, if any, notes were kept at such meetings, identify who took those notes, and identify where those notes are now;

10. summarize the factors discussed or considered regarding

a. who would run the partnership,

b. the decision as to who would be a partner,

c. the decision as to who would be a general partner,

d. the decision as to who would be a limited partner,

e. responsibility of general partner,

f. liability of general partner,

g. whether general partner should be a corporation, trust or individual,

h. the extent of each partner's interest in the partnership

i. the fiduciary duty of a general partner and the impact of that on the limited partners,

j. the ability of creditor or bankruptcy trustee to reach partnership assets,

k. the rights and duties of limited partners,

l. when to make gifts of limited partnership interests,

m. the circumstances under which limited partnership interests could be sold,

n. the circumstances under which limited partner could withdraw,

o. what assets should be used to fund the partnership,

p. what would be the reporting position regarding income taxation of the partnership,

q. what would be the reporting position regarding gift and estate taxation of the partnership interests,

r. what would be the reporting position regarding discounts for purposes of gift and estate taxation of partnership interests,

s. how income from the partnership would be divided,

t. family problems (such as sibling rivalry) among the partners,

u. sources of funds to be used to buy a partner's interest in a partnership under any buy-sell provision,

v. what was the understanding of the meaning of the term "fair value", and

w. whether the understanding of the meaning of the term "fair market value" was before or after any discount;

11. identify Decedent's heirs using a family tree, state their years of birth, and explain how the existence of those persons affected Decedent's decision to form the partnership;

12. identify the benefits of the partnership perceived by Decedent or her POA, and by whom was she so advised;

13. identify who represented the Decedent and each of the other partners;

14. state whether the partnership was a prepackaged transaction, if so, identify the provider/vendor;

15. identify decedent's prior history of gift giving, if any;

16. identify what portion of Decedent's assets she subjected to the partnership agreement;

17. identify the origin of partnership assets by category;

18. identify what assets were retained by decedent, not subjected to the partnership agreement;

19. identify nonfamily members, if any, having independent knowledge of decedent's mental and physical state during all or part of the period 1983-1998, and furnish their names, addresses and telephone numbers;

20. identify the source of partnership contributions by partners other than decedent;

21. describe by category how the partnership assets (e.g. cash, securities, real property) were historically managed prior to being subjected to the partnership agreement, and explain why that could no longer continue;

22. identify who historically managed the assets prior to their being subjected to the partnership agreement, describe his/her qualifications to manage, the amount of time devoted to such management, and schedule of fees charged, if any;

23. state the business purposes for the creation of the partnership, and identify by what facts and documentation they are supported;

24. explain how, if at all, management of the assets changed as a consequence of their being subjected to the partnership agreement;

25. state whether the partnership issued certificates of limited partnership;

26. identify what factors each partner considered in agreeing to each restriction on his or her interest in the partnership;

27. identify the subjective intent of the parties to the partnership other than this decedent, indicate whether they were concerned about decline in value of their property as a consequence of subjecting it to the partnership agreement, and explain their thinking either way;

28. identify who, if any, of the partners have initiated/completed divorce, filed bankruptcy, or been sued since they received their partnership interest, and, if there has been a will contest of any partner, provide the identity of the court and cause number, and furnish copies of pleadings, judgements, etc.;

29. if there has been a divorce, bankruptcy, law suit or will contest of any partner, then describe how the court treated the partnership interest in resolving the issues;

30. to the extent the partnership has been appraised other than by HFBE, indicate for what purpose, by who it was appraised, and for HFBE and others identify who each appraiser(s) contacted in connection with his appraisal;

31. state whether each partner in fact physically transferred from their own accounts to an account of the partnership the capital contribution allocated to them, if so furnish evidence of those transfers;

32. identify the extent to which, if any, each partner's capital contribution had its origin in Decedent;

33. identify the date after 1982 when Decedent executed any will or codicil and explain what prompted/motivated her to do that then;

34. explain to what extent property subjected to FLP came to rest in hands of same persons as would have received it upon Decedent's death had the property not been subjected to FLP;

35. identify the person who drafted or was responsible for drafting the Decedent's will, the partnership agreement, and documents of transfer of assets made subject to the partnership agreement;

36. state whether Decedent or her POA received counseling on the disposition of Decedent's wealth and planning for the disposition of her estate, if so, by whom;

37. briefly describe the state of decedent's mental and physical health for the period 1988-1998, especially as of date of execution of the partnership agreement;

38. furnish all detailed information/documents related to decedent's medical status for the period 1988-1998 (the period), including,

a. statements by persons having personal knowledge of the facts wherein they describe Decedent's physical and mental health for the period, noting especially her condition as of date of formation of the FLP, and as of dates of any intervivos gifts, and identify medical conditions for which she sought/received medical treatment within that period,

b. the name, address, telephone and dates of occupancy by Decedent in any nursing home(s) or other care facility,

c. the identity of all medical providers (e.g. doctors, nurses, facilities, agencies), if any, from whom Decedent sought or received treatment during the period, and furnish their name, address, telephone and city,

d. identify what, if any, medical treatment Decedent received during the period, and what was the objective of that treatment,

e. indicate the dates, if any, when the Decedent was perceived by anyone (e.g. heir, doctor, nurse, aide, attorney) to be other than competent, and identify such perceiving person(s), if any (please do diligent enquiry),

f. copies of the admission and dismissal summaries that show dates hospitalized during the period, the symptoms at time of admission, her medical/social history, and the final diagnosis,

g. state whether Decedent suffered pain, whether it was progressively severe, to what extent it was ameliorated by medication, and to -what extent he/she did not tolerate the pain medication,

h. provide information regarding what was the expected probability of Decedent's survival as of date of formation of the FLP for 6mo, for 1yr, for 18mo, for more than 18mo,

i. identify who, besides Decedent, was aware of those expectations, and

j. furnish completed Forms 4452, Authorization to Disclose Medical Information; and

39. indicate to what extent you, as POA for Decedent sought and or received court approval for subjecting Decedent's assets to the family limited partnership.

WORKSHEET
INFORMATION re OPERATION

G. Re the FLP, please furnish the following INFORMATION regarding OPERATION of the partnership:

1. describe how, from an economic standpoint, the partnership operated;

2. describe how, if at all, there was a joining in the common conduct of a business by the family members;

3. describe in what trade or business transactions, if any, the partnership engaged, in particular whether the real property was leased to tenants or operated by the partnership;

4. describe how the Decedent's relationship to the property (subjected to the partnership agreement) and its income changed, if at all, as a result of the partnership;

5. state whether the partnership filed suit or was otherwise involved in litigation;

6. indicate to what extent, if any, the partnership,
   a. purchased, conveyed, leased, mortgaged or disposed of property,

   b. voted or dealt in shares of other interests or entities,

   c. subscribed or otherwise acquired notes or obligations of another entity,

   d. owned, held, sold, loaned or otherwise disposed of obligations of another entity,

e. borrowed money or otherwise incurred debt,

f. loaned money and received a security interest in property as security for repayment,

g. was a promoter, partner, or manager of another entity.

h. has an office, if so furnish address/location,

i. hire employees or agents, define their (employees or agents) duties, fixed their compensation, or established pension plans or other employee benefit plans,

j. made contributions,

k. indemnify anyone, or

l. marketed or sold any of the real property;

7. indicate the extent to which each partner was involved in or consulted in the operation of the partnership;

8. describe specific circumstances whereby, if at all, the partners held themselves out as partners to third parties;

9. describe how, if at all, the partners concealed the partnership or themselves as partners from third parties, and identify from whom and explain why;

10. indicate whether any partnership interests were sold, exchanged, or otherwise liquidated in the time since partnership agreement was executed;

11. state whether the other partners view themselves as partners;

12. describe how partnership books and records were kept;

13. identify the persons who make entries into the partnership books and records, and furnish their addresses and telephone numbers;

14. to the extent entries in the partnership books and records are not made by a partner, identify at whose direction entries are made;

15. explain how the transaction was treated for income tax purposes and for state law purposes;

16. indicate any charitable deduction taken for any partnership interests transferred to any qualified organization; and

17. identify who provided investing information and made investment decisions, both before and after creation of the partnership, and provide a copy of schedule of fees charged, if any.

WORKSHEET
INFORMATION re VALUATION

I. Re the FLP, please furnish the following INFORMATION regarding VALUATION of the partnership:

1. state the fair market net asset valuation of partnership assets/liabilities (and show the computation thereof) as of
   a. the legal date of creation of partnership,

   b. the dates of any intervivos gifts, and

   c. date of death;

2. state the valuations (and show the computation thereof) of all partnership interests as of
   a. date of creation of partnership

   b. the date of any intervivos gifts by Decedent's of partnership interest, and

   c. as of date of death;

3. state the valuations (and show the computation thereof) of partnership interests if restrictions per agreement or state law on its sale or use were disregarded under IRC 2703(a)(1)
   a. as of the date of creation of partnership,

   b. the date of any intervivos gifts by Decedent's of partnership interest, and

   c. as of date of death; and

4. state the valuations (and show the computation thereof) of partnership interests if restrictions per agreement or state law on its sale or use were disregarded under IRC 2704(b)

   a. as of the date of creation of partnership,

   b. the date of any intervivos gifts by Decedent's of partnership interest, and

   c. as of date of death.

No Other Distributions. Except as provided in this Article, the Partnership shall make no distributions of cash or other property to any Partner until its liquidation as provided in Section 10.05.

Distributable Cash. Distributable Cash includes only that cash held by the Partnership at the end of a Fiscal Year after reasonable reserves of cash have been set aside by the Partnership Management, subject to the duties imposed by Section 3.07, for working capital and other cash requirements, including current and reasonably projected expenses, current and reasonably projected investment opportunities, and reasonably anticipated contingencies. For purposes of this Section, any of the Partnership Assets that are contributed to the Partnership by the Partners, any borrowed funds, and any cash generated upon the sale of any of the Partnership Assets, including Partnership Assets that are purchased with borrowed funds and including the cash attributable to appreciation in value, shall be considered as necessary for investment purposes.

Operating Distributions. From time to time during each Fiscal Year, the Partnership may distribute any part or all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests; provided that no more than sixty days after each Fiscal Year, the Partnership shall distribute all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests. No distributions under this Section shall have the effect of changing any of the Percentage Interests. In addition, from time to time during each Fiscal Year and during the sixty-day period after the end of a Fiscal Year, the Partnership may distribute additional cash and Partnership Assets in kind and proportionately to the General Partners and Limited Partners based on their Percentage Interests; provided that, within sixty days after the end of each Fiscal Year, distributions of Partnership Assets and cash from the Partnership to the General Partners and Limited Partners shall not aggregate more than four percent (4%) of the net fair market value of the Partnership Assets as of the beginning of that Fiscal Year. No distributions under this Section shall have the effect of changing any of the Percentage Interests.

Income Tax Distributions. Regardless of the amount of Distributable Cash, the Partnership shall distribute during the course of each Fiscal Year an amount of cash to each Partner that would be sufficient for each Partner to pay the Partner's federal and state income taxes attributable to profit and loss allocations by the Partnership at the highest marginal income tax rate and also would be sufficient to allow the Partner to make estimated tax payments on a quarterly basis without incurring any penalty; provided that any such distributions shall reduce the amount to which the recipient Partner thereafter is entitled under Section 7.03 as if the distributions were an advance on the Partner's distributive share.

EXHIBIT 5

DRAFTING CONCERNS FOR THE FAMILY LIMITED PARTNERSHIP

Turney P. Berry
Wyatt, Tarrant & Combs, LLP
Louisville, Kentucky

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SECTION E

DRAFTING CONCERNS FOR THE FAMILY LIMITED PARTNERSHIP

* See substantive outlines, Section A and Section D of binder
for reference materials on this presentation.

NOTES

NOTES

NOTES

THE TOP 10
ESTATE PLANNING MISTAKES

Gordon B. Wright
Wyatt, Tarrant & Combs, LLP
Louisville, Kentucky

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SECTION F

31ST ANNUAL MIDWEST/MIDSOUTH ESTATE PLANNING INSTITUTE

University of Kentucky College of Law
Lexington, Kentucky

July 15, 16 & 17, 2004

THE TOP 10

ESTATE PLANNING

MISTAKES

Gordon B. Wright
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Louisville, Kentucky 40202-2898

THE TOP 10 ESTATE PLANNING MISTAKES

MISTAKE NO. 1: FAILURE TO PROVIDE SUFFICIENT ASSETS TO FUND A CREDIT SHELTER SHARE F-1

MISTAKE NO. 2: FUNDING THE CREDIT SHELTER SHARE IN A MANNER THAT RESULTS IN "SHRINKAGE" F-2

MISTAKE NO. 3: FAILURE TO KEEP AN ESTATE PLAN CURRENT WITH TAX LAW CHANGES F-4

MISTAKE NO. 4: FAILURE TO PERMIT THE DEFERRAL OF RETIREMENT PLAN AND IRA BENEFITS F-5

MISTAKE NO. 5: FAILURE TO INCLUDE THE UPJOHN PROVISION F-6

MISTAKE NO. 6: FAILURE TO ANTICIPATE A DISCLAIMER F-8

MISTAKE NO. 7: FAILURE TO CHOOSE THE APPROPRIATE TAX CLAUSE F-9

MISTAKE NO. 8: FAILURE TO CHOOSE THE BEST MARITAL DEDUCTION PROVISION F-10

MISTAKE NO. 9: FAILURE TO ALLOCATE GST EXEMPTION OR FAILURE TO OPT OUT OF AUTOMATIC ALLOCATION F-11

MISTAKE NO. 10: FAILURE TO DEFINE RESPONSIBILITIES WITH THE CLIENT F-12

SECTION F

Estate planning attorneys must be aware of all of the "moving parts" of a client's estate plan when designing and implementing a new plan. Estate planners must consider how one change to a client's plan will cause ripple effect throughout the entire plan. Considerations include a host of tax systems, federal and state, as well as non-tax, personal considerations. In many instances, the personal considerations outweigh the tax considerations. However, in naming the top ten mistakes in estate planning, this article concentrates on the tax considerations and attorneys' common errors in integrating parts of a complex estate plan to make a cohesive and functional plan for the client. In some cases, the mistakes may result in tax disasters; in others, the errors may merely be missed opportunities. In either case, the mistakes are avoidable, and a vigilant eye and careful consideration are keys to avoiding them.

Mistake No. 1

Failure to provide sufficient assets to fund a credit shelter share.

The most common general estate plan for married individuals involves division of assets into a credit shelter share and marital share at the death of the first spouse to die. By segregating the credit shelter share in a trust, those trust assets may benefit the surviving spouse (and other family members or other beneficiaries) for the remainder of the surviving spouse's lifetime and may be excluded from the surviving spouse's estate for estate tax purposes at such spouse's death. An attorney may prepare estate planning documents, including wills and/or revocable trust agreements, that may implement this plan, but if the first spouse to die does not have sufficient assets available to fund the credit shelter share, the plan is useless.

Many married individuals hold a significant amount of assets in joint title with the right of survivorship. At the death of the first-to-die, those assets pass to the surviving joint tenant. A qualified disclaimer of such property is rarely possible. The Internal Revenue Code ("Code") and regulations thereunder specify that a disclaimant may not have received any interest in the property prior to making a qualified disclaimer. Usually, both joint tenants enjoyed the property during their joint lifetime, and in such instance, a qualified disclaimer may not be used to shift more assets to the credit shelter share.

Spouses who wish to take advantage of the credit shelter plan at the death of the first-to-die should retitle assets in their individual names or divide them and place them in their respective revocable trusts. Tenancy-in-common is also an alternative, and it may be particularly attractive for real estate. Practitioners should be advised that a transfer of assets to a person within one year prior to his or her death may succeed in funding the decedent's credit shelter share, but may not result in a step-up in basis for such property if at the death the property is returned to the transferor.

At times, dividing assets between spouses may be accomplished as simply as retitling bank or brokerage accounts. In other instances, real estate transfers may be advisable, particularly if only one spouse is employed full time, and such employment includes significant benefits such as employer-sponsored life insurance coverage and retirement benefits. Obviously, employer-sponsored benefits may not be transferred to the non-employee spouse during lifetime, so cash, securities, real estate or other property provide other sources to boost the value of the non-employee spouse. Transfer of real estate from joint name to one spouse may be accomplished fairly easily with a quitclaim deed.

Changing the beneficiary of life insurance or retirement plan assets payable to the surviving spouse to the client's estate may help fund the credit shelter share, but caution is advised. Life insurance proceeds received by a decedent's estate are subject to the claims of the decedent's creditors. However, insurance proceeds received by designated individual beneficiaries or the decedent's revocable trust are probably outside the reach of the creditors. Kentucky inheritance tax should be a consideration as well. Life insurance proceeds payable to the decedent's estate are subject to Kentucky inheritance tax and, unless the distributive shares of the estate are payable to Class A beneficiaries, inheritance tax must be paid. If the insurance is payable to named individual beneficiaries or a trust (including the decedent's revocable trust), Kentucky inheritance tax will not apply.

Retirement benefits payable to the estate present the same creditor considerations as life insurance. In addition, designating the client's estate as beneficiary of tax-qualified retirement benefits or individual retirement accounts (IRAs) reduces post-mortem options for income tax planning as designation of the estate as the beneficiary will usually curtail the ability of the beneficiary to defer recognition of taxable income and a spousal rollover of the benefits. Since it is difficult to determine the optimal beneficiary designation until the client's death, it may be advisable for the client to designate the spouse as primary beneficiary and the client's revocable trust or testamentary credit shelter trust as contingent beneficiary so that the spouse may claim the benefits or disclaim them to the contingent beneficiary if the spouse finds it advisable.

Mistake No. 2

Funding the credit shelter share in a manner that results in "shrinkage."

Since practitioners work so hard to develop a cohesive and workable plan to preserve and fund a credit shelter share at the first death for a married couple, any event which diminishes that share should be avoided. Diminution or "shrinkage" occurs when that share must recognize taxable income. Often the credit shelter share is set aside and retained in a trust following the client's death.

Practitioners should anticipate and avoid two events which may result in shrinkage: allocation of income in respect of a decedent (IRD) to the credit shelter share and the distribution of trust accounting principal which may carry out distributable net income (DNI) to a credit shelter trust. IRD is difficult to define but consists of a receipt of property following death for which the recipient must recognize taxable income even though such receipt may be properly allocable to trust accounting principal. Examples include retirement benefits and IRA balances (other than the decedent's after-tax contributions), installment notes which include a portion attributable to capital gain, dividends not received at death but for which the ex-dividend date has passed and accrued income on fixed income securities such as bonds. If a credit shelter trust receives such IRD items, the trust must recognize taxable income. If the trustee must allocate the IRD to trust accounting principal, it is likely that the income tax will be borne at the trust level, thereby reducing trust principal directly. The Tax Reform Act of 1986 compressed federal income tax brackets for estates and trusts, so estates and trusts reach a maximum income tax bracket at approximately $9,000 in taxable income annually. Hence, a large receipt of IRD to fund a credit shelter trust may have a significant impact on the value of the principal in a credit shelter trust.

Distribution of other assets (other than IRD) to fund a credit shelter trust may result in shrinkage of trust assets, although perhaps not as severely. A distribution of assets from the decedent's estate or revocable trust to a credit shelter trust carries out DNI in most instances. Preservation of the credit shelter share is advisable since such share is sheltered from estate tax at the death of the surviving spouse. Taxable income not carried out by distributions to beneficiaries is taxed at the trust level. When tax is "trapped" at the trust level, the trust must pay the tax, and in accordance with the Uniform Principal and Income Act, taxes attributable to trust accounting principal are paid out of trust accounting principal. At one time, "trapping distributions" were encouraged as trusts were usually in a lower marginal income tax bracket than trust beneficiaries. That is rarely the case now, and payment of income tax at the trust level, which also shrinks the principal sheltered from estate tax, can be a tax disaster.

Planning can avoid or ameliorate the shrinkage problem. Occasionally, the planning opportunities arise after the decedent's death. Such post-mortem planning techniques include judicious selection of the timing of distributions to the credit shelter trust. If such distributions occur in a year in which the gross income is minimal, the tax impact on the credit shelter trust will also be minimal.

Mistake No. 3

Failure to keep an estate plan current with tax law changes.

While practitioners have not seen a wholesale revision of the federal estate tax system since the early 1980s, there have been significant revisions to the federal and state transfer tax systems which affect the estate plans of many clients. Most notable (and recent) are the changes brought about by EGTRRA in 2001. Among other changes, EGTRRA (1) increased the credit shelter equivalent for estate tax steadily, leading to an elimination of estate tax in 2010, (2) created different (although unified) exclusions for gift tax and estate tax, and (3) eliminated the credit for state death tax subject to a phase-out period. Below is a chart which illustrates the differences between the gift tax exclusion and estate tax exclusion over the years anticipated in EGTRRA:

Year	Lifetime Gift Tax Threshold	Estate Tax Exemption Amount	Highest Estate & Gift Tax Rate
2001	$675,000	$675,000	55% (+5% surtax)
2002	$1 million	$1 million	50%
2003	$1 million	$1 million	49%
2004	$1 million	$1.5 million	48%
2005	$1 million	$1.5 million	47%
2006	$1 million	$2 million	46%
2007	$1 million	$2 million	45%
2008	$1 million	$2 million	45%
2009	$1 million	$3.5 million	45%
2010	$1 million	Repealed	Max gift tax rate = max inc tax rate
2011	$1 million	Reinstate $1 million	55% (+5% surtax)

Prior to EGTRRA, due to uncertainty within the federal estate tax system, many clients put their estate planning decisions on hold. Now, although practitioners expect further legislation which will affect at least the exemption equivalent, practitioners should review estate plans to make sure those plans still fit their clients' needs and desires. The increase in the exemption equivalent had an immediate impact. Practitioners who advised clients when the exemption equivalent was $600,000 in the 1990s should revisit those plans since the exemption equivalent for persons dying in 2004 is $1,500,000.

Consider the example of a blended family in which husband and wife each have children by a prior marriage or relationship. If husband adopted an estate plan which left the credit shelter amount directly to his children and the marital share in a qualified terminable interest property (QTIP) trust for his wife, his wife's share may be insufficient now to provide for her needs following his death. By extension, if the plan remains as written and the estate tax is repealed in 2010, the client's children may receive the entire estate, and no assets pass into the QTIP trust for the wife's benefit. Surely, the husband did not intend such a consequence when he and his attorney developed the estate plan just a few years ago.

Mistake No. 4

Failure to permit the deferral of retirement plan and IRA benefits.

Everyone is familiar with the great advantage of tax-deferred compounding within a defined contribution plan or IRA. If such assets are not needed at the current time, deferral of benefits from such plans and the consequent growth opportunities are advisable. Careful designation of beneficiaries of retirement plans and IRAs and the appropriate structuring of IRAs can allow the benefits to grow exponentially well after the original owner's death.

Distributions from tax-qualified retirement plans and IRAs are generally governed by Code Section 401(a)(9) and the regulations promulgated thereunder. The latest regulations, issued in 2002, significantly simplified what was an unnecessarily complex system of determining the minimum distributions which a participant must receive each year from retirement plans and IRAs to avoid excise taxes and additional income taxes. A thorough discussion of planning for retirement benefits and distributions is beyond the scope of this outline and, indeed, is covered elsewhere in the materials for the Estate Planning Institute. Nevertheless, a few general rules may help the estate planning practitioner avoid mistakes.

Since deferral of retirement plan or IRA distributions is a general objective, a practitioner should be wary of any retirement vehicle which restricts the ability of a participant or beneficiary to stretch out the benefits. Most employer-sponsored retirement benefits are designed with ease of the employer's administration in mind. It also makes sense that an employer would like to distribute benefits of a terminated or deceased participant as soon as possible to cut the costs of administering the retirement plan. Consequently, the plan may offer no alternative to a lump sum distribution in such event. On the other hand, IRA sponsors such as banks, securities brokers and mutual fund companies, acting through their trust company affiliates, would like to retain clients' resources for as long as possible to generate goodwill and earn revenue. An estate planning client may be well advised to roll the benefits from his employer-sponsored retirement plan at separation of service (due to retirement or other event) into an IRA so that he will have more distribution options during his lifetime or following his death. A trustee-to-trustee transfer is usually preferable to a true rollover as it avoids the issuance of a Form 1099-R and the resulting confusion at income tax preparation time, and it avoids recognition of taxable income if the participant does not complete the rollover within the allotted time.

Another area in which mistakes frequently occur involves designating the client's estate as the beneficiary of retirement benefits. A client may wish to divide his retirement assets among many beneficiaries or may wish to combine retirement assets with other assets, all of which will be divided as part of an integrated estate plan. Despite the taxpayer-friendly 2002 regulations, designation of the client's estate remains inadvisable as it forestalls deferral by the beneficiaries over a period which might otherwise extend over the beneficiaries' individual life expectancies. Designation of individual beneficiaries is generally preferable, and designation of the client's revocable trust may also present a solution.

A third common mistake in planning for distribution of retirement benefits occurs when a client wishes to benefit both a charity and individual beneficiaries. Again, despite the taxpayer-friendly regulations issued in 2002, naming both charitable and non-charitable beneficiaries for the same retirement plan or IRA will jeopardize the ability of the non-charitable beneficiaries to stretch payments over their life expectancies. Let's say a father has three sons. He wants to designate 25% of his IRA benefits to pass to each son and 25% to charity. By dividing the IRA into two separate IRAs and designating his sons as equal beneficiaries of one and the charity as the beneficiary of the other, he will insure his sons' rights to elect to receive the IRA benefits over their life expectancies. Most IRA sponsors would, under the latter plan, allow the IRA to be divided into three shares at the father's death and would allow each son to make independent decisions about how much to withdraw each year (subject to the minimum distribution requirements of Code Section 401(a)(9) and each son's life expectancy).

Mistake No. 5

Failure to include the Upjohn provision.

Situations arise in estate plans in which a parent or legal guardian may serve in a fiduciary capacity for a child or other dependent. On such occasions, the fiduciary may have the authority to use or direct trust assets in a way which could discharge the fiduciary's support obligation for such minor or dependent. Code Sections 678 and 2041 may cause unforeseen tax results for such fiduciary.

If a fiduciary distributes trust income and such distribution discharges a support obligation which the fiduciary owes to the beneficiary, the fiduciary will be treated as the owner of such trust under the grantor income tax provisions of the Code. The fiduciary must recognize such income in the fiduciary's individual capacity and not the trust's. As the person serving as fiduciary is probably in a higher income tax bracket than the beneficiary, most persons serving as fiduciary would not want to be tagged with the taxable income.

The estate tax consequences of holding a power which may be used to discharge a support obligation are even more severe. Trust assets which may be used to discharge a support obligation must be included in the fiduciary's gross estate even if the fiduciary never used such assets to discharge the obligation. Restricting the fiduciary's discretion over principal to an ascertainable standard such as health, maintenance, support or education will not alleviate the problem. It is obvious that this situation is to be avoided through the nomination or appointment of fiduciaries who would not have a legal obligation to support a trust beneficiary or by judicious drafting of the trust document.

The most common way to avoid the adverse income and estate tax consequences of support obligation is the inclusion of the "Upjohn" provision in documents. The Upjohn language restricts the fiduciary's ability to discharge his or her support obligation by expressly prohibiting it. An example of such language follows:

> Any of the foregoing provisions of this document to the contrary notwithstanding, Trustee shall make no discretionary distribution or expenditure of either trust income or trust corpus if such distribution or expenditure would discharge the legal obligation of any person to provide for the health, support, maintenance and education of the beneficiary or if such distribution or expenditure would discharge any other legal obligation (including, without limitation, a contractual obligation) of any person other than the beneficiary.

Use of such a provision in estate planning documents has proven to be effective to eliminate the adverse tax consequences. Still, many practitioners do not anticipate that a fiduciary may be nominated or appointed to serve with respect to the fiduciary's own children or other dependents, and the Upjohn provision is frequently overlooked. A relatively simple way to address the problem is to insert the provision in the standard trustee's powers of all estate planning documents.

Mistake No. 6

Failure to anticipate a disclaimer.

Donees of inter vivos gifts and beneficiaries of assets which pass at death are never forced to accept a gift, bequest or devise. Rather, recipients may execute a disclaimer, which is a right afforded them under state law. If a disclaimer meets the criteria under Code Section 2518, it will be a "qualified disclaimer." The person making a qualified disclaimer will not be treated as receiving a gift and making a corresponding gift for transfer tax purposes. Instead, the property is deemed to have passed from the original owner directly to the ultimate recipient.

Disclaimers are used frequently in the post-mortem context to alter transfer tax consequences of unplanned or unforeseeable events. Such events may include the good or bad fortune of estate or trust beneficiaries, deaths out of the expected order, beneficiaries' generosity, special needs of beneficiaries, and changes in the laws and regulations which govern gift, estate and income taxes.

For a disclaimer to be a qualified disclaimer, the property must pass, as a result of the disclaimer, as if the disclaimant had not survived the decedent. Thus, in the case of property passing by beneficiary designation, a primary beneficiary may disclaim so that the contingent beneficiary will receive the property. The decedent's surviving spouse is the only beneficiary who may execute a qualified disclaimer and still receive a benefit in the disclaimed property as the result of the disclaimer. Savvy practitioners plan for the possibility of disclaimer by recommending a client designate the spouse as the primary beneficiary of life insurance proceeds or retirement benefits and recommending the client's revocable trust or credit shelter trust as the contingent beneficiary. Then, after a death, if the surviving spouse feels he or she has sufficient assets in his or her sole name and if it is advantageous from an estate tax perspective, the spouse may disclaim the outright interest in the insurance proceeds or retirement benefits but may still receive benefits from assets passing into the credit shelter trust. Planning for disclaimers adds flexibility to the estate plan, but such flexibility must be weighed with the client's confidence in the spouse to make a decision within the limited disclaimer period which will benefit the family as a whole.

In anticipating the possibility that a client's child may disclaim so that property may pass directly to the client's grandchildren, additional issues present themselves. Obviously, generation-skipping transfer tax may be generated. Also, the needs and resources of a grandchild should be considered and whether additional assets may disqualify the grandchild from government assistance and scholarship opportunities. Finally, if disclaimed assets pass into trust for a grandchild and the grandchild's parent is to serve as trustee, the Upjohn language should be included and (presuming the client so wishes) surety should be waived on the trustee's bond or other arrangements made.

Mistake No. 7

Failure to choose the appropriate tax clause.

Absent a provision in the governing instrument, Kentucky law dictates that beneficiaries of an estate individually bear the burden of estate and inheritance taxes on their respective shares. However, most practitioners include in wills and revocable trust agreements a provision which directs the fiduciary to pay most (if not all) estate, inheritance or other transfer taxes out of the general probate estate or out of the residuary share. Such a direction to pay taxes "off the top" of the probate estate may skew benefits dramatically. The disparity may become greater as the popularity of non-probate assets continues to grow. Joint property and property passing by beneficiary designation may constitute a large portion of the gross estate for tax purposes, and if the taxes on such property are paid out of the probate estate, the probate estate could be exhausted to the detriment of legatees and residuary beneficiaries.

Consider the situation of a young executive who has employer-sponsored life insurance, tax-qualified retirement benefits and miscellaneous supplement benefits such as salary continuation, vacation pay, unpaid sick leave and deferred compensation arrangements. Such benefits comprise the vast majority of assets passing at the executive's death. All of such benefits typically pass by a beneficiary designation at the executive's death. If the executive directs all taxes generated by reason of her death to be payable from her probate estate, her wishes regarding the division of assets may be thwarted.

In choosing the appropriate tax clause, a practitioner must also gain full knowledge of the client's assets including those held in trust and any expectancy which can be anticipated. In addition to joint property and property passing by beneficiary designation, the practitioner must also consider powers of appointment the client may possess (both general and limited), QTIP elections, generation-skipping transfer tax trusts (both exempt and non-exempt), and the rights of reimbursement which may be afforded an estate for taxes assessed against property passing outside the estate.

Still, if a client's integrated estate plan benefits the same individuals under the client's will, trust agreement, beneficiary designations and joint tenancy, the practitioner may choose a tax clause which directs payment out of the general probate estate or residue. Such a general tax provision is usually the easiest to administer as the personal representative has control over the assets to be used to pay the tax. The personal representative may anticipate the cash needs of the estate and may liquidate assets in a timely manner to insure the personal representative has cash at the tax filing deadlines. An apportionment of taxes among beneficiaries such as the default provision under state law may force a personal representative to contact beneficiaries of non-probate assets to contribute or "cough up" cash, an unpleasant and sometimes next-to-impossible task.

Mistake No. 8

Failure to choose the best marital deduction provision.

As stated earlier, the most common general estate plan for married individuals involves setting aside the credit shelter share at the first death and taking advantage of the unlimited marital deduction for the remaining assets. Such marital share may pass outright to the surviving spouse or in a trust which qualifies for the marital deduction such as a general power of appointment trust or a QTIP trust. Volumes have been written on the subject of choosing the best marital deduction given the client's personal situation, net worth and the types of assets the client holds. Another presentation at the Estate Planning Institute will explore this subject thoroughly. Mistakes occur when practitioners fail to acknowledge that one formula will not fit all clients' needs.

Some marital deduction formulas which may be included in a client's will or revocable trust agreement include the following:

1. Pecuniary Credit Shelter Lead Bequest
   - Date of distribution funding
2. Pecuniary Marital Lead Bequest
   - Date of distribution funding
   - Minimum worth funding
   - Ratable sharing funding
3. Fractional Shares for Credit Shelter and Marital

The primary tax dangers of choosing the wrong marital deduction formula are recognition of capital gain upon funding of a share and recognition of taxable income when the right to receive IRD is allocated to a share. Some of the considerations may be unforeseeable at the time the estate plan is developed, such as whether the assets held in the estate will increase in value (a rising market) during the period of estate administration or whether they will drop in value. Others, such as built-in gain on a decedent's installment note, significant retirement benefits or other forms of IRD are foreseeable, and the practitioner should plan accordingly so that the personal representative will not be forced to recognize otherwise deferrable taxable income during the course of estate administration.

Generally, the situations to be avoided are as follows:

1. Recognition of capital gain upon funding certain pecuniary shares with appreciated property; and

2. Recognition of income when the right to receive IRD is allocated in satisfaction of a pecuniary amount.

I defer further discussion of the marital discussion to my colleague on the panel.

Mistake No. 9

Failure to allocate GST exemption or failure to opt out of automatic allocation.

Before Congress passed EGTRRA, gift tax return preparers sometimes missed opportunities with respect to GST allocations. Since a proper GST allocation for inter vivos transfers, including transfers in trust, are properly made on a federal gift tax return (Form 709), the practitioner must alert the gift tax return preparer to use a client's exemption where it is intended. Although late allocations were possible, late allocations frequently did not yield the most efficient use of the GST exemption. The automatic allocations in Code Section 2632(c), added by EGTRRA, are intended to "save" taxpayers from failure to allocate GST exemptions when it is advisable. Code Section 2632 also provides a taxpayer with an opportunity to "opt out" of the automatic allocation on a timely-filed gift tax return.

Unfortunately, the automatic allocation is sometimes over-inclusive, resulting in allocation of the GST exemption in situations that are not beneficial for the taxpayer. For instance, life insurance trusts may contain provisions which trigger automatic allocations every time the insured contributes to the trust to enable the trustee to pay premiums on the insurance. Consequently, a taxpayer who wants to avoid wasting GST exemption must opt out of the automatic allocation on a timely-filed gift tax return. Some estate planning authorities suggest reserving the GST exemption by opting out anytime the taxpayer is unsure of the best allocation. Such an attitude may be called "when in doubt, opt out." A late allocation will be beneficial in some circumstances, such as when the value of trust assets have declined in value. However, a late allocation is risky, and if trust assets increase substantially in value, a late allocation may be costly for the taxpayer.

Mistake No. 10

Failure to define responsibilities with the client.

Preparation and execution of the estate planning documents do not constitute the entire estate plan. Often, there is much work to be completed after the client leaves the attorney's office with signed wills and trust agreements. Such tasks include retitling or transferring assets, preparing beneficiary designations, transferring ownership of life insurance policies, communicating with insurance companies, securities brokers and transfer agents, filing of deeds, preparation of Crummey notice letters, and tax elections such as S corporation elections, qualified sub S trust (QSST) and electing small business trust (ESBT) elections. Gift tax returns may be necessary, and the proper preparation may include the allocation or opt-out of GST exemption and the election of the marital deduction for an inter vivos QTIP trust.

Only in unusual circumstances should an attorney take on responsibility for all tasks necessary to complete the estate plan. Such acts may cause the attorney to act out of the sphere of his or her knowledge, and generally clients don't wish to pay attorneys to perform non-legal work. It is easy to see how an attorney, even acting with a complete knowledge of all relevant facts, may omit or neglect part of such duty.

It is a much better practice to define with the client the limited scope of the attorney's responsibilities extending after the estate planning documents are signed. Of course, an attorney's communication with the client regarding such responsibilities is best if made in writing so that a copy will remain in the attorney's file.

An attorney may use a standard memorandum to the client, handed to the client when documents are executed or mailed to the client shortly thereafter, which specifies the legal names for suggested primary or contingent beneficiaries for life insurance, retirement benefits and IRAs and suggests retitling assets. The memorandum or letter may also remind the client of the obligation to file a gift tax return and that elections consistent with the estate plan should be made. Finally, the memorandum or letter should remind the client if the attorney is not undertaking responsibility of preparing the gift tax return and the due date for filing same.

★ ★ ★ ★

Common themes run throughout this list of common mistakes. Those themes are the absolute necessity for client communication and for integration of all aspects and considerations of an estate plan. As the estate plan is comprised of many "moving parts," knowledge and understanding of all component parts and the effect which each decision has on the remaining parts is essential.

MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

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SECTION G

MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

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MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

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A. OVERVIEW

1. The Statutory regime

Medicaid financial eligibility requirements are codified generally within the maze of regulations set out within Title 42 of the United States Code, and Title 20 in the Code of Federal Regulations. The program is jointly administered by the Health Care Finance Administration ("HCFA") and local state governments. HCFA has published the so-called State Medicaid Manual which establishes all federal rules and policy pertaining to the Regulations.

In Kentucky, the Regulations pertaining to financial eligibility are generally set out at Chapter 907 of the Kentucky Administrative Regulations. The Kentucky Department for Medicaid Services ("DMS") is the primary agency responsible for implementation of the Medicaid program. DMS contracts with the Department for Community Based Services ("DCBS") which has generated a manual to provide guidance to caseworkers. This Manual, known as the Field Services Operation Manual (the "manual") contains very specific provisions as to how a particular set of facts should be interpreted.

2. Why is it important to know about Medicaid?

Medicaid is the only program of governmental financial assistance by which an individual's long term institutional care is paid. Medicare only pays in limited circumstances, and then for a limited period of time. In that nursing home expenses in Louisville currently approach an average of $5,000 per month, a basic understanding of these rules is an important component of any practitioners knowledge to provide effective estate planning advice to elderly clients.

B. OVERVIEW OF ESSENTIAL RULES

1. The Transferred Resource Factor Rule

(a) Basic concept

Since a fundamental component of long-term institutional care Medicaid eligibility requires the would-be applicant to be within resource limits ($2,000 of counted resources for a single person, 1/2 counted resources, not more than $92,760 (and not less than $20,000) in 2004, and as adjusted in later years for a couple), consideration of transferred funds is always relevant.

(1) The rule - Funds transferred for less than fair market value (gratuitous transfers) to the recipient will trigger a penalty which is expressed in terms of an ineligibility period, or length of time from date of gratuitous transfer until the transferor may become eligible for benefits.

(2) Transfers considered - There is a 36 month "lookback rule" which establishes the time parameter during which transfers are considered. The lookback period extends to 36 months for outright transfers preceding the month an individual is institutionalized and an application for Medicaid is made. For transfers to trust, the lookback is increased to 60 months from the date all ,or a portion of, the trust is not available to the transferor.

(b) Transfer penalty

Once it is learned that there was a transfer made for less than fair value during the lookback period, a transfer penalty is determined. Each transfer is assessed a penalty in a process by which the transfer is divided by the so-called "transferred resource factor" in the year of Medicaid application. In 2004, in Kentucky, that is $2,614.

(1) Thus, a transfer of $26,000 is divided by $2,614, resulting in 9.9464.

(2) Figures to right of decimal are disregarded.

(3) The result is the number of months of Medicaid ineligibility starting with and subsequent to the month of transfer, with the month of transfer being regarded as the first month.

(4) See Medicaid Manual Volume IVA, Section 2080 (D) for illustrations, and examples of multiple transfers. Multiple transfers which do not overlap are treated separately.

(5) Transfers made further back in time than the reach of the lookback period are generally irrelevant.

(c) Planning with transfers

(1) Rule of halves - Typically, transfers of all resources are inadvisable since the larger the transfer the larger the penalty, and funds will be necessary to pay for the cost of care until the penalty expires and a Medicaid bed is available. Thus, transfer planning must take into account cost of care during the ineligible interval.

Example: Mother has $100,000. A transfer of all funds will mean that she will not be able to apply to be eligible for benefits for 3 years. Why? $100,000 divided by $2,614 = 38 months. In the meantime nursing home expenses will need to be paid. Instead of transferring $100,000, consider a gift of half. $50,000 divided by $2,614 will result in a transfer penalty of 19 months of the $50,000 retained; that would mean that $2,614 per month would be available to pay the facility, along with mother's Social Security.

Consideration of expenses and also income must be factored into determining the amount required, and it is wise to adjust the gift accordingly.

If mother's Social Security is $1,200 per month, and facility costs run $5,000 per month, the shortfall is $3,800 per month. Provision for the difference between this amount and the ineligibility period must be considered.

(2) Rolling transfers - May shorten ineligibility period. For instance, a transfer of $5,200 per month will, in a year when the transfer factor is $2,614, result in a 1.989, or 1 month, penalty. Thus, $20,000 may be transferred in monthly increments at $5,200 per month, with only a 4 month penalty, whereas a transfer of $20,000 outright in 1 month will result in a 7 month penalty. Again, be sure that penalties do not overlap, and there were no other gifts during the ineligibility period which may produce an overlap.

2. Planning for Couples – The Community Spouse Allowances

Spousal Impoverishment

Until the passage of the Medicaid Catastrophic Coverage Act of 1988 (MCCA), in situations where one spouse was institutionalized (the "institutionalized spouse") and another spouse remained at home (or in the community, known as the "community spouse"), since the only financial resource exclusion was limited to $2,000 per spouse, the cost of care for an institutionalized spouse frequently brought about the impoverishment of not only the institutionalized spouse, but also the community spouse. Stated differently, the community spouse was required to contribute of his or her resources to support the institutionalized spouse until the resources of both spouses had been reduced to the exclusion amount.

The MCCA, however, provided some relief to the community spouse at least with respect to individuals who entered an institution on or after September 30, 1988. Basically the rules provide that the community spouse may retain a much higher level of assets than was allowed previously.

(a) Determination of Community Spouse RESOURCE Allowance

The Community Spouse Resource Allowance ("CSRA") is determined as follows:

(1) Aggregate countable resources. All non-exempt resources of both spouses must be counted together, regardless of their character, and regardless of whose name appears on the title of the resources. Such non-exempt resources are pooled, and the total value is calculated.

(2) Segregate community spouse's allowable share. The community spouse is entitled to her or his CSRA, determined as follows:

(i) Effective June 1, 2003 in Kentucky the CSRA is a minimum of $20,000, or one-half of the value of the pooled counted resources, whichever is greater, up to a maximum of $92,760.

(ii) Both the base amount and the maximum is adjusted for federal cost of living adjustments as evidenced by the Consumer Price Index.

(iii) The other one-half of the spousal resources, or, if greater, the amount of those resources which exceed the CSRA maximum amount (in 2004 that is $92,760) count as resources of the institutionalized spouse, which will either disqualify that spouse for Medicaid until either "spent down," that is, applied towards the cost of that spouse's care in the institution, converted to excluded resources, given away followed by the conclusion of the ineligibility period, or a combination thereof.

(iv) Note that only counted resources are factored in to determine CSRA. Thus, for instance the residence, retirement plans and excluded vehicles of the spouses are not considered in determining the CSRA.

(b) Inter-spousal Transfers

Since the transfer of resource rules (discussed more fully below) are not applicable with respect to transfers to or for the benefit of an individual's spouse, the institutionalized spouse (or his or her attorney-in-fact with sufficient authority to transfer resources on his or her behalf) may transfer resources to a community spouse without penalty in order to bring the community spouse up to the maximum CSRA allowance.

It should be noted by the practitioner that in Kentucky all resources owned by both spouses at the time the institutionalized spouse applies for Medicaid are counted even if there is a pre-nuptial agreement which purports to maintain assets for the exclusive use of the community spouse.

(c) Preserving the CSRA maximum under new rules.

(1) Post May 31, 2003 rules differ substantially from pre-June 1 rules.

(i) CSRA is now limited to 1/2 of resources, up to the annual maximum. Thus, if spouses own $90,000 when application is made, the CSRA is $45,000. The institutionalized spouse may keep $2,000, and thus the couple exceeds limits by $43,000.

(ii) In all cases where the couple has more than $20,000, there will be a potential eligibility problem unless a "Resource Assessment" precedes application to establish the amount of resources, set the CSRA, and determine excess resources which must be spent, transferred or converted by the time the application is made.

(iii) It should finally be noted that under present policy starting after the month in which Medicaid eligibility is established as to the institutionalized spouse, the resources of the community spouse are no longer considered. Thus, once the institutionalized spouse is Medicaid eligible, should the community spouse acquire additional resources, the community spouse will not be required to contribute such excess resources towards the cost of care of the institutionalized spouse unless the institutionalized spouse goes off Medicaid and a new application is made.

(d) Income rules between spouses – The Community Spouse INCOME Allowance

Since the MCCA was enacted, the community spouse has been permitted to retain not only more substantial assets, but also a much higher level of income. Basically, the income of the community spouse is no longer required to be used to help pay for the cost of the institutionalized spouse. Unlike the rule with respect to assets, the income of each spouse is considered owned by the spouse in whose name it is paid. Income paid in both names is considered to be owned by each spouse as to one-half of the amount of such income.

(1) There is more to the income rule, however, than meets the eye. A very important aspect of the income rule is that the *income and assets* of the institutionalized spouse are available to the community spouse if necessary in order to bring the Community Spouse's Income Allowance ("CSIA"). In Kentucky, the CSIA is

$1,515 per month for year 2004. This amount may be increased by court ordered support, or by certain "shelter expenses".

(2) What this means is the following:

(i) The community spouse may draw against the institutionalized spouse's income (which may include the institutionalized spouse's Social Security) to the extent necessary in order to bring the community spouse's income up to the $1,515.

(ii) In Kentucky, the CSIA may be increased by documented monthly "shelter expenses" - basically monthly rent or mortgage, home insurance, utility expenses, telephone - but only that portion of such items in excess of a shelter standard of, in year 2004, $455 per month. The CSIA may also be increased by Court Order.

Example: Shelter expenses come to $755 per month. The extra $300 is added to the $1,515 allowance. Thus, the community spouse will be permitted to draw on the institutionalized spouse's income to bring her income up to $1,815 per month.

C. PLANNING TECHNIQUES

1. Converting Assets to Income – The Private Annuity

(a) CAVEAT

Recently, although this author believes erroneously, the Kentucky Department for Medicaid Services ("DMS") has begun challenging annuities acquired close in time to Medicaid application date. The reader is advised to proceed with caution in using this technique. Under policy adopted late in 2003, all annuities must be reviewed by DMS staff in Frankfort which has begun to deny eligibility where annuities were acquired on the eve of Medicaid application. Thus, this technique, although philosophically sound, may nonetheless be denied by a DMS regime which seems to be shooting down any effort to save resources. Thus, the reader is cautioned that this technique is not presently recommended, but may be useful if Kentucky policy were to clarify under what circumstances (if any) that can be protected.

(i) In certain instances, if time is of the essence and there are no other alternatives, a private annuity may be advisable, depending on the client's risk sensitivity.

The reader will recall that the transfer of resource rule triggers a penalty period of ineligibility in connection with a transfer made for less than full and adequate consideration. Although this rule operates generally to attach a penalty period to most transfers, transfers for adequate consideration are thus not subject to a penalty. Perhaps the most effective device to utilize the "adequate consideration" option is the Private Annuity, which is nothing more than a transfer of assets in exchange for a payment of income...a conversion of assets to income Such a transfer, properly structured, should enable the transferor to become eligible for Medicaid benefits immediately, without any penalty period whatsoever, so long as the transfer results in the transferor receiving annuity payments which are "actuarially sound" as deemed by the Kentucky Medicaid regulations. In effect, the technique should be viable in that the property transferred in exchange for the annuity is transferred for consideration (i.e., the annuity payment) which is worth an amount precisely equal to the value of the property transferred.

(b) Life expectancy tables have been set forth in the HCFA regulations, and such tables must be taken into account in determining the amount of the annuity payout. The tables are set out at Manual Section 1890 and 1900.

Example: Mrs. Smith, age 72, is institutionalized and has been told that a Medicaid bed is available to her. Under the HCFA regulations, she has a life expectancy of 13.99 years. Thus, payments under a private annuity cannot be established under a fixed term of years which will extend significantly beyond her life expectancy, or the arrangement will be deemed to be not actuarially sound. If not actuarially sound, adequacy of consideration will be questioned, and a possible gift element will be involved.

(c) Let's take a closer look at the Private Annuity structure.

(1) Mechanics - Those familiar with the estate planning utility of a Private Annuity know that the arrangement is a means of converting assets into income, whereby the individual transferring assets (known as the "annuitant") transfers assets to another individual (the "obligor") in exchange for the obligor's commitment to make payments back to the annuitant, either for life, a term certain, or a term of years as determined by reference to the annuitant's life expectancy, the last of which is known as a "Private Annuity for Term of Years" or "PATY." Essentially, the Private Annuity operates just like a commercial annuity purchased through

an insurance company, or other financial institutions offering annuities; however, the difference is that the private annuity arrangement is between individuals not normally engaged in the business of providing annuities, typically family members. Thus, the arrangement is referred to as a "Private Annuity."

(2) The way it works is as follows.

(i) Transfer of assets - the annuitant irrevocably transfers assets to the obligor. Upon transfer, the transferred assets then belong to the obligor. For reasons discussed below, clients should earmark a specific account, or portfolio, where the transferred assets can be segregated from other assets of the obligor.

(ii) The annuity agreement sets forth the obligation - A written agreement should be prepared to recite and set forth the annuity obligation, specifying the amount of the payout, the term of the annuity, and the disposition in the event of the death of the obligor. Some key points are as follows:

a) Investment element - For the transaction to hold water insofar as Medicaid eligibility is concerned, not only is there a requirement that the term of the annuity be actuarially sound, but the payment must reflect a return on investment which is reasonable.

b) Purpose - starting with the post-June 2003 rules, Kentucky bureaucrats have been – this author believes without proper authority – looking at the purpose of the annuity: was it to gain Medicaid eligibility? If so, even a properly structured transaction may, depending on circumstances, be disrespected, with the result that resources so transferred may be considered subject to transfer of resource penalty; or the funds may be considered to be a "resource."

A. This approach to denial of eligibility should, as a technical matter, be baseless. Even HCFA, speaking of "purpose" states that it must be viewed in light of actuarial soundness. If DMS' theory is correct – that a transfer is deemed as having occurred, what is it that has been transferred when the annuity is actuarially sound? Where is the failure of fair market value? If the transfer is disregarded altogether, i.e. the funds are considered a "resource", what of the fact that the funds are not available? These are troubling questions have been blithely disregarded by DMS bureaucrats intent on denying eligibility.

(iii) Disposition at death - Typically, at death the annuity obligor's payment obligation would simply cease, and the assets transferred pursuant to the obligation would remain with the obligor. As an alternative, the annuitant may set forth a beneficiary designation in the private annuity that directs the disposition of any payment obligation which may survive him or her.

(iv) Power to amend - As of this writing, as is true with regard to trust amendatory powers, it is prudent to authorize the obligor (not the annuitant) to collapse the annuity and return funds to the annuitant should either the arrangement cause the annuitant to lose eligibility for Medicaid benefits for any reason, or if the funds transferred are regarded as available to the annuitant. A collapse should give the obligor power to commute the remaining payment obligation to its present value. Note that the annuitant must NOT have a power to access the principal.

(v) Why it should work - "actuarial soundness" - In theory, the annuitant no longer has a resource to the extent of funds transferred, but an income stream that will result in consumption of the asset so transferred based on the individual's life expectancy.

(d) Tax consequences - The tax consequences which flow from the arrangement are as follows:

(1) Income tax aspects - The obligor will receive taxable income with respect to a fraction of the payments, since a portion represents a return on investment, and a portion represents a return of contributed capital. A discussion of the income tax aspects of annuities is beyond the scope of this outline, however, the practitioner is referred to Section 72 of the Internal Revenue Code. Basically, the practitioner should determine the expected payout over the life of the annuity, divide this by the amount contributed, and determine a return of contribution, and anticipated return on investment. This results in a fractional share which should be multiplied by each annuity payment to arrive at the amount which is taxable income for the year.

(i) It should be noted that regardless of whether the amount transferred is invested by the obligor in a tax free obligation, the annuitant nonetheless must report his or her return on investment as determined in Section 72.

Typically, in the context of individuals interested in Medicaid eligibility planning, this will be a fairly small amount, and generally will be immaterial since the annuity payment will be applied toward the cost of long term health care, and therefore tax deductible at any rate.

(ii) Where assets other than bank deposits, certificates or deposit, or cash equivalents are part of the arrangements, the obligor will receive the annuitant's basis in the assets, with some adjustment, as determined by applicable IRS basis rules under Section 1014 and 1015 of the Internal Revenue Code.

Caution: The annuity may be structured so that any unpaid amounts at the annuitant's death will be paid by the obligor to named beneficiaries. Where large amounts are involved, if the annuitant dies before receiving all payments, if the obligor simply keeps the funds transferred and is relieved of the annuity obligation, there may be taxable income to the obligor in the year of the annuitant's death to the extent of the unpaid annuity amount. See Revenue Ruling 55-119. Having the unpaid balance paid by way of a beneficiary designation or general testamentary power of appointment retained by the annuitant may, properly designed, cause the annuity to be includable in the annuitant's estate and thus pass to heirs from the annuitant, possibly avoiding income taxability to the obligor.

(2) Gift tax aspects - Structured properly, the transaction is a sale of assets for valuable consideration, and not a taxable gift.

(3) Inheritance tax aspects - Depending on how it is structured, the annuity may avoid estate taxation. If the assets were acquired during lifetime for consideration of the annuity promise, the obligor should receive the assets at the death of the annuitant free from Kentucky inheritance tax, or, where applicable, federal estate tax. The latter will rarely, if ever, be involved, except in those unusual instances where the annuitant has already used up his or her unified credit, and enters into a private annuity transaction and dies with a payment obligation outstanding. Such an annuity should not be covered by Section 2039 of the Internal Revenue Code, and in this author's view is not required to be reported on IRS Form 706 under the IRS instructions.

(e) Uses and limitations

1) Generally - A private annuity in the context of estate conservation planning is quite useful in two very important respects. The first is that the arrangement is a means of taking a Medicaid bed when offered when transferred resources would preclude making a Medicaid application. Secondly, the structure is a means of slowing down the dissipation of resources.

2) Limitations - The arrangement may not provide the family with the perfect financial solution to the cost of care, since the annuity income will, with some small allowances (notably personal monthly needs and the cost of health insurance), be regarded as patient liability, and thus turned over to the nursing home. Over a long period of time, the transferred funds will, in fact, be dissipated. Yet, in situations where there is no time to plan, and assets will be consumed in any event, the private annuity can give the family a chance to receive an inheritance. Even in smaller estates where a Rule of Halves transfer will facilitate eligibility in a relatively short period of time, there will still be a waiting period before eligibility can be established. A private annuity can eliminate the waiting period. As a rule of thumb, this technique will provide maximum benefits where the client is on the relatively younger end of the elder client spectrum, especially where the annuitant's actual life expectancy is not very long. A payout of fourteen years with good investment performance can slow down the rate of consumption of $100,000 assets to $8,000 per year, versus $30,000.

(f) Why not a commercial annuity?

For several reasons a private annuity offers advantages over a commercial annuity.

(1) No sales load - typically, insurance companies charge a hidden fee which is built into the return.

(2) Flexibility - since the transferred funds remain in the family, if the annuitant ever needs more money, there is a pool of assets which can be used for him or her. This may especially be critical if the annuitant is on Medicaid for a while, but then goes off the program, returning to personal care or independent living. With an irrevocable commercial annuity (remember, to be effective the arrangement must be irrevocable) that flexibility is not there.

(3) Opportunity for growth - if the family gets good investment performance, it is possible that the yield on transferred assets will result in growth, rather than consumption. In low interest times where the applicable federal rate is low, funds may be able to generate the payout on earnings alone, thus preserving the principal for the family.

(g) Annuities in current environment

In light of adversarial perspective of current DMS policy makers, and fact that all annuities must now be reviewed by DMS before case can be approved, commercial annuities can be either salvific or punishing. Indiana has a statute that only recognizes commercially issued annuities.

(1) Salvific – commercial annuities may be more defensible in that annuitant will NOT be able to access funds, whereas familial transfers may be set aside.

(2) Punishing – if even commercial annuities are disallowed, problem is that family can NOT access funds. Thus, can be "damned if you do, damned if you don't."

2. THE HOMESTEAD (PERSONAL RESIDENCE) IN THE WAKE OF 9-1-03 RULES

(a) Overview

(1)Under law in effect prior to September 1, 2003, the homestead was not counted as a resource. This was true regardless of whether the Medicaid recipient could ever be expected to return home, and in fact whether he or she ever even set foot in the home. Under pre-September 1 rules, excess resources could be used to improve or buy a bigger residence, and thus converted into an excluded resource.

(b)Post-August 31, 2003 Rules

(1)Under new rules, the homestead will in many cases lose the protection of the old rules even for existing cases upon recertification. The result will be that the new laws may apply.

In cases where residential property was jointly owned prior to the effective date of the new law, so long as Co-owners refuse to relinquish their portion and thus facilitate a sale, the property may continue to be excluded at least for cases where the recipient's eligibility was prior to 9/1/2003.

This may be a "Pyrrhic victory" however. Eligibility may be maintained, but the recipients' interest in the property may be subject to estate recovery.

(2)The homestead will even under the new rules continue to be excluded in the following cases –

(i) For the first six (6) months of the recipient's institutionalization;

(ii) For up to the 1st recertification where the recipient has signed a statement to the effect that he or she intends to return home within a specified time (possibly even longer depending on the facts and circumstances);

(iii) The home has been owned by, or transferred to, a specified class of individuals under 907 KAR 1:650 Section 2-

a) the recipient's spouse;

b) a child under age 21

c) a caretaker child who has resided with the recipient for two years prior to institutionalization and who provided care to prevent institutionalization;

d) a disabled child of the recipient.

e) A sibling of the individual who has an equity interest in the home and who has lived with the institutionalized individual for one year prior to institutionalization.

(c)What to do ?

(1) Transfer house as advance plan when health care seas are calm.

(2) In situations where there is not sufficient time, it may be advisable to sell all, or a portion of, the house to children for assessed value which may be less than market value.

(i) It maybe advisable to sell for less than assessed value – this would trigger a gift penalty.

(3) Retain life estate; transfer remainder.

(i) This technique will permit a reduction in value of what has been sold. The manual has tables at Section 2056 which establish the value of a life estate and remainder interest.

a) Example: An 80 year old woman has a house which is tax assessed at $100,000. She retains a life estate and sells the remainder to her children. Her life interest under the tables is worth 43.66% of the property, or $43,660.

b) The children purchase the remainder interest for $56,340. Through a combination of gifts and private pay spend down, assume she consumes $6,000 per month. In 10 months she is eligible because the funds are gone

c) Same example, but children purchase the remainder for half, or $28,000. There has been an uncompensated transfer (gift) of

$28,000. Assume the transfer factor was $2,800 in the year of application. Transfer penalty will be 10 months.

d) Assume children pay nothing. Penalty will be 20 months. Query: how will 20 months cost of care be paid? May need to retransfer property and start over. See HCFA Regulation 3258.10 for "curing" prohibited transfer penalities.

(d)Income tax considerations .

(1)Where property must be sold, consider sale of property in recipients' name for capital gains tax exclusion where recipient has lived at property for at least 1 of previous five years, which is required to exclude as "personal residence" under Internal Revenue Code Section 121(d)(7).

(2)If property is transferred to children who then sell, children will pick up recipient's adjusted basis, which often is quite low relative to current market, thus creating current tax liability to children.

(3) Property may be transferred to individuals who plan to live there without tax concerns if it becomes their residence with requisite holding period.

(4) Query as to whether property which is subject to retained life estate will enable heirs to receive stepped up basis under Code Section 1015 based on includibility in estate under Code Section 2036.

(e) Estate recovery – under post-August 31, 2003 rules, estate recovery is no longer limited to the recipient's "estate" as defined for purposes of state probate law, but purports to embrace any and all interest which the recipient owned at death. Thus, even survivorship property, property in trusts, and - amazingly - life interests are to be made subject to new estate recovery rules.

(1) It is difficult to see what transfer occurs at the death of a life tenant. The retention of a life tenancy is an excluded resource under Manual Section 2055, with the result that the remainder interest is regarded as having been transferred. At the deceased recipient's death, the life estate simply terminates and there is no "transfer".

(2) Transfers to avoid estate recovery may be advisable even if transferor goes off Medicaid.

(i) Example: Recipient owns property in joint survivorship with children in a pre-September 1, 2003 deed for a pre 9/1/2003 approved case. Assume the property is worth $200,000. Son purchases remainder interest of mother's half of the property for $56,340, mother goes off Medicaid as per above example for 9 months. If half property subjected to estate recovery at death, son could lose $100,000 to estate recovery claims instead.

3. THIRD PARTY SUPPLEMENTAL SUPPORT TRUSTS

(a) Overview

An important exception to the available resource rules applies in the context of a trust created for the benefit of a potential Medicaid recipient other than the individual who is the grantor, or his or her spouse. Where the funds utilized in the establishment of a trust have originated with the Medicaid applicant, his or her transfer is generally going to be either disregarded and the trust funds counted as available, or the transfer will constitute a transfer of resources which will result in a period of ineligibility, as determined by the look-back rule unless the special needs trust exception applies. See 907 KAR 1: 645 for treatment of trusts and transfer of resource policy. Trusts created for oneself that may receive special exclusionary treatment are not the subject of this section, but are discussed more fully in Section 5, below.

The third party trust referred to in this section contemplates a trust agreement which is created by the third party (i.e., one other than the prospective Medicaid recipient) with assets which have originated at all times with the third party. In other words, this section will focus on trusts established by a third party which, at the time a Medicaid application is made, are not regarded as having been created by the Medicaid applicant, and where the trust assets are not regarded being available resources to the Medicaid applicant.

Example: Father creates a trust for his daughter, a handicapped individual. The trust will be funded with the father's assets. The trust is, as to the daughter, a third party trust.

In particular, at this point consideration will be with the need for responsible family members to take into account how to best plan for those who may be dependent upon funds which will be set aside either for dependent survivors at the death of the third party; or be set aside for dependent individuals who are categorically eligible for benefits, and resource eligible based on their own resources, but the third party wishes to establish a source of supplemental support as to such individual in such a manner as to not preclude public assistance benefits from being available to such person, referred to herein as the "disabled person."

In all events, planning will emphasize the need for structuring the funds so set aside in order that such funds constitute only a "supplemental source of income," of the disabled person with the result that any funds as to that individual will not be regarded as available resources, subject to spend down limitation rules as a condition to the disabled person's continuing eligibility for Medicaid benefits, or anticipated eligibility for such benefits. Thus, the primary issue relating to third party trusts centers on whether the trust assets are "available" to the disabled person/Medicaid applicant.

(b) "Supplemental Support" Trusts

The key to understanding the rules of third party trusts is that such trusts must be written in such a way that at all relevant times, the assets and/or income therefrom will not be available to meet the disabled person's basic cost of care, including institutional care, or generally the type of services which are normally covered by public assistance programs.

A "special needs trust" or "supplemental support trust" can take two forms: (1) a "pure" supplemental support trust; and (2) a so-called "trigger trust."

Included among the definition of items which go towards a disabled person's "special needs" or "supplement support" are those items which are not necessary to provide for the disabled person's basic needs, including room and board in an institution or other facility, or under circumstances where governmental benefits are payable. Special needs would include such items as entertainment, vacations, travel, audio and visual entertainment, non-essential clothing, and generally all other items which may provide for a beneficiary's enjoyment of life but which are not among the beneficiary's essential needs.

(1) "Pure" supplemental support trust - This is a trust which, by its terms, is at all times limited to making disbursements which are strictly to provide for a beneficiary's supplemental support or special needs. The trust does not authorize distributions for a beneficiary's general health, maintenance, and support, even where such distributions are discretionary with the trustee. Such a trust is normally confined to circumstances where a beneficiary is already disabled and receiving public assistance. Neither the trust corpus nor income of such a trust would be considered available to the beneficiary in the determination of his or her eligibility for benefits.

(2) Trigger Trust - is a type of trust which provides that the trustee may, in the trustee's sole and absolute discretion, apply so much of the trust income and/or principal as the trustee deems advisable to provide for the beneficiary's reasonable health, maintenance, and support. However, upon a beneficiary's application for public assistance benefits to be applied towards the cost of providing for the beneficiary's institutionalization or other care of a sort for which governmental benefits for the beneficiary's health care become and remain, payable,then, at that time, the trustee shall no longer have the authority to distribute to or for the trust beneficiary any amounts from the trust income or principal which may supplant or displace public assistance benefits. Thus, the Medicaid application(or eligibility, as the case may be) triggers the restrictive supplemental support provisions of the trust, where no distributions may be made other than for the purpose of providing for a beneficiary's special needs, or supplemental support, during any period where benefits through a program of public assistance are, and remain, payable.

(i) Under the current regulatory system, a third party special needs trigger trust will generally not negatively affect a beneficiary's eligibility for public assistance, provided that::

a) the Trustee is never required to distribute income or corpus to be applied toward the beneficiary's health, maintenance or support;

b) the Trustee's power to even make discretionary disbursements for health, maintenance and support is shut down upon the application for public assistance benefits. So long as benefits are paid, the Trustee has no power to make disbursements which supplant or displace same. Some flexibility may be inserted in the language of trust such that "insubstantial" public assistance benefits, (usually small cash assistance payments such as SSI) may be disregarded if the beneficiary has needs which are not being met by those benefits, and the trust fund could meet those needs;

c) The potential special needs beneficiary should not have a definable interest in the trust;

d) Ideally (but often this is not practical) a person who has a support obligation to the special needs beneficiary should not be trustee, if someone else is available.

(c) Comparison of Trusts

(1) This author tends to favor third party trigger trusts over pure supplemental support trusts, as the former are much more flexible to a given set of facts. Such trusts require more intensive management, particularly as the Medicaid beneficiary's situation changes, so as to not make a prohibited distribution during a relevant time.

(a) Even should such a distribution be made, if spent before that month end, the Medicaid rules of "administrative feasibility" may not necessarily result in a disqualification.

(2) Trigger trusts can be adapted to a class of beneficiaries, including non-disabled beneficiaries, thus facilitating broadly permissible support distributions to some beneficiaries, while restricting distributions to others.

(3) A trigger provision is commonly utilized where a beneficiary does not at present have a life situation which requires the beneficiary's institutionalization or other long term care, but in order to be responsive to circumstances which, by virtue of the passage of time, and a change in life situation, the need for estate planning and trust administration can become compellingly important. A typical example may be a trust which is testamentary in character.

(d) Special Needs Provision

(1) Override Provision
For the above reasons, an override provision in the trust document may be advisable.

(2) Indirect distributions
Whether the trust is a pure, special needs or trigger trust, some other technical aspects of the trust should be drafted for. Included among the special needs language, should be a proviso that any beneficiary who is eligible for public assistance benefits will never receive payments directly from the trust. Thus, distributions from a special needs trust should preferably be paid to third parties on behalf of the beneficiary and limited to those expenditures that cannot be considered to be, or converted to, food, shelter, utilities, or essential clothing.

(i) Note that in-kind and indirectly paid support items will reduce SSI payments generally up to a maximum reduction in SSI by 1/3.

(3) Trust agreement vs. testamentary trust
(i) OBRA '93 specifically sanctioned a third party testamentary trust for the benefit of a spouse. This should not be relevant for a disabled non-spousal beneficiary. Query as to whether an inter vivos trust agreement created by a third party can provide supplemental support for a beneficiary and come within the protection of the statute. Does this mean that revocable trusts should be collapsed at death and poured over to a testamentary trust? At

this point, the solution which is advocated is the grant of authority via specific powers given to the executor to create a testamentary trust and receive such a distribution from an inter-vivos Trustee, even if that means re-opening the estate, if necessary.

(ii) In cases where the trust beneficiary is not the spouse of the trust creator, the trust should not present problems. Where the surviving spouse is beneficiary, arguably the exception to transfer penalty under Manual Volume IV A Section 2010(B) (2) may not apply to a living trust versus a testamentary trust, since that section appears to limit the exemption for trusts for a spouse to trusts created "by will." This exemption *should* be construed to apply to trusts which create benefits upon death of a spouse, as opposed to benefits while the non-applicant spouse is living.

(iii) If the government is stingy and refuses to cover inter-vivos trusts which come into effect after the death of the creator spouse, perhaps the most compelling argument is with the fact that the trust was not created for the purpose of gaining Medicaid eligibility. The transfer occurred upon and came into being by reason of the spouse's death, which was not motivated by Medicaid eligibility reasons. See also Manual Volume IV A, Section 2105 for an analogous situation.

(e) Transfers to disabled beneficiaries to benefit the transfer.

(1)The plan here is to utilize the exception under Medicaid Manual Volume IVA, section 2070(E)under which transfers to a disabled child of the transferor are exempt from transfer of resource considerations.

(a) Usefulness: This can be of value to an individual who is institiutionalized and who is looking for Medicaid eligibility for himself or herself and has assets that, if transferred, would potentially result in a penalty. Funds transferred to a disabled child – of any age – are excluded.

(b) Example: Mother has a house and $100,000 in cash. She transfers all to her disabled son.

(i) Penalty as to mother – none.

(ii) Consequences to son.

b) If he is on SSI or Medicaid he will become ineligible unless he transfers funds to a disable person's (NOT third party) trust discussed below.

c) If disabled, but not on Medicaid or SSI, this will not be an issue.

4. SELF-CREATED "INCOME ONLY" TRUST

Because of the change in the law brought about by OBRA '93, any trust established after August 10, 1993, will be considered under the new transfer of resource rules applicable with respect to self-settled trusts. Self-settled trusts generally entail a 60 month look-back period, which commences with the date at which no distributions of all, or only a specified portion, of the trust can be made to the beneficiary, even if such distributions are made only in the discretion of an independent trustee. It would seem that it would be a rare circumstance where a self-settled trust would be a desirable planning technique, since such a trust entails a longer waiting period than an outright transfer, and affords the trust grantor/beneficiary/prospective Medicaid applicant little beneficial enjoyment of the trust property other than a potential income interest.

Of course, even a gift made in trust is "penalized" based on the transfer of resource factor, which in 2004 is $2,614. Thus, the trust rule only extends the *lookback* period from 36 to 60 months. Whether the transfer will result in an extended penalty depends on the *amount* of transferred funds.

(a) Specifics

(1) Usefulness

The Income Only Trust is usually compared against a direct gift of assets to children or other heirs. Generally speaking, where an individual has been financially independent, and is healthy, he or she may like to retain some but not all, rights to his or her their assets and independence. With an outright gift, the funds are gone. If the individual wants money, he or she has to ask the donees. Also, when an outright gift has been made, the gifted funds would generate income to the donees which would be reported on the donees income tax return.

(2) Tax Features

With an Income Only Trust, the income from the assets would be paid from the trust to the trust creator ("the Grantor"), and is not taxed to the donees, presumably.

(3) Limitations

With an Income Only Trust, by definition the Grantor's rights would be limited to income, and he or she would not have an interest in the trust principal. If the document permits, the Trustee could have the power to distribute principal to persons other than the Grantor, which could then, if the distributees desire, be gifted back to him or her, or used to pay his or her bills.

(a) This may although it should not, create problems as to issue of availability of principal funds as to the grantor.

(4) Security to Grantor

Before leaving the subject, consider the potential dangers of gifts made directly to children. For example, should a child run into creditor problems, the gifted assets might be subject to the claims of a child's creditors. Additionally, should the child predecease the trust Grantor, then the funds that have been given to the child might be subject to claims of a surviving spouse of the child, or would generally be available to the creditors or other claimants of a child through the child's probate estate. In this regard, if the Grantor wishes to restrict access to principal, the Income Only Trust offers him or her the additional security that his or her money still remains available to provide for him or her, and no one else.

(5) Medicaid Effect

As to the second point, the creation of an Income Only Trust starts the Medicaid waiting period from the time assets are transferred into the trust. Upon the expiration of no more than five years from the date of the establishment of the trust, the trust principal should no longer be considered available to the Grantor and if he or she requires long-term care, the trust assets should not thereafter prevent him or her from being eligible for Medicaid benefits. In other words, through the creation of the trust mechanism, the Grantor would be starting the time period of which, upon expiration of five years at the longest, would mean that he or she would be "resource eligible" for Medicaid benefits should he or she require long-term institutional or home health care for which Medicaid benefits are normally payable. The five year period should be the maximum. As stated earlier, the ineligibility period will depend on amount of transfer.

(a) Given the current low yield interest rate environment, such trusts may not be popular. If rates were to rise there may be a renewed interest.

(b) Tax Implications

(1) Estate and Gift Tax

The establishment of the trust can or cannot be a completed gift for gift tax purposes, depending on what is decided. If the Grantor's estate is less than $1.5 Million, (in 2004) it may be advisable that he or she retain a general testamentary power of appointment over the trust assets which may be exercised in his or her Will. Basically, that just means that the Grantor retains the power to say who gets what at death. The advantage to the transfer to the trust's not being considered a completed gift is with the fact that where the gift becomes complete upon death, then the trust assets will receive a stepped up basis equal to date-of-death value. This would enable the trustee to liquidate the trust assets at that time *without realizing capital gains tax.*

The trade off for deferring the completion of the gift to the time of death is that the assets would be includable in the taxable estate. As mentioned, the federal estate tax will only apply to estates which exceed (in 2004) $1.5 million dollars. In other words, if there is no estate taxation in any event, it would be better to get the step up in basis. One must select one or the other.

Generally, where it is believed that a taxable estate not will be an issue, it is advisable to complete the gift at death which would afford the heirs with the ability to eliminate capital gains tax. If it is believed that the estate will exceed the projected estate tax exemption in the year of death, then it may be advisable to complete the gift now. The federal gift tax exemption is $1 million. If the transfer to trust is a completed gift at the time of transfer, then that would lock in the heirs to the Grantor's basis in the property which may trigger the potential for significant capital gains.

(a) Caution may be advisable to avoid exposure to estate recovery.

(2) Income Taxation

From an income tax point of view, as stated earlier the trust should be taxed to the Grantor under the grantor trust sections of the Internal Revenue Code, IRC §§ 671-679. Where the Grantor retains a right to income for life, he or she will be taxed on the income generated by the trust assets.

This is an advantage in that a trust is normally taxable at more highly compressed brackets than is an individual. Of course, the trustee can control the extent of income generated, and the Trustee will not normally (in a well-drafted trust agreement) be limited by any requirement to make the trust assets productive of income. Thus, should the trustee design an investment portfolio which contains primarily growth securities which do not pay dividends and there are few income paying securities, income flow can be minimized or maximized as needs require.

(a) The trust could be established to generate higher income first which could later be minimized at such time as the Grantor applies for Medicaid benefits. Reason: Where the grantor goes on Medicaid, his or her income must be paid to the facility.

5. DISABLED PERSON'S ("SELF-SETTLED") TRUSTS

(a) Overview

In August 1993, OBRA'93 specifically sanctioned the use of a special needs trust established for the benefit of a disabled individual who is under 65 years of age even if that individual's own assets are used to create the trust. The grantor must be the disabled person's parents, grandparents, legal guardian, or a court. In certain instances, a non-profit organization can establish a trust pooling arrangement.

A so-called "disabled person's trust" is authorized under 42 USC 1396p(d)(4)(A) and 1396p(d)(4)(C), and is a means of qualifying a disabled individual who otherwise has excess resources and is thus not eligible for public assistance benefits. Such trusts are exempt from transfer of resource penalty.

(b) Special applications

The trust beneficiary qualifies for available Medicaid benefits as soon as the funds are transferred into the trust and not used for the beneficiary's support. Note: Unlike the issue regarding third party funds (discussed in Section 3, above) what is involved here is the disabled beneficiary's own funds which, once placed in the trust, are excluded from consideration. Thus he or she can immediately receive governmental benefits. As to this type trust, there is no waiting period. The trust may thus be established either well in advance of the time participation in a public assistance program is offered, or the day before.

(1) The technique can be used to shelter from spend down requirements personal injury awards as, for instance, where the person sustained his or her disabling injury in an act which was the source of a settlement or damage award.

(a) Similarly, funds which a person receives by way of an inheritance can be protected through use of the trust.

In addition to qualifying a disabled individual for Medicaid, such a trust can qualify a disabled beneficiary for Social Security benefits during a certain phase, (so long as principal is not available at the beneficiary's demand; i.e., the trust is Trustee discretionary for health, maintenance and support) while containing a "trigger" provision that will qualify the disabled person for Medicaid benefits by shutting down all basic support discretion at such time as a care facility, group home, or other arrangement offers participation in a Medicaid program to the beneficiary. For instance, a trust can contain a purely discretionary provision authorizing certain payments on behalf of a developmentally disabled beneficiary so as to render the beneficiary eligible for a monthly Medicaid card to cover that beneficiary's hospitalization and other health care benefits even though participation in a long term care program might be deferred until a future date. Then, at the future date when participation is available to the beneficiary, the trigger provision can scale back the trust to provide more restrictive benefits (i.e., supplement support only) to complete this important estate conservation technique. In particular, individuals who are awaiting eligibility in the "Supports in Community Living" program (the "SCL program") may find such a trust to be quite helpful on both a short and long term basis.

(c) Qualification requirements

(1) Payback requirement

In order to qualify the individual for Medicaid, the trust must contain a mandatory state reimbursement provision. The provision must specifically state that at death of the disabled person the trust property passes to the state to reimburse the state for medical assistance furnished the beneficiary during his or her lifetime.

(2) Substantive requirements

The other qualification requirements relate to the substantive or dispositive provisions of the trust: i.e., non-availability to the trust beneficiary except as discretionary with the third party trustee. The terms can generally track the guidelines previously discussed with reference to the third party supplemental support trusts.

a) As of this writing, the statutory language authorizing a disabled person's trust does not contain any guidance with regard to what happens in the event the disabled individual recovers from his or her disability and returns to independent living while assets remain in the trust. There is a question as to whether the disabled person may receive unrestricted principal benefits from the trust at that time, or thereafter, which will cause a substantial depletion or dissipation prior to such individual's death, thus cutting down or eliminating a state's right of recovery.

(3) Age limitation

The trust can only be established for disabled individuals under age 65, and may not be added to after that age.

(d) Subrogation

Counsel preparing disabled person's trusts will often work with personal injury lawyers. In this regard, it is important to determine whether there may be an outstanding Medicaid subrogation claim against assets which are contemplated for placement in the trust. The matter of subrogation rights is not clear under Kentucky law, and it is possible under the so-called "made whole" theory of tort law that even in the wake of a large subrogation claim, the Plaintiff's lawyer may negotiate a reduced payment. Nonetheless the practitioner is alerted to KRS 205.629.

Although Special Needs Trust legislation facilitates future benefit eligibility subsequent to receipt of funds from a settlement or judgment, there may well be an obligation to repay Medicaid for benefits advanced prior to receipt of funds, even where the injured party never receives funds that are conveyed into trust. Failure to report funds may trigger harsh Medicaid penalties with respect to future or ongoing benefits. This matter should be reviewed with the client and personal injury attorney for guidance and risk evaluation.

(e) Qualifying Income Trust Compliance ?

In an interesting recent intepretation (some might say "misinterpretation") of the law, DMS staff have sought to apply QIT rules (discussed in the next section) to Special Needs Trusts. Thus, even though SNTs are specifically authorized under 42 USC Section 1396(p)(D)(4) which sets out the requirements, DMS has sought to engraft further requisites on the Congressional statute passed in 1993, with the result being that SNTs which do not comport with QIT rules may be rejected by Frankfort.

The author believes that DMS theory is simply wrong. QIT rules are intended to provide a framework whereby individuals with income in excess of the income standard (in 2004, $1,692 per month) must place their excess income in a QIT. The federal regulations on such matters, HCFA Transmittal 64, makes it clear that only income "of the individual" is subject to QIT rules. As to SNTs, so long as the income is that of the trust, and not the individual, QIT rule are inapposite.

6. QUALIFYING INCOME TRUSTS

In 2003 Kentucky joined the ranks of a handful of "income cap states". This means that individuals with income above a certain ceiling are not eligible for Medicaid, regardless of whether they are resource eligible.

(a) Definition – A "qualifying income trust" ("QIT") is a trust agreement which is established to receive income of Medicaid applicants/recipients whose income exceeds the income standard applicable under Kentucky's income qualification rules which changed on September 1, 2003. QITs are not a planning device as much as a compliance requisite. In effect, any individual whose income exceeds the annual income standard (in 2004 it is $1,692 per month) must place his or her income in excess of this amount in the QIT, and by so doing the individual will no longer be income ineligible.

(1)Note that resource eligibility is still required.

(b) Requirements – Under 907 KAR 1:650 Section 3(5)(a)-(g), a QIT must contain the following provisions –

(1) All income over the resource standard will be regarded as "patient liability" and thus must be distributed currently toward the patient's cost of care unless under the relevant facts use of funds for allowable deductions such as dependency deductions (i.e. community spouse) is allowed by the DCBS caseworker.

(2) The trust must be irrevocable.

(3) Only income above the annual income standard must be placed in the trust.

a. Thus, in cases where income is $1,992 per month, only $300 must be placed in trust. The first $1,692 can keep coming in to the same source as always.

(4) At the death of the recipient, any income which has not been paid must be paid to the state.

(5) The trust must terminate only at the recipient's death.

a) Query as to what happens if the patient recovers? This is not addressed under the regulations. Presumably the recipient's income would then be directed away from the trust.

(6) The trust must be notarized. This requirement is not set out in the regulations, but it has been a strict requirement of DMS policy makers.

PRIVATE FOUNDATIONS

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SECTION H

University of Kentucky College of Law
Lexington, Kentucky

31st Annual Midwest/Midsouth

ESTATE PLANNING INSTITUTE

PRIVATE FOUNDATIONS
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- Maintaining
- Advising

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PRIVATE FOUNDATIONS

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1. BACKGROUND

1.1. ***Philanthropy in the United States***

1.1.1. "In works of beneficence, no country has surpassed, perhaps none has equaled the United States," James Bryce, British Journalist,1888.

1.1.2. In 2002, private giving by individuals, corporations and foundations was $240.9 Billion. Foundation Yearbook: Facts and Figures on Private and Community Foundations, 2003 Edition.

1.1.3. In that year there were 61,800 grant making foundations giving an aggregate of $30.3 Billion. Id.

1.1.4. These 61,800 foundations held $476.8 Billion in assets. Id.

1.2. ***Charities***

1.2.1. A Charity is any organization that is exempt from tax under Section 501(c)(3) of the Internal Revenue Code. (All references to the "Code" shall mean the Internal Revenue Code of 1986, as amended).

1.2.2. There are two broad categories of charities, public charities (or Code §509(a)(1) – (a)(4) charities) and private foundations. By definition, private foundations are any charity other than a public charity. Private foundations also have two broad categories: Operating Foundations and Non-Operating Foundations. Operating Foundations perform an exempt function. That is, the assets of the operating foundation are expended in direct performance of a charitable activity. Non-Operating Foundations in contrast, invest assets and make grants to other charities, typically public charities or operating foundations, which will use the grants to directly perform charitable activities.

1.2.2.1. *Private Foundations More Specifically* - To elaborate on the statement made in 1.2.2, above, a private foundation is any 501(c)(3) organization other than:

1.2.2.1.1. A church or a convention or association of churches;

1.2.2.1.2. A school;

1.2.2.1.3. An organization operated for the benefit of certain state and municipal colleges and universities;

1.2.2.1.4. A hospital;

1.2.2.1.5. A medical research organization operated in conjunction with a hospital;

1.2.2.1.6. A governmental unit;

1.2.2.1.7. A publicly supported charity; and

1.2.2.1.8. An organization that is organized and operated to test for public safety.

1.2.3. All charities are capable of receiving deductions that are deductible by the donor for federal income tax (Code §170), federal estate tax (Code §2055) and federal gift tax (Code §2522) purposes. But there are many differences between private foundations and public charities.

1.2.4. *Some of the Differences*:

1.2.4.1. One difference between public charities and non-operating private foundations is the extent to which a donor can deduct a contribution for income tax purposes. Generally, donors can deduct each year contributions made to public charities up to 50% of the donor's adjusted gross income. Donors to private foundations can deduct up to 30% of the donor's adjusted gross income. Operating foundations are generally treated as public charities in this respect. Note that these limitations apply only for purposes of income tax deductions. It makes no difference whether the charity is public charity or private foundation for purposes of gift or estate tax.

1.2.4.2. Another difference between public charities and private foundations is the excise taxes. Since the Tax Reform Act of 1969, private foundations have been subject to excise taxes intended, for the most part, to regulate the conduct of the private foundations. One of the excise taxes, the tax on investment income, was implemented in order to pay for the investigation of private foundations and enforcement of the private foundation excise taxes. The excise taxes will be discussed later in this outline.

1.2.4.3. Finally, the practical difference between public charities and private foundations is the amount of control exercised by the persons establishing the organization. Typically public charities receive the bulk of their funding from the general public on a continuous basis. This reliance on the public for operational financing results in the public charity being accountable to the public; hence the policing of public charities is, in many respects, undertaken by the public. St. John's Orphanage, Inc. v. U.S.,89-1 USTC ¶9176 (Cl. Ct. 1989).

In contrast, private foundations are typically formed with a large infusion of cash or property, the endowment, from a single person or family who control the operations of the foundation. As the operations of the private foundation are typically funded by the earnings on the initial endowment, a private foundation is not accountable to the public. Id. While these characteristics make the private foundation uniquely suited in many cases to meet the philanthropic desires of wealthy individuals, these same characteristics resulted in Congress implementing the excise tax scheme of regulation, and enforcement thereof, through the Tax Reform Act of 1969.

2. ESTABLISHING A FOUNDATION- FORMATION NUTS AND BOLTS.

2.1. *Form of Entity*

2.1.1. "Corporations, and any community chest, fund, or foundation" may qualify under Code § 501(c)(3) as an exempt organization. Neither the Code nor the Treasury Regulations ("Regs.") define "community chest, fund or foundation". Thus, it appears that trusts and corporations (or LLCs that elect to be taxed as corporations) are the forms in which an exempt organization may operate.

2.1.1.1. In keeping with the "generally" theme, single member LLCs which are disregarded for income tax purposes have been growing in popularity as a means of segregating risk within a charity. For example, where a donor wishes to contribute real estate to a charity, the charity may decide to accept that contribution through a single member LLC. The LLC provides state-law liability protection, without creating a separate entity subject to tax reporting requirements. See PLRs 200249014; 200304036.

2.2. *The Application Process*

2.2.1. *Forms to be Filed*:

2.2.1.1. Specifically Required for Exemption: Form 1023, Application for Recognition of Tax Exempt Status under Code Section 501(c)(3) of the Internal Revenue Code, Form 8718 - User Fee;

2.2.1.1.1. Included with the Form 1023 must be conformed copies of the organizational documents in order to show satisfaction of the organizational test discussed below. A conformed copy is one that agrees with the document it purports to copy and is accompanied by a declaration, signed by an officer authorized to sign for the organization, that it is a complete and correct copy of the document it purports to copy. Rev. Proc. 68-14.

Articles of Incorporation must be "stamped filed" by the Secretary of State. Rev. Proc. 90-27.

2.2.1.2. Required for Entities Generally: Form SS-4 - Application for Employer Identification Number.

2.2.1.3. Not Required, but Recommended: Form 2848 - Power of Attorney. Allows the IRS to discuss exemption issues of the applicant with the attorney-in-fact.

2.2.2. Timing. An organization's exempt status generally commences on the date of the filing of Form 1023, unless the Form 1023 is filed on or before the end of the 15th month following the end of the month in which the organization was formed. Regs. 1.508-1(a)(2)(i). If the application cannot be filed within the 15 month period, a 12 month extension will be automatically granted if the application states: "Filed Pursuant to § 301.9100-2" across the top of the application. Regs. §301.9100-2.

2.2.2.1. An organization is formed as of the date the organizational instrument is recorded in the proper state or local office where instruments are required to be filed. Rev. Rul. 75-290.

2.2.2.2. The application for exemption is deemed filed on the date that a "substantially complete" Form 1023 is postmarked or, if there is no postmark, on the date it is stamped "received" by the Internal Revenue Service. Rev. Rul. 77-114.

2.2.2.3. If the IRS determines that the organization must change its activities or its organizational documents in substantive way, the organization's exemption is effective as of the date of the change. Rev. Proc. 90-27.

2.2.3. Content of Form 1023. In order to be exempt under Code § 501(c)(3), the organization must show through its Form 1023 and its attachments that it: (i) meets the organizational test; and (ii) meets (or will meet once operations commence) the operational test. Regs. § 1.501(c)(3)-1(a).

2.2.3.1. Organizational Test Generally: The organizational test is focused upon the content of the Articles of Organization of the entity seeking exemption. "Articles of Organization" include the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created. Regs. § 1.501(c)(3)-1(b)(2).

2.2.3.1.1. The Articles of Organization must: (i) restrict the permissible activities of the organization "exclusively" to certain enumerated purposes; and (ii) contain a provision (either explicitly or by operation of law) requiring the organization to dedicate its assets to one or more exempt purposes. An organization's assets will be deemed to be dedicated to exempt purposes if, on its dissolution, the assets are required to be distributed for one or more exempt purposes or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. Regs. § 1.501(c)(3)-1(b)(1).

2.2.3.1.2. Exempt Purposes: Religious, Charitable, Scientific, Testing for public safety, Literary, Educational, or Prevention of cruelty to children or animals. Exempt purposes include the activities of a private foundation, e.g. to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a). Rev. Rul. 64-182.

2.2.3.1.3. The Articles of Organization may not expressly empower the organization to: (i) engage in activities which are not in furtherance of one or more exempt purposes other than as an insubstantial part of its activities Regs. § 1.501(c)(3)-

1(b)(1)(iii); (ii) to devote more than an insubstantial part of its activities to attempting to influence legislation Regs. § 1.501(c)(3)-1(b)(3)(i); (iii) directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office. Regs. § 1.501(c)(3)-1(b)(3)(ii).

2.2.3.2. Organizational Test - Specific Provisions for Private Foundations. A private foundation will not qualify under Code §501(c)(3) unless its Articles of Organization require its income for each taxable year to be distributed at such time and in such manner as not to subject the foundation to tax under Code §4942 and prohibit (i) the foundation from engaging in any act of self-dealing (as defined in Code §4941(d)), (ii) from retaining any excess business holdings (as defined in Code §4943(c)); (iii) from making any investments in such manner as to subject the foundation to tax under Code §4944; (iv) and from making any taxable expenditures (as defined in Code §4945(d)); Code §508(e).

2.2.3.3. Operational Test In order to satisfy the operational test, an organization must operate exclusively for one or more exempt purposes. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). Reg. §1.501(c)(2)-1(c)(1). How an organization will satisfy the operational test is what the Form 1023 seeks to elicit from an applicant.

2.2.3.4. No part of the organization's net earnings may inure to the benefit of any private individuals or shareholders;

2.2.3.4.1. No substantial part of the activities of the organization may be carrying on propaganda or otherwise attempting to influence legislation; and

2.2.3.4.2. It must not participate or intervene in any political campaign on behalf of, or in opposition to, any candidate for public office.

2.3. ***Protest of Adverse IRS Determinations; Administrative Remedies***. If an organization applies for tax-exempt status and receives an adverse determination letter, the organization will be advised of its right to protest the determination by requesting Appeals Office consideration. Reg. §601.201(n)(5). The organization must sent its protest to the District Director within 30 days from the date of the adverse determination letter and must state whether it wishes an Appeals conference.

2.4. ***Appeals Office Consideration***. The protest to the Appeals Office should be filed with the district office considering the application. The protest must contain the following information:

2.4.1. the organizations name, address and employer identification number;

2.4.2. A statement that the organization wants to protest the determination;

2.4.3. The date and symbols on the determination letter;

2.4.4. A statement of facts supporting the organization's position in any contested factual issue.

2.4.5. A statement outlining the law or other authority the organization is relying upon; and

2.4.6. A statement as to whether a conference at the Appeals Office is desired. If a conference is requested it will be held at the Appeals Office, unless the organization requests that the meeting be held at a district office convenient to both parties. IRS Publication No. 557, *Appeal Procedures*.

The statement of facts provided under 2.4.4 above must be declared true under penalties of perjury. This can be done by adding to the protest the following signed declaration "Under penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and statements and, to the best of my knowledge and belief, it is true, correct and complete." Signed.

If the organization's representative submits the protest, a substitute declaration must be included, stating: (a) that the representative prepared the protest and accompanying documents and (b) whether the representative knows personally that the statements of fact contained in the protest and accompanying documents are true and correct. *Id.*

After considering the organization's protest and the information presented in any conference, the Appeals Office will notify the organization of its decision and issue a determination letter. An adverse decision may be appealed to the courts.

2.5. ***National Office Consideration***. The Appeals Office must request technical advice from the National Office on any issue concerning qualification for exemption or foundation status for which there is no published precedent or for which there is reason to believe that nonuniformity exists. Reg. §601.201(n)(5)(iv). If an organization believes that its case involves such an issue, it should ask the Appeals Office to request technical advice. Any determination letter issued on the basis of technical advice from the National Office may not be appealed to the Appeals Office for those issues which were subject of the technical advice.

2.5.1. If an application is referred to the National Office for issuance of a ruling and an adverse ruling is issued, the organization will be informed of the basis for the conclusion, its right to file a protest within 30 days, and its right to have a conference at the National Office.

2.6. ***Administrative Remedies***. In the case of an application under Code §501(c)(3), the following actions, called administrative remedies, must be completed before an unfavorable ruling or determination letter can be appealed to the courts:

2.6.1. The filing of a substantially completed application Form 1023 or the filing of a request for a determination of foundation status;

2.6.2. In the case of a late-filed application requesting relief under Treas. Reg. § 301.9100 regarding applications for extensions of time for making an election or application for relief from tax;

2.6.3. The timely submission of all additional information requested to perfect an exemption application or request for determination of private foundation status; and

2.6.4. Exhaustion of all administrative appeals available within the IRS.

2.6.5. These actions will not be considered completed until the IRS has had a reasonable time to act upon the appeal or protest.

2.6.5.1. Exhaustion of Administrative Remedies. An organization will not be considered to have exhausted its administrative remedies before the earlier of: (i) the completion of the steps listed above and the sending by the IRS of a notice of final determination by certified or registered mail, or (ii) the expiration of the 270-day period in which the IRS has not issued a notice of final determination that the organization has taken in a timely manner, all reasonable steps to secure a ruling or determination.

2.7. ***Appeal to Courts***. If the IRS issues an unfavorable determination letter or ruling and all of the administrative remedies have been exhausted, the organization may seek judicial remedies. The option are: filing a refund suit in the U.S. District Court or Court of Federal Claims, or Petition the U.S. District Court for the District of Columbia, the U.S. Tax Court of the Court of Federal Claims for a Declaratory Judgment.

2.7.1. *Filing Suit*. If the organization has paid the tax resulting from the unfavorable determination and met all other statutory prerequisites, it can file suit for a refund in a U.S. District Court or in the U.S. Court of Federal Claims. Alternatively, if the organization has elected not to pay the tax deficiency resulting from the unfavorable determination and met all other statutory prerequisites, it can file suit for the redetermination of the tax in the U.S. Tax Court.

2.7.2. *Declaratory Judgment.* The organization may file suit for declaratory judgment in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims or the U.S. Tax Court. Declaratory Judgment is available only if the organization received an adverse notice of final determination on its initial or continuing qualification or classification as an exempt organization. Code §7428(b)(2). This adverse notice of final determination is a ruling or determination letter that the organization is either not described in Code §501(c)(3) or Code §170(c)(2), is a private foundation or is a public charity described in a part of Code §509 or §170(b)(1)(A) other than the part under which the organization requested classification. Code §7428(a)(1).

2.7.3. The exempt status claim must be as: (i) An organization qualifying under Code § 501(c)(3); (ii) an organization to which a deduction for contribution is allowed under Code § 170(c)(2); (iii) an organization other than a private foundation under Code § 509; or (iv) a private operating foundation under Code § 4942(j)(3).

3. MAINTAINING

3.1. ***Annual Report For Foundations***. Foundation managers of private foundations having at least $5,000 of assets at any time during the tax year must file Form 990-PF. Regs. §1.6033-3(a). If the private foundation is subject to any excise taxes on foundation expenses, the private foundation must also file Form 4720 with the 990-PF. Excise Taxes will be addressed later.

3.1.1. *Public Inspection.* Prior to March 13, 2000, a private foundation was required to publish in a newspaper of general circulation a "Notice of Availability" of its Form 990-PF. This is no longer required. Current regulations provide that Section 501(c)(3) organizations must make their application (Form 1023) and the three most recent annual returns (Form 990 or Form 990-EZ) available to the public, upon request and without charge (except for a reasonable charge for copying). The IRS also makes these documents available for public inspection and copying. These documents must be made available at the organization's principal office during regular business hours. Upon request, an organization must furnish copies of the application and the three most recent annual returns. The requests may be made in person or in writing.

The organization may charge a reasonable fee for providing copies. It can charge no more for the copies than the per page rate the IRS charges for providing copies. That rate is stated in section 601.702(f)(5)(iv)(B) of the regulations. (As of June 2001, the rate was $1.00 for the first page and 15 cents for each additional page.) The organization can also charge the actual postage costs it pays to provide the copies.

3.1.2. *Exceptions to Copying Rules*

3.1.2.1. Making applications and returns widely available. An exempt organization does not have to comply with requests for copies of its annual returns or exemption application if it makes them widely available. However, making these documents widely available does not relieve the organization from making its documents available for public inspection. The organization can make its application and returns widely available by posting the application and returns on a World Wide Web page. Regs. 301.6104(d)-2(b).

If the organization has made its application for tax exemption and/or annual returns widely available, it must inform any individual requesting a copy where the documents are available, including the address on the World Wide Web, if applicable. If the request is made in person, the notice must be provided immediately. If the request is made in writing, the notice must be provided within 7 days.

3.1.2.2. Harassment campaign. If the tax-exempt organization is the subject of a harassment campaign, the organization may not have to fulfill requests for information. Regs. 301.6104(d)-3. A tax-exempt organization may apply for a determination that it is the subject of a harassment campaign by submitting a signed application to the district director for the key district where the organization's principal office is located. The application must consist of a written statement giving the organization's name, address, employer identification number, and the name, address and telephone number of the person to contact regarding the application. The application must describe in detail the facts and circumstances that the organization believes support a determination that the organization is subject to a harassment campaign. The organization may suspend compliance with respect to any request for a copy of its documents based on its reasonable belief that such request is part of a harassment campaign, provided that the organization files an application for a determination within 10 business days from the day the organization first suspends compliance with respect to a request that is part of the alleged campaign.

Harassment is defined as "[a] group of requests for an organization's application for tax exemption or annual information returns is indicative of a harassment campaign if the requests are part of a single coordinated effort to disrupt the operations of a tax-exempt organization, rather than to collect information about the organization." Regs. §301.6104(d)-3(b). Whether a group of requests constitutes such a harassment campaign depends on the relevant facts and circumstances.

3.2. *Other Returns*

3.2.1. *Unrelated Business Returns.* Form 990-T must be filed by every organization exempt under Code § 501(a) if the unrelated trade or business gross income is $1,000 or more.

3.2.2. *Employment Tax Returns.* Every employer who pays wages to employees is responsible for withholding, depositing, paying and reporting federal income tax, social security tax, FICA and FUTA unless that employer is specifically excepted by law or the taxes do not apply. Form 941E, Quarterly Return of Withheld Federal Income tax, is used by tax-exempt organizations that do not report social security taxes to the IRS as to employee wages and annuity payments.

3.2.3. *Estimated Tax Payments.* Before the Tax Reform Act of 1986, private foundations subject to the net investment income excise tax imposed by IRC 4940 were required to pay these taxes annually with their returns. For taxable years beginning after December 31, 1986, private foundations are required to make estimated tax payments through deposits to the Federal Tax Deposit (FTD) system. Each payment must be accompanied by a Federal Tax Deposit Coupon (Form 8109). Due dates for estimated tax payments are on the 15th day of the fourth, sixth, ninth, and twelfth months of the taxable year.

3.2.4. *Estimated Tax Payments.*

3.2.5. *Donee Information Return.* If an organization receives a contribution of charitable deduction property and sells, exchanges or otherwise disposes of the property within two years after its receipt, the organization must file Form 8282, Donee Information Return (Sale, Exchange or other Disposition of Donated Property). It must be filed within 125 days after the disposition. A copy of Form 8282 is to be given to the donor. Penalties apply if the organization does not file the return.

3.2.5.1. Charitable Deduction Property is any property (other than money or publicly traded securities) for which the organization signed as donee must provide an appraisal.

3.2.5.2. The donor must obtain a qualified appraisal for contributions of property (other than money or publicly traded securities) the claimed value of which is more than $5,000.

3.2.5.3. The donor must attach Form 8283, Noncash Charitable Contributions, to the return on which the deduction is shown. The person who signs for the donee must be an official authorized to sign the donee's tax or information returns or a person specifically authorized to sign by that individual. The signature does not represent the donee's agreement with the appraised value, it represents receipt of the property. In addition, the donee's signature indicates knowledge of the reporting requirements. A copy of Form 8283 must be given to the donee.

4. ADVISING

4.1. ***Excise Taxes***. As mentioned briefly above, private foundations (both operating and non-operating) are subject to certain excise taxes. These are:

4.1.1. Excise tax on net investment income (§4940);

4.1.2. Excise tax on self-dealing transactions (§4941);

4.1.3. Excise tax on failure to distribute income (§4942);

4.1.4. Excise tax on excess business holdings (§4943);

4.1.5. Excise tax on jeopardy investments (high risk) of foundation assets (§4944); and

4.1.6. Excise tax on taxable expenditures of foundation funds (§4945).

4.2. ***Excise tax on net investment income (§4940)***

4.2.1. This is an annual tax paid by almost all private foundations. It is a 2% tax measured by the net investment income of the foundation.

4.2.2. The exception: Exempt Operating Foundations. An exempt operating foundation is a private operating foundation that: (1) has been publicly supported for at least 10 tax years; (2) has a governing body that, at all times during the tax year, consists of individuals at least 75 percent of whom are not disqualified individuals and is broadly representative of the general public; and (3) does not have an officer who is a disqualified individual at any time during the tax year. Code §4940(d). (Note - These are a subset of Private Operating Foundations.)

4.2.2.1. "Disqualified Individual". The term "disqualified individual" means, with respect to any private foundation, an individual who is (i) a substantial contributor to the foundation; (ii) an owner of more than 20 percent of (x) the total combined voting power of a corporation, (y) the profits interest of a partnership, or (z) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation; (iii) a member of the family of any individual described in clause (i) or (ii). Code §4940(d)(3)(B).

4.2.3. *Net investment income.* Net investment income is gross investment income and net capital gain, less expenses paid or incurred in earning the gross investment income. Code §4940(c). Tax-exempt interest on governmental obligations and related expenses are excluded. Code §4940(c)(5).

4.2.3.1. Gross investment income means the gross amount of income from interest, dividends, rents, and royalties that is received by a private foundation from all sources, unless the income is taxable as unrelated business income.

All of the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income are deductible.

If any expenses are incurred for both investment purposes and exempt purposes, they must be allocated between the investment activities and the exempt activities. RegS. §53.4940-1(e)(1)(ii). Expenses paid or incurred for exempt functions are not deductible in figuring net investment income.

Capital gains are fully included in the base for the net investment income tax (Code Sec. 4940(c)(4). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales (there are no capital loss carryovers).

4.3. *Excise tax on self-dealing transactions (§4941)*

4.3.1. *Self Dealing Defined.* Acts of self-dealing between a private foundation and a disqualified person are:

4.3.1.1. The sale, exchange, or leasing of property;

4.3.1.2. Lending money or other extensions of credit;

4.3.1.3. Providing goods, services, or facilities;

4.3.1.4. Paying compensation or reimbursing expenses to a disqualified person;

4.3.1.5. Transferring foundation income or assets to, or for the use or benefit of, a disqualified person, and

4.3.1.6. Certain agreements to make payments of money or property to government officials.

4.4. ***Disqualified Person***. The term "disqualified person" means, with respect to a private foundation, a person who is:

4.4.1. A substantial contributor to the foundation;

4.4.2. A foundation manager;

4.4.3. An owner of more than 20 percent of

4.4.3.1. the total combined voting power of a corporation;

4.4.3.2. the profits interest of a partnership, or

4.4.3.3. the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation,

4.4.4. A member of the family of any individual described above;

4.4.5. A corporation of which persons described above own more than 35 percent of the total combined voting power;

4.4.6. A partnership in which persons above own more than 35 percent of the profits interest; and

4.4.7. A trust or estate in which persons described in above more than 35 percent of the beneficial interest. Code § 4946(a).

4.4.8. A "substantial contributor" is any person who contributes more than $5,000 to a private foundation if it amounts to more than two percent of the total contributions and bequests received by the foundation for its tax year. Once a person becomes a substantial contributor, he or she will always be a substantial contributor as to that private foundation. Code § 4946(a)(2), referring to Code §507(d).

4.5. ***Per Se Self Dealing***. Leasing property to or from a disqualified person for any amount of rent, and paying any amount of compensation to a disqualified person are acts of self dealing irrespective of the amounts involved.

4.5.1. *Exceptions*. The following transactions between a private foundation and a disqualified person are not considered self-dealing.

4.5.1.1. Providing goods, services, or facilities by a private foundation to a disqualified person is not self-dealing if the goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person ***and*** the goods, services, or facilities are ***functionally related*** to the exercise or performance by a private foundation of its exempt purpose. The term "general public" includes those persons who reasonably would be expected to use the foundation's goods, services, or facilities.

4.5.1.2. Payment of compensation or reimbursement of expenses by a private foundation to a disqualified person for personal services that are reasonable and necessary to carry out the exempt purpose of the private foundation is not considered an act of self-dealing if the compensation or reimbursement is not excessive.

4.5.1.3. Leases**.** The leasing of property by a disqualified person to a private foundation is not an act of self-dealing if the lease is without charge. The lease will be considered without charge even though the foundation agrees to pay for janitorial expenses, utilities, or other maintenance costs it incurs as long as payment is not made directly or indirectly to a disqualified person.

4.6. *Taxes on Failure to Distribute Income Code §4942*

4.6.1. Private non-operating foundations are required to annually distribute, as a "qualifying distribution" an amount at least equal to its "distributable amount". Code § 4942(a).

4.6.2. A qualifying distribution includes: (1) distributions to unrelated public charities and to private operating foundations (not other private foundations, but see exceptions below); (2) direct expenditures (including administrative expenses) for charitable purposes; (3) expenditures for assets to be used for charitable purposes; and (4) in many cases, amounts set aside for a specific charitable project. Code §4942(g). The distributable amount must be fully distributed by the end of the tax year following the tax year for which it is calculated. That is, for example, by the end of 2005 the distributable amount determined on the 2004 990-PF must be distributed.

4.6.3. *Definitions.*

4.6.3.1. The distributable amount is equal to the organization's minimum investment return for the year, reduced by any net investment income tax paid under Code §4940 for the taxable year.

4.6.3.2. A Foundation's minimum investment return is equal to 5% of the aggregate fair market value of all of the Foundation's assets reduced by acquisition indebtedness thereon.

4.6.4. *Exceptions for Related Charities and Private Foundations.* Qualifying distributions *can* be made to related charities and to non-operating foundations so long as the recipient makes a qualifying distribution of the amount it received by the end of the calendar year following the year it was received. Code §4942(g)(3). The second qualifying distribution must be treated as being made out of corpus. Id. The foundation making the initial distribution must receive sufficient evidence from the recipient private foundation that the flow through has been made. *Id.* A related charity is one that is controlled by the foundation, or by a disqualified person with respect to that foundation.

4.7. *Taxes on Excess Business Holdings Code §4943*

4.7.1. Generally, a foundation generally cannot own more than 20% of a corporation, partnership, joint venture or other business enterprise without being subject to this excise tax. For this purpose, the interests in a business enterprise that are owned by a disqualified person with respect to the foundation are treated as owned by the foundation. So, the aggregate amount a foundation together with its disqualified persons can own in any business enterprise is 20%.

4.7.2. A business enterprise is the active conduct of a trade or business other than: (i) a functionally related business (defined below); or (ii) a trade or business at lest 95 percent of the gross income of which is derived from passive sources such as interest, dividends, rent, royalties and capital gains. Code §4943(d)(3).

4.7.3. A functionally related business is:

4.7.3.1. A trade or business the conduct of which is substantially related (aside from the mere provision of funds for the exempt purpose) to the exercise or performance by the private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption;

4.7.3.2. A trade or business in which substantially all the work is performed for the foundation without compensation,

4.7.3.3. A business carried on by the foundation primarily for the convenience of its members. students, patients, officers, or employees;

4.7.3.4. A business that consists of the selling of merchandise, substantially all of which has been received by the foundation as gifts or contributions; or

4.7.3.5. An activity carried on within a larger combination of similar activities or within a larger complex of other endeavors that is related to the exempt purposes of the foundation (other than the need to simply provide funds for these purposes). Code Sec. 4942(j)(4; Regs. §53.4942(a)-2(c)(ii).

4.7.4. For example, a cafeteria operated by a museum for the convenience of its members, employees, and visitors is a functionally related business. IRS Publication 578, *Tax Information for Private Foundation and Foundation Managers.*

4.8. *Taxes on Investments which Jeopardize Charitable Purposes Code §4944*

4.8.1. Generally, if a private foundation makes any investments that would financially jeopardize the carrying out of its exempt purposes, both the foundation and the individual foundation managers may become liable for taxes on these jeopardizing investments.

4.8.1.1. Jeopardizing investments generally are those that show a lack of reasonable business care and prudence in providing for the long and short-term financial needs of the foundation for it to carry out its exempt function. Reg. §53.4944-1(a)(2)(i). No single factor determines a jeopardizing investment. No category of investments is treated as an intrinsic violation, but careful scrutiny is applied to:

4.8.1.1.1. Trading in securities on margin;

4.8.1.1.2. Trading in commodity futures;

4.8.1.1.3. Investing in working interests in oil and gas wells;

4.8.1.1.4. Buying "puts," "calls," and "straddles";

4.8.1.1.5. Buying warrants; and

4.8.1.1.6. Selling short. *Id.*

In deciding whether the investment of an amount jeopardizes the carrying out of the exempt purposes, the determination must be made on an investment-by-investment basis taking into account the foundation's portfolio as a whole, it is permissible for the foundation managers to take into account expected returns, risks of rising and failing prices, and the need for diversification within the investment portfolio. *Id.* But to avoid the tax on jeopardizing investments, a careful analysis of potential investments must be made and good business judgment must be exercised. Whether an investment jeopardizes the foundation exempt purposes is determined at the time of making the investment. if is investment is proper when made, it will not be considered a jeopardizing investment even if it later results in loss. *Id.*

4.8.2. *Exception for Program Related Investments*

4.8.2.1. Program-related investments are not subject to the tax on jeopardizing investments. Program-related investments are those in which:

4.8.2.1.1. The primary purpose to accomplish one or more of the foundation's exempt purposes,

4.8.2.1.2. Production of income or appreciation of property is not a significant purpose, and

4.8.2.2. Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose. Reg. §53.4944-3(a)(1).

Investments, to be program related, must significantly further the foundation's exempt activities. Reg. §53.4944-3(a)(2). They must be investments that would not have been made except for their relationship to the exempt purposes. *Id.* The investments include those made in ***functionally related activities*** (described in the discussion of the Tax on Excess Business Holdings) that are carried on within a larger combination of similar activities related to the exempt purposes.

The following are some typical examples of program-related investments:

1) Low-interest or interest-free loans to needy students,

2) High-risk investments in nonprofit low-income housing projects.

3) Low-interest loans to small businesses owned by members of economically disadvantaged groups, where commercial funds at reasonable interest rates are not readily available,

4) Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or training for unemployed residents, and

5) Investments in nonprofit organizations combating community deterioration.

See Regs. §53.4944-3(b), Examples 1-8.

If a foundation changes the form or terms of an investment, and if the investment no longer qualifies as program-related, it then must be determined whether or not the investment jeopardizes carrying out its exempt purposes.

Once an investment is determined to be program-related, it will continue to qualify as a program-related investment so long as changes in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. Reg. §53.4944-3(a)(3)(i).

4.9. ***Taxes on Taxable Expenditures Code §4945***

4.9.1. *Taxable Expenditure*. Generally, a ***taxable expenditure*** is an amount paid or incurred to: 1) carry on propaganda or otherwise attempt to influence legislation, 2) influence the outcome of any specific public election or carry on any voter registration drive, unless certain requirements are satisfied, 3) make a grant to an individual for travel, study, or other similar purposes, unless certain requirements are satisfied, 4) make a grant to an organization (other than an organization described in section 509(a)(1), (2), or (3) or an exempt operating foundation), unless the foundation exercises expenditure responsibility with respect to the grant, or 5) carry out any purpose other than a religious, charitable, scientific, literary, or educational purpose, the fostering of national or international amateur sports competition or the prevention of cruelty to children or animals. Regs. §53.4945-2(a)(1).

4.9.2. *Influencing Legislation*. A taxable expenditure includes amounts used to attempt to influence legislation: 1) by affecting public opinion ("grass roots"), or 2) by communicating with any member or employee of a legislative body, or with any other government official or employee who may participate in formulating the legislation ("direct lobbying"). Reg. §53.4945-2(a)(1) referring to Reg. §56.4911-2.

"Legislation" includes action by Congress, any state legislature, any local council or similar governing body, or the public by way of referendum, constitutional amendment, or the like. *Id.*; Reg. §46.4911-2(d)(1)(i). The term "action" includes the introduction, enactment, defeat, or repeal of legislation. Reg. §56.4911-2(d)(2).

4.9.2.1. Exceptions.

4.9.2.1.1. Non-Legislative Action. Actions by executive, judicial, or administrative bodies are not legislation. Reg. §56.4911-2(d)(3). Therefore, expenditures made to influence action by these bodies are not attempts to influence legislation.

4.9.2.1.2. Exception for nonpartisan analysis, study, and research. Engaging in nonpartisan analysis, study, or research and making the results of this work available to the general public or to governmental bodies, officials, or employees is not carrying on propaganda, or otherwise attempting to influence legislation. Code §4945(c); Reg. §53.4945-2(d)(i1)(ii). Nonpartisan analysis, study, or research means an independent and objective exposition of a particular subject matter, including activities that qualify as educational activities. Reg. §53.4945-2(d)(i)(ii). Nonpartisan analysis, study, or research may advocate a particular position or viewpoint as long as there is a sufficiently full and fair exposition of the relevant facts to enable the public or an individual to form an independent opinion or conclusion. *Id.* However, a mere presentation of unsupported opinion does not qualify as nonpartisan analysis, study, or research. *Id.*

4.9.2.1.3. Exception for technical advice or assistance. Amounts are not taxable expenditures if they are paid or incurred in connection with providing technical advice or assistance to a governmental body, a government committee, or a subdivision of either, in response to a written request. Reg. §53-4945-2(a)(2)(i). Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee, or subdivision rather than an individual member *Id.* Similarly, the response to the request must be available to every member of the requesting body, committee, or subdivision. *Id.*

4.9.2.1.4. Exception for decisions affecting the powers, duties, etc., of a private foundation. Taxes on lobbying activities, discussed earlier, do not apply to any amount paid or incurred in connection with an appearance before, or communication with, any legislative body on a possible decision of the body that might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to the foundation Reg. §53-4945-2(d)(3)(i). Under this exception, a foundation may communicate with the entire legislative body, committees, or subcommittees of the legislative body, individual congressmen or legislators, members of their staffs, or representatives of the executive branch, who are involved in the legislative process if the communication is limited to the prescribed subjects. *Id.* In addition, the foundation may make expenditures to initiate legislation if the legislative concerns only matters that might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to the foundation. *Id.*

4.9.2.1.5. Exception for examinations and discussions of broad social, economic, and similar problems. Expenditures for examinations and discussions of broad social, economic, and similar problems are riot taxable expenditures even if the problems are the type the government would be expected to deal with ultimately. Reg. §53.4945-2(d)(4).

4.9.2.2. *Influencing elections and carrying on voter registration drives.* Taxable expenditures include amounts paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive. Code §4945(d)(2). Activities that are considered participation or intervention in a political campaign include, but are not limited to: 1) publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to a candidate, 2) paying salaries or expenses of campaign workers, and 3) conducting or paying the expenses of conducting a voter registration drive limited to the geographic area covered by the campaign. Regs. §43-4945-3(a)(2).

4.9.2.3. Exceptions. This rule does not apply to nonpartisan activities carried on under all the following conditions: 1) the organization making the expenditure is described in section 501(c)(3) and is exempt from tax, 2) its activities are nonpartisan, are not confined to one specific election period, and are carried on in at least 5 states, 3) the organization spends at least 85% of its income directly for the active conduct of the exempt purposes or functions for which it is organized and operated, 4) the organization receives at least 85% of its support (other than gross investment income) from exempt organizations, the general public, governmental units, or any combination of these; it does not receive more than 25% of its support (other than gross investment income) from any one exempt organization; and it does not receive more than 50% of its support from gross investment income, and 5) contributions to the organization for voter registration drives are not subject to conditions that they may be used only in specified states or other localities of the United States, or that they may be used in only one specific election period. Regs. §43.4945-3(b).

In determining whether the organization meets the support test in item (4) for a tax year, the support received during the tax year and the 4 immediately preceding tax years of the organization is taken into account. Regs. §53.4945(b)(3)(i).. For organizations with less than 4 years of operational experience, the support test may be determined by taking into account all available years the organization has been in existence.

4.9.3. *Grants to individuals.* Grants to individuals for travel, study, or other similar purposes are taxable expenditures, unless the following conditions are met: 1) the grant must be awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the Service; and 2) it must he shown to the satisfaction of the Service that one of the following requirements is met--

4.9.3.1. The grant is a scholarship or fellowship and is to be used for study at an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where the educational activities are carried on. Code §4945(g)(1).

4.9.3.2. The grant qualifies as a prize or award under Code §74(b), if the recipient is selected from the general public. For this purpose, the recipient may keep the prize or award, and need not authorize the foundation to transfer the prize or award to a governmental unit or to another charity. Code §4945(g)(2).

4.9.3.3. The grant's purpose is to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or similar capacity, skill, or talent of the grantee. Code §4945(g)(3).

4.9.3.4. *Advance approval of grant-making procedure*. The grant-making procedure, to be approved in advance by the Internal Revenue Service, must provide the following:

4.9.3.4.1. The group from which the grantees are selected must be reasonably related to the purposes of the grant, and the group must be large enough to constitute a charitable class (unless, taking into account the purposes of the grant, only a few individuals are qualified to be grantees, as in the case of scientific research). Reg. §43.4945-4(b)(2).

4.9.3.4.2. The criteria used in selecting grant recipients from the potential grantees should be related to the purpose of the grant. Reg. §53.49455-4(b)(3). For example, proper criteria for selecting scholarship recipients might include (but are not limited to) the following: past academic performance, performance on tests designed to measure ability and aptitude for college work, recommendations from instructors, financial need, and the conclusions the selection committee might draw from personal interviews. *Id.*

4.9.3.4.3. The person or persons who select recipients of grants should not be in a position to receive a private benefit, directly or indirectly, if certain potential grantees are selected over others. Reg. §53.4945-4(b)(4).

4.9.3.4.4. Periodic progress reports must be made to the foundation, at least once a year, to determine whether the grantees have performed the activities the grants are intended to finance. Reg. §53.4945-4(c)(3).

4.9.3.4.5. When these reports are not made or there are other indications that the grants are not being used as intended, the foundation must investigate and take corrective action. Reg. §53.4945-4(c)(4).

4.9.3.4.6. The foundation must keep all records relating to all grants to individuals, including-- a) information obtained to evaluate grantees, b) identification of grantees, including any relationship of the grantee to the foundation sufficient to make the grantee a disqualified person, c) amount and purpose of each grant, and d) follow-up information, including required annual reports and investigation of jeopardized grants. Reg. §53.4945-4(c)(6). However, no single procedure or set of procedures is required. Reg. §53.4945-4(c)(1). Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved. *Id.* Requests for approval of grant-making procedures should be sent to the District Director of the IRS office servicing your area. Reg. §53.4945-4(d)(2). If, by the 45th day after a request for approval of grant procedures has been properly submitted, the foundation has not been notified that the procedures are unacceptable, they may be considered approved from the date of submission until receipt of actual notice from the Service that they do not meet the requirements. Payments of remaining installments of fixed-sum grants awarded during the period the foundation's procedures were considered approved, after the foundation is notified that the procedures are unacceptable, are not taxable expenditures. *Id.*

4.9.3.5. Renewals. A renewal of a qualified grant will not be treated as a grant to an individual subject to the requirements of this chapter if:

4.9.3.5.1. The grantor has no information indicating that the original grant is being used for any purpose other than that for which it was made,

4.9.3.5.2. The reports due under the terms of the grant have been provided, and

4.9.3.5.3. Any additional criteria and procedures for renewal are objective and nondiscriminatory. Reg. §53.4945-4(a)(3)(iii).

4.9.3.5.4. Any extension of a period over which a grant is to be paid will not by itself be regarded as a grant or a renewal of a grant.

4.9.4. Grants to Organizations. Grants to organizations (including loans and program-related investments) are taxable expenditures, unless the recipients are public charities described in section 509(a)(1), (2), or (3), or unless the private foundation exercises expenditure responsibility with respect to the grant. Code §4945(d)(4).

Expenditure responsibility means that the foundation exerts all reasonable efforts and establishes adequate procedures: 1) to see that the grant is spent only for the purpose for which it is made, 2) to obtain full and complete reports from the grantee organization on how the funds are spent, and 3) to make full and detailed reports on the expenditures to the IRS. Reg. §53.4945-5(b)(1).

4.9.4.1. Pre-grant inquiry. If expenditure responsibility must be exercised, the foundation should conduct a limited inquiry concerning the potential grantee before the grant is made. Reg. §53.4945-5(b)(2). The inquiry should deal with matters such as the identity, past history and experience, management, activities, and practices of the grantee organization, and should be complete enough to give reasonable assurance that the grantee will use the grant for the purposes for which it is made. *Id.*

4.9.5. Terms of grants. To meet the expenditure responsibility requirements, each grant must be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. Reg. §53.4945-5(b)(3). This commitment must include the following agreements by the grantee: 1) to repay any amount not used for the purposes of the grant, 2) to submit full and complete annual reports to the grantor foundation on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant, 3) to keep records of receipts and expenditures and to make its books and records available to the grantor at reasonable times, and 4) not to use any of the funds to influence legislation, to influence the outcome of elections, to carry on voter registration drives, to make grants to individuals or other organizations, or to undertake any nonexempt activity, when such use of the funds would be a taxable expenditure if made directly by the foundation. *Id.*

4.9.5.1. Terms of program-related investment. To meet the expenditure responsibility requirements in making a program-related investment, a private foundation must require that each investment be made subject to a written commitment signed by an appropriate officer, director, or trustee of the recipient organization. Reg. §53.4945-5(b)(4). The commitment should specify the purpose of the investment and should contain an agreement by the organization: 1) to use all amounts received from the private foundation only for the purposes of the investment and to repay any amount not used for those purposes, provided that, for equity investments, the repayment is within the limitations concerning distributions to holders of equity interests, 2) to submit, at least once a year, a full and complete financial report of the type ordinarily required by commercial Investors under similar circumstances and a statement that it has complied with the terms of the investment, 3) to keep adequate books and records and to make them available to the private foundation at reasonable times, and 4) Not to use any of the funds to carry on propaganda, influence legislation, influence the outcome of any public elections, carry on voter registration drives, or, when the recipient is a private foundation, to make grants that do not comply with the requirements regarding individual grants or expenditure responsibility. Reg. 53.4945-5(b)(4).

4.9.5.2. Reports from grantees. The granting private foundation must require reports on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made. Reg. §53.4945-5(c)(1). The grantee must make an annual accounting of the funds at the end of its accounting period and must make a final report on all expenditures made from the funds in addition to the progress made toward the goals of the grant. *Id.*

4.9.5.3. Reliance on information supplied by grantee. A private foundation, exercising expenditure responsibility with respect to its grants, may rely on adequate records or other sufficient evidence supplied by the grantee organization showing the information that the grantor must submit to the IRS.

4.9.5.4. Recordkeeping requirements. In addition to the information required when filing a return, the granting foundation must make available to the IRS at its main office each of the following items: 1) a copy of the agreement covering each expenditure responsibility grant made during the year, 2) a copy of each report received during the tax year for each grantee on any expenditure responsibility grant, and 3) a copy of each report made by the grantor's personnel or independent auditors of any audits or other investigations made during the tax year on any expenditure responsibility grant. Reg. §53.4945-5(d)(1).

4.9.5.5. Violations of expenditure responsibility requirements. Any diversion of grant funds for a use not specified in the grant may result in that part of the grant being treated as a taxable expenditure. Reg. §53.4945-5-(e)(1). If the use of the funds is consistent with the purpose of the grant, the fact that a grantee does not use any funds as indicated in the original budget projection is not a diversion of funds.

If a grantor foundation determines that any part of the grant has been used for improper purposes and the grantee has not previously diverted grant funds, the foundation will not be treated as having made a taxable expenditure if it: 1) takes all reasonable and appropriate steps either to recover the grant funds or to ensure the restoration of the diverted funds and the dedication of the other grant funds held by the grantee to the purposes of the grant, and 2) withholds any further payments to the grantee, after being made aware that a diversion of funds may have taken place, until it has received the grantee's assurance that future diversions will not occur and required the grantee to take extraordinary precautions to prevent further diversions from occurring. Reg. §53.4945-5(c)(1)(iii).

4.9.5.6. Grantee's failure to make reports. A failure to make the required reports by the grantee will result in the grant being treated as a taxable expenditure by the grantor unless the grantor: 1) awarded the grant according to the expenditure responsibility requirements discussed earlier, 2) complied with all the reporting requirements, 3) made a reasonable effort to get the required reports, and 4) withholds all future payments on this grant and on any other grant to the same grantee until the report is provided. Reg. §53.4945-5(e)(2).

4.9.5.7. Violations by the grantor. In addition to the circumstances discussed earlier concerning taxable expenditures, a granting foundation will be treated as making a taxable expenditure if it: 1) fails to make a pre-grant inquiry, 2) fails to obtain the required written commitments described earlier, or 3) fails to make reports to the IRS as discussed earlier. Reg. §53.4945-5(e)(3).

4.9.5.8. The reports to the Internal Revenue Service by the foundation on each expenditure responsibility grant must be made each year that any part of the grant remains unexpended by the grantee at any time during the year. Reg. §53.4945-5(d)(1). The required reports must be submitted with the organization's annual return (Form 990-PF or Form 5227).

4.10. *Expenditures for Non-Charitable Purpose.*

4.10.1. *Grants to noncharitable organizations*. A private foundation cannot make a grant for a purpose not described in section 170(c)(2)(B). Code §4945(d)(5). Permitted purposes are religious, charitable, scientific, literary or educational purposes, fostering national or international amateur sports competition (but only if no part of the activities involve providing athletic facilities or equipment), and preventing cruelty to children or animals. Code §170(c)(2)(B). Section 501(c)(3) describes organizations that are organized and operated exclusively for these purposes. Grants for nonpermitted purposes are taxable expenditures.

Accordingly, a private foundation may not make a grant to an organization that is not described in section 501(c)(3) unless, making the grant itself is a direct charitable act or a program-related investment, or the grantor is reasonably assured that the grant will be used exclusively for the purposes of an organization described here. Reg. §53.4945-6(c)(1).

4.10.2. *Exceptions*. Examples of expenditures ordinarily not treated as taxable expenditures include: 1) expenditures to acquire investments that generate income to be used to further the purposes of the organization, 2) reasonable expenses related to acquiring these investments, 3) payment of taxes, 4) expenses that qualify as allowable deductions in figuring the tax on unrelated business income, 5) any payment that is a qualifying distribution, 6) any deduction allowed in arriving at taxable net investment income, 7) reasonable expenditures to evaluate, acquire, modify, and dispose of program-related investments, and 8) business expenses of the recipient of a program-related investment.

However, payment of unreasonable administrative expenses, including wages, consultant fees, and other fees for services performed, ordinarily will be taxable expenditures unless made by the foundation in the good faith belief that the amounts were reasonable and were consistent with ordinary business care and prudence.

4.11. ***Unrelated Business Income Tax Code §§ 511 - 514.***

4.11.1. *Definition.* Unrelated business income is the income from a ***trade or business*** that is ***regularly carried on*** by an exempt organization and that is ***not substantially related*** to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.

4.11.1.1. Trade or business. The term "trade or business " generally includes any activity carried on for the production of income from selling goods or performing services. Reg. 1.513-1(b). An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization. *Id.* For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose. *Id.* Similarly, soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose. *Id.*

4.11.1.2. Regularly carried on. Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations. Reg.

§1.513-1(c)(1). For example, a hospital auxiliary's operation of a sandwich stand for 2 weeks at a state fair would not be the regular conduct of a trade or business. The stand would not compete with similar facilities that a nonexempt organization would ordinarily operate year-round. Reg. §1.513-1(c)(2). However, operating a commercial parking lot every Saturday, year-round, would be the regular conduct of a trade or business. *Id.*

4.11.1.3. Not substantially related. A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Reg. §1.513-1(d)(2). Whether an activity contributes importantly depends in each case on the facts involved. *Id.* In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. Reg. §1.513-1(d)(3). For example, to the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. *Id.* The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business. *Id.*

Also in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the following principles apply.

4.11.1.4. Selling of products of exempt functions. Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. Regs. §1.513-1(d)(4)(ii). Thus, for an exempt organization engaged in rehabilitating handicapped persons (its exempt function), selling articles made by these persons as part of their rehabilitation training is not an unrelated trade or business. *Id.* However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it as is, the activity is an unrelated trade or business. *Id.* For example, if an exempt organization maintains an experimental dairy herd for scientific purposes, the sale of milk and cream produced in the ordinary course of operation of the project is not an unrelated trade or business. *Id.* But if the organization uses the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the sale of these products is an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization. *Id.*

4.11.1.5. Dual use of assets or facilities. If an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. REg. §1.513-1(d)(4)(iii). The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes. For example, a museum has a theater auditorium designed for showing educational films in connection with its program of public education in the arts and sciences. *Id.* The theater is a principal feature of the museum and operates continuously while the museum is open to the public. *Id.* If the organization also operates the theater as a motion picture theater for the public when the museum is closed, the activity is an unrelated trade or business. *Id.*

4.11.1.6. Exploitation of exempt functions. Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. Reg. §1.513-1(d)(4)(iv). When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make the commercial activities a related trade or business. *Id.* Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business. *Id.*

4.11.2. *Exceptions.*

4.11.2.1. Volunteers. Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.

4.11.2.2. Sale of Contributed Property. Any trade or business which consists of selling merchandise substantially all of which has been received by the organization as a gift.

4.11.3. *Calculating Unrelated Business Taxable Income.* The term "unrelated business taxable income " generally means the gross income derived from any unrelated trade or business regularly carried on by the exempt organization, less the deductions directly connected with carrying on the trade or business. Code §512(a)(1). If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to all the activities. Regs. §1.512(a)-1(a). In computing unrelated business taxable income, gross income and deductions are subject to modifications and special rules. *Id.* Whether a particular item of income or expense falls within any of these modifications or special rules must be determined by all the facts and circumstances in each specific case.

4.11.4. *Partnership Distributive Share.* An organization may have unrelated business income or loss as a member of a partnership, rather than through direct business dealings with the public. If so, it must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. Reg. §1.512(c)-1. No distinction is made between limited and general partners. Rev. Rul. 79-222. Thus, if an organization is a member of a partnership regularly engaged in a trade or business that is an unrelated trade or business with respect to the organization, the organization must include in its unrelated business taxable income its share of the partnership's gross income from the unrelated trade or business (whether or not distributed), and the deductions attributable to it. Code §512(c). The partnership income and deductions to be included in the organization's unrelated business taxable income are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization.

4.11.4.1. Example. An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its unrelated business taxable income, but may exclude its share of any dividends the partnership received from the corporation.

4.11.5. *Income that is not Unrelated Business Income.*

4.11.5.1. Dividends, interest, annuities and other investment income. All dividends, interest, annuities, payments with respect to securities loans, income from notional principal contracts, and other income from an exempt organization's ordinary and routine investments that the IRS determines are substantially similar to these types of income are excluded in computing unrelated business taxable income. Code §512(b)(1).

4.11.5.2. Royalties. Royalties, including overriding royalties, are excluded in computing unrelated business taxable income. Code §512(b)(2).

4.11.5.3. Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Code §512(b)(3)(A)(i). Rents from personal property are not excluded. Code §512(b)(3)(A)(ii).

4.11.5.4. Gains and losses from disposition of property. Also excluded from unrelated business taxable income are gains or losses from the sale, exchange, or other disposition of property. Code §512(b)(5).

4.11.6. *Debt Financed Property.* Investment income that would otherwise be excluded from an exempt organization's unrelated business taxable income must be included to the extent it is derived from debt-financed property. Code §512(b)(4). The amount of income included is proportionate to the debt on the property. Code §514(a)(1).

4.11.6.1. Debt-Financed Property. In general, the term "debt-financed property " means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). Code §514(b)(1). It includes rental real estate, tangible personal property, and corporate stock.

4.11.6.2. Acquisition Indebtedness. For any debt-financed property, acquisition indebtedness is the unpaid amount of debt incurred by an organization: 1) when acquiring or improving the property, 2) before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, and 3) after acquiring or improving the property if:

4.11.6.2.1. The debt would not have been incurred except for the acquisition or improvement, and

4.11.6.2.2. Incurring the debt was reasonably foreseeable when the property was acquired or improved. Code §514(c)(1).

4.12. *Termination of Private Foundation Status*

4.12.1. *Voluntary termination.* To voluntarily terminate under section 507(a)(1), the organization must send a statement to its District Director of its intent to terminate its status under section 507(a)(1). Code §507(b)(1). The statement must provide, in detail, the computation and amount of tax imposed under section 507(c). Reg. §1.507-1(b)(1). Unless the organization requests abatement, it must pay the tax at the time the statement is filed. *Id.* The organization may request abatement of all the tax imposed under section 507(c), or it may pay part of the tax and request abatement of the unpaid part. *Id.* However, if the organization's request for abatement is denied, the organization must pay the tax in full when notified by the Service that the tax will not be abated. *Id.*

4.12.1.1. Termination of private foundation status under section 507(a)(1) will not relieve the foundation, or any disqualified person, of any liability for excise taxes. Reg. §1.507-1(b)(2).

4.12.1.2. If an organization that has terminated its private foundation status under section 507(a) continues in operation and wishes to be treated as a charitable, educational, religious, scientific, etc., organization, it must apply for appropriate exemption recognition. Reg. §1.507-1(b)(3).

4.12.1.3. Notice to the public. The Internal Revenue Service will publish in the Internal Revenue Bulletin any notice it receives of voluntary termination under section 507(a)(1). Reg. §1.507-1(b)(5).

4.12.1.4. Non-Terminating Distributions. No termination can take place under section 507(a)(1) if the private foundation transfers all or part of its assets to another private foundation or to one or more private foundations and to one or more section 509(a)(1), (2), (3), or (4) organizations, under a liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization. Reg. §1.507-1(b)(6).

4.12.2. *Transferee liability.* A termination under section 507(a) does not result from either a transfer of all its assets or a significant disposition of its assets (defined later) by a private foundation unless it chooses to terminate under section 507(a)(1), or an involuntary termination occurs. Reg. §1.507-1(b)(7). If a private foundation incurs any liability for the excise taxes before or in connection with the transfer, transferee liability may be applied against the transferee organization for payment of those taxes. Reg. §1.507-1(b)(8). Liability for excise taxes is considered to be incurred on the date the act or failure to act occurs that gives rise to the initial tax liability. *Id.*

4.12.3. A private foundation that transfers all of its net assets must file Form 990-PF, Return of Private Foundation. Reg. §1.507-1(b)(9). However, neither a private foundation nor its managers are required to file this form for any tax year after the tax year in which the last transfer occurs if during those later years the foundation has neither legal nor equitable title to any assets nor engages in any activity. *Id.*

4.12.4. *Section 507(c) tax.* The tax imposed under section 507(c) on the termination of a private foundation is the lesser of:

4.12.4.1. The combined tax benefit resulting from the section 501 (c)(3) status of the organization, or

4.12.4.2. The value of the net assets of the organization. Code §507(c).

4.12.5. The **combined tax benefit** resulting from the section 501 (c)(3) status of any private foundation is the sum of: 1) the combined increases in income, estate, and gift taxes that would have been imposed on all ***substantial contributors*** if deductions for all contributions made by those contributors to the foundation had been disallowed, and 2) the combined increases in income tax that would have been imposed on the private foundation's income if a) the foundation had not been tax exempt, and b) in the case of a trust, its charitable deduction had been limited to 20% of its taxable income, and in figuring the combined increases in tax under (1), all deductions for a particular contribution for income, estate, or gift tax purposes must be included. Code §507(d)(1). For example, if a substantial contributor had taken income tax and gift tax deductions for a charitable contribution to the foundation, the amount of each deduction must be included. The combined tax benefit may be more than the fair market value of the property transferred.

4.12.5.1. Substantial Contribution.

4.12.5.2. **The value of the net assets** of the organization is the greater of: 1) the value on the first day action was taken to terminate private foundation status, or 2) the value on the date the organization ceased to be a private foundation. Code §507(e). The valuation date in (1) is the date the organization gave notice it was terminating private foundation status.

4.12.6. *When tax is imposed.* These same dates determine when liability for the section 507(c) tax is imposed because a transfer of assets by a private foundation is involved. Code §507(f).

4.12.7. *Abatement of section 507(c) taxes.* The unpaid part of section 507(c) tax can be abated by the IRS if: 1) the private foundation distributes all of its net assets to one or more charitable organizations described in section 509(a)(1) that have been in existence and so described for at least 60 months, Code §507(g)(1); Reg. §1.507-9(a0(1) or 2) The Service receives effective assurance through corrective action taken in state proceedings that assets dedicated to charitable purposes will, in fact, be used for charitable purposes.

4.12.7.1. Corrective action in state proceedings. The section 507(c) tax may be abated by the IRS if, within a year from the date of issuing a notice of deficiency for that tax, an appropriate state officer certifies that ***corrective action*** has been initiated under state law under court order or approval. Reg. §1.507-9(b)(2). **Corrective action** is the vigorous enforcement of state laws sufficient to assure implementation of the excise tax provisions and to insure that foundation assets are preserved for charitable purposes. Reg. §1.507-9(b)(3).

4.13. ***Involuntary termination***. An organization's status may be involuntarily terminated if the IRS notifies the organization that, because of willful, flagrant, or repeated acts or failures to act giving rise to the Chapter 42 excise taxes, the organization is liable for section 507(c) tax. Code §507(a)(2). Willful repeated acts are at least two acts or failures to act which are voluntarily, consciously, and knowingly committed in violation of the excise tax provisions, and which appear to a reasonable person to be a gross violation of these provisions. Reg. §1.507-1(c). The act or failure to act may result in termination of the foundation's status even though the tax is imposed on the foundation's managers rather than on the foundation itself. Reg. §1.507-1(c)(3). Furthermore, the failure to correct the act or acts (or failure or failures to act) that gave rise to excise tax liability may cause involuntary termination of the private foundation. Reg. §1.507-1(c094). No motive to avoid legal restrictions or incur tax is necessary to make the act or failure to act willful. Reg. §1.507-1(c)(5). However, a foundation's act or failure to act is not willful if the foundation or its manager, if applicable, does not know that the act or failure to act is an act of self dealing, a taxable expenditure, or other act or failure to act giving rise to liability for excise taxes. *Id.* In the case of an involuntary termination, section 507(c) tax is computed in the same manner as for voluntary terminations. Reg. §1.507-7(b)(2). However, in determining the value of net assets of the foundation on the first day action was taken to terminate private foundation status, the valuation date is the date a willful and flagrant act, failure to act, or series of repeated acts or failures to act first occurred. *Id.* Although the section 507(c) tax resulting from an involuntary termination may be abated, this is not true for any excise tax liability attributable to the acts or failures to act that caused the involuntary termination.

FLEXIBLE TRUSTS AND ESTATES FOR UNCERTAIN TIMES

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SECTION I

FLEXIBLE TRUSTS AND ESTATES FOR

UNCERTAIN TIMES

Jerold I. Horn
June 23, 2004

CHAPTER 1

INTRODUCTION

Uncertainty abounds, particularly from the perspective of an owner of property who is addressing the disposition of his or her estate. The uncertainty extends to births and deaths, to marriages, to health, to abilities and personalities, to resources and needs and, not least, to a system of law of which the only constant is unpredictable, and perhaps revolutionary, change. What is the owner to do? Although not a solution, per se, flexibility at least offers the possibility of solutions.

The writer suggests and analyzes provisions and systems that are designed to enhance flexibility, and to define its limits, in the planning of trusts and estates. Although subtly in some cases, all of the book relates to flexibility. Some of the forms (e.g., *Form 3.1* through *Form 3.4*) preclude flexibility and are included solely for purposes of comparison. Some (e.g., *Form 3.6* and *Form 3.7*) are formulae that show that flexibility is important even if no one is to possess any discretion. Others (e.g., *Form 14.6*, *Form 14.15* and *Form 14.16*) are drafted in terms of the outer limits of flexibility and are intended to enhance the ability of a power holder to operate within those limits.

1.01 OBJECTIVES

The primary objectives of planning relate to enjoyment, management, protection against creditors, control, tax efficiency and investment efficiency. The objectives are not necessarily consistent. Accomplishment of one or more of them might necessitate the sacrifice of one or more others, in whole or in part. Tensions particularly exist between control and enjoyment, between control and protection against creditors and between control and tax efficiency. The property owner must select the desired balance.

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1.01(a) Enjoyment

Provide such (and only such) enjoyment as the property owner desires, often, as a practical matter, such enjoyment as a beneficiary desires.

1.01(b) Management

Provide management for any beneficiary who needs or wants it.

1.01(c) Protection Against Creditors

Avoid claims of creditors, spouses and former spouses.

1.01(d) Tax Efficiency

Prevent attribution of property, for transfer tax purposes, to any person except to any extent that the person becomes entitled to receive the property or becomes entitled as a beneficiary to exercise a general power to appoint the property or wants the attribution in order to avoid another, more onerous tax.

Prevent attribution of property, for income tax purposes, to any person except to any extent that the person becomes entitled to receive the income or the person wants the attribution in order to avoid recognition or to deflect tax liability from another person.

1.01(e) Control

Maximize control, consistently with the tax objectives, if

(1) one or more beneficially interested persons, solely by themselves, are to possess any nonfiduciary powers and

(2) (a) one or more independent trustees, solely by themselves, are to possess any fiduciary powers (see the illustrations at 1.02, Column A) or

(b) one or more beneficially interested persons, solely by themselves, are to possess any fiduciary powers (see the illustrations at 1.02, Column B) or

(c) one or more independent trustees, solely by themselves, are to possess any fiduciary powers that beneficially interested persons cannot possess consistently with accomplishment of the tax objectives, and either

(i) one or more independent trustees and one or more beneficially interested persons are to share any fiduciary powers that beneficially interested persons can possess consistently with accomplishment of the tax objectives or

(ii) one or more beneficially interested persons, solely by themselves, are to possess any fiduciary powers that beneficially interested persons can possess consistently with accomplishment of the tax objectives

(see the illustrations at 1.02, Column C).

1.01(f) Investment Strategy

Accommodate optimal investment strategy.

1.01(f)(1) Challenge to Principal-Income Model

Classic applications of the principal-income model include the following:

	Capital		Inurement
(i)	Land	-	crop,
(ii)	Tree	-	fruit,
(iii)	House	-	use,
(iv)	Bond	-	interest and
(v)	Stock	-	dividend.

The purpose and operation of the principal-income model are subject to challenge. According to the challenge, the results of the principal-income model often deviate from the objectives of property owners concerning (i) consumption, (ii) conservation and (iii) total-return concepts of modern- portfolio theory.

1.01(f)(2) Trust Models

Models A, B and C, below, illustrate choices. An ability to enjoy the tax results of B (or, better, the tax and nontax results of C) rather than those of A depends upon the design of the trust. The hypothesis is that the planner should design the trust so that the dispositive provisions will provide for the desired beneficial enjoyment and permit the designed management and control without precluding the optimal method of investment.

	Model A Pay-All-Income Trust	Model B Preferred-Tax-Result Trust	Model C Total-Return Trust
Principal	100,000*	100,000**	100,000***
Interest & Dividends	5,000	0	1,000
Appreciation	0	5,000	5,000
Tax Rate	40%†	20%†	23+%†

* Invested to generate trust-accounting income according to the principal-income model.

** Invested to generate capital appreciation.

*** Invested to optimize total return.

† Ignoring possibly temporary reductions.

1.02 ILLUSTRATIONS OF DRAFTING TO APPROACH BENEFITS (BUT NOT BURDENS) OF OUTRIGHT OWNERSHIP

A	B	C
Holder of fiduciary powers is independent trustee	Holder of fiduciary powers is beneficially interested trustee	Holder of fiduciary powers is beneficially interested trustee and independent trustee
1.a. Mandatory distribution of all income to one person (*Form 3.2*) OR Income per discretion of independent trustee, to one person or spray (*Form 3.8 and Form 3.9*)	1.a. Mandatory distribution of all income to one person (*Form 3.2*) OR Income per ascertainable standard, to one person, no spray (*Form 3.14*)	1.a. Mandatory distribution of all income to one person (*Form 3.2*) OR Combination of income per discretion of independent trustee, to one person, no spray (*Form 3.8*), and income per ascertainable standard, to one person, no spray (*Form 3.13*)
b. Principal per discretion of independent trustee, to one person or spray (*Form 3.8 and Form 3.9*)	b. Principal per ascertainable standard, to one person, no spray (*Form 3.14*)	b. Combination of A.1.b. (with one distributee) and B.1.b. (*Form 3.17*)
c. Nonfiduciary 5 + 5 power (*Form 3.21*)	c. Same as A.1.c.	c. Same as A.1.c.
OR	OR	OR
2.a. Nonfiduciary power to withdraw unitrust percentage (*Form 3.31*) OR Mandatory distribution of unitrust amount to one person (*Form 3.29*)	2.a. Same as A.2.a.	2.a. Same as A.2.a.
b. Additional payments to unitrust recipient per discretion of independent trustee (*Form 3.8*)	b. Additional payments to unitrust recipient per ascertainable standard (*Form 3.13*)	b. Combination of A.2.b. and B.2.b. (*Form 3.17*)
AND	AND	AND
3. Nonfiduciary, inter vivos, nongeneral power of appointment (*Form 3.32*)	3. Same as A.3.	3. Same as A.3.
AND	AND	AND
4. Nonfiduciary, testamentary, nongeneral power of appointment (*Form 3.37*)	4. Same as A.4.	4. Same as A.4.
	AND	AND
	5. "Back-up" systems:	5. "Back-up" systems:
	a. Diversion from sensitive trustee (*Form 14.15* and *Form 14.16*)	a. Same as B.5.a.
	b. Addition of independent trustee (*Form 14.10*)	b. Same as B.5.b.

CHAPTER 2

THE CHIEF UNCERTAINTY

2.01 OVERVIEW OF RULES

Before the end of 2009, in phases, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") reduces transfer tax rates and increases the estate tax and generation-skipping tax exemptions. The repeal of the estate tax and generation-skipping tax is scheduled to occur at the beginning of 2010. The restoration of these taxes is scheduled to occur at the beginning of 2011, "as if [, according to the sunset provision,] the provisions and amendments [of EGTRRA] had never been enacted."

A regime of carryover basis, modified to include limited amounts of bases increases for certain assets transferred at death, is scheduled to coincide with the repeal of the estate tax and generation-skipping tax. According to Internal Revenue Code ("Code") Section 1022(b), bases increases of at least $1,300,000 are available to the extent that appreciated property passes from a decedent, regardless of the format of the estate plan. According to Code Section 1022(c), bases increases of at least an additional $3,000,000 are available to the extent that appreciated property passes from a decedent to or in a QTIP-style trust for the surviving spouse of the decedent.

2.02 METHOD OF ANALYSIS

Classification of the changes based upon three periods of time might facilitate planning. The first is the period during which estate tax and generation-skipping tax exemptions will increase and transfer tax rates will decline. Generally, subject to increased vigilance to prevent inadvertent shifting of beneficial enjoyment, the planning strategies that appear appropriate during the first period are those which were appropriate before EGTRRA.

The second is the period during which the estate tax and the generation-skipping tax will not be in effect, a modified system of carryover basis will be in effect and limited amounts of bases improvements will be available for certain assets transferred at death. A principal purpose of planning for the second period is to tend to maximize both (i) bases increases and (ii) sheltering of assets transferred at death.

The third is the period of sunset or restoration during which the regimes of the estate tax, the generation-skipping tax and new bases at death will reappear. Planning strategies that were appropriate for the first period will tend to be appropriate also for the third period. However, a principal purpose of planning during the first and second periods will be to produce optimal results during the third period as well.

2.03 MEANING OF SUNSET

Although the prospect of sunset looms heavily upon planning, the sunset provision is egregiously unclear in its application to the transfer taxes. Determination of the meaning of sunset is essential to determination of the limits of planning.

2.03(a) Effect Upon Exempt Property

Literally, but nevertheless incredibly, the sunset provision could undo some or all of the exemptions that, immediately before the restoration of the estate tax and the generation-skipping tax, shelter assets from the estate tax, and from the generation-skipping tax, in by-pass-type trusts. Focus, for example, upon property that passed free of tax to an exemption-shelter trust because of an increase in exemption which occurred after the enactment of EGTRRA, that reposes in the trust upon restoration of the estate tax before the death of a surviving spouse and that would have passed, outright or in a QTIP trust, to or for the surviving spouse if the exemption had not existed. Literally, the sunset provision could subject this property to estate tax upon the death of the surviving spouse. Similarly, focus upon property that, at the time of restoration before the occurrence of a generation-skipping transfer, reposes in a by-pass-type trust which has an inclusion ratio of zero because of an increase in GST exemption that occurred after the enactment of EGTRRA. Literally, the sunset provision could subject this property to generation-skipping tax. Nevertheless, notwithstanding the expansive language of the sunset provision, assets that are sheltered, in whole or (in some QTIPs and some generation-skipping trusts) in part, by exemptions that apply before the sunset probably will remain sheltered, to the same extent, after the sunset.

2.03(b) Effect Upon Nonexempt Property

How will the sunset provision apply to the *non*exempt portion of "mid-stream" situations? Specifically, how will the sunset provision apply, upon the death of the surviving spouse, to the portion of a QTIP trust with respect to which a QTIP election was made, in whole or in part, upon the death of the predeceasing spouse? The surviving spouse will not own QTIP assets or, in the case of a QTIP that only can qualify for the marital deduction according to Code Section 2056(b)(7), possess a general power to appoint them. Thus, unless the sunset provision will treat a QTIP election, previously made, as ownership for purposes of the restored tax, the surviving spouse will have no nexus that will include the property in the gross estate of the surviving spouse or otherwise subject the property to the restored tax. Similarly, how will the sunset provision apply, upon the occurrence of a generation-skipping transfer, to a generation-skipping trust that, before the repeal of the generation-skipping tax, had an inclusion ratio of more than zero?

The likely answer is that the sunset will reach the nonexempt portions of these arrangements. However, if the restoration of the taxes were to result from a repeal of the sunset provision followed by a reenactment of the repealed taxes, rather than from the sunset provision, per se, the restoration could grandfather situations that were in midstream at the time of the reenactment, and not subject them to the restored taxes.

2.03(c) Is Property Transferred During Repeal "Exempt" or "NonExempt"?

A restoration of the taxes by means of a sunset of repeal probably will not apply to assets that an owner transferred and attempted to shelter, by means of by-pass-type trusts, during repeal before the sunset. These assets should have the same status as assets that are sheltered because of exemptions.

According to EGTRRA, the exemptions increase greatly, in stages, until upon repeal they effectively become unlimited. Literal statement of this result in terms of unlimited exemptions would have required indefinite retention of the structures of the effectively repealed taxes. Any argument that sheltering which is based upon repeal of the estate tax and the generation-skipping tax is different, somehow, from sheltering which is based upon exemptions would seem to rely upon a distinction without a difference. Arguably, the distinction would violate requirements of substantive due process of law.

2.03(d) Continuation of By-Pass-Trust Sheltering Until, and Even After, Repeal

The *tax* advisability of using by-pass-type trusts to shelter exempt transfers of a property owner from estate tax and generation-skipping tax is a function of the extent to which the addition of the transfers to the property of a beneficiary would cause the transfers of the beneficiary to exceed the exemptions of the beneficiary.

2.03(d)(1) Risk of Restoration of Taxes

The statutory environment is unsettled and unstable. A not-unlikely scenario is that periodically Congress might defer the sunset, by means of a series of extensions of repeal and, with or without any deferral, Congress might modify the sunset to include "permanent" reductions in rates and permanent increases in exemptions.

The unstable environment poses at least a tax risk, and possibly a tax catastrophe, to those who fail to shelter exemptions (including those of a possibly temporary repeal that might exist for one or more years) by means of by-pass-type trusts to such extent (if any) as is necessary to immunize the assets from estate tax, gift tax and generation-skipping tax. The stakes are high, as tax rates will remain high even as exemptions increase greatly. If, as the writer argues below, the costs of a shelter trust are relatively small compared to the tax savings that a shelter trust might generate, an owner of wealth that according to any reasonably likely scenario can generate liability for transfer tax should consider indulging the conservative assumption that the addition of any of the estate of the owner to the estate of a descendant might generate transfer tax at the level of the generation of the descendant.

2.03(d)(2) Risk of Retention in Trust

The property owner must weigh the tax and nontax benefits of by-pass-type trusts against the tax and nontax disadvantages. The thesis of the writer is that the advantages are relatively large and the disadvantages are relatively small.

The typical client for whom the writer drafts multigenerational trusts is an individual who, but for his or her dialogue with the writer, probably would choose not to use shelter-type trusts. Rather, the client probably would choose at the death of the survivor of the client and the client's spouse to leave his or her estate outright to his or her surviving descendants, per stirpes, subject to provision of management until one or more stated ages at which the primary beneficiary is able to manage for himself or herself.

Most of the by-pass-type trusts that the writer creates are intended to confer upon the primary beneficiary powers and interests that are as close to outright ownership as possible without attracting tax burdens of ownership. The trust is designed, to the extent possible, to permit the primary beneficiary to manage, use, consume and control the property similarly to how the primary beneficiary could manage, use, consume and control the property if the primary beneficiary were to own the property outright, without owning for tax purposes any of the property that the primary beneficiary does not consume. Often, the client does not care whether anything remains for subsequent generations but only cares that what (if anything) does remain should pass free of transfer tax. The configuration that the writer has described is quite different from a configuration which mandates payment of all income, or a unitrust amount, and which is calculated to provide only such benefits as can permit the trust to provide the same benefits for each generation, sequentially, in perpetuity.

The writer often uses the following features to accomplish the purpose:

(i) the ability of the primary beneficiary to serve as the trustee,

(ii) a Give-Me-Five, withdrawable-percentage unitrust (i.e., a right-to-withdraw unitrust percentage of five percent keyed to Code Section 2041(b)(2)),

(iii) ascertainable-standard-limited powers of the primary beneficiary to pay the trust estate to himself or herself,

(iv) a broadest form of nongeneral power of the primary beneficiary to appoint during life,

(v) a broadest form of nongeneral power of the primary beneficiary to appoint at death and

(vi) an ability to add an independent trustee that, if added, can distribute any or all of the trust estate to the primary beneficiary for any purpose (even to the extent of terminating the trust).

The purpose that the writer has posed enables the writer to avoid agonizing about the propriety of the unitrust percentage, i.e., five percent, being greater than the after-inflation productivity of a balanced portfolio. It also enables the writer to avoid worrying about whether the production and payment of a stream of distributions will tend to erode the value of the trust estate.

The view of the writer about the "real" purpose of many clients has implications not only for trusts of which the primary beneficiary can serve as trustee solely by himself or herself. It also has implications for many wide-open, discretionary arrangements that permit distributions to more than one person at a time.

2.03(d)(3) The View of the Writer

The experience of the writer is that most clients and advisers wrongly believe that by-pass-type trusts inherently constrain the primary objects of bounty from controlling the management and enjoyment of the property, and from enjoying the property, similarly, as a practical matter, to how the primary objects could control the management and enjoyment, and could enjoy the property, if the primary objects were to own the property outright. Indeed, the writer would argue that, as a practical matter, the only inherent differences, if any, between outright ownership and ownership in a flexible, by-pass-type trust are complexity and an increase in involvement with lawyers and accountants.

The writer believes that a properly-conceived, by-pass type of trust is a modest price to pay for tax savings, actual or potential. At least when the shelter of a by-pass-type trust is reasonably likely to reduce tax, the writer presently intends to use extremely flexible, by-pass-type trusts (or, by means of disclaimer procedures, by-pass-type trusts that are as flexible as possible) to shelter exempt amounts including amounts that effectively are exempt because of repeal.

2.03(d)(4) Drafting for Shelter

Tend to provide that if the United States estate tax is not in effect at the death of a settlor, all of the trust estate shall pass to exemption-shelter trusts or other exemption-shelter dispositions (e.g., gifts directly to children or grandchildren). However, avoid inadvertently diverting beneficial enjoyment from the surviving spouse. The diversion is particularly likely when the settlor is married to a second spouse, has children by a first marriage and wants to benefit the children at his or her death regardless of whether the spouse survives. The diversion also is particularly likely when the settlor wants to leave a significant amount to or for descendants upon his or her death even if his or her first, and only, spouse survives.

Tend to provide that if the United States generation-skipping tax is not in effect at the death of a settlor, all of the trust estates of shelter trusts shall pass eventually to one or more exempt-style, generation-skipping trusts for descendants. A subtle application of this principle involves property in a QTIP trust with respect to which the executor of the predeceasing spouse made a QTIP election, but not a reverse-QTIP election, and which, but for the nonexistence of the estate tax at the death of the surviving spouse, would be included in the gross estate of the surviving spouse. Except for the repeal of the estate tax and the generation-skipping tax, the surviving spouse would own this property, in both an estate tax sense and a generation-skipping tax sense, at death. Accordingly, if the surviving spouse were to die during repeal, repeal effectively should exempt the property by creating an exemption that effectively is unlimited.

This result would require the tax-writing bodies of Congress to perceive something that is relatively subtle, i.e., that repeal effectively should exempt not only property that a taxpayer actually owns and property that a taxpayer has a general power to appoint but also property that, but for the repeal of the estate tax, Code Section 2044 would *deem* the taxpayer to own. Consider making available a procedure that can permit the surviving spouse *actually* to own the assets at his or her death. One alternative is to permit an independent trustee to distribute the assets from the QTIP trust to the surviving spouse before the death of the surviving spouse. Another alternative is mandatorily to divide the marital trust into a reverse-QTIP portion and an excess portion and to give the surviving spouse, if he or she survives by fifteen months (i.e., the time at which, as a practical matter, a decision about a QTIP election is necessary), a power to withdraw all of the trust estate of the excess marital trust.

Tend to provide that if the United States generation-skipping tax is not in effect at the death of the settlor, all of the trust estate which upon the death of the settlor is to benefit descendants shall pass to one or more exempt-style, generation-skipping trusts for descendants.

Tend to provide that if the United States generation-skipping tax is in effect at the death of a settlor but is not in effect at the death of the surviving spouse, all of the trust estate of any marital trust which qualified for the marital deduction upon the death of the settlor and was not the subject of a reverse-QTIP election according to Code Section 2652(a)(3) and which upon the death of the surviving spouse is to benefit descendants shall pass to one or more exempt-style, generation-skipping trusts for descendants.

2.03(d)(5) Hedging Against Restoration of Taxes After Repeal of Sunset

If the taxpayer believes that restoration of the estate tax and the generation-skipping tax will result from reenactment of the taxes after a repeal of the sunset provision, rather than result from a sunset of the repeal of the taxes, consider allocating all assets, exempt and nonexempt, to by-pass-type trusts (i.e., QTIP trusts with no rights to withdraw, in the case of marital-deduction transfers, and GST-exempt-style trusts, in the case of dispositions for descendants).

2.03(d)(6) Implications for Pecuniary Gifts and Fractional Shares

Consider (i) reducing the use of exemption-lead arrangements that are expressed as true pecuniary gifts and (ii) increasing the use of exemption arrangements that are expressed as fractional shares. Phased increases in exemptions, resulting ultimately in repeal and, therefore, in effective exemptions of one hundred percent, will tend to cause pecuniary gifts of exempt amounts to force recognition of gain upon funding. A marital disposition that is expressed as a pecuniary amount which is satisfiable in kind at values at dates of distribution will tend to force recognition of gain if the marital disposition is large relative to the exemption disposition. The first-scheduled increases in exemptions might not change a marital disposition from being a larger disposition, to being a smaller disposition, relative to the exemption disposition. Accordingly, if a pecuniary marital was inappropriate before EGTRRA, it will tend to remain inappropriate after EGTRRA.

CHAPTER 3

THE BUILDING BLOCKS FOR PAYMENTS TO BENEFICIARIES

SUBCHAPTER A:
PRIMARY BENEFICIARIES

3A.01 MANDATORY PAYMENTS

Examples of mandatory accumulation and distribution are included for purposes of orientation and comparison.

* * *

3A.01(b)(1) Examples

Form 3.2: Single Distributee

(1) Income. The Trustee shall pay the net income to my wife quarter-annually.

* * *

3A.01(b)(2) Taxation of Ordinary Income

Subject to the Treasury regulations that became effective on January 2, 2004, with the effect of changing some principal to income (and some income to principal) according to Code Section 643(b), all of the ordinary income of the trust, to the extent of distributable net income, is includable in the gross income for income tax purposes of the (a) distributee or (b) distributees proportionately. Code §§651 and 652.

3A.01(b)(3) Taxation of Corpus Income

Generally, subject to the Treasury regulations that became effective on January 2, 2004, with the effect of changing some principal to income (and some income to principal) according to Code Section 643(b), none of the corpus income of the trust is deductible from the gross income of the trust for income tax purposes. Code §§641, 643(a)(3), 651, 652, 661 and 662.

* * *

3A.02 DISCRETIONARY DISTRIBUTIONS:
INDEPENDENT TRUSTEE POSSESSES DISCRETION

3A.02(a) Examples

Form 3.8: Single Distributee

a [(2) Principal]

b [(B) Additional Distributions]. **The Trustee shall pay to my wife so much or all, if any, of the**

a [principal]

b [trust estate]

as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

Form 3.9: Plural Distributees

a [(2) Principal]

b [(B) Additional Distributions]. **The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the**

a [principal]

b [trust estate]

as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3A.02(b) Taxation of Ordinary Income

A permissible distributee includes in his or her gross income for income tax purposes only such ordinary income of the trust as he or she receives. Code §§661 and 662. The balance of the ordinary income is not deductible from the gross income of the trust. Code §§661 and 662.

3A.02(c) Taxation of Corpus Income

Generally, subject to the Treasury regulations that became effective on January 2, 2004, with the effect of changing some principal to income (and some income to principal) according to Code Section 643(b), none of the corpus income of the trust is deductible from the gross income of the trust for income tax purposes. Code §§641, 643(a)(3), 661 and 662.

3A.02(d) Drafting

According to the forms, the discretion of the trustee is unlimited. The trust does not contain any standard, ascertainable or otherwise. The trust does not contain any specification of purpose.

Any limiting standard or specification of purpose tends to impede flexibility. The trustee can make such distributions as it believes the grantor, if serving as trustee, would make, including distribution of the entire trust estate and termination of the trust. The trustee can include (or not include) the trust estate in the gross estates of one or more beneficiaries, to such extent as the trustee believes advisable, taking into account (i) the portion of the trust that is exempt from generation-skipping tax and (ii) the transfer tax bases of the permissible distributees. The trustee might avoid multiple incidence of the generation-skipping tax by means of taxable distributions before the occurrence of a taxable termination.

Form 3.10: Optional Limitation: Statement of Purpose Concerning Discretion

(D) Purpose.

a [Upon my death or upon the death of my wife if my wife survives me, if use of the trusts provided in this Section did not permit tax savings, I would have directed the Trustee (i) to allocate the trust estate on a per stirpital basis with respect to my descendants then living, treating all prior distributions as advancements without interest, (ii) upon the death of any descendant with respect to whom a share is allocated, subject to the descendant's exercise of any power of appointment granted to the descendant in this instrument, to reallocate the descendant's share with respect to the descendant's then living descendants, per stirpes, or, if no descendant of the descendant then is living, with respect to the then living descendants, per stirpes, of the descendant's nearest ancestor who is a descendant of mine and who then is living or of whom one or more descendants then are living or, if no descendant of the ancestor then is living, with respect to the ancestor or, if no ancestor of the descendant is a descendant of mine who then is living or of whom one or more descendants then are living, with respect to my descendants then living, per stirpes, treating all prior distributions as advancements without interest, (iii) from and after the time a child of mine attains twenty-five years of age, to distribute to the child so much or all, if any, of the trust estate of the share allocated with respect to the child, not before the child attains thirty years of age to exceed in value one-third, and not before the child attains thirty-five years of age to exceed in value two-thirds, of the value of the trust estate at the time as of which the right commences, as the child directs in writing at any time and from time to time, (iv) when any other descendant with respect to whom a share is allocated attains twenty-one years of age, to distribute the share to the descendant and (v) subject to the foregoing, to distribute to the descendant with respect to whom the share is allocated so much or all, if any, of the share as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.]

My purpose is not to withhold beneficial enjoyment or to preserve the trust estate or to favor any remainder person. Rather, my primary purpose is to provide a vehicle that can permit

b [(i) management during the times described in clauses (iii) and (iv) of the first sentence of this paragraph and (ii)]

such retention in trust as will not deprive any descendant with respect to whom the trust estate of the Family Trust would be allocated if at the particular time it were allocated to my descendants then living, per stirpes, of any beneficial enjoyment that the descendant desires and that only an outright distribution can provide. I do not limit the discretion granted the Trustee in prior provisions of this Section, but I request the Trustee to distribute the trust estate outright to such extent and to such person or persons as the Independent Trustee in its sole and absolute discretion determines that, based on the foregoing, I if then serving as the Independent Trustee would direct the distribution of the trust estate, even to the extent of distributing all of the trust estate.

Form 3.11: Optional Limitation: Precatory Preference for Specified Person(s)

Each trust is primarily for the benefit of the descendant with respect to whom the trust is created, and I would approve (but do not direct) the exercise of each power (determined as if this sentence did not exist) to the maximum extent in favor of the descendant.

* * *

3A.02(e) Special Drafting for Avoidance of Claims of Creditors

Transfers by others for the benefit of a debtor have the advantage (compared to interests that the debtor retains in property that the debtor transfers) of being structurable so that the creditors of the debtor cannot reach the interests of the debtor. See Restatement (Third) of Trusts §§57-60. See 3A.04(d) and *Form 3.20* for a special application of this planning.

3A.02(f) Special Drafting for Disabled Beneficiaries

Although the law is state-specific, the writer believes that a discretionary trust as a receptacle for transfers by others for the benefit of a disabled person generally offers the greatest flexibility and protection against creditors. Cf. 760 ILCS 5/15.1, Department of Mental Health and Developmental Disabilities v. Phillips, 114 Ill. 2d 85 (1986), 500 N.E. 2d 29, 102 Ill. Dec. 407, and Department of Mental Health and Developmental Disabilities v. First National Bank, 60 Ill. Dec. 187 (1st Dist. 5th Div. 1982), 432 N.E. 2d 1086. See 3A.04(d) and *Form 3.19* for a special application of this planning.

The preferable format is for the disabled person to be only one of two or more permissible distributees. The possibility of plural distributees tends both to enhance protection against creditors and also to address the issue that often the amount of trust estate which is appropriate for a disabled person is inherently uncertain.

3A.02(g) Marital-Deduction Planning When Spouse is Disabled or Insolvent

Marital-deduction planning for the benefit of a spouse with respect to whom asset-protection or disability planning is appropriate presents mostly a dilemma, i.e., forgo the deduction or create vulnerability. Nevertheless, some alternatives appear better than others. Consider using QTIP or an "estate" trust as the vehicle for any marital-deduction transfer for the insolvent or disabled spouse. QTIP offers the advantage of allowing the grantor permanently to shield the principal (but not the income) from the creditors of the insolvent spouse and to control the ultimate disposition. An estate trust offers the advantage of not requiring current payment of income. However, if the surviving spouse cannot make a will, an estate trust will cause the property to pass by intestacy.

3A.02(h) Use of Discretionary Trusts to Avoid Gift Tax

Although EGTRRA increases the exemption from the gift tax to $1,000,000 and reduces the rates of the gift tax to the nominal levels of the rates of the estate tax, EGTRRA does not provide for repeal of the gift tax. Nevertheless, from and after his or her death during repeal of the estate tax and the generation-skipping tax, a property owner can avoid all of the transfer taxes, including the gift tax. The decedent can use for this purpose a by-pass-type trust which grants an independent trustee unlimited discretion to make distributions not only to a primary beneficiary but also to the descendants of the primary beneficiary. This technique also, of course, is available before repeal but, however, at the cost of at least one transfer tax.

3A.03 DISCRETIONARY DISTRIBUTIONS: NONINDEPENDENT TRUSTEE POSSESSES DISCRETION

3A.03(a) Examples

Form 3.13: Single Distributee

a [(2) Principal]
b [(B) Additional Distributions]. The Trustee shall pay to my wife so much or all, if any, of the
a [principal]
b [trust estate]
as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed.

Form 3.14: Plural Distributees

a [(2) Principal]
b [(B) Additional Distributions]. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the
a [principal]
b [trust estate]
as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed.

3A.03(b) Tax Problems

Generally, a person is deemed, for income tax purposes and transfer tax purposes, to own all property that he or she can pay to himself or herself, even if the power holder does not exercise the power. Code §§678(a)(1), 2041(a)(2) and 2514(b).

Further, even a nongeneral power of appointment can cause the power holder to make a taxable gift. If the exercise of a nongeneral power has the effect of transferring the beneficial interest of the power holder, the *exercise* might produce a taxable transfer of any enjoyment that the power holder forgoes. Rev. Rul. 79-327, 1979-2 C.B. 342, Regester v. Commissioner, 83 T.C. 1 (1984). Contra James C. Self, Jr. v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), 56-2 USTC ¶11,613. Cf. Treas. Reg. §25.2511-1(g)(2).

A person who can pay property to another, in discharge of his or her legal obligation, is regarded to that extent as being able to pay the property to himself or herself and thus as having a general power of appointment.

3A.03(c) Solutions

3A.03(c)(1) Preventing (i) Ownership (for Tax Purposes) Because of Powers To Pay to Self and (ii) Gifts Because of Powers To Pay to Others: Ascertainable Standards

Use of an ascertainable standard to limit the power of the power holder is a potential solution to the first and second problems. If the ascertainable standard is described in Code Sections 2041(b)(1)(A) and 2514(c)(1), the power of the power holder to pay to himself or herself is not a general power of appointment. Also, the power holder arguably will not be treated as owning the subject income for income tax purposes.

A judicial gloss supplies the standard for purposes of Code Section 678(a)(1). See Casner, 3A ESTATE PLANNING §12.9.2 (Little, Brown, Fifth Edition, 1986), Agnes R. May, 8 T.C. 860 (1947), Ruth W. Oppenheimer, 16 T.C. 515 (1951), Townsend v. Commissioner, 5 T.C. 1380 (1945), United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960), 60-1 USTC ¶9430 (involving a legal life estate but decided under Code §678(a)(1) and involving a loosely-written standard including even the "comfort" of the life tenant), United States v. Smither, 205 F.2d 518 (5th Cir. 1953), 53-2 USTC ¶9482 (also involving a standard including the "comfort" of the beneficiaries), and Funk v. Commissioner, 195 F.2d 127 (3d Cir. 1950), 50-2 USTC ¶9507 (involving payment for the "needs" of the beneficiaries. "Thus, its use [i.e., the use of the word 'needs'] confined the trustee to limits objectively determinable, and any conduct on [the trustee's] part beyond those limits would be unreasonable and a breach of trust. . . ." 50-2 USTC ¶9507). But see Falk v. Commissioner, 189 F.2d 806 (3d Cir. 1951), 51-1 USTC ¶9337 cert. denied, 342 U.S. 861, 72 S. Ct. 89. Cf. Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945), 45-1 USTC ¶9134, cert. denied, 324 U.S. 871, 65 S. Ct. 1017.

If the power is a fiduciary power of a trustee and is limited by an ascertainable standard described in Treasury regulations section 25.2511-1(g)(2), the exercise of the power to pay to other than the power holder property in which the power holder has a beneficial interest but no general power of appointment is not a taxable gift. This ascertainable standard relates to one or more persons *other than the power holder.* According to Treasury regulations section 25.2511-1(g)(2),

> If a *trustee* has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a *fiduciary* power the *exercise or nonexercise* of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument . . . [emphasis added].

Although some of the important drafting issues relate to the amount of *discretion* that is consistent with the exception, others relate to the *advisability*, for nontax reasons, of using ascertainable standards in particular configurations.

First, the standard in the forms requires the trustee to consider the resources otherwise available to the distributee. *Required consideration* of other resources tends to limit the ability of the power holder to distribute trust property. It tends to require the distributee to exhaust other resources, including any source of support, from other than the trust. Therefore, it also tends to cause any distribution that *is* made from the trust not to discharge an obligation of another person to the distributee.

Conversely, *required non*consideration of other resources tends to limit the ability of the power holder *not* to distribute trust property. The concerns that this formulation presents are whether it limits sufficiently the access of the power holder to the property and whether a payment can discharge a legal obligation of someone who is not named as a beneficiary.

The power holder has the greatest discretion if he or she *may, but need not, consider* the resources otherwise available to the distributee. This formulation broadens the realm within which the power holder may, but need not, distribute the property. The additional concern that it presents is whether it complies with those Treasury regulations sections (i.e., 20.2041-1(c)(2) and 25.2511-1(g)(2)) that require the standard to limit both the exercise and the nonexercise of the power.

Consideration of the other resources of the distributee should be optional for at least some tax purposes. Whether the power holder must take into account the other "income" of the distributee is "immaterial" for purposes of determining whether the ascertainable standard exception of Code Sections 2041(b)(1)(A) and 2514(c)(1) is applicable. Treas. Reg. §20.2041-1(c)(2). However, the regulation is unclear whether "income" is used advisedly or whether it crudely refers to "resources" generally.

The formulation regarding consideration of other resources seems material, in any event, for purposes of Code Section 678(a)(1). Arguably, the effectiveness of a standard to prevent attribution according to Code Section 678(a)(1) requires that the standard prevent the power holder from having the absolute ability to pay and not to pay. Therefore, "considering or not considering" might dissipate any protection that a formulation of "considering" might afford.

This writer recommends the conservative approach. *Do* require the power holder to take into account resources that otherwise are available to the distributee.

Second, the mandatory "shall" (rather than the permissive "may") requires the trustee to exercise the power if the ascertainable event occurs. The issue is whether an ascertainable standard is sufficient if it limits the *extent* to which the power is *exercisable* but does not control whether and when the power holder must exercise the power. See generally Estate of Carpenter v. United States, 80-1 USTC ¶13,339 at 84,323 (W.D. Wis. 1980). Is the standard sufficient if it places a "ceiling" upon the exercise of the power but does not place a "floor" under it?

The answer might depend upon the nature of the power and upon the particular tax risk that it presents. Certain sections of the Internal Revenue Code appear to describe the amount of power that a person can possess to benefit himself or herself without owning the property for estate, gift or income tax purposes. They suggest that the standard need limit only the extent to which the power is exercisable. See Code §§ 2041(b)(1)(A), 2514(c)(1) and 678(a)(1). Cf. Treas. Reg. §20.2041-1(c)(2). Other statutory and regulatory provisions seem concerned with control or discretion, per se. They suggest that the standard must limit *both* the exercise, *and* the nonexercise, of the power. See Code §§674(b)(5)(A) and 674(d), Treas. Reg. §§25.2511-1(g)(2) and 20.2041-1(c)(2), Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), 47-1 USTC ¶10,551, Estate of Budlong, 7 T.C. 756 (1946), and Estate of Carpenter v. United States, 80-1 USTC ¶13,339 (W.D. Wis. 1980).

Again, this writer recommends the conservative approach. Draft the standard explicitly to limit *both* (i) the right *to exercise* the power *and* (ii) the right *not to exercise* it. According to this approach, the right not to exercise the power is discretionary only to a limited extent and a person who the power can benefit can force its exercise. Cf. Security - Peoples Trust Co. v. United States, 238 F.Supp. 40 (W.D.Pa. 1965), 65-1 USTC ¶12,294. Further, this approach might serve the collateral function of assuring the creator of the trust and the beneficiaries that the trust will discharge desired purposes.

Third, an ascertainable standard does not exist according to Treasury regulations section 25.2511-1(g)(2) if the determination of the trustee regarding exercise or nonexercise is "conclusive."

Fourth, if a power is exercisable in favor of more than one person, an ascertainable standard can make the power unwieldy. A mandate to use the power might force the power holder unsatisfactorily to reconcile the competing interests of the various beneficiaries. How should the power holder reconcile present and future needs? How should the power holder reconcile concurrent needs of persons in different generations?

Fifth, unless each of the permissible distributees has limited resources and is a person, for example an orphaned child or an unmarried adult, to whom no one owes any obligation of support, this writer generally does not recommend a trust that requires *each* distribution to comply with an ascertainable standard. Required consideration of resources otherwise available tends to preclude distributions and, if *each* distribution is subject to the standard, impede the usefulness of the trust. Rather, this writer generally suggests that a useful format is (i) a mandate to pay income (see *Form 3.2*) coupled with an ascertainable standard with respect to principal (see *Form 3.13*), or (ii) a mandate to pay (see *Form 3.30*), or a right to withdraw (see *Form 3.31*), a unitrust percentage coupled with an ascertainable standard with respect to the balance of the trust (see *Form 3.13*).

3A.03(c)(2) Preventing General Powers of Appointment Because of Powers To Pay to Other Than Power Holder

3A.03(c)(2)(A) Examples

Form 3.15: Removal of Discretion

> **(1) No trustee shall possess, or participate in the exercise of, any power that, but for this paragraph (1), the trustee would have to make any determination with respect to any payment which would discharge any legal obligation of the trustee personally.**

Form 3.16: Prohibition of Payment

> **(1) The Trustee shall not make (or have any power to make) any payment which would discharge any legal obligation of any person to whom the Trustee cannot make payment directly.**

3A.03(c)(2)(B) Purpose

The ability of a trustee to use trust property to discharge his or her legal obligation seems very unlikely in the context in which it often is asserted to exist. Consider a trust in which (i) the power holder is *not* named or described as a permissible distributee and (ii) the governing instrument does *not* explicitly permit payments for the *support* of any person who *is* named or described as a permissible distributee. In this context, the distribution of trust property in discharge of a personal obligation of the power holder seems to be solely for the benefit of someone who is not named or described as a beneficiary. Therefore, the distribution appears to violate the trust.

However, consider a configuration in which the problem *might* exist. Assume that a testator creates a trust that requires the trustee currently to pay income to the child of the grantor for life and permits the trustee to distribute principal to the child for the health, education and support of the child, remainder to the descendants, per stirpes, of the child who survive the child. Assume additionally that the grantor creates the trust upon the death of the grantor, the spouse of the grantor (the surviving parent of the child) is the trustee and the child is a minor when the grantor dies. The person serving as trustee is empowered only to make distributions to other than himself or herself. The ascertainable standard relates to other than the power holder *and permits distributions for the support of the named or described distributee*. The issue is whether a person who has a legal obligation to support the named or described distributee can exercise the power to discharge his or her personal obligation. This result seems unlikely if the ascertainable standard includes a requirement that the trustee consider resources otherwise available to the named or described distributee.

3A.03(c)(2)(C) Drafting

The draftsperson should assume that an ascertainable standard cannot remove a power from the category of a general power of appointment unless the standard relates to the health, education or support of the power holder. The only ascertainable standards that, according to applicable statute, cause a power not to be a general power are those that relate to the health, education or support of the power holder. Code §§2041(b)(1)(A) and 2514(c)(1). The Internal Revenue Service seems to insist upon this construction. Rev. Rul. 79-154, 1979-1 C.B. 301. Cf. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), 47-1 USTC ¶10,551, Estate of Budlong, 7 T.C. 756 (1946), and Sowell v. Commissioner, 708 F.2d 1564 (10th Cir. 1983), 83-1 USTC ¶13,526.

What strategy, then, *is* appropriate? The draftsperson absolutely can prohibit any distribution that would discharge any legal obligation owed by a person who is not named or described as a permissible distributee. See *Form 3.16*. Cf. Upjohn v. United States, 72-2 USTC ¶12,888 (W.D. Mich. 1972). However, if the drafting objective is only to prevent a general power of appointment, the appropriate focus appears to be upon the particular power relative to the power holder, rather than upon the power, per se. Therefore, if the drafting objective is only to prevent a general power of appointment, an absolute prohibition of any distribution that purportedly can discharge a legal obligation of a person who is not named or described as a permissible distributee of the distribution seems unnecessary.

3A.04 DISCRETIONARY DISTRIBUTIONS: COMBINATION OF (i) NONINDEPENDENT TRUSTEE POSSESSES SOME DISCRETION AND (ii) INDEPENDENT TRUSTEE POSSESSES OTHER DISCRETION

3A.04(a) Examples

Form 3.17: Single Distributee

a [(2) Principal]
b [(B) Additional Distributions]. The Trustee shall pay to my wife so much or all, if any, of the
a [principal]
b [trust estate]
as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to my wife so much or all, if any, of any balance of the
a [principal]
b [trust estate]
as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

Form 3.18: Plural Distributees

a [(2) Principal]
b [(B) Additional Distributions]. The Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the
a [principal]
b [trust estate]
as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for their respective health, education and support in the manner of living to which accustomed. Additionally,

the Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of any balance of the

a **[principal]**

b **[trust estate]**

as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

3A.04(b) Purpose

This approach is a combination of the approach described at 3A.02 and the approach described at 3A.03. It can allow greater flexibility than either of the constituent approaches alone.

3A.04(c) Drafting

This hybrid is usable with an independent trustee always serving or an independent trustee serving only according to a mechanism for the discretionary addition of an independent trustee.

The writer often uses "two tiers" of dispositive powers, with some but not all of the powers granted solely to an independent trustee. He particularly uses a variation in which an independent trustee is not required always to serve and is only a permissible or mandatory addition, or a required successor, to one or more beneficially interested trustees.

Even if a beneficially interested person could add an independent trustee, a difference arguably would exist between (i) an ability to add someone that could exercise a power and (ii) the possession of the power by oneself. See generally United States v. Byrum, 72-2 USTC ¶12,859 (Sup. Ct. 1972), United States v. Winchell, 61-1 USTC ¶12,015 (9th Cir. 1961), and Wall v. Commissioner, 101 T.C. 300 (1993).

If an interest holder exercises a power to add an independent trustee and the addition shifts an interest so that the interest holder relinquishes beneficial enjoyment, arguably a gift lurks somewhere. Consider, for example, what happens if a holder of a mandatory income interest can appoint an independent trustee with the effect of transforming the mandatory income interest into a discretionary interest. Because of loss of dominion and control, a gift might occur upon a mere shift of the interest as a result of the appointment. If a gift does not occur upon the shift of the interest as a result of the appointment, a gift (or a transfer for estate tax purposes) probably does occur if and when, because the holder appoints an independent trustee, the person who previously had the mandatory income interest receives less than all of the income.

Consider an embellishment to the system. The embellishment would permit a beneficially interested trustee to possess certain powers exclusively, notwithstanding the discretionary or mandatory addition of an independent trustee. See, e.g., *Form 14.13* and *Form 14.14*. Absent the embellishment, the discretionary or mandatory addition of an independent trustee would mean that the beneficially interested trustee would share all powers with the new, independent trustee, although, of course, the independent trustee *could* (but need not) delegate back to the beneficially interested trustee all powers except those that would be sensitive in the hands of the beneficially interested trustee.

Set forth below are some configurations in which the writer grants one set of powers to a beneficially-interested trustee and another to an independent trustee, or grants dispositive powers only to an independent trustee, and contemplates that an independent trustee will, or will not, serve at all times.

3A.04(c)(1) Single Distributee

3A.04(c)(1)(A) First Configuration

3A.04(c)(1)(A)(i) Facts

An independent trustee has wide-open discretion to pay income to one person, or to accumulate it, and to pay principal to the same person or not to pay it. Only the independent trustee can make a distribution. No independent trustee is required to serve. Any independent person can direct the addition of an independent trustee.

3A.04(c)(1)(A)(ii) Examples

Examples of this configuration include (i) an irrevocable insurance trust where the insured has only one descendant, (ii) a wide-open discretionary trust for one distributee, (iii) a Code Section 2503(c) trust, (iv) a Code Section 2642(c) trust and (v) a Crummey trust for a non-skip person.

3A.04(c)(1)(A)(iii) Comment

A common denominator among the examples is that the trust might have little property, and, therefore, no need for distributions, for an extended period. Although this configuration does not involve the grant of any powers to any beneficially interested trustee, it presents some of the same issues.

3A.04(c)(1)(B) Second Configuration

3A.04(c)(1)(B)(i) Facts

The governing instrument directs the trustee to pay income currently to one person, permits a beneficially interested trustee to distribute principal to the income beneficiary according to an ascertainable standard and accords an independent trustee wide-open discretion to distribute principal to the income beneficiary. No independent trustee is required to serve. Any independent person can direct the addition of an independent trustee.

3A.04(c)(1)(B)(ii) Examples

Examples of this configuration include (i) QTIP, right-to-withdraw and general-testamentary-power-of-appointment-marital trusts, (ii) a trust for one person for life, including a credit-shelter trust for the sole benefit of the spouse of the settlor, and (iii) a trust for one person until the person attains stated age(s).

3A.04(c)(1)(C) Third Configuration

3A.04(c)(1)(C)(i) Facts

The facts are the same as in the second configuration except, instead of a mandate concerning income, a beneficially interested trustee either (i) can pay income to himself or herself, according to an ascertainable standard, or (ii) can pay income to one person other than himself or herself, according to an ascertainable standard, and in each case an independent trustee has wide-open discretion to pay income to the person who is the permissible recipient of income.

3A.04(c)(1)(C)(ii) Examples

Examples of this configuration include (i) a trust for one person for life, including a credit-shelter trust for the sole benefit of the spouse of the settlor, and (ii) a trust for one person until the person attains stated age(s).

3A.04(c)(1)(D) Fourth Configuration

Also included in this classification is the ability of an independent trustee to grant a general testamentary power of appointment to the person who is described as the distributee in each of the preceding configurations, or is described as the primary beneficiary in the seventh configuration.

3A.04(c)(2) Plural Distributees

3A.04(c)(2)(A) Fifth Configuration

3A.04(c)(2)(A)(i) Facts

An independent trustee has wide-open discretion to pay income to any one or more of a number of persons, or to accumulate it, and to pay principal to any one or more of the same persons or not to pay it. Only the independent trustee can make a distribution. No independent trustee is required to serve. Any independent person can direct the addition of an independent trustee.

3A.04(c)(2)(A)(ii) Examples

Examples of this configuration include (i) an irrevocable insurance trust for multiple descendants of the grantor and (ii) a wide-open discretionary trust for multiple distributees.

3A.04(c)(2)(A)(iii) Comment

A common denominator among the examples is that the trust might have little property, and, therefore, no need for distributions, for an extended period. Although this configuration does not involve the grant of any powers to any beneficially interested trustee, it presents some of the same issues.

3A.04(c)(2)(B) Sixth Configuration

During the incapacity of the grantor of a revocable trust, a beneficially interested trustee can pay income and principal according to an ascertainable standard to the grantor and to any person who is dependent upon the grantor, and an independent trustee can make gifts and qualified transfers on behalf of the grantor. No independent trustee is required to serve. Any independent person can direct the addition of an independent trustee.

3A.04(c)(2)(C) Seventh Configuration

3A.04(c)(2)(C)(i) Facts

The facts are the same as in the fifth and sixth configurations except that, when the trust must terminate within a relatively short period of time (for example, a trust that is created for the period of the Rule Against Perpetuities and must terminate within twenty-one years), the independent trustee has wide-open discretion to distribute principal to any one or more among the primary beneficiary and the descendants of the primary beneficiary. Only the independent trustee can distribute principal to descendants of the primary beneficiary. No independent trustee is required to serve. Any independent person can direct the addition of an independent trustee.

3A.04(c)(2)(C)(ii) Comment

If an independent trustee could distribute any of the trust estate to other than the primary beneficiary, with the effect of reducing the amount that the primary beneficiary otherwise would have a right to receive, the primary beneficiary should not possess, or if he or she possesses should not exercise, any power to add an independent trustee. See the eighth configuration.

3A.04(c)(3) Eighth Configuration

3A.04(c)(3)(A) Facts

The instrument directs the trustee to pay income currently to one person but provides that, if an independent trustee is serving, the independent trustee, instead, has wide-open discretion to pay income and principal to one or more members of the group that consists of the person who previously was the mandatory beneficiary of income and that person's descendants. No independent trustee is required to serve. An independent trustee serves either as a successor to, or solely at the instance of, the mandatory beneficiary of income.

3A.04(c)(3)(B) Comment

A problem inheres in the coupling of (i) a shift from a mandatory payment of income to a discretionary interest with (ii) the mechanics, described in the preceding sentence, for initiation of the service of an independent trustee. Accordingly, *do not use this configuration.*

3A.04(d) Special Drafting for Disabled Beneficiaries and Avoidance of Claims of Creditors

Consider (i) a variation in which an independent trustee can grant an ascertainable-standard-limited power to a nonindependent trustee and revoke all or any of any power so granted and (ii) a variation in which the grantor initially grants an ascertainable-standard-limited power to a beneficially-interested trustee and authorizes an independent trustee to revoke and restore all or any of the power.

Form 3.19

(1) Distributions.

(a) By NonIndependent Trustee. The Trustee shall make such payments, if any, as the NonIndependent Trustee directs according to such powers, if any, as the Independent Trustee in its sole and absolute discretion grants to the NonIndependent Trustee pursuant to subsection (i) of this subsection (B)(1)(a).

(i) Except to such extent (if any) as the Independent Trustee in its sole and absolute discretion has released this authority, the Independent Trustee in its sole and absolute discretion at any time and from time to time may grant to the NonIndependent Trustee any power that is described in subsection (ii) of this subsection (B)(1)(a) and may revoke all or any of any power so granted, in each case by means of a signed instrument delivered to the NonIndependent Trustee.

(ii) Each power that is described in this subsection (ii)

(A) is described in Section 2041(b)(1)(A) of the Code (to such extent as the power holder is described in Section 2041(b)(1)(A)) or in Section 25.2511-1(g)(2) of the Treasury Regulations (to such extent as the power holder is described in Section 25.2511-1(g)(2)),

(B) applies to such portion or all of the trust estate as the Independent Trustee in its sole and absolute discretion determines at the time that the Independent Trustee grants the power,

(C) provides for payment to such one or more of my descendants as the Independent Trustee in its sole and absolute discretion determines at the time that the Independent Trustee grants the power and

(D) provides for payments for any one or more of health, education, support and maintenance, subject to such terms, conditions and limitations, if any, and for such period or periods, as the Independent Trustee in its sole and absolute discretion determines at the time that the Independent Trustee grants the power.

(b) By Independent Trustee. The Trustee shall pay to any one or more of my descendants, without any duty of equalization, so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(2) Termination. Unless sooner terminated by distribution or expenditure according to the foregoing, the trust shall terminate upon the death of my son, JOHN, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who then are living; provided, any share thus inuring to a descendant of mine shall be held in a separate trust (then or previously created with respect to the descendant under subsection (A) of this Section) to be administered as provided in subsection (A) of this Section.

Form 3.19 depicts a vehicle in which a sibling of the disabled person can exercise trustee powers that an independent trustee can grant or revoke. It exemplifies the first format. See *Form 14.6* for the definition of "NonIndependent Trustee."

Form 3.20

(A) Distributions. The Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Except to such extent (if any) as the Independent Trustee in its sole and absolute discretion has released this authority, the Independent Trustee in its sole and absolute discretion at any time and from time to time may revoke or restore all or any of the power granted according to the preceding sentence. Additionally, the Trustee shall pay to the descendant so much or all, if any, of any balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. Additionally, the Trustee shall pay so

much or all, if any, of the trust estate to such one or more appointees, other than the descendant and the estate, creditors and creditors of the estate of the descendant, in such amounts and portions and subject to such trusts, terms and conditions as the descendant directs in writing at any time and from time to time.

Form 3.20 illustrates the second format, a situation in which the grantor gives a person an ascertainable-standard-limited power to benefit himself or herself, gives an independent trustee a power to distribute in its discretion and also gives an independent trustee a power in its discretion to revoke and restore all or any of the ascertainable-standard-limited power and does not direct payment of income, a unitrust amount or an annuity amount and does not include any right to withdraw. If a creditor were able to enforce in favor of itself an ascertainable-standard-limited power that directs payment for "support," the power of the independent trustee to revoke and restore the ascertainable-standard-limited power might afford protection by permitting an independent trustee to leave solely the power to distribute in its discretion.

3A.05 DISCRETIONARY DISTRIBUTIONS: PRIMARY BENEFICIARY POSSESSES NONFIDUCIARY DISCRETION (RIGHT TO WITHDRAW): FIVE-AND-FIVE POWER

The "five-and-five" exception to the general rule concerning the existence of a general power of appointment permits a person to have extremely flexible access to property for his or her benefit without the usual tax cost.

3A.05(a) Example

Form 3.21: Right to withdraw greater of $5000 and 5%

Additionally, if my wife is living immediately before the end of a calendar year, the Trustee shall pay to my wife so much or all, if any, of the

a [principal]
b [trust estate]

, not to exceed in value the greater of five thousand dollars and five percent of the value of the

a [principal]
b [trust estate]

as of the end of the year, as my wife last directs in writing before the end of the year.

3A.05(b) Transfer Tax Implications and Planning

The transfer tax implications are discussed in detail at 3A.08. Suffice it to say here that a lapse during any calendar year during the life of the power holder is treated as a transfer for estate tax purposes

> only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:
>
> (A) $5,000, or
>
> (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of

> which, the exercise of the lapsed powers could have been satisfied. Code §2041(b)(2).

The gift tax rules are similar. See Code §2514(e).

3A.05(c) Income Tax Implications and Planning

The most important of the income tax implications is that the right to withdraw causes the power holder to own both (i) all ordinary income that is subject to the power and (ii) all income, ordinary and other, that is attributable to the principal that is subject to the power. Code §678(a)(1). See generally Code §671 and Treas. Reg. §1.671-3. The income tax implications are discussed in detail at 3A.08.

3A.06 CHANGES BECAUSE OF PRUDENT INVESTOR RULE AND MODERN-PORTFOLIO THEORY

The prudent investor rule (the "Rule"), Restatement (Third) of Trusts §§227 et seq. (1992), is superseding the prudent person rule, Restatement (Second) of Trusts §§227 et seq. (1959), as the law of investment of private trusts.

3A.06(a) Prudent Person Rule

The prudent person rule served for more than one hundred fifty years as the foundation statement of the investment duties of trustees of private trusts. The prudent person rule originally appeared in Harvard College v. Amory, 9 Pick. (26 Mass.) 446 (1830). According to Harvard College, trustees should

> observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested. Id. at 461.

The Restatement of the Law of Trusts, published by the American Law Institute in 1935, included the prudent person rule.

The Restatement Second of the Law of Trusts, published by the American Law Institute in 1959, included the following statement of the prudent person rule:

> §227. Investments Which a Trustee Can Properly Make
>
> In making investments of trust funds the trustee is under a duty to the beneficiary
>
> > (a) in the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived;
> >
> > (b) in the absence of provisions in the terms of the trust, to conform to the statutes, if any, governing investments by trustees;

> (c) to conform to the terms of the trust, except as stated in §§165-168.

3A.06(b) Prudent Investor Rule

The American Law Institute replaced the prudent person rule with the prudent investor rule in May of 1990. The Institute in 1992 published a complete revision, entitled "Restatement of the Law Third (Trusts), Prudent Investor Rule," of the part of Restatement Second that addressed the same subject. Unless otherwise noted, all references to the prudent investor rule, and to the Rule, are to the version that appears in Restatement Third.

According to the Restatement Third,

> §227. General Standard of Prudent Investment
>
> The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
>
> (b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
>
> (c) In addition, the trustee must:
>
> (1) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183);
>
> (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and
>
> (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).
>
> (d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.

3A.06(c) Scope

The focus here is upon the *changes* that the prudent investor rule might produce compared to the prudent person rule.

3A.06(d) Reasons for the Rule

The prudent investor rule is the product of a perception that the manner in which the prudent person rule had developed was preventing the law from accommodating modern-portfolio theory and, therefore, was hindering investment that best served the purposes for which private trusts were created. Specific rules that were derived from specific results in specific cases, rather than broad principles, were driving the law. The promulgation of the prudent investor rule was more an attempt to restore flexibility than an attempt to change the foundation statement.

3A.06(d)(1) Deficiencies of Existing Law

According to the critics, the law, as it had developed according to the prudent person rule, tended to:

(i) Focus upon the propriety of each asset in isolation rather than as an integral part of a portfolio,

(ii) Focus upon preservation of nominal value of principal rather than upon maintenance of purchasing power,

(iii) Prohibit certain investments entirely,

(iv) Provide a "safe harbor" for certain investments,

(v) Deter the fiduciary from delegating management and

(vi) Deter the fiduciary from acquiring new types of investment products.

3A.06(d)(2) Evidence of Dissatisfaction

The ferment that ultimately produced the prudent investor rule is reflected also in

(i) The Uniform Management of Institutional Funds Act, which applies to funds held by charitable institutions,

(ii) Code Section 4944, which prohibits any investment that would prevent a private foundation from prosecuting its purposes,

(iii) Section 404(a)(1)(B) of ERISA, 29 U.S.C. §1104(a) and

(iv) Reform, usually relatively narrow in scope, in various states.

3A.06(e) Accommodation of Modern-Portfolio Theory

The Rule is designed to accommodate modern-portfolio theory. See generally Restatement (Third) of Trusts §227 Comments, Macey, An Introduction to Modern Financial Theory (American College of Trust and Estate Counsel Foundation, 2d ed. 1998), Longstreth, Modern Investment Management and the Prudent Man Rule (Oxford University Press, 1986) and Malkiel, A Random Walk Down Wall Street (Norton, 6th ed. 1996). This accommodation has vast implications, in turn, for the administration, planning and drafting of trusts.

3A.06(e)(1) First Principle of The Theory: Risks of Shortfall According to modern-portfolio theory, the value or price of an asset is a function of two factors. The first is the rate of *total return*

> (i.e., ordinary income and capital appreciation) that the asset is anticipated to generate. The second is the risk that the actual return will fall short of the anticipated return.

An analysis of the risk of shortfall of return leads to a focus upon assets as integral parts of a whole portfolio rather than to a focus upon each asset in isolation. This focus in turn enhances the importance of the rate of total return.

The analysis leads to the conclusion that determination of whether a trustee has discharged its duties must focus upon the manner in which the trustee has made investment decisions. Restatement (Third) of Trusts §227, Comment *b*. The analysis leads away from the labeling of any asset as inherently prudent or imprudent, per se. The behavior of the trustee is judged in relation to circumstances, not in a vacuum. Id. Because the Rule is a rule of trustee conduct rather than a rule of portfolio performance, the Rule purports to diminish the importance of hindsight. Id.

3A.06(e)(1)(A) Two Risks of Shortfall

The risk of shortfall of return is divided into two categories. The first is market risk, sometimes known as systemic, systematic, nondiversifiable or compensated risk, i.e., the risk that the return in the market in which the asset is situated will fall short of the anticipated return.

> Certain . . . sorts of risks plague all firms more or less indiscriminately. This sort of risk is called market risk, or sometimes systematic or undiversifiable risk. The risk associated with a presidential assassination, or a change in the monetary policy of the Board of Governors of the Federal Reserve System, or a general economic downturn affect all firms, and are, therefore, examples of market risk. Macey, op. cit. 23.

The second is nonmarket risk, sometimes known as diversifiable, specific, unique or uncompensated risk, i.e., the risk that something which might occur particularly with respect to the particular asset might increase or decrease its return.

> Firm-specific risk, also called unique risk, residual risk, unsystematic risk, and diversifiable risk, refers to those elements of risk that are unique to particular companies. The risk that the chief executive officer of a particular firm will have a fatal heart attack, or that an earthquake or flood will render a plant inoperable, or that a firm will suffer a labor strike all are examples of firm-specific risks because they are unique to a particular company. Some sorts of firm-specific risks, such as the risk that the government will cut the defense budget are unique to particular classes of firms (i.e., contractors), but these sorts of risks are also defined as firm-specific risks. Id. at 23.

3A.06(e)(1)(B) Market Risk

According to modern-portfolio theory, the market (for at least a certain class of assets, for example, stocks, relative to the market for other assets, for example, bonds) compensates the investor for market risk (i.e., the first type of risk). Any compensation for this risk is in the form of an adjustment of the return that inures to the particular asset (i.e., generally, a higher rate of return corresponds to a higher market risk of a shortfall). See generally Restatement (Third) of Trusts §227, Comment *g*. Because, other things being equal, investors seek to avoid volatility, investors attempt to "charge" as a price for their investment, and the market (for at least some assets relative to the market for other assets) provides, a return that varies directly with volatility. See generally Macey, op. cit. 15-17, and Restatement (Third) of Trusts §227, Comment *e*. See, however, Fama and French, "The Cross-Section of Expected Stock Returns," The Journal of Finance (June, 1992) 427.

A return that is more volatile because of the market will tend at certain times to exceed, and at other times to fall short of, the return that inures to assets for which the return is less volatile. However, additionally, the market (for at least some assets relative to the market for other assets) will tend to yield to an asset that has a volatile return a premium return that is directly attributable to volatility. Some investors are willing to suffer large losses over a long time in anticipation of ultimately receiving a higher return. Other investors are willing to forgo higher returns in exchange for greater stability.

Arguably, the substance of volatility rather than volatility, per se, is what investors seek to avoid. The substance of volatility is the likelihood that a failure to realize a certain return will prevent a beneficiary from having something that the trustee wants the beneficiary to have at the time that the trustee wants the beneficiary to have it. See Jeffrey, "A New Paradigm for Portfolio Risk," The Journal of Portfolio Management (Fall, 1984) 33.

According to the Restatement Third,

> Risk tolerance [i.e., tolerance of volatility of return] largely depends on a combination of the regular distribution requirements of the trust and any irregular distributions that may in fact become necessary or appropriate. These obligations in turn are likely, depending on the terms of the trust, to be affected by the needs of one or more of the beneficiaries. Thus, these various distribution requirements facing the trustee effectively serve to define the consequences of the volatility risk with respect to a particular trust. Restatement (Third) of Trusts §227, Comment *e*.

An investor can regulate market risk by selecting a level of risk and (at least to some extent) reward and by selecting investments that are consistent with that level. For example, the investor can select investments that are more, less or as risky as the market as a whole. Stated differently, an investor might select investments that tend to rise and fall in value at a rate greater than, less than or the same as the market as a whole, and the investor can tend to obtain rewards that vary commensurately.

The trustee should attempt to assemble a portfolio that maximizes return at any level of risk. Conversely, the trustee should attempt to assemble a portfolio that minimizes risk at any level of return.

The Restatement Third makes clear that the trustee must regard inflation as a risk. It implies that, absent special circumstances, selection of a level of reward that will cause inflation to erode the value of principal breaches the duty of the trustee to use caution to preserve safety of capital. Restatement (Third) of Trusts §227, Comments *c* and *e*. A trustee usually has a duty to incur what risk is necessary to attempt to preserve real values.

The trustee should orient itself to the opportunities. It easily can accomplish a large part of the orientation by determining both a risk-free return (i.e., the return that inures to United States Treasury obligations) and an average-risk return (i.e., the return that prevails generally in the market).

3A.06(e)(1)(C) Nonmarket Risk

Again according to modern-portfolio theory, to the extent that the risk of shortfall of return is nonmarket risk, i.e., the risk is unique to the particular asset, the market does not compensate for the risk. See generally Restatement (Third) of Trusts §227, Comment *g*. Thus, the market does not compensate for the risk that an unanticipated event, such as the departure of key personnel, might reduce the fortunes of a particular company.

An investor can protect against nonmarket risk by diversifying, i.e., acquiring assets that tend to offset the unique risk that attends each asset separately. See generally Restatement (Third) of Trusts §227, Comment *g*. Therefore, the Rule generally imposes a duty upon the trustee to eliminate the risk that is unique to each asset, i.e., a duty to diversify.

Diversification that is accomplished without pooling of assets can tend to increase transactional costs. However, pooling among trusts and with other investors, by means, for example, of mutual funds, can accomplish diversification without increasing transactional costs.

The duty to diversify for the purpose of eliminating nonmarket risk is a centerpiece of the Rule. The duty to diversify induces the trustee to focus upon each asset as an integral part of a portfolio and not in isolation. No asset inherently is appropriate or inappropriate, per se.

3A.06(e)(1)(D) Prime Duty

The duty to diversify should solve the problem, and, therefore, reduce the importance, of nonmarket risk. Correlatively, it should elevate the importance of market risk and lead to the conclusion that the chief duties of the trustee are to determine and implement the mix of market risk and reward that is appropriate for the trust.

3A.06(e)(2) Second Principle of the Theory: Ability to Outperform the Market

A second tenet of modern-portfolio theory, expressed in varying degrees of conviction, is that an investor is not able to outperform the market at whatever mix of risk and reward the investor is seeking and, therefore, any attempt to do so is futile, counterproductive and wasteful. See generally, Macey, op. cit. 37 et. seq., and Restatement (Third) of Trusts ch. 7 (Introduction, pp. 6-7, and Reporter's Notes, pp. 75-76). According to the theory, capital markets are efficient, information is disseminated and reflected in prices immediately, and, therefore, no asset is relatively overpriced or underpriced. This principle has important implications for the conduct of trustees. It tends to reduce the value of certain types of advisers and advice. It tends to increase the value of certain types of investments such as index funds that tend to mimic a market as a whole. Generally, it tends to sanction the use of certain strategies of passive investment and to challenge the use of strategies of active investment that produce inferior returns.

The Rule specifically prohibits the trustee from incurring costs that are not reasonable in amount. Restatement (Third) of Trusts §227(c)(3). An implication is that a trustee that uses a strategy of active investment must justify the increased costs in terms of an increase in expected returns.

3A.06(f) Trusts That Are Designed for Diminished Distinction Between Income and Principal

3A.06(f)(1) General Principles

The focus of the Prudent Investor Rule upon the integration of each asset into a portfolio (as opposed to a focus on each asset separately and in isolation from each other asset) and the focus of the Rule generally on total return from both ordinary income and capital appreciation (as opposed to a focus solely on ordinary income, or a focus separately on ordinary income and capital appreciation) tend to diminish the focus of the law upon a distinction between income and principal. The most significant implication of the Rule's diminishment of the distinction between income and principal is that the diminishment might permit and encourage planners and drafters to prepare dispositive instruments that do what the Rule does, i.e., reduce or eliminate distinctions between income and principal and, therefore, reduce the significance of the difference between ordinary income and capital appreciation. This diminishment signals a revolution in drafting and administration of private trusts.

Except to such extent as changes in state law permit adjustments between income and principal or permit the transformation of pay-all-income trusts into unitrusts, and changes in income tax law complement the changes in state law, the Rule's reduction of the significance of the distinction between income and principal will have little effect on the amount of ordinary income that a trustee must generate when administering a trust according to a governing instrument that includes a functional distinction between income and principal. The Rule at least seems to permit trustees of some of these trusts to focus upon the production of ordinary income by the portfolio rather than asset-by-asset. However, trustees of other of these trusts, such as trusts that are designed to qualify for the marital deduction because of a requirement to pay all income to the spouse, apparently must heed any direction by the surviving spouse to invest, with respect to productivity of ordinary income, asset-by-asset. Treas. Reg. §20.2056(b)-5(f)(5).

A trust that provides that a particular beneficiary shall receive ordinary income and that principal shall pass solely to one or more others requires the trustee to distinguish carefully between income and principal and to make all investment decisions on the basis of impartiality between income and principal.

Form 3.22

(A) Income. The Trustee shall pay the net income to my wife quarter-annually.

(B) Principal. The Trustee shall not distribute principal.

(C) Termination. Upon the death of my wife, the trust shall terminate, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

A trust that permits the trustee to pay principal to the person to whom the trustee is required to pay income (see *Form 3.23*) tends to reduce, but not eliminate, the distinction between income and principal.

Form 3.23

(A) Income. The Trustee shall pay the net income to my wife quarter-annually.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

A trust that, according to an ascertainable standard (see *Form 3.24*) or without any standard (see *Form 3.25*), permits the trustee to pay income to a person, or to any one or more persons in a group of persons, or to accumulate it, and to pay principal to the same person or persons, tends to eliminate the significance of the distinction between income and principal and to free the trustee to concentrate upon total return.

Form 3.24

(A) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. The Trustee shall accumulate any net income that it does not pay.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

Form 3.25

(A) Income. The Trustee shall pay to my wife so much or all, if any, of the net income as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust. The Trustee shall accumulate any net income that it does not pay.

(B) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(C) Termination. Unless sooner terminated according to the foregoing, the trust shall terminate upon the death of my wife, and the Trustee shall distribute the trust estate of the trust to my descendants, per stirpes, who survive my wife.

3A.06(f)(2) Facilitating the Change

Given the decreased importance that the Rule attaches to whether a particular asset is unproductive or underproductive of trust accounting income, the draftsperson should consider (i) eliminating requirements that assets produce a requisite amount of ordinary income and (ii) waiving the application of statutory and other law concerning property that fails to produce a requisite amount of ordinary income.

Form 3.26

> **(1) To retain property in the form and character in which received and to invest in any kind of property (including common trust funds and securities of any trustee), whether or not income-productive or located in the United States or authorized for trust investments.**

However, contrary to the Rule, the marital-deduction rules seem to focus upon each asset in isolation from each other asset. Therefore, the draftsperson should not eliminate the ability of a spouse to insist that the trustee eliminate from a marital trust any asset that is not productive. See Treas. Reg. §20.2056(b)-5(f)(5).

Form 3.27

> **Unproductive property shall not be held for more than a reasonable time in the trust estate of the Marital Trust without the consent of my wife.**

Similarly, when dealing with a trustee that has a beneficial interest in the decision about retention or acquisition of unproductive or underproductive property and a trust that mandates the distribution of trust accounting income, so that the investment decision will affect how much the trustee personally will receive, the draftsperson should not exonerate the trustee for deviating from any productivity requirements that, absent the exoneration, the law of the state imposes. See generally Code §§2041 and 2514.

3A.07 MODERN STYLES OF DISTRIBUTIONS: ANNUITY TRUSTS AND UNITRUSTS

The ability of the trustee, as a matter of law, to concentrate upon total return seems to enhance the importance of annuity trusts and unitrusts. The underlying reason is that, even if one assumes the decreasingly accurate proposition that a pay-all-income trust adequately can allocate enjoyment when the trustee invests separately for ordinary income, a new method of allocating enjoyment is necessary when the trustee invests for total return.

Form 3.28: Annuity Trust Example

(1) Annuity Interest. Each year,

a [after the descendant has attained thirty years of age,]

the Trustee shall pay to the descendant [X] dollars

b [, adjusted to reflect any increase in the consumer price index between the date of this instrument and the date of the first payment for the year]

. The Trustee shall pay the annuity amount in equal quarter-annual installments. The Trustee shall prorate the annuity amount for any short year.

Form 3.29: Conventional Unitrust Example

(1) Unitrust Interest. Each year,

a [after the descendant has attained thirty years of age,]

the Trustee shall pay to the descendant a unitrust amount equal to [X] percent of the

b [net fair market value of the trust estate of the trust valued as of the first business day of the year]

c **[average of the net fair market values of the trust estate of the trust valued as of the first business day of the year and of each year of the preceding four] . The Trustee shall pay the unitrust amount in equal quarter-annual installments. The Trustee shall prorate the unitrust amount for any short year.**

3A.07(a) Rationales and Characteristics

A traditional annuity trust pays a fixed amount of dollars per period of time, without regard to whether the annuity amount is derived from income or from principal. A conventional unitrust pays a dollar amount per period of time equal to a fixed percentage of the total value of the trust estate redetermined each period, also without regard to whether the unitrust amount is derived from income or from principal.

The traditional type of annuity trust produces a fixed, rigid and unvarying amount to the annuitant. Attorney William L. Hoisington, commenting to this writer, suggested the consideration of an "indexed" annuity that fluctuates with changes in price levels and purchasing power. According to Hoisington, by being able to focus, simply, upon the number of dollars necessary to accomplish an objective (for example, the support of the annuitant) and knowing the amount required for this purpose at the time of the creation of the trust and that the purchasing power will remain constant, a client might understand an indexed annuity trust better than the client might understand a unitrust.

Whereas a traditional annuity does not change at all and an indexed annuity changes according to changes in values outside the trust, a unitrust amount is linked to changes in value of the trust property itself. Therefore, a unitrust amount precisely reflects changes in the trust but only roughly reflects changes in price levels and purchasing power. Because the unitrust amount varies directly with changes in value of the trust property, the number and the timing of valuation dates affect the fluctuation of the amount. A greater number of dates and a greater time over which they occur tend to produce a "smoother" flow than a fewer number of dates over a shorter time.

An annuity trust periodically generates an obligation, or debt, in an amount that is fixed upon the creation of the trust, subject, however, in the case of a trust that provides an annuity which is indexed to changes in cost of living, only to fluctuation because of changes in price levels. By comparison, a conventional unitrust periodically generates an obligation in an amount that is fixed only on the date of determination of the trust value which fixes the unitrust amount.

Both an annuity trust and a unitrust permit the trustee to focus upon total return. An annuity trust requires the trustee to seek the total return that best will generate the annuity and, consistent with payment of the annuity, enhance the assets that can inure to others upon termination of the annuity. Similarly, a unitrust impels the trustee to seek the total return that best will enhance both the unitrust interest and the property that will inure to others upon termination of the unitrust interest.

Because the level of payout is the primary factor that determines the value of the property that can continue to produce the annuity or unitrust amount and remain when the annuity or unitrust interest terminates, determination of the investment objectives for the trust involves a complex analysis of the extent to which payments *should* decrease the value, and the extent to which ordinary income and capital appreciation *should* increase the value. By contrast, a trust that pays only income might imply, relatively directly, that the investment objectives of the trustee are to produce a reasonable stream of income and yet maintain, in real terms, a constant value of principal.

The payout requirement of the conventional unitrust seems to place less pressure upon the trustee than the payout requirement of a traditional annuity trust, regardless of whether the distributions are in cash or in kind. The reason is that in a declining market the payout required from a traditional annuity trust represents an increasing percentage of a decreasing value, whereas the payout required from a unitrust is an unvarying percentage of a changing value. Because satisfaction of the required distribution in kind seems to produce the same economic effect as satisfaction of the required distribution in cash, the trustee seems unable to relieve the pressure by satisfying the annuity interest or the unitrust interest in kind.

Special problems confront any attempt to draft a trust that both is to qualify for the marital deduction and also is to permit the trustee to invest for total return. Certain annuity trusts might not qualify for the marital deduction. Code §§2056(b)(7)(B)(ii), 2056(b)(10), 2523(e) and 2523(f)(3), Treas. Reg. §§20.2056(b)-7(e) and 25.2523(f)-1(c)(3). A trust that is solely a unitrust might pay less than its income and, therefore, cannot meet the income requirement of the marital deduction. Code §§2056(b)(5) and (b)(7). Cf., however, Treas. Reg. §§20.2056(b)-5(f)(1), 20.2056(b)-7(d)(1) and 20.2056(b)-10, which, for taxable years that end after January 2, 2004, assuming the existence of the required substance of state law, permit a unitrust to qualify.

A trust that pays the *greater of* trust accounting income and a unitrust amount must pay at least its income and, therefore, can meet the income requirement. However, the important issue is whether this "greater-of" arrangement permits the trustee to focus upon total return. The possibility that income can exceed the unitrust amount might force the trustee to continue to concentrate on producing a yield in the form of income for trust accounting purposes. If the unitrust percentage that is specified is clearly as high as the yield of ordinary income that an income beneficiary can demand according to state law, the "greater-of" arrangement will protect the income beneficiary and, therefore, should free the trustee to invest for total return. Cf. Treas. Reg. §20.2056(b)-5(f)(5). However, the grantor usually has no way to know this amount with certainty. Selection of a lesser amount can undermine the elimination of the focus upon ordinary income. Although selection of a greater amount can eliminate the focus on ordinary income, it also can eliminate a portion of the trust.

Purposely, no form mentions income or principal. The forms contrast in this respect with most forms of charitable remainder and charitable lead arrangements. See, e.g., Rev. Proc. 89-20, 1989-1 C.B. 841, Rev. Proc. 89-21, 1989-1 C.B. 842, Rev. Proc. 90-30, 1990-1 C.B. 534, Rev. Proc. 90-31, 1990-1, C.B. 539, Rev. Proc. 90-32, 1990-1 C.B. 546, and Rev. Proc. 90-33, 1990-1 C.B. 551. Indeed, the forms also contrast with most forms, of which this writer is aware, of private annuity trusts and private unitrusts.

Code Sections 661 and 662 govern what the trust is deemed to distribute and what the annuitant or the unitrust recipient is deemed to receive. The "deeming" generally appears to occur regardless of any statement in the governing instrument to the effect that a distribution has a specified complexion.

A notable exception is that provision in the governing instrument can determine the extent, if any, to which distributable net income includes corpus income, i.e., capital gains. See Code §643(a)(3) and Treas. Reg. §1.643(a)-3. However, a mandate to pay an annuity (or, by implication, a unitrust amount) seems not to include capital gains in distributable net income even when a distribution of principal is necessary to satisfy the distribution obligation. See also Rev. Rul. 68-392, 1968-2 C.B. 284. The apparent rationale is that even though a distribution of principal is necessary, capital gains still are not "[a]llocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." Treas. Reg. §1.643(a)-3(b)(3).

An ordering system similar to that which applies (according to Code Section 664(b)) to charitable remainder arrangements would seem, in the context of a private annuity trust and a private unitrust, to have no economic substance apart from tax results. Arguably, therefore, the inclusion in a governing instrument of the ordering system would seem ineffective to determine the income-tax complexions of distributions from private annuity trusts and private unitrusts to annuitants and unitrust recipients. Cf. Code §661(b).

Given (i) the apparent difficulty of including capital gains in the distributable net income of an annuity trust or unitrust and (ii) the apparent lack of other tax function of the mandate that usually appears in the forms of others to pay the annuity or the unitrust amount first from income and, to any extent that income is insufficient, from principal, apparently the only function of the mandate is to mandate a purposeless separation, and accounting, of income and principal. The reason that this writer does not include the mandate is to attempt to dispense entirely with separate treatment of income and principal and to permit accounting simply on the basis of receipts and disbursements.

Because taxation of a given amount of income of any complexion might tend to generate less tax in the hands of an individual (i.e., an annuitant or a unitrust recipient) than in the hands of the trustee of a trust, a grantor might want to maximize distributable net income and, hence, maximize the distributable net income that a distribution of a given value carries from a trust to a beneficiary. However, movement of a tax burden from a trust to a beneficiary will tend to reduce the after-tax value of any distribution and, correspondingly, necessitate a compensating increase in the annuity amount or unitrust percentage in order to leave the beneficiary with a given amount after tax.

3A.07(b) Mandated-Percentage Unitrusts

Consider expressing as a percentage of the trust estate, rather than as a dollar amount, the unitrust interest that the trustee is required to distribute.

Form 3.30

(1) Unitrust Interest. If
[, after attaining thirty years of age,]
the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant a [X] fractional share of the trust estate. The Trustee shall prorate the fractional share for any short year.

3A.07(b)(1) Rationale and Characteristics

An economic difference exists between a conventional unitrust, in which the unitrust interest is expressed as a dollar amount, and the mandated-percentage unitrust, in which the unitrust interest is expressed as a fraction of the trust estate. The former describes a fixed number of dollars, but the latter describes something that can change in value until the trustee satisfies it.

More importantly for purposes of this analysis, compared to a conventional unitrust in which the unitrust interest is expressed as a dollar amount, the mandated-percentage unitrust enhances flexibility in (i) timing of recognition of gain and (ii) determining the identity of the taxpayer that recognizes the gain. Unless the trustee elects to the contrary according to subsection 643(e) of the Code, satisfaction of the percentage in kind should not produce a deemed sale. See generally Code §663(a)(1), Treas. Reg. §§1.661(a)-2(f)(1), 1.1014-4(a)(3) and 1.663(a)-1(b)(1), Rev. Rul. 60-87, 1960-1 C.B. 286, Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), and Suisman v. Eaton, 15 F. Supp. 113 (D.Conn. 1935), affirmed 83 F.2d 1019 (2d Cir. 1935), cert. denied 299 U.S. 573 (1936). If the satisfaction in kind does not produce a deemed sale, (a) the distributee takes for income tax purposes the same basis that the trustee had and (b) the distributable net income that the distribution carries to the beneficiary is the lesser of (i) the basis of the property in the hands of the beneficiary and (ii) the fair market value of the distributed property. Code §643(e). By making or not making the election according to subsection 643(e) of the Code, the trustee can defer or accelerate recognition of gain and can determine which, the trustee or the unitrust recipient, shall pay the tax on any gain.

The ability of the trustee to satisfy the percentage in kind (rather than in dollars) should permit the trustee (but not the unitrust recipient) to avoid the need for cash. Any distribution of an asset in kind will carry distributable net income from the trust to the distributee and include it in the gross income of the distributee to the extent of the lesser of (a) the income tax basis of the distributed asset in the hands of the beneficiary and (b) the fair market value of the distributed property. Code §§643(e), 661 and 662. Therefore, although the distribution of distributable net income is limited to the basis of the distributed asset in the hands of the beneficiary, the distribution in kind nevertheless will tend to require the distributee to obtain cash in order to pay tax.

Use of the concept of a percentage can give the trustee considerable flexibility about how to satisfy the unitrust interest. If the governing instrument authorizes the trustee to make distributions in nonprorata shares, the trustee should have flexibility that ranges from satisfying the unitrust interest with one asset to satisfying it with a fractional share of each and every asset including both income and principal.

Absent Code Section 643(e) and the trustee's possession and use of "pick-and-choose" authority to distribute other than the fixed percentage of each and every asset, the mandated percentage unitrust would seem to carry to the unitrust recipient the fixed fraction of all ordinary income and capital gain attributable to the trust. Code Section 643(e) would seem to limit, to the lesser of the bases of the distributed property in the hands of the beneficiary and the fair market value of the distributed property, the ordinary-income component of distributable net income that is deemed distributed because of the distribution in kind.

The more important inquiry for purposes of this analysis is the income-tax effect of the trustee's use of "pick-and-choose" authority to determine the exact assets to distribute. Does the use of this authority transform the trust, subject to the mandate concerning the total amount, into a discretionary trust for income tax purposes? Alternatively, if the unitrust recipient is the trustee and, therefore, by means of the pick-and-choose authority, the unitrust recipient has unlimited power to select the exact assets that are to satisfy the unitrust interest, is the paradigm that of an individual who, according to Code Section 678, is treated as owning particular assets for income tax purposes? According to grantor-trust principles under Code Section 678, can the trustee-unitrust recipient own (for income-tax purposes) whatever assets the unitrust recipient in fact receives? Stated differently, do principles of Code Section 678 "trump" a portion of the principles of Code Sections 651, 652, 661 and 662 when the recipient has the unlimited power to select the assets that the recipient shall receive? The writer is not aware of any application of this theory, notwithstanding that the issue would seem to appear frequently in the context of nonprorata allocations of assets to dispositions.

Compare with this issue the similar issue that attends a Give-Me-Five withdrawable-percentage unitrust when, in one version, the donee has pick-and-choose authority as a trustee and, in an alternative version, the donee has pick-and-choose authority both personally and as a trustee. Whereas in the mandated-percentage unitrust the issue arises in the context of a potential clash between the distributable net income rules, on the one hand, and the grantor-trust rules, on the other, in the Give-Me-Five withdrawable-percentage unitrust the issue arguably arises only in the context of the proper interpretation of Code Section 678.

3A.08 MODERN-STYLE DISCRETIONARY DISTRIBUTIONS: PRIMARY BENEFICIARY POSSESSES NONFIDUCIARY DISCRETION: WITHDRAWABLE-PERCENTAGE ("GIVE-ME-FIVE") UNITRUSTS

Next, instead of requiring the trustee to distribute a unitrust percentage or a unitrust amount, consider specifying a percentage of the trust estate, not in excess of five percent (or specifying, alternatively, so much of the trust estate as has a value equal to the value, at a particular time, of a percentage of the trust estate, not in excess of five percent) and providing that the unitrust recipient may, but need not, withdraw all or any of it until the particular time each year. The withdrawable-percentage ("GIVE-ME-FIVE") unitrust is an attractive alternative to (i) a trust that mandates the current payment of income, (ii) a conventional unitrust in which the unitrust interest is expressed as a dollar amount and the current payment of the unitrust amount is mandated and (iii) a unitrust in which the unitrust interest is expressed as a percentage of the trust estate and the current distribution of the unitrust percentage is mandated.

Form 3.31: Withdrawable-Percentage ("GIVE-ME-FIVE") Unitrust Example

(1) Give-Me-Five. If

a **[, after attaining thirty years of age,]**
the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant

b **[such fractional share (not to exceed one-twentieth), if any, of the trust estate]**

c **[so much, if any, of the trust estate, not to exceed in value five percent of the value of the trust estate as of the end of the year,]**
as the descendant last directs in writing before the end of the year.

d **[As soon as possible after each taxable year of the descendant, except to such extent (if any) as the Independent Trustee in its sole and absolute discretion last directs in writing before the end of the year, the Trustee shall pay to the descendant (i) the amount (if any) by which the income tax liability of the descendant for the year is increased because, as a result of one or more lapses of rights granted according to the preceding sentence, the descendant is deemed, according to Subpart E of Subchapter J of Chapter 1 of Subtitle A of the Code, to own any of the trust estate for purposes of determining the United States income tax of the descendant and (ii) the amount (if any) by which the income tax liability of the descendant is increased because the Trustee must pay according to this sentence.]**

3A.08(a) Rationale and Characteristics

The withdrawable-percentage unitrust is particularly attractive when (as in a credit-shelter or generation-skipping configuration) the trust is exempt from the generation-skipping tax, the primary beneficiary is a non-skip person (e.g., the spouse or child of the grantor), or is a skip person (e.g., the grandchild of the grantor) who is assigned to a generation higher than that of another skip person, and the primary beneficiary might not need, but wants the security of, the beneficial enjoyment that the trust can provide. The withdrawable-percentage unitrust allows the primary beneficiary to conserve the resources of the trust that are sheltered from the transfer taxes and, thus, consume the resources of the beneficiary that, if not consumed, will generate liability for gift tax, estate tax or generation-skipping tax (or more than one of them).

As an example, instead of forcing the spouse of the grantor to receive all income from a marital-deduction trust and all income from a credit-shelter trust, a withdrawable-percentage unitrust can permit the spouse of the grantor to receive all income from the marital-deduction trust and to consume the property of the spouse (or principal of the marital-deduction trust) in an amount that approximates the income of the credit-shelter trust. Thus, the withdrawable-percentage unitrust allows the spouse to conserve the trust estate of the credit-shelter trust.

As a similar example, instead of forcing the child of the grantor to receive all income from a trust that has an inclusion ratio of zero for generation-skipping tax purposes, a withdrawable-percentage unitrust can permit the child of the grantor to consume the property of the child in an amount that approximates the income of the generation-skipping trust, or can permit the trustee to distribute property from a trust that is not exempt from the generation-skipping tax in an amount that approximates the income of the trust that is exempt from the generation-skipping tax. Thus, the withdrawable-percentage unitrust allows the child to conserve the trust estate of the generation-skipping trust.

3A.08(a)(1) Alternative Versions

One version of the withdrawable-percentage unitrust permits the beneficiary to withdraw a percentage or fractional share of the trust estate. See **variable b** of *Form 3.31*. An alternative version permits the beneficiary to withdraw so much of the trust estate as has a value equal to the value of a specified fraction of the trust estate as of the time of lapse of the right to withdraw. See **variable c** of *Form 3.31*. Technically, this aspect of the latter version seems identical to that which appears in a conventional unitrust. The only economic difference between the versions is that the former version seems to describe something that can change in value until the trustee satisfies it, but the latter version seems to impose a ceiling of a fixed number of dollars. At least if a withdrawal according to the alternative version is not expressed as a dollar amount *and* the dollar ceiling in fact does not define the withdrawal, each version should produce similar income tax results. See generally Treas. Reg. §1.671-3.

The version that permits the beneficiary to withdraw "so much . . . of the trust estate" might offer greater flexibility than the version that permits the beneficiary to withdraw a "fractional share." If the governing instrument authorizes the trustee to distribute nonprorata shares of assets in satisfaction of any withdrawal, the version that permits the beneficiary to withdraw a "fractional share" should vest in the trustee, and arguably solely in the trustee, the ability to satisfy a withdrawal with other than a fractional share of each and every asset. The version that permits the beneficiary to withdraw "so much . . . of the trust estate," on the other hand, might allow the beneficiary, himself or herself, to select the assets that are to satisfy any exercise of the right to withdraw.

3A.08(a)(2) Advantages

Use of a lapsing right to withdraw, instead of a mandated payment, permits the unitrust recipient to exclude the trust estate from the gross estate of the recipient for estate tax purposes and from the gifts of the recipient for gift tax purposes.

The right to withdraw also permits the unitrust recipient to regulate the efficiency of the trust for generation-skipping tax purposes by determining whether a non-skip person (or a skip person who is in a generation that is higher than that of another skip person) shall receive distributions. Additionally, the lapsing right to withdraw permits the power holder to avoid dissipation of GST exemption. Id.

The unitrust concept eliminates any functional distinction between income and principal. Therefore, it permits the trustee to take full advantage of the prudent investor rule and modern-portfolio theory by investing for total return.

Expression of the unitrust interest as a percentage, rather than as a dollar amount, permits satisfaction of the interest in kind without recognition of gain.

Similarly, at least if (i) the exercise of the right is expressed as a percentage rather than as a dollar amount and (ii) the dollar ceiling in fact does not define the withdrawal, expression of the right to withdraw as so much of the trust estate as has a value equal to the value of a percentage at the time of the lapse or exercise should permit satisfaction of the interest in kind without recognition of gain.

Example: Assume a right to withdraw so much of the trust estate as has a value equal to five percent of the value of the trust estate at the end of the year. Assume that the donee exercises the right by withdrawing, as an example, a one-percent fractional share of the trust estate, or, as another example, particular assets that have an aggregate value at the time of distribution of less than five percent of the value of the trust estate at the time of the partial exercise and partial lapse (i.e., immediately before the end of the year) of the right. The portion withdrawn does not have a fixed value and does fluctuate in value subject to a dollar ceiling. See Rev. Rul. 60-87, 1960-1 C.B. 286.

The unitrust percentage of five percent assures that the unitrust recipient can receive approximately the same enjoyment that he or she would receive if he or she were to receive all income of a trust that owned a balanced portfolio of investments.

The primary beneficiary can serve as the sole trustee of a withdrawable-percentage unitrust at least as well as he or she can serve as the sole trustee of a mandated-payment-of-income trust. The primary beneficiary can serve as the sole trustee of a withdrawable-percentage unitrust just as well as he or she can serve as the sole trustee of a conventional unitrust and a mandated-percentage unitrust.

Because, within limits, the unitrust recipient, himself or herself, can determine the transfer tax results, a withdrawable-percentage unitrust seems more flexible for transfer tax purposes than (i) a grant of discretion to an independent trustee to make distributions (see *Form 3.8*), (ii) a mandate to a trustee to make distributions (see, for example, *Form 3.2*) and (iii) a grant of discretion, limited by an ascertainable standard, to a person to make distributions to himself or herself (see *Form 3.13*).

3A.08(a)(3) Rights of Creditors

According to the laws of some jurisdictions, a Give-Me-Five power might make a portion of the trust estate vulnerable to creditors of the donee of the power. According to the theory, a lapse of a right to withdraw has the economic result, and also the creditor-rights result, of, first, a withdrawal of the subject property and, second, a contribution of the withdrawn property to the trust. Pursuing the theory, the donee becomes the settlor to the extent of the deemed contribution. According to section 58 of the Restatement Third of Trusts, creditors of a donee who is a deemed contributor can reach the assets so contributed, to the extent of the interest of the donee in the trust.

According to the Restatement Third, a lapse of a right to withdraw a contribution to a trust, i.e., a Crummey power, causes the donee to become the settlor with respect to the subject property and brings the subject property within the rule that is described in the preceding paragraph. Restatement (Third) of Trusts §58,. Comment f(1) and Illustration 11. According to Reporters Notes in Restatement Third, the "Uniform Trust Code §505(b)(2) adopted, essentially, a '5 or 5' (estate-and gift-tax type) exception to its general rule (which is otherwise like the rule of this Comment) on releases and lapses of withdrawal powers." Reporters Notes on §58, Comments f and f(1).

The deemed-contribution theory does not necessarily prevail in the case of a Give-Me-Five power. Unlike, for example, a Crummey power, which operates with respect to a contribution to a trust, a Give-Me-Five unitrust power operates solely with respect to what constituted the trust estate before the power became operative. Conceptually, the property that is subject to a Crummey power passes (i) from a donor, (ii) by means of the Crummey power, to a donee and (iii) by means of a lapse of the Crummey power, from the donee to the trust. By contrast, because the property that is subject to a Give-Me-Five power is property that is part of the trust estate before the right to withdraw becomes operative, the donee of a Give-Me-Five power arguably does not participate in the transfer of any property to the trust. This reasoning highlights a distinction, but whether the distinction supports a difference is another issue.

Even if a lapse of a Give-Me-Five power were to make the subject property vulnerable to creditors, the vulnerability would appear no more, and possibly less, than that of a pay-all-income trust over an economic cycle, a mandate to pay a unitrust amount of five percent and an exercise of the Give-Me-Five power. Both a mandate to pay all income and a mandate to pay a unitrust amount "force" property from the trust to the distributee. Each of these mandates causes the recipient to own all of each distribution. Thus, each of these mandates renders all of the distributed assets vulnerable. By comparison, the lapse of a Give-Me-Five power appears to empower a creditor only to such extent, if any, as the trustee can distribute the subject property to the donee after the lapse.

If an ascertainable standard were to limit the property that the trustee could distribute to the donee after the lapse of the Give-Me-Five power, the empowerment (and thus the vulnerability) would appear to depend upon the facts and circumstances, including those of the donee and of the trust, that were material to the application of the standard. If, instead, after the lapse the trustee could pay the subject property to the donee without limitation, all of the subject property would appear vulnerable to creditors.

Regardless of whether and to what extent the lapse of a Give-Me-Five power confers rights upon creditors, any vulnerability to creditors appears not to undermine any tax benefits. The Code and applicable regulations seem conclusively so to provide. See Code §§2041(b)(2) and 2514(e) and Treas. Reg. §§20.2041-3(d) and 25.2514-3(c)(4).

What effect should rights of creditors have upon the use of Give-Me-Five powers? Arguably, the answer is little or none. Obviously, a Give-Me-Five power (or, for that matter, any mandate, to pay all income, to pay a unitrust amount, to pay an annuity amount or to pay anything else, including according to an ascertainable standard) is incompatible with a dominant objective of asset protection. However, this analysis of rights of creditors vis-a-vis Give-Me-Five powers appears to support, rather than undermine, the thesis that a Give-Me-Five power is a flexible means of enabling a certain, but very common, type of beneficiary to have control and enjoyment similar to outright ownership but without the transfer-tax burdens.

3A.08(a)(4) A Problem

Although the withdrawable-percentage unitrust offers superior results for transfer tax purposes, it poses a problem, fortunately solvable, for income tax purposes. The right to withdraw includes in the gross income of the power holder all gross income that is attributable to the subject property. Code §678(a)(1). If the inclusion is inadvertent and not desired *and* the power causes inclusion of more than the income that is attributable to the property to which the power applies during the taxable year, the inclusion can present the power holder with an unexpected and unwanted obligation that the power holder can lack the resources to discharge. A grantor can avoid the issue by permitting or requiring the trustee to pay to the donee each year at least an amount equal to the marginal amount of tax increase that the donee incurs because of the existence of the trust. See, e.g., (i) the discretionary power of an independent trustee in *Form 3.8* and (ii) **variable d** of *Form 3.31*. Further, as discussed later, the attribution potentially is desirable.

The withdrawable-percentage unitrust seems less flexible for income tax purposes than a power granted to an independent trustee and, arguably, a power to withdraw limited by an ascertainable standard. However, the more appropriate comparison is probably between (i) the withdrawable-percentage unitrust and (ii) a mandate to a trustee to distribute all income. See, for example, *Form 3.2*.

3A.08(a)(5) Transfer Tax Implications and Planning

Generally, the lapse of a general power of appointment is treated as a transfer for gift and estate tax purposes. Code §§2041(a)(2) and 2514(b). However, a lapse during any calendar year during the life of the power holder is treated as a transfer for estate tax purposes only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

> (A) $5,000, or
>
> (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied. Code §2041(b)(2).

The gift tax rules are similar. See Code §2514(e).

A lapse that is within the limits of Code Sections 2041(b)(2) and 2514(e) is not a gift for gift tax purposes. Treas. Reg. §§20.2041-3(d)(3) and 25.2514-3(c). Similarly, the lapse is not a transfer with retained enjoyment for estate tax purposes. Treas. Reg. §20.2041-3(d)(3) and (4).

Possession of the right to withdraw at the death of the power holder does include in the gross estate of the power holder any property that the power holder could have withdrawn immediately before death. Code §2041(b)(1) and Treas. Reg. §20.2041-3(d)(3). However, confining the existence of the power to immediately before the end of the year should prevent the power from including any of the trust estate in the gross estate of the power holder. Similarly, conditioning the power upon the exhaustion of another trust (for example, a marital-deduction trust, such as a QTIP or testamentary-power-of-appointment trust) that the power holder does not have discretion to exhaust prevents the power from including property in the gross estate of the power holder unless the power holder dies after the other trust is exhausted. Treas. Reg. §20.2041-3(b). Cf. Estate of Kurz v. Commissioner, 101 T.C. 44 (1993), affirmed 95-2 USTC ¶60, 215 (7th Cir. 1995).

Except to any extent that the power subjects property to gift tax or estate tax or the power holder exercises the power, the power does not cause the power holder to become the transferor for generation-skipping tax purposes. Therefore, the power does not dissipate the effect of allocation of GST exemption of the original transferor. Code §2652(a).

3A.08(a)(6) Income Tax Implications and Planning

The most important of the income tax implications is that the right to withdraw causes the power holder to own both (i) all ordinary income that is subject to the power and (ii) all income, ordinary and other, that is attributable to the principal that is subject to the power. Code §678(a)(1). See generally Code §671 and Treas. Reg. §1.671-3. For example, a right to withdraw a fractional portion of a trust estate causes the power holder to own, for income tax purposes, all of the ordinary and other income of the fractional portion.

If, as in the alternative version of the Give-Me-Five unitrust in **variable c** of *Form 3.31*, the donee has the unlimited power to select the exact assets that are to satisfy the right, what portion of the trust is subject to the right, and, thus, what items of income and deduction, etcetera is the donee deemed to own? Cf. Rev. Rul. 67-241, 1967-2 C.B. 225. According to grantor-trust principles under Code Section 678, does the donee of the right to withdraw own (for income-tax purposes) whatever assets the donee in fact uses to satisfy the right? Even if this theory can apply to an exercise of the right to withdraw, this theory, per se, seems not to offer any guidance to the extent of any lapse of the right. To such extent (if any) as the Give-Me-Five power is not exercised, what basis exists for attributing certain assets rather than others? Absent any basis (and this writer does not know of any), treatment of the Give-Me-Five power as a right to withdraw a fractional portion (at least except to any extent that any withdrawal exceeds a fractional portion) would seem most fair.

Similarly, if (as is possible in the case of each alternative of the Give-Me-Five unitrust) (i) the trustee has an unlimited power (subject in **variable c** of *Form 3.31* to a similar power in the donee personally) to select the exact assets that are to satisfy the right and (ii) the donee is the trustee, what portion of the trust is subject to the right, and, thus, what items of income and deductions, etcetera is the donee deemed to own? Again, according to grantor-trust principles under Code Section 678, can the donee of the right to withdraw own (for income-tax purposes) whatever assets the donee in fact uses to satisfy the right? Again, even if this theory can apply to an exercise of the right to withdraw, this theory, per se, seems not to offer any guidance to the extent of any lapse of the right. Again, to such extent (if any) as the Give-Me-Five power is not exercised, what basis exists for attributing certain assets rather than others? Again, absent any basis (and this writer does not know of any), treatment of the Give-Me-Five power as a right to withdraw a fractional portion (at least except to any extent that any withdrawal exceeds a fractional portion) would seem most fair.

The rules that apportion income, for income tax purposes, between a trust and its beneficiaries based upon the amount of distributable net income that is, or is not, carried from the trust to the beneficiaries upon distributions of assets from the trust should not apply to any portion of the trust that, because of the right to withdraw, is treated as owned by the donee according to Code Section 678. Rev. Rul. 67-241, 1967-2 C.B. 225. Rather, the system should treat the holder of the power as receiving that which he or she already owns. The holder, for example, of a right to withdraw a fractional portion is regarded, for income tax purposes, as owning the fractional portion.

Although Revenue Ruling 67-241, 1967-2 C.B. 225, seems to support the proposition that the power holder owns, for income tax purposes, that which he or she can withdraw and, therefore, the distributable net income rules do not apply to any exercise of the power, the regulations promulgated according to Code Section 665 (Treasury regulations section 1.665(b)-1A(d), Example 4) clearly assert that the throwback rules do apply to any exercise of the power. Subsequent to the promulgation of the regulations, Congress abolished most of the application of the throwback rules. However, the abolition might not prevent the reasoning from continuing to apply. See Code §665(c). Although the two sets of rules seem inconsistent, and arguably the distributable net income rules should not oust the grantor trust system where the two systems overlap, the planner should appreciate the possibility that the distributable net income rules might apply to an exercise.

The Internal Revenue Service asserts that even after the right to withdraw lapses because the power holder fails to exercise it, except to any extent that the power holder ceases to be the "grantor" according to the principles of Code Sections 671 through 677, the power holder owns, for income tax purposes, all of the trust estate that the exercise of the power would have permitted the power holder to possess. Code §678(a)(2) and Ltr. Ruls. 200022035, 9034004 and 8701007. This result depends upon (i) the theory that a "lapse" is a "release" for purposes of Code Section 678(a)(2) or (ii) the theory that a lapse of a right to withdraw has the same economic effect, and should have the same tax effect, as a withdrawal of property from a trust and a recontribution of the property to the trust. See Early, "Income taxation of lapsed powers of withdrawal: Analyzing their current status," Journal of Taxation (April, 1985) 198.

Neither of the theories mentioned in the preceding paragraph clearly controls. Code Sections 2041(b)(2) and 2514(e), on the one hand, state that a lapse is treated as a release except to any extent that a lapse within the limits of the five-and-five rules is not treated as a release. Code Section 678(a)(2), on the other hand, does not state that a lapse ever is treated as a release. Therefore, according to the argument, a release is something other than a lapse, for purposes of Code Section 678(a)(2). Nevertheless, for purposes of planning, this writer assumes that a lapse is equivalent to a release for purposes of Code Section 678(a)(2).

Assume that a person has a right to withdraw five percent of a trust which has $1,000 of principal and which generates $50 of ordinary income and $100 of corpus income ratably during its first year. As a first example of the application of the Service's position, assume that the power applies during the entire year and lapses at the end of the year. The power holder is regarded as owning five percent of the trust estate and, therefore, as owning five percent of the $50 of ordinary income and five percent of the $100 of corpus income. Even if the power holder never possesses any other power to withdraw, except to any extent that the power holder ceases to be the "grantor" according to the principles of Code Sections 671-677, the power holder owns, for income tax purposes, all of the fractional portion, and thus all of the income of the fractional portion, both during the year in which the power exists and at all times after the power lapses.

As a second example, assume that the facts are the same as in the first example except that the power holder exercises the power. The results are the same as in the first example for the first year and for as long as the power holder owns the withdrawn property and the withdrawn property continues to be a fractional share of the aggregate of what is withdrawn and what remains in the trust.

As a third example, assume that the facts are the same as in the first example except that the power exists only on the first day of the first year. The results are the same as in the first example.

As a fourth example, assume that the facts are the same as in the first example except that (as in the forms) the power exists only immediately before the end of the year. The results are the same as in the first example except that in the first year the power holder arguably does not own, for income tax purposes, any of the trust estate.

As a fifth example, assume that the facts are the same as in the first example except that the power recurs each year. The Internal Revenue Service might assert that the power holder becomes the owner, for income tax purposes, of an additional portion of the trust estate each year. See Code §678(a)(2) and Ltr. Ruls. 200022035 and 9034004. The theory of the Service in Letter Rulings 200022035 and 9034004 is that a power to withdraw five percent each year applies to all of the trust estate (i.e., the same property) each year and, therefore, the power holder has the right each year to withdraw both (i) five percent of the portion of the trust estate that the power holder previously did not own for income tax purposes and (ii) five percent of the portion of the trust estate that the power holder previously did own for income tax purposes. The effect of the theory is that each year the power holder additionally becomes the owner for income tax purposes of five percent of the portion of the trust estate that previously the power holder did not own. The theory of Letter Rulings 200022035 and 9034004 is not binding.

According to another theory applied to the fifth example, the power applies each year to all of the trust estate (i.e., the same as according to the theory of Letter Rulings 200022035 and 9034004) but the power applies, for income tax purposes, each subsequent year the same as it applies the first year, so that the portion that the power holder owns does not increase each year.

According to yet another theory, previously discussed, a lapse is not a release. Therefore, Code Section 678(a)(2) is not operative and the taxpayer owns only any portion that the taxpayer presently can withdraw. An implication of this theory is that the amount of income that the taxpayer owns is a function of the time that the power exists. Arguably, a power that is exercisable only immediately before the end of the year does not cause the taxpayer to own any income.

Perhaps a taxpayer can choose any of the theories, if he or she follows the chosen theory consistently.

If the gross income of the power holder would include all ordinary income of the trust even if the power were not to exist, the power additionally would include only a portion of corpus income in the gross income of the power holder. If, on the other hand, the gross income of the power holder would not include all ordinary income of the trust if the power were not to exist, the power additionally would include a portion of ordinary income and a portion of corpus income in the gross income of the power holder.

The extent to which the addition of the power would alter the tax burden of the power holder would depend upon whether the power would cause the power holder to own the same, or an additional, portion of the trust estate each year. The grantor, in any event, should consider including sufficient flexibility to permit the power holder to receive from the trust sufficient property to discharge any income tax liability of the power holder that is attributable to the trust.

An additional implication for income tax purposes is that even if satisfaction in kind of a right to withdraw a dollar amount would produce a deemed sale of the property which is distributed, expression of the unitrust interest as a right to withdraw a fractional (or percentage) portion of the trust estate (or, alternatively, at least if the exercise of the right is not framed as a withdrawal of a dollar amount and the dollar ceiling in fact does not define the withdrawal, expression of the right to withdraw as so much of the trust estate as has a value at the time of distribution equal to the value of a fractional portion at the time of lapse or exercise of the right) should cause satisfaction of the right in kind not to produce a deemed sale. Code §663(a)(1), Treas. Reg. §§1.661(a)-2(f)(1), 1.1014-4(a)(3) and 1.663(a)-1(b)(1), Rev. Rul. 60-87, 1960-1 C.B. 286, Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), and Suisman v. Eaton, 15 F. Supp. 113 (D.Conn. 1935), affirmed 83 F.2d 1019 (2d Cir. 1935), cert. denied 299 U.S. 573 (1936). Cf. Rev. Rul 67-241, 1967-2 C.B. 225.

Even more comprehensively, an alternative theory might prevent sale or exchange treatment upon satisfaction in kind of the alternative version of the right to withdraw which appears at **variable c** of *Form 3.31*. According to grantor-trust principles under Code Section 678, because of how the right to withdraw is expressed, the donee of the right to withdraw arguably is the owner (for income-tax purposes) of whatever assets in fact satisfy the right. Cf. Rev. Rul. 67-241, 1967-2 C.B. 225. According to the theory, any deemed sale is a sale by the trustee to the donee. However, because of grantor-trust principles, the trust, to this extent, is an alter ego of the donee. A sale by a person to himself or herself is not cognizable for income-tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 194.

3A.08(a)(7) Interface Between Income Tax and Transfer Tax Implications, and Planning for It

By including income in the gross income of a unitrust recipient who does not receive the income but who nevertheless pays the income tax upon it and thus preserves it intact for others, the right to withdraw might enhance the property that a given amount of transfer (for gift or estate tax purposes) can make available for members of the family of the power holder. However, with uncertain effect, the Internal Revenue Service might attempt to treat the power holder's payment of income tax as a contribution to the trust to any extent that the payment exceeds the amount that the power holder receives from the trust. The Internal Revenue Service announced this position in Letter Ruling 9444033. However, the Internal Revenue Service withdrew the position in Letter Ruling 9543049, which the Service used to modify Letter Ruling 9444033.

Treatment of the payment of tax as a contribution would include the deemed contribution in the gross estate or transfers for gift tax purposes, or (depending upon the configuration of the trust) both the gross estate and the transfers for gift tax purposes, of the power holder. Code §2511. The power holder can avoid these results by receiving from the trust, each year, property that has a value at least equal to the marginal amount of income tax which the right to withdraw causes the power holder to pay.

A grantor can arm the power holder, himself or herself, with the solution to this transfer-tax issue by giving the power holder a nongeneral power to appoint the trust estate and a continuing right to withdraw any of the trust estate that, because the power holder contributed it or is deemed to have contributed it, would be included in the gross estate of the power holder for estate tax purposes if the power holder were to die. Alternatively, the grantor can address the issue by giving the power holder a nongeneral power to appoint the trust estate and, instead of giving the power holder a power to withdraw the would-be-"included portion," give an independent trustee a discretionary power to pay the would-be-included portion to the donee of the Give-Me-Five power. As an additional alternative, perhaps a trustee can address the issue by exercising an ascertainable-standard-limited power to pay the would-be-included portion to the donee.

Because of the apparent dissipation of the transfer-tax issue as an issue, the writer now prefers not to include a right to withdraw the included portion but, rather, to rely upon a discretionary power in the hands of an independent trustee and an ascertainable-standard-limited power in the hands of any trustee and, if the grantor wants, to add only a provision that eliminates any income-tax burden which the donee of the Give-Me-Five power might want not to assume.

The issue of imposition of an unwanted burden to pay income tax appears more important than the issue of whether a donee's payment of income tax is deemed a contribution to the trust. Even if the donee's payment were a contribution, the contribution would tend not to increase exposure to transfer tax. The same exposure would exist if the trustee were to return the contribution to the donee. Additionally, an independent trustee with discretionary power (or perhaps even any trustee pursuant to an ascertainable-standard-limited power) could avoid the inclusion by distribution to the donee of any of the trust estate that, but for the distribution, the Give-Me-Five power would include in the transfer tax base of the donee. By contrast, although an independent trustee can use a discretionary power (or perhaps even any other trustee can use an ascertainable-standard-limited power) to eliminate the burden of a donee of a Give-Me-Five power to pay income tax on income that the donee is deemed to own according to Code Section 678, the donee might prefer in any event to avoid the insecurity of not knowing whether the trustee will relieve the burden.

A grantor who is considering eliminating the insecurity confronts a dilemma. Elimination of the insecurity seems to require inclusion of a mandate in the governing instrument. Although a donee can exercise a power of appointment to install or eliminate the mandate for beneficiaries after the death of the donee, the donee appears unable to install or eliminate a mandate for the donee. Inclusion of a mandate will tend to enhance the security of the donee but, assuming that a donee's payments of income tax are not deemed contributions, reduce the portion of the trust estate that can escape transfer tax. Elimination of a mandate will tend to reduce the security of the donee but, assuming that a donee's payments of income tax are not deemed contributions, increase the portion of the trust estate that can escape transfer tax. The solution that the writer currently endorses is to include the mandate but to permit an independent trustee to remove it.

3A.08(a)(8) Conclusion

Compared to a trust that mandates the current payment of all income, a withdrawable-percentage unitrust might increase the taxable income of the primary beneficiary and reduce the taxable income of the trustee. However, the rate that applies to the taxable income of a trustee reaches the maximum at a lower level of taxable income than the rate that applies to the taxable income of an individual. Therefore, the withdrawable-percentage unitrust usually will not increase (and often will decrease) the aggregate of the income tax. Although the withdrawable-percentage unitrust will tend to increase the difficulty of determining the income tax, it will tend not to increase the tax itself. A withdrawable-percentage unitrust that is designed for flexibility can cope with the additional complexity.

Transfer tax advantages and investment advantages are what make the withdrawable-percentage unitrust an attractive alternative to a trust that mandates the current payment of income. Free of transfer tax, the primary beneficiary of the withdrawable-percentage unitrust can cause the trust to shelter from transfer tax at least all of the trust estate in excess of the aggregate of the income tax liabilities of the beneficiary, and of the trustee, with respect to taxable income that is attributable to the trust. By contrast, the most that the primary beneficiary can allow to pass free of transfer tax by means of the pay-all-income trust is the portion of the trust estate that exceeds the sum of the trust accounting income and the income tax liability of the trustee. Stated differently, this portion consists of the trust accounting principal that remains after the trustee pays all income tax upon corpus income.

Even assuming that the Internal Revenue Service is correct about a beneficiary making a contribution to a trust to the extent that the beneficiary's payment of income tax upon taxable income which is attributable to the trust exceeds what the beneficiary receives from the trust, (i) all of the trust estate (i.e., trust accounting income plus trust accounting principal) net of the income tax upon the taxable income that is attributable to the trust exceeds (ii) the trust accounting principal net of income tax upon corpus income. The difference is significant. It consists of the amount by which trust accounting income exceeds the income tax that is attributable to the trust accounting income. Stated differently, this amount is the after-tax income of the trust.

SUBCHAPTER B:
OTHER BENEFICIARIES:
DISCRETIONARY DISTRIBUTIONS:
NONINDEPENDENT PERSON
POSSESSES NONFIDUCIARY DISCRETION
(POWERS OF APPOINTMENT)

3B.01 DURING LIFE OF POWER HOLDER

3B.01(a) Nongeneral Power of Appointment

Form 3.32

Additionally, the Trustee shall pay so much or all, if any, of the
a **[principal]**
b **[trust estate]**
to such one or more
c **[members of a group consisting exclusively of my descendants]**
d **[appointees, other than my wife and the estate, creditors and creditors of the estate of my wife,]**
in such amounts and portions and subject to such trusts, terms and conditions as my wife directs in writing at any time and from time to time.

e **[Section 4.06. Certain Powers of Appointment. Anything to the contrary notwithstanding, no power of appointment granted in this instrument with limitation of permissible appointees shall be exercisable, directly or indirectly, (a) to discharge any legal obligation of the person given the power or (b) in favor of the person given the power or the creditors or the estate or the creditors of the estate of the person given the power. The preceding sentence shall not apply to any power given a trustee or to any power to withdraw.]**

3B.01(a)(1) Effects of Possession and Exercise

The exercise of a nonfiduciary, nongeneral power of appointment by a power holder who has a beneficial interest in the subject property is deemed to be a gift to such extent as the exercise transfers the beneficial interest of the power holder. Rev. Rul. 79-327, 1979-2 C.B. 342, and Regester v. Commissioner, 83 T.C. 1 (1984). Contra James C. Self, Jr. v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), 56-2 USTC ¶11,613. Because the power is not a fiduciary power of a trustee, an ascertainable standard is not a solution. Treas. Reg. §25.2511-1(g)(2). The mere possession of this power does not include the property in the transfer tax base of the power holder.

3B.01(a)(2) Preventing General Power of Appointment Because of Power Holder's Powers To Pay to Other Than Self

The ability of a person to exercise this power to discharge his or her legal obligation seems very unlikely. The power permits payments only to other than the power holder. Any payment that would discharge a legal obligation of the power holder would seem to be solely for the benefit of, and, therefore, a payment to, someone to whom the power does not permit distributions and, therefore, would appear to violate the trust. Assuming that the issue otherwise would exist, use of **variable e** in *Form 3.32* should avoid it.

* * *

3B.02 AFTER DEATH OF POWER HOLDER

3B.02(a) Nongeneral Power of Appointment Exercisable by Will

Form 3.37

(B) Disposition on Death of Survivor. Upon the death of my wife, if my wife survives me, the Trustee shall distribute the trust estate of the Remainder Trust to such one or more
a **[members of a group consisting exclusively of my descendants]**
b **[appointees, other than the estate, creditors and creditors of the estate of my wife,]**

> **in such amounts and portions and subject to such trusts, terms and conditions as my wife may appoint by Will specifically referring to this power. Upon the death of the survivor of my wife and me, to such extent, if any, as the trust estate of the Remainder Trust is not effectively appointed, the Trustee shall distribute the trust estate of the Remainder Trust to the Trustee of the Family Trust under Section 3.05.**

3B.02(a)(1) Estate and Gift Tax Effects

Neither the possession nor the exercise of a nongeneral power of appointment that is exercisable by will generates any liability for gift tax or estate tax.

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CHAPTER 4

SHELTERING OF EXEMPTIONS: METHODS, AMOUNTS AND ADJUSTMENTS

4.01 OWNERSHIP AND PAYMENT OF ASSETS

4.01(a) Transfer Tax

As estate tax and generation-skipping tax exemptions increase, in phases, according to the tax law of 2001, increased opportunities will exist for spouses to benefit themselves and the survivor of the two of them and yet leave assets to or for other beneficiaries totally free of estate tax and generation-skipping tax. Nevertheless, many are dying without using even current exemptions, under circumstances in which surviving spouses will have assets that greatly will exceed their own exemptions. These situations are wasted opportunities.

The manner in which a spouse owns his or her assets during his or her life and provides for their payment upon his or her death is critically important. It will become even more important as increased exemptions phase into existence. Use of the increased exemptions of each of two spouses, regardless of which spouse dies first, will require corresponding adjustments in ownership and payment. Contrary to the use of the marital deduction, the use of the exemptions of a predeceasing spouse upon his or her death requires that the predeceasing spouse transfer property in such manner as does not cause the surviving spouse to own (or be deemed to own) it.

A lawyer can prepare documents that can implement the clients' plan. However, the clients must arrange the ownership and payment of their assets in such manner as enables the documents to operate properly.

A first prerequisite to the full use of the exemptions of each of two spouses is that each spouse must own, in his or her separate name (or in the name of the trustee of his or her revocable trust) or by means of an interest in an inter vivos QTIP trust, assets which will not pass outright to the surviving spouse and which have a value equal to the greater of the unused amount of the estate tax exemption and the unused amount of the generation-skipping tax exemption.

Even though proper ownership is critically important, it is only a first prerequisite to the use of the exemptions. A second prerequisite is that assets which are intended to use exemptions must not be subject to payment arrangements (such as, for example, joint tenancy, tenancy by the entireties, community property with right of survivorship, payable-on-death and beneficiary designation) which "force" the assets outright to a surviving spouse. These payment arrangements do not use the exemptions. Indeed, as the exemptions increase, these payment arrangements will tend increasingly to prevent the use of the exemptions.

Not all (or, in a given case, even necessarily any) assets are available to permit the use of exemptions. First, any assets that should pass outright to the surviving spouse upon the death of the predeceasing spouse are not available. Second, upon the death of the owner, certain assets, such as interests in qualified plans of deferred compensation, individual retirement accounts and tax-deferred annuities, produce better results for income tax purposes if they are payable outright to a surviving spouse rather than to a trust. Accordingly, absent special circumstances, the writer usually counsels (i) naming the surviving spouse as first beneficiary of interests in qualified plans of deferred compensation and individual retirement accounts and (ii) providing for passage to a trust only to any extent that the spouse disclaims. Thus, usually, these interests are only conditionally available upon the death of the owner and the use of other assets is preferable. Third, during the life of the owner, the mere transfer of certain assets (such as interests in qualified and nonqualified plans of deferred compensation, individual retirement accounts, tax-deferred annuities and any other assets that include ordinary income not yet taxed) can accelerate the recognition of income for income tax purposes. Accordingly, these assets generally are not available for transfer during the life of the owner. Fourth, because life insurance tends to have relatively little value until the death of the insured, a given policy of life insurance tends to use the exemptions much better when the insured is the owner. Fifth, other considerations, relating for example to divorce, security, control, management and psychological and mechanical issues (including debt acceleration and dissipation of title and other insurance), are potentially valid reasons to avoid or limit lifetime transfers between spouses.

4.01(b) Income Tax

The general principle of planning to maximize bases for income tax purposes regardless of which of two spouses dies first is that each of two spouses should own, outright, assets that are sufficient to maximize increases in bases (i) if either spouse dies first (i.e., in 2010, assets that have unrealized appreciation of $1,300,000 plus $3,000,000 = $4,300,000) and (ii) if either spouse survives the other spouse but the predeceasing spouse uses a QTIP-style trust to accomplish the spousal increase at his or her prior death (i.e., in 2010, assets that have unrealized appreciation of $1,300,000).

Deemed ownership by means of an interest in an inter vivos QTIP trust clearly is sufficient to enable the owner to use his or her exemptions from the estate tax and the generation-skipping tax. However, deemed ownership by means of an interest in an inter vivos QTIP trust appears insufficient for purposes of permitting a basis increase according to Code Section 1022.

4.01(c) The Reluctant Donor

A property owner often is reluctant to transfer large amounts of property outright to his or her spouse. Considerations of control, management, security and marital stability can loom large. A property owner who is reluctant to transfer assets to his or her spouse but who nevertheless wants to avoid the risk that the prior death of his or her spouse will waste exemptions can consider two options. They are the inter vivos QTIP trust mentioned at 4.01(c)(1) and the intraspousal agreement mentioned at 4.01(c)(2).

4.01(c)(1) Inter Vivos QTIP Trust

Upon the donor's election, the donee spouse is deemed for transfer tax purposes to own the trust estate of an inter vivos QTIP trust. Therefore, the inter vivos QTIP trust is an alternative to outright ownership to enable a less pecunious spouse to use his or her exemptions if he or she dies first. The extent of the flexibility that an inter vivos QTIP trust might offer is the subject of Chapter 11.

4.01(c)(2) Intraspousal Agreement

If an outright gift from one spouse to the other becomes the nonmarital property of the donee, the gift, outright or in trust, can reduce the amount that the donor will receive in the event of a subsequent divorce. An agreement between the spouses that the outright gift or (as the case may be) the trust estate shall be marital property after the transfer might cause the transfer not to reduce the property that the donor will receive upon dissolution of the marriage.

The only difference between the outright transfer and the gift in trust is that, if the gift is in trust and the donee spouse does not receive the trust estate outright upon dissolution of the marriage, a court might not "credit" it entirely to the donee as marital property. The trustee might avoid this problem by terminating the trust upon dissolution of the marriage and distributing the trust estate to the donee. Indeed, if the donor prefers to credit the trust estate to the donee rather than to prevent the property from passing to a subsequent spouse of the donee, the donor might draft the trust to *require* outright distribution to the donee upon any dissolution of the marriage.

Might the characterization of the transferred property as marital property cause the transferor to be deemed to retain an interest in it? Could an interest thus retained undermine the arrangement for tax or dispositive purposes? Consider, for example, whether whatever is deemed retained could prevent the gift from being outright, force qualification for the marital deduction to depend upon compliance with the format of QTIP and preclude compliance by depriving the donee of an income interest for life. Arguably, however, this property would be no different from any other marital property. According to some state law, the classification of property as marital or nonmarital does not regulate the respective interests of the spouses in the property during the marriage. Kujawinski v. Kujawinski, 17 Ill. Dec. 801 (1978), 71 Ill. 2d 563, 376 N.E.2d 1382.

If the donor believes that the characterization of the transferred property as marital property might create some sort of reversionary interest which might jeopardize the marital deduction for gift tax purposes, the donor might avoid the risk by waiving all right to receive the transferred property upon any dissolution of the marriage. If the donor retains less than fifty percent of the marital property of the spouses, the transfer coupled with the waiver might reduce the amount that the donor will receive upon dissolution of the marriage. However, if the donor retains at least fifty percent of the marital property of the spouses, the waiver should tend not to reduce the amount that the donor will receive upon dissolution of the marriage.

4.02 WHY SHELTER RATHER THAN DEDUCT?

Except for gifts that are excluded from taxable gifts, the spouse of the property owner is the only individual for whose benefit the property owner can choose between taxable transfers and (by means of the marital deduction) nontaxable transfers. When transferring property for the benefit of a spouse, to what extent (if any) should a donor or predeceasing spouse avoid including the transferred property in the transfer tax base of the other spouse, i.e., not use the marital deduction and instead avoid transfer tax by using a taxable transfer and a credit against the resulting tax?

The applicable or unified credit of a taxpayer can "shelter" the transfer of the "exemption equivalent" from transfer tax not only upon its transfer by the decedent or donor but also at least at the level of the generation of the decedent or donor. The amount that can pass free of transfer tax because of the applicable or unified credit and that, therefore, is equivalent to an amount that is exempt from transfer tax is sometimes known as the "credit-shelter" or "exemption-equivalent" amount. As to the portion of the exemption equivalent that is consumed and, thus, is not available for beneficiaries, "sheltering" refers to using various credits to eliminate tax. A property owner can make the exemption equivalent (minus such portion of it as is represented by items that are consumed, e.q., costs of administration that are not deducted for United States estate tax purposes) available for enjoyment by one or more persons without including in the transfer tax base of any person any of the property that is not distributed to the person.

The applicable or unified credit (and certain other credits) permanently can eliminate tax at the level of a particular generation. However, to such extent as it causes the recipient to have a sum of adjusted taxable gifts and taxable estate greater than the amount that the applicable or unified credit of the recipient can shelter, the marital deduction only can defer the tax.

4.03 ALL OR NOTHING AT ALL

Some practitioners apparently intend to use by-pass-type trusts to shelter to the maximum extent transfers that occur while the estate and generation-skipping taxes exist and not to use at all these types of trusts to shelter transfers that occur after repeal. These practitioners would create ever-larger shelters until 2010, and no shelters whatever after 2009.

Unrefined versions of this planning appear to present inconsistencies. A first glance might suggest that consistency requires either termination of all shelter vehicles at the time of repeal, or, alternatively, that it requires continuation of sheltering of all transfers that occur while the estate and generation-skipping taxes do not exist.

The first glance would appear incomplete, as the variables have different implications for different situations. As seen from the perspective of a possible restoration of the taxes after repeal, repeal is simply the upper limit of a progression of increases in exemptions. As seen from this perspective, the planner would continue to use the shelter possibilities of repeal, for the same reason that the planner would use the shelter possibilities of the exemption increases that precede repeal.

4.04 A MORE MEASURED APPROACH

Rejection of planning that would terminate all shelters in all situations at the same time does not necessarily imply rejection of planning that would terminate some shelters in some situations at some time. If some level of exemption is sufficient, per se, without the use of any trust, to shelter all transfers from tax, the use of trusts to supplement exemptions might become unnecessary at some level of exemption. Focusing solely upon estate tax at the level of the generation of a property owner and his or her spouse, if the aggregate transfers that would be taxable for estate tax purposes would be less than the exemption, the predeceasing spouse could transfer his or her property any way he or she wished, outright or otherwise, because no sheltering by means of by-pass trusts would be necessary to eliminate estate tax at the level of his or her generation.

Focusing again solely upon estate tax at the level of the generation of a property owner and his or her spouse, if the aggregate transfers that would be taxable for estate tax purposes would be between one and two times the exemption, some use of by-pass-type trusts to shelter the exemption would be indicated upon the death of the predeceasing spouse in order to eliminate estate tax at the level of the generation of the spouses. The indicated shelter would range from zero (at the level of aggregate transfers equal to one exemption) to the entire amount of the unused exemption of the predeceasing spouse (at the level of aggregate transfers equal to two exemptions).

Planning for aggregate transfers of more than one but less than two times the exemption often follows a pattern of using by-pass-type trusts to shelter *all* of the exemption of the predeceasing spouse rather than using by-pass-type trusts to shelter only so much of the exemption as, if the exempt transfers were added to the property of the surviving spouse, would exceed the unused exemption of the survivor. Assume, for example, that the exemption is $2,000,000, that a husband has $2,100,000 and that his wife has zero. The husband can eliminate tax by using a by-pass-type trust to shelter only $100,000 of the husband's exemption. Thus, the husband can make an outright disposition of $2,000,000. However, "classical" marital-deduction planning would use a by-pass-type trust to shelter $2,000,000 and would include a disposition of only $100,000 outright.

Assume that the husband owns most of the income-producing property of the family, that the value of this property approximates the exemption and that the nonincome-producing property (consisting of a home and tangibles) should pass outright to the surviving spouse. Is "classical" planning appropriate? Asked differently, is a shelter trust an appropriate vehicle for most of the income-producing property of the family? Because of possible increases in values and decreases in exemptions, any other planning risks adding too much value to the gross estate of the surviving spouse.

Focusing yet again solely upon estate tax at the level of the generation of a property owner and his or her spouse, if the aggregate transfers that would be taxable for estate tax purposes would exceed two times the exemption, use of a by-pass-type trust would be indicated to shelter all of the property of the predeceasing spouse to the extent of the unused exemption of the predeceasing spouse.

The unknown variables are, first, the amounts of transfers that will occur and, second, the amounts of exemptions that will be available when the transfers occur. These variables will determine the extent to which shelter by means of by-pass-type trusts is necessary to avoid the taxes.

As concerns the amounts of exemptions, the property owner might plan by assuming exemptions equal to the exemptions that are in place, or that shortly are to become effective, as of the time of the planning. A premise is that Congress might repeal increases that are scheduled for the future. Another premise is that Congress will not repeal increases that presently exist or that are the first-scheduled to occur.

As concerns the amounts of transfers, the planner might apply procedures similar to those that the planner used before EGTRRA to determine the propriety of sheltering by means of by-pass-type trusts. The property owner might project forward from the time of the planning to the scheduled time of repeal and, on the basis of the owner's view about the value of the owner's property, the likelihood of the occurrence and continuation of repeal and the amounts of exemptions that likely will attend a restoration of the taxes, determine the extent (if any) that shelter by means of a by-pass-type trust is reasonably likely to save tax.

As a matter of principle, an analysis that compares exemptions and transfers under the EGTRRA regime is quite similar to, but much more tenuous than, the type of analysis that a property owner often undertook before EGTRRA to determine the advisability of using by-pass-type trusts to shelter exempt amounts. A property owner in any event might have little ability to know whether the shelter of a by-pass-type trust is reasonably likely to save tax. Often, a property owner will have little ability to predict the net worth of a descendant. Among the unknowables are the one or more marriages of the descendant and the one or more marriages of each ancestor of the descendant who also is a descendant of the property owner. Uncertainty about the rules and about the time that apparently must pass before a by-pass-type trust can save tax after repeal compound the difficulty.

Repeal might prove, for many situations, a convenient and otherwise appropriate juncture at which to stop, or at least to reassess, the use of trusts to supplement exemptions. The propriety is attributable to the probability that, even if the taxes are restored, the exemptions greatly will exceed the wealth of many, if not most, individuals for whom sheltering by means of by-pass-type trusts is standard fare. The convenience is attributable to a necessity, in any event, to change dispositions, or at least the description of dispositions, upon repeal. Standard formulae will tend to function intelligibly, albeit in some cases increasingly roughly, until repeal. Any attempt to refine by terminating shelter at a particular level of increased exemption would appear to present greater risks than those that it would address. A property owner might determine that repeal is a convenient and appropriate time to stop using by-pass-type trusts to shelter future transfers but to continue to use by-pass-type trusts to shelter prior transfers.

Increases in bases according to Code Section 1022(c) are available for dispositions that are outright or in QTIP-style trusts. Therefore, whether a property owner will use the format of the QTIP-style trust (i.e., a by-pass-type trust), rather than an outright gift, can depend solely on transfer tax and nontax, rather than on income tax, considerations. A property owner whose wealth clearly does not exceed the amount that the restored taxes would exempt and who is willing to use an outright transfer to a surviving spouse to maximize bases increases according to Code Section 1022(c) might have no need for by-pass-trust sheltering upon and after repeal.

Interestingly, the exemptions that will be available before repeal will permit a property owner to transfer assets to other than a surviving spouse, but the effectively unlimited exemptions that will be available during repeal will tend to skew dispositions solely to or for the spouse. The reason is that repeal also will carry with it an incentive to allocate assets (consisting of such assets as are sufficient to absorb bases increases of three million dollars or more) in a basis-increase type of trust for the surviving spouse. The planning implications of this diversion are startling. Even in situations in which the surviving spouse is wealthy and does not need the beneficial enjoyment of the assets of the decedent, and persons other than the spouse do need the beneficial enjoyment of those assets, a decedent who wants to maximize bases might have to deploy most or all of his or her wealth to or for his or her spouse.

The property owner whose estate clearly exceeds the amounts necessary to increase bases according to Code Section 1022 can use a formula to allocate to a nonQTIP-style, by-pass-type trust the assets that are necessary to increase bases according to Code Section 1022(b), can use the same formula to allocate to a QTIP-style trust the assets that are necessary to increase bases according to Code Section 1022(c) and can use the same formula yet again to allocate the balance of the assets to the nonQTIP-style, by-pass-type trust.

The uncertainty and corresponding desire for flexibility and simplicity might cause a property owner who remains reluctant entirely to forgo sheltering by means of by-pass-type trusts to determine, at least, that repeal is a convenient and appropriate time to shift to the discretionary use of by-pass-type trusts, by means of disclaimers, and to stop the mandatory use of by-pass-type trusts. For example, a property owner who encounters the increasingly likely situation in which only a relatively small amount of assets will remain for a basis increase according to Code Section 1022(c), after the amount that can maximize bases according to Code Section 1022(b) is allocated to a nonQTIP-style, by-pass-type trust, can use a formula to allocate to a nonQTIP-style, by-pass-type trust the assets that can maximize basis according to Code Section 1022(b) and to allocate the balance outright to the spouse or, to such extent as the spouse disclaims in order also to shelter some or all of the excess, to a QTIP style of disclaimer receptacle. Alternatively, a property owner can leave all assets outright to the spouse or, to such extent (if any) as the spouse disclaims in order to shelter by means of a by-pass-type trust, to a QTIP style of disclaimer receptacle.

Alternatively, a property owner who wants to mandate a maximum shelter or for nontax reasons does not want to use an outright gift to a spouse but nevertheless wants to respond to uncertainty with relative flexibility and simplicity can allocate all assets to a QTIP-style trust. This configuration will sacrifice some efficiency of shelter, as, of course, it will force all income into the hands of the surviving spouse. Accordingly, the owner who uses this type of vehicle will trade some inefficiency of shelter for some efficiency of administration.

* * *

4.07 PRESERVING THE CHOICE

The alternatives with respect to transfers in excess of the exemption equivalent are (i) use the marital deduction and defer tax, (ii) forgo the marital deduction and (iii) forgo the marital deduction and use the credit for tax on prior transfers. The extent to which use of the marital deduction is advisable might depend upon (i) the ability of the surviving spouse to benefit from the deferred tax after the death of the predeceasing spouse and (ii) the availability of the credit for tax on prior transfers. Each of these is a function, among things, of the length of time that the surviving spouse survives. Use of the credit for tax on prior transfers often is the most attractive alternative in terms of minimizing the cost of transferring property to beneficiaries in lower generations.

The principal object of planning is to preserve the choice as long as possible. Maximization of flexibility to use or not to use the marital deduction requires (i) making the deduction available *both* (a) for the estate of the predeceasing spouse if one spouse survives the other *and* (b) for whichever estate for which it will produce the better result if the spouses die simultaneously and (ii) avoiding dispositive provisions that force the use of the marital deduction before other rules force the making of a choice.

QTIP is the only marital arrangement that meets these criteria. QTIP is the only arrangement that need not have dispositive provisions that force the principal into the gross estate of the surviving spouse. Unlike outright gifts and power-of-appointment arrangements, the creation, per se, of a QTIP arrangement does not include the principal in the gross estate of the surviving spouse. A power-of-appointment arrangement can defer the choice only for the longest time (i.e., six months) that the predeceasing spouse can require the surviving spouse to survive or, at most, the time within which any disclaimer is timely (i.e., nine months). However, a QTIP arrangement can defer it at least fifteen months. The choice between use and nonuse of the marital deduction is required by the due date (including extensions) for the estate tax return. The return is due nine months after the death of the decedent, but an extension of six months automatically is available.

Preserving the possibility (but nevertheless avoiding the necessity) of qualifying the arrangement for the marital deduction requires the planner always to consider providing that the spouse is presumed to survive if the testator and the spouse die under circumstances that there is no sufficient evidence that they died other than simultaneously. *If* the testator desires to include a general power of appointment over any of the trust, condition it upon the spouse's survival by fifteen months, in order, if the spouse dies before the power becomes operative, to preserve the choice.

The interest of the spouse in a disposition that has the format of QTIP but with respect to which a QTIP election is not made is measurable according to actuarial principles. Therefore, a failure to make a QTIP election avoids inclusion of the principal in the gross estate of the spouse but qualifies the interest for the credit for tax on prior transfers.

* * *

4.09 RECEPTACLES FOR SPOUSAL DISCLAIMERS

A person who wants to make a qualified disclaimer according to Code Section 2518 must not have any power to direct enjoyment of any disclaimed interest in a nontaxable transfer. Several approaches appear available to produce this result when a trust is to serve as a receptacle for disclaimed property. The passage of disclaimed property to a disclaimant who is not the spouse of the decedent prevents the disclaimer from being qualified. Therefore, any approach that causes the disclaimer to "pass" the property from one disposition to another and yet to accord the disclaimant an interest or a power is available only if the disclaimant is the spouse of the decedent.

The disclaimant should consider supplementing each of the approaches by disclaiming any powers over the disclaimer receptacle that otherwise might permit the disclaimant to direct the enjoyment of the portion of the trust estate which passes to the disclaimer receptacle because of the disclaimer. The regulations use a rule of convenience for this purpose. Treas. Reg. §25.2518-2(e)(5) Ex. (5). The regulations permit the disclaimant to disclaim such fractional portion of the power(s) as corresponds to the value of the disclaimed property compared to the value of all of the property including the disclaimed property.

4.09(a) Special "Disclaimer" Trust

Form 4.5

(D) Certain Disclaimers. If my wife disclaims any property that (absent the disclaimer) would be disposed by the preceding portion of this Section, the Trustee as of my death shall distribute the property to the Trustee of the Disclaimer Trust under Section 3.03, without my wife being deemed to predecease me because of the disclaimer. If my wife disclaims all interest that (absent the disclaimer) my wife would have in any property according to Section 3.03, the Trustee as of my death shall distribute the property as if my wife were to have predeceased me.

Section 3.03. Disclaimer Trust. The Trustee shall set apart, in a separate trust to be known as the "Disclaimer Trust" and to be administered according to this Section, any property distributed to the Trustee of the Disclaimer Trust. Anything to the contrary notwithstanding,

a **[except for a fiduciary power granted in this Section to distribute to my wife subject to an ascertainable standard,]**

my wife shall not possess any power to direct the beneficial enjoyment of the trust estate of the Disclaimer Trust.

(A) Disposition During Life of My Wife. During the life of my wife, the Trustee shall administer the Disclaimer Trust as provided in this subsection (A). The Disclaimer Trust is primarily for the benefit of my wife, and I would approve (but do not direct) the exercise of each power (determined as if this sentence did not exist) to the maximum extent in favor of my wife.

(1) Income. The Trustee shall pay the net income to my wife quarter-annually.

(2) Principal. The Trustee shall pay to my wife so much or all, if any, of the principal as the Trustee determines to be necessary or advisable from time to time, considering resources otherwise available, to provide for her health, education and support in the manner of living to which accustomed. Additionally, the Trustee shall pay to my wife so much or all, if any, of any balance of the principal as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the trust.

(B) Disposition on Death of My Wife. Upon the death of my wife, the Trustee shall distribute any undistributed or accrued income to her estate and shall distribute the principal to the Trustee of the Family Trust under Section 3.05.

4.09(a)(1) Purpose and Drafting

A first approach, of which Form 4.5 is an example, is to include a trust that solely is a receptacle for disclaimed property. Although this approach increases the length of the governing instrument, it avoids uncertainty about the terms of the disclaimer vehicle. The disclaimer trust might have an uneconomic size if it remains a separate trust. However, the fiduciary might avoid the problem by consolidating the disclaimer trust with an identical or similar trust. If the other trust is similar but not identical, the fiduciary might accomplish the consolidation by causing certain features to apply only to a fractional portion of the consolidated trust. This, of course, is an analogy to the disclaimer of powers that this writer has suggested as a supplement to each of the approaches.

4.09(b) Existing Trust

A second approach is to cause the disclaimed property to pass to a trust that is designed to serve other than solely as a disclaimer receptacle and, therefore, is to be included in the governing instrument in any event. This arrangement is available only if an existing trust is a satisfactory vehicle. This approach might tend to cause the drafter to draft the dual-purpose trust more rigidly than its principal purpose, considered alone, would require.

4.09(c) Existing Trust, With Modifications

A third approach is to cause the disclaimed property to pass to a trust that exists to serve another purpose and to provide additionally that, with respect to the existing trust, the disclaimant shall not have any power to direct enjoyment which would cause the disclaimer to be a transfer for transfer tax purposes. If this approach describes a vehicle that is similar, but not identical, to the existing trust, it effectively describes a situation similar to that of the consolidation, discussed above, of trusts that are similar but not identical. Because this approach tends to be self-executing in the sense that it shapes the complexion of the receptacle at least partially by reference to tax results rather than by reference to specific powers, some draftspersons might decline to use it. Additionally, this approach is available only if an existing trust is (with the prescribed modifications) a satisfactory vehicle.

4.09(d) Special "Disclaimer" Trust, Created by Reference to Existing Trust

A fourth approach is to create a trust that solely is to serve as a receptacle for disclaimed property but, unlike the first approach which uses a verbatim statement of all features of the trust, to create the trust by means of a single paragraph that incorporates by reference (with modifications) the description of another trust that is included for a different purpose. For example, the draftsperson might incorporate by reference and with specified modifications the description of the trust that is designed to qualify for the marital deduction, either specifically or by reference to tax results, or both. This approach is similar to the first. Compared to the first, it shortens the instrument. However, the brevity requires difficult drafting and can produce confusion.

4.09(e) Original Trust

A fifth and different approach is simply to use the original disposition modified by the deletion of any disclaimed interest. This approach does not cause the property to pass to another vehicle. Thus, it does not require special drafting. However, if the governing instrument in any event includes drafting for one of the approaches discussed above, the disclaimant has a choice. The disclaimant can invoke one approach by disclaiming one or more "interests" or can invoke the other approach by disclaiming the "property."

4.10 ENHANCING THE USE OF SPOUSAL DISCLAIMERS THAT SALVAGE EXEMPTIONS BUT DO NOT FORGO ENJOYMENT

The purpose of the planning that is discussed in this 4.10 is to permit a surviving spouse to salvage the estate tax exemption (and, in some cases, also the GST exemption) of a predeceasing spouse with respect to property which, but for a disclaimer, is destined to pass outright to the surviving spouse. The planning also is intended to enable the surviving spouse to avoid the dilemma of including the property in his or her gross estate or forgoing beneficial enjoyment. This type of planning will become increasingly important as exemptions increase.

4.10(a) Outright to Spouse by Joint Tenancy, Beneficiary Designation or Bequest but, if Spouse Disclaims, in Sheltered Disposition for Primary Benefit of Spouse

Form 4.6

> **Section 2.03. Certain Disclaimers. If my wife disclaims any tangible personal property that (absent the disclaimer) would pass to my wife outright (including, without limitation, by bequest, survivorship or beneficiary designation) because of my death and that (considering the disclaimer but assuming that this Section were absent) would pass according to this Will, I give the property as of my death to my wife for her life (with the power, without diverting value, to sell in fee simple any or all of the property; provided, the life tenant and remainder persons shall have the same rights and responsibilities with respect to proceeds of any sale as each, absent the sale, would have had in the property sold, and any purchaser may pay the proceeds to the life tenant without any duty to**

inquire about her application of them) and, upon the death of my wife (upon her death any undistributed or accrued income shall be distributed to her estate), in fee simple to

a [the Trustee of the

ai [Portion Two]

Family Trust created according to the Trust described in Section 2.04]

b [my descendants, per stirpes, who survive my wife]

. If my wife disclaims all interest that (absent the disclaimer) my wife would have in any property according to the preceding sentence, I give the property as of my death as if my wife were to have predeceased me. If my wife disclaims any property (other than any tangible personal property) that (absent the disclaimer) would pass to my wife outright (including, without limitation, by bequest, devise, survivorship or beneficiary designation) because of my death and that (considering the disclaimer but assuming that this Section were absent) would pass according to Section 2.04, I give the property as of my death to the Trustee of the Disclaimer Trust created according to the Trust described in Section 2.04, without my wife being deemed to predecease me because of the disclaimer. If my wife disclaims all interest that (absent the disclaimer) my wife would have in any property according to the Disclaimer Trust, I give the property as of my death as if my wife were to have predeceased me. My Executor shall not take possession of any real property disposed by this Section.

4.10(a)(1) Purpose and Drafting

Form 4.6 is intended greatly to increase the assets (and, therefore, the value) that the surviving spouse can enjoy inside or outside of his or her gross estate and, correspondingly, include in or exclude from the taxable estate of the predeceasing spouse. A QTIP election is available to fine-tune tax results. The form offers a "last chance" for spouses who never have heeded instructions to reconfigure their assets between themselves or who have failed to adjust ownership from time to time to facilitate sheltering of increased exemptions. The form applies to property that, but for a disclaimer, would pass outright to a surviving spouse by bequest or devise or, arguably, joint tenancy or some types of beneficiary designations.

According to Illinois law, for example, "Unless expressly provided otherwise in an instrument transferring the property or creating the interest disclaimed, the property, part or interest disclaimed shall descend or be distributed . . . if a present interest . . . in the case of a transfer by reason of the death of any person, as if the disclaimant had predeceased the decedent . . . ." 755 ILCS 5/2-7(d). As applied to a joint tenancy, the critical question is whether a will is "an instrument transferring the property . . . disclaimed . . . ." Although the "transferring" according to the will occurs only after (and not before) the disclaimer, the answer appears affirmative. Whether the statute originally was intended to apply to the disclaimer of the accretive portion of a joint tenancy appears immaterial, as no reason (including that of public policy) is apparent why a disclaimant of an accretive portion is required, but a disclaimant of a bequest is not required, to be deemed to predecease his or her spouse because of the disclaimer.

Commonly, a beneficiary designation provides that the property passes to a subsequent designee if the primary designee (the spouse of the property owner, in this case) fails to survive the owner. This type of designation "trumps" *Form* 4.6. However, *Form* 4.6 appears to control in the limited situation in which the beneficiary designation includes an ultimate, contingent disposition to the estate of the property owner and either all intermediate designees disclaim their interests or the beneficiary designation does not include any intermediate designee. Whether and to what extent an intermediate designee who is not the spouse of the owner can disclaim a present interest but accept a future interest, consisting of a remainder interest in a disclaimer vehicle, appears unclear. Therefore, a preferred method of accomplishing the desired planning is to avoid the intermediate designation entirely and to plan instead (as in *Form* 4.7) for a disclaimer as an adjunct of the primary designation.

Arguably, a legal life estate is the receptacle of choice in the case of a disclaimer of tangible personal property. A legal life estate permits the surviving spouse to have relatively unimpeded use of tangibles, such as paintings and antiques, until death. The legal life estate for these tangibles is relatively unintrusive for nontax purposes. Nevertheless, it is sufficient for tax purposes.

Some tangibles, such as jewelry, can have significant value but not much "use" to a surviving spouse. By disclaiming both the outright gift and the legal life estate of a particular asset, the surviving spouse can cause the asset to pass outright to children according to a contingent gift to children conditioned upon nonsurvival of the spouse.

Relative flexibility makes a trust the disclaimer receptacle of choice for intangibles and at least some realty. Although some of the "use" characteristics of residences are similar to those of paintings and antiques and, therefore, relatively easily can lend themselves to the configuration of a legal life estate, residences tend to have greater values than tangibles and the greater values can present greater needs for sales and for investment and management of proceeds.

By precluding a surviving spouse from retaining any ability to direct beneficial enjoyment, including by means of powers of appointment exercisable during life and at death, a disclaimer "ossifies" the disposition that begins upon the death of the surviving spouse, perhaps many years after the disclaimer. Thus, a high incentive exists at the drafting stage to fashion a disclaimer vehicle that will tend to obsolesce least over time. Perhaps, simpler is better. Because tax laws and trust designs change more frequently than the feelings of owners about the objects of their bounties, a disposition, for example, "to my descendants, per stirpes, who survive my wife," seems likely to obsolesce less than a disposition to a perpetual trust or, even, a disposition to management trusts for descendants until staged ages. However, because simpler is not necessarily better from a tax perspective, this reasoning seems most persuasive in the case of tangibles, less in the case of realty and least in the case of intangibles. Further, because an owner can transform property of any category into property of any other category, a receptacle that is appropriate only for one type of property is exposed to a risk of a change. Additionally, if a surviving spouse must rely on disclaimers to "fill" the GST exemption of the predeceasing spouse, use of the exemption will tend to require continuing trusts for descendants as receptacles for the disclaimed assets. Arguably, a trust that is appropriate for the entire life of a person in a younger generation is appropriate also, in the event of a disclaimer, for the remaining life of the disclaimant plus the life of a person in a younger generation.

If spouses are unsure at the planning stage about whether the survivor should own a particular asset, such as a home, outright, or instead should enjoy the asset as a beneficiary of a disclaimer vehicle, the spouses should consider whether to retain the asset in joint tenancy or, instead, title the asset solely in the name of one of them and provide specifically by will that the asset shall pass outright to the other if the other survives. According to the former arrangement one-half, and according to the latter all, of the asset can pass to a disclaimer vehicle according to *Form* 4.6. Although in a given situation ownership in the name of one spouse or the other might maximize the property with respect to which the disclaimer planning can operate, in some situations joint ownership might hedge against the inability to know in advance which spouse will die first and whether a need will exist to enhance the taxable estate of the predeceasing spouse whomever it is. Also, spouses might have a reluctance to change title of certain assets, such as a home, from joint tenancy to one of the spouses during the marriage.

Before they transfer ownership of a home, spouses should confirm with the mortgagee that they can transfer ownership without accelerating mortgage debt and they should ask the title insurer whether the transfer will dissipate the insurance and, if it will, whether they can retain the insurance by purchasing an endorsement. Also, they should engage the insurers of the home and its contents to cause the insurance properly to apply after any change of ownership of the home or any other asset.

The inclusion of certain assets in a trust or legal life estate presents special issues. Inclusion of a home, for example, in a trust might (i) make unavailable a homestead exemption for real estate tax purposes, (ii) prevent the surviving spouse from excluding from taxable income any amount by which the home appreciates in value between the death of the predeceasing spouse and the sale of the home and (iii) induce the surviving spouse, for income tax reasons, to purchase or rent the home from the trust. However, the issues arise only if the assets are to pass outright to the surviving spouse upon the death of the predeceasing spouse and the surviving spouse disclaims the outright gift. Therefore, a surviving spouse can review the issues, and accept or avoid them, at the death of the predeceasing spouse.

A remainder interest that follows a legal life estate in a personal residence or farm can qualify for the charitable deduction. Code §§170(f)(3)(B) and 2055(e)(2). If the legal life estate-charitable remainder version is intended to qualify for both the marital deduction and the charitable deduction upon the death of the predeceasing spouse, rather than qualify as QTIP for the marital deduction upon the death of the predeceasing spouse and qualify for the charitable deduction upon the death of the surviving spouse, delete the power of sale. See Code §2056(b)(8).

4.10(b) Gift of Interest in IRA or Qualified Plan Outright to Spouse but, if Spouse Disclaims, in Sheltered Disposition for Primary Benefit of Spouse

Form 4.7

FIRST - If my spouse, JANE A. SMITH, survives me, to my spouse. Notwithstanding the preceding portion of this beneficiary designation, if my spouse disclaims any property that (absent the disclaimer) would be disposed by the preceding portion of this beneficiary designation, the property shall pass as of my death to the Trustee of the Disclaimer Trust created according to my Declaration of Trust dated November 25, 2002, without my spouse being deemed to predecease me because of the disclaimer. If my spouse disclaims all interest that (absent the disclaimer) my spouse would have in any property according to the Disclaimer Trust, the property shall pass as of my death as if my spouse were to have predeceased me.

4.10(b)(1) Purpose

The purpose of this provision is similar to the purpose of the disclaimer planning that is implicit in *Form* 4.6.

4.10(c) Effect of Disclaimer upon Sizes of Marital and Credit-Shelter Dispositions

Form 4.8

For purposes of determining the numerator, the United States estate tax payable because of my death shall be computed as if:

* * *

(ii) All of the trust estate (and all property that because of a disclaimer is not part of the trust estate) of the Marital Trust (and of any other trust the name of which is or includes Marital Trust but does not include Remainder) were to qualify for the marital deduction, and no election according to Section 2056(b)(7) (other than, to the extent possible, a deemed election described in Section 2056(b)(7)(C)) of the Code were to qualify other property for the marital deduction.

4.10(c)(1) Purpose

The draftsperson of a formula-marital or exemption-shelter disposition should consider whether a disclaimer, either solely of property that absent the disclaimer would (but because of the disclaimer would not) fund the formula-marital disposition or, alternatively, of any property, shall cause the marital formula to enhance the marital disposition to the size that the marital disposition would have been if the surviving spouse had not made any disclaimer, or cause the exemption-shelter formula to reduce the exemption-shelter disposition so that the taxable estate is the size that it would have been absent the disclaimer, i.e., effectively, the formula shall ignore the disclaimer.

According to *Form* 4.5, *Form* 4.6 and *Form* 4.7, depending upon the extent of any QTIP elections, the disclaimer can transform the transfer of the disclaimed assets from a deductible transfer to the surviving spouse into a taxable transfer to a disclaimer vehicle. Assume, for purposes of analysis of this 4.10(c)(1) that *Form* 4.8 is part of the formula-marital disposition.

Assume in this paragraph that absent the disclaimer the disclaimed assets would have funded the formula-marital disposition. Even if the transfers to the disclaimer vehicle are taxable and the sum of the values of the disclaimed assets and the taxable estate absent the disclaimer would have exceeded the United States estate tax exemption, the inclusion of *Form 4.8* causes the disclaimer not to "oust" any property from the credit-shelter disposition and not to replace in the formula-marital disposition property with a value equal to the value that the disclaimer removed from the formula-marital disposition. The reason is that inclusion of *Form 4.8* in the formula which produces the formula-marital disposition and the credit-shelter disposition causes the formula to ignore the disclaimer of any assets which, but for the disclaimer, would have funded the formula-marital disposition, i.e., the formula includes assumptions that *this* disclaimer, as opposed to the disclaimer that is described in *Form* 4.6 or *Form* 4.7, did not occur.

Assume in this and the next paragraph that absent the disclaimer the disclaimed assets would have passed outright to the surviving spouse by joint tenancy, beneficiary designation, devise or nonformula bequest, i.e., absent the disclaimer the disclaimed assets would have funded a *nonformula*-marital disposition and would not have funded the *formula*-marital disposition that is described in the first and second paragraphs of this 4.10(c)(1). Taxable transfers of the disclaimed assets to the disclaimer vehicle appear first to "fill" the taxable estate of the predeceasing spouse to the extent of the estate tax exemption and second to "oust" from the credit-shelter disposition (but not from the disclaimer vehicle itself, i.e., the disclaimer does not oust from the disclaimer vehicle any of the disclaimed assets themselves) any amount by which the taxable estate exceeds the exemption and shift the amount to the *formula*-marital disposition. The reason is that *Form 4.8* does *not* cause the formula which produces the formula-marital disposition and the credit-shelter disposition to ignore the effects of *these* disclaimers, i.e., it does *not* include the assumption that *these* disclaimers did not occur.

Reversal of the result that is described in the preceding paragraph would require either (i) broadening of the language of *Form 4.8* to cause the formula to ignore *all* disclaimers by the surviving spouse or (ii) special provision in the disclaimer itself. Is a reversal desirable, by means of provision in the formula? Alternatively, is a reversal desirable by means of *ad hoc* provision in the disclaimer itself? Reversal in the formula would appear in certain situations to foreclose, in advance, a means of "escape" from a taxable estate that, because of unanticipated increases in the value of what would have constituted the taxable estate absent the disclaimer, or because of unanticipated increases in the value of the assets that are disclaimed, unexpectedly exceeds the exemption. Broadening the language of the formula would limit the extent of the disclaimer. The alternative of adding to the disclaimer itself would tend to increase the extent of the disclaimer. Whether to reverse the result that is described in the preceding paragraph should invite scrutiny on a case-by-case basis, as the reversal can deprive the surviving spouse of any estate tax that the reversal generates. Thus, the reversal also can deprive the disclaimant of desired enjoyment or flexibility.

4.10(d) Effect of Disclaimer Upon Size and Inclusion Ratio of GST-Exemption Disposition

4.10(d)(1) Examples

***Form* 4.9**

(C) Disclaimer Trusts 1 and 2. Notwithstanding the preceding portion of this Section:

(1) Creation.

(a) The Trustee as of my death shall set apart, in a separate trust to be known as "Disclaimer Trust Number 1," such fractional share or all, if any, of the trust estate of the Disclaimer Trust as has a numerator equal to the amount (if any) by which (I) my GST exemption unallocated immediately before my death exceeds (II) the sum of the values (for purposes of determining the United States estate tax payable because of my death) of the trust estates of all other trusts the names of which include Number 1 and which are created according to this instrument, and a denominator equal to the value (for such purposes) of the trust estate of the Disclaimer Trust. Notwithstanding the preceding sentence, if the United States generation-skipping tax is not in effect at my death, the Trustee as of my death shall set apart, in a separate trust to be known as "Disclaimer Trust Number 1," all of the trust estate of the Disclaimer Trust.

(b) The Trustee as of my death shall set apart, in a separate trust to be known as "Disclaimer Trust Number 2," the balance of the trust estate of the Disclaimer Trust.

(2) Administration. The Trustee shall administer Disclaimer Trust Number 1 and Disclaimer Trust Number 2 as if each, separately, were the Disclaimer Trust; provided, the Trustee shall pay principal to my wife pursuant to subsection (A)(2) of this Section solely from the trust estate of Disclaimer Trust Number 2 until the trust estate of Disclaimer Trust Number 2 is exhausted.

***Form* 4.10**

(C) Disclaimer Trusts 1 and 2. Notwithstanding the preceding portion of this Section:

(1) Creation.

(a) The Trustee as of my death shall designate as "Disclaimer Trust Fractional Share Number 1" such fractional share or all, if any, of the trust estate of the Disclaimer Trust as has a numerator equal to the amount (if any) by which (I) my GST exemption unallocated immediately before my death exceeds (II) the sum of the values (for purposes of determining the United States estate tax payable because of my death) of the trust estates of all trusts (and other fractional shares) the names of which include Number 1 and which are created according to this instrument, and a denominator equal to the value (for such purposes) of the trust estate of the Disclaimer Trust. Notwithstanding the preceding sentence, if the United States generation-skipping tax is not in effect at my death, the Trustee as of my death shall set apart, in a separate trust to be known as "Disclaimer Trust Number 1," all of the trust estate of the Disclaimer Trust.

(b) The Trustee as of my death shall designate as "Disclaimer Trust Fractional Share Number 2" the balance of the trust estate of the Disclaimer Trust.

(2) Administration. The Trustee at any time may, and in any event no later than upon the death of my wife the Trustee shall, divide the trust estate of the Disclaimer Trust into separate trusts consisting, respectively, of Disclaimer Trust Fractional Share Number 1 and Disclaimer Trust Fractional Share Number 2, and from and after the division the separate trust that is attributable to Disclaimer Trust Fractional Share Number 1 shall be known as "Disclaimer Trust Number 1" and the separate trust that is attributable to Disclaimer Trust Fractional Share Number 2 shall be known as "Disclaimer Trust Number 2." The Trustee shall administer Disclaimer Trust Fractional Share (or, as the case may be, Disclaimer Trust) Number 1 and Disclaimer Trust Fractional Share (or, as the case may be, Disclaimer Trust) Number 2 as if each, separately, were the Disclaimer Trust; provided, until the division of Disclaimer Trust Fractional Share Number 1 and Fractional Share Number 2 into separate trusts, the Trustee shall pay principal to my wife pursuant to subsection (A)(2) of this Section prorata from the trust estate of Disclaimer Trust Fractional Share Number 1 and the trust estate of Disclaimer Trust Fractional Share Number 2, and from and after the division the Trustee shall pay principal to my wife pursuant to subsection (A)(2) of this Section solely from the trust estate of Disclaimer Trust Number 2 until the trust estate of Disclaimer Trust Number 2 is exhausted.

Form 4.11

(c) Portion One additionally shall consist of such of the trust estate of the Family Trust as is attributable to the largest fractional portion of the trust estate of the Disclaimer Trust, of which I am the transferor for generation-skipping tax purposes, that can have an inclusion ratio of zero for generation-skipping tax purposes given the assumption that upon my death my personal representative allocated to the Disclaimer Trust the amount (if any) by which my GST exemption unallocated immediately before my death exceeded the sum of the values (for purposes of determining the United States estate tax payable because of my death) of the trust estates of all trusts the names of which included Number 1.

4.10(d)(2) Purpose

The purpose of expressing a disposition in terms of the GST exemption that is unallocated immediately before the death of the transferor ("unallocated-GST-exemption disposition") is to create a generation-skipping disposition that exactly can absorb all unallocated GST exemption of the transferor and have an inclusion ratio of zero. If the transferor is the predeceasing spouse and the subject property is to benefit the surviving spouse in a marital-deduction or credit-shelter disposition (so that the generation-skipping aspect is not to occur until the death of the surviving spouse), the predeceasing spouse must create the unallocated-GST-exemption disposition (or the components of the disposition) upon the death of the predeceasing spouse and should segregate the disposition (or the components) until the death of the surviving spouse and channel the disposition (or the components) to the ultimate disposition upon the death of the surviving spouse. The Code requires the allocation of a GST exemption no later than upon the date prescribed for filing the estate tax return of the transferor. Code §2632(a)(1).

4.10(d)(3) Drafting

How can the language that creates the unallocated-GST-exemption disposition upon the death of the predeceasing spouse allocate to the disposition not only any property that remains in the disposition after the surviving spouse disclaims property "from" it but also such additional property, from the disclaimer vehicle (*Form* 4.5), as is necessary to permit the unallocated-GST-exemption disposition exactly to absorb all unallocated GST exemption of the predeceasing spouse and have an inclusion ratio of zero? Absent a disclaimer of the benefits of the disclaimer vehicle itself, the disclaimer vehicle can include assets that the formula-marital disposition additionally would have included absent the disclaimer. Additionally, if *Form* 4.6 and *Form* 4.7 are used in conjunction with *Form* 4.5, the disclaimer vehicle will include any assets that absent the disclaimer would have passed outright to the surviving spouse by beneficiary designation, joint tenancy, bequest or devise but that because of the disclaimer pass instead to the disclaimer vehicle for the benefit of the surviving spouse.

Consider two models. Model #1 creates a reverse-QTIP-marital trust (i.e., Marital Trust Number 1) with a value equal to "the amount (if any) by which (i) my GST exemption unallocated immediately before my death exceeds (ii) the sum of the values (for purposes of determining the United States estate tax payable because of my death) of (a) the trust estate of Remainder Trust Number 1 [i.e., the GST-exempt-credit-shelter trust] and (b) all property that because of a disclaimer by my wife is not part of the trust estate of Remainder Trust Number 1." Upon the death of the surviving spouse, Model #1 routes to the unallocated-GST-exemption disposition "such of the trust estate of the Family Trust as is (or but for a disclaimer by my wife would be) attributable to the trust estate of a trust the name of which includes Number 1 [i.e., the reverse-QTIP-marital trust and the GST-exempt-credit-shelter trust]." According to a variation, Model #1 additionally channels to the unallocated-GST-exemption disposition such of the trust estate of the Family Trust as "but for my outright gift to my wife and the disclaimer of the gift by my wife" would have been attributable to a trust the name of which includes Number 1.

Model #2 creates a reverse-QTIP-marital trust (i.e., Marital Trust Number 1) with a value equal, simply, to "the amount (if any) by which (i) my GST exemption unallocated immediately before my death exceeds (ii) the value (for purposes of determining the United States estate tax payable because of my death) of the trust estate of Remainder Trust Number 1 [i.e., the GST-exempt-credit-shelter trust]." According to different variations (i.e., *Form* 4.9, *Form* 4.10 and *Form* 4.11), fractional shares are created upon the death of the predeceasing spouse (*Form* 4.9 and *Form* 4.10) or upon the death of the surviving spouse (*Form* 4.11) and, in the case of the variations that create fractional shares upon the death of the predeceasing spouse, the fractional shares are severed into separate trusts either upon the death of the predeceasing spouse (*Form* 4.9) or no later than upon the death of the surviving spouse (*Form* 4.10).

Upon the death of the surviving spouse, Model #2 does not allocate specifically to the unallocated-GST-exemption disposition the assets that absent the disclaimer would have been, but because of the disclaimer are not, part of the reverse-QTIP-marital trust (i.e., Marital Trust Number 1) or the GST-exempt-credit-shelter trust (i.e., Remainder Trust Number 1). Rather, upon the death of the surviving spouse, according to the variations that create the fractional shares upon the death of the predeceasing spouse (*Form* 4.9 and *Form* 4.10), Model #2 specifically allocates to the disposition each fund (as, for example, a reverse-QTIP-marital trust, i.e., Marital Trust Number 1, the GST-exempt-credit-shelter trust, i.e., Remainder Trust Number 1, and a fractional portion of the disclaimer vehicle, i.e., Disclaimer Trust Number 1) that exists for the purpose of segregating GST-exempt property during the survival of the surviving spouse and funding the unallocated-GST exemption disposition at the death of the surviving spouse. According to a variation that creates the fractional shares upon the death of the surviving spouse (*Form* 4.11), (i) Model #2 specifically allocates to the disposition each fund (as, for example, a reverse-QTIP-marital trust, i.e., Marital Trust Number 1, and the GST-exempt-credit-shelter trust, i.e., Remainder Trust Number 1) that exists for the purpose of segregating GST-exempt property during the survival of the surviving spouse and funding the unallocated-GST-exemption disposition at the death of the surviving spouse and (ii) by formula (*Form* 4.11), Model #2 allocates to the disposition the largest fractional share of the disclaimer vehicle, of which the predeceasing spouse is the transferor, that upon the death of the surviving spouse can have an inclusion ratio of zero assuming that the executor of the predeceasing spouse allocated GST exemption to the disclaimer vehicle in an amount equal to the amount (if any) by which (i) the unallocated GST exemption of the predeceasing spouse exceeded (ii) the sum of the original values (for purposes of determining the United States estate tax payable because of the death of the predeceasing spouse) of the funds that specifically are allocated.

Do the models permit the unallocated-GST-exemption disposition exactly to absorb all of the unallocated GST exemption of the predeceasing spouse and have an inclusion ratio of zero? What are the advantages and disadvantages of each model and variation?

Unless the unallocated GST exemption of the predeceasing spouse exceeds the value (for purposes of determining the United States estate tax payable because of the death of the predeceasing spouse) of the property of which the predeceasing spouse is (or, with a reverse-QTIP election, can be) the transferor for generation-skipping tax purposes, and, therefore, the trust estate of a disclaimer vehicle inherently will have an inclusion ratio of zero, accomplishment of the purpose will require either (i) creation of separate disclaimer vehicles, each with an inclusion ratio of zero or one, upon the death of the predeceasing spouse, or (ii) reliance upon severing a disclaimer vehicle, upon the death of the surviving spouse, into separate trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one, in a "qualified severance" according to Code Section 2642(a)(3). Also, regardless of which of the two alternatives is used, accomplishment of the purpose will require a mechanism to add the trust estate of a trust with an inclusion ratio of zero to the generation-skipping disposition and to add the trust estate of a trust with an inclusion ratio of one to another disposition.

Model #1 *can* permit accomplishment of the purpose. However, compared to Model #2, Model #1 can apply relatively inefficiently. If accomplishment of the purposes requires extension of the reach of Model #1 to property that absent a disclaimer would have passed outright to the surviving spouse by joint tenancy, beneficiary designation, bequest or devise, Model #1 will present an issue. The extension will require the use of the variation of Model #1, and the variation will require the tracking of each asset that the spouse disclaims and that absent the outright gift to the surviving spouse and the disclaimer would have funded the unallocated-GST-exemption disposition. If the only assets that pass to the disclaimer vehicle are those which absent the disclaimer would have funded the unallocated-GST-exemption disposition, the disclaimer vehicle can consist of a single trust with an inclusion ratio of zero. However, if any other assets (or undivided portions) also pass to the disclaimer vehicle, accomplishment of the purpose will require division of the disclaimer vehicle into separate trusts upon the death of the predeceasing spouse, no fewer than two and perhaps as many as are necessary to segregate disclaimed assets or, even, to segregate undivided portions of disclaimed assets.

Unlike Model #1, Model #2 does not track particular assets. Rather, Model #2 focuses upon a single receptacle, a disclaimer vehicle, and upon fractional shares of the receptacle. The latter approach appears easier to conceptualize and to manage. It uses only two shares each of which is a fractional share of the whole. The severance of the fractional shares into separate trusts permits one of the shares to have an inclusion ratio of zero and the other of the shares to have an inclusion ratio of one. By limiting the disclaimer to the minimum that allows the trust estate of the disclaimer vehicle fully to absorb the unallocated-GST exemption of the predeceasing spouse, the surviving spouse can avoid the need for an additional vehicle or portion. Usually, no need will exist for a greater disclaimer, as usually, but not always, a disclaimer that is the minimum necessary to exhaust the GST exemption of the predeceasing spouse is also sufficient to exhaust any otherwise-unused-estate-tax exemption of the predeceasing spouse.

The availability of a "qualified severance" can permit deferral of a severance until the death of the surviving spouse. It also can enhance flexibility and minimize proliferation of trusts upon the death of the predeceasing spouse. Code Section 2642(a)(3), added in 2001, authorizes a "qualified severance." As is material to this analysis, a qualified severance is a severance, "on a fractional basis," "made at any time," of a single trust, with an inclusion ratio of more than zero and less than one, into two trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one, under circumstances in which "the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust." If any severance that is not a "qualified severance" is to create two trusts from a single pool and one of the two is to have an inclusion ratio of zero and the other is to have an inclusion ratio of one, the severance must occur upon the death of the predeceasing spouse before the GST exemption of the predeceasing spouse is allocated.

Model #2 appears to permit severance of the fractional shares in a qualified severance. Model #1, on the other hand, generally appears not to permit a qualified severance. However, Model #1 appears generally to require separate vehicles from the outset. The reason is that the focus of Model #1 upon particular assets seems generally incompatible with the concept of a severance "on a fractional basis."

If, pursuant to a mandate or discretion, the trustee of Model #2 were to sever the fractional shares into separate trusts upon the death of the predeceasing spouse rather than during the survival or upon the death of the surviving spouse, the trustee could hold the separate trusts "in solido" as owners in common. After the severance, depending upon the terms of the governing instrument, the trustee could make any discretionary distributions from each of the separate trusts proportionately, or could make distributions disproportionately and adjust appropriately the respective fractions of ownership. This method would protect against the need for, and possible unavailability of, a qualified severance. Also, it might economize the time and cost required for administration.

Assuming that discretionary distributions are possible during the survival of the surviving spouse, the variation of Model #2 that creates separate trusts upon the death of the predeceasing spouse (*Form* 4.9) is the most efficient for purposes of the generation-skipping tax. It is the only system that will retain inclusion ratios of zero and one, respectively, regardless of whether and to what extent discretionary distributions are made nonprorata from the two trusts. It also is the only system that will maximize the value of the separate trust that has an inclusion ratio of zero, assuming that the trustee makes all discretionary distributions from the separate trust that is intended to have an inclusion ratio of one.

A variation of Model #2 that creates fractional shares upon the death of the predeceasing spouse but that does not sever the shares into separate trusts until later will produce inclusion ratios of zero and one, respectively, only if all discretionary distributions during the survival of the surviving spouse before the severance of the shares into separate trusts are made prorata from each share. By contrast, the variation that creates the shares upon the death of the predeceasing spouse but also immediately transforms the shares into separate trusts (*Form* 4.9) avoids an important problem that attends the variation that creates fractional shares, unsevered, upon the death of the predeceasing spouse (*Form* 4.10). The reason is that regardless of whether for fiduciary accounting purposes the trustee of the last-described variation charges a discretionary distribution to a particular share, the distribution effectively is chargeable proportionately to both shares for GST-exemption purposes. See the chart, below, entitled "Three Variations of Model #2 Showing Effects of Different Times of Creation and Severance of Shares."

If a severance of fractional shares is not a qualified severance and, therefore, each of the severed trusts has the same inclusion ratio, greater than zero and less than one, as the disclaimer vehicle before the severance, or if for any other reason a trust with an inclusion ratio greater than zero is destined for addition to the unallocated-GST-exemption disposition, the trustee still might minimize the effect of the taint. The trustee might retain the tainted trust in a disposition parallel to the unallocated-GST-exemption disposition and invade the tainted, parallel disposition, to the extent possible, for nonskip persons.

Notwithstanding the complexity of the generation-skipping-tax planning that can attend spousal disclaimers, enhancement of spousal disclaimers for the purpose of salvaging exemptions appears critical and destined to become increasingly critical. A property owner who entirely wants to avoid the generation-skipping-tax planning can "disconnect" the disclaimer receptacle from the unallocated-GST-exemption disposition and instead can route the trust estate of the disclaimer vehicle entirely to another disposition, as, for example, "to my descendants, per stirpes, who survive my wife."

Three Variations of Model #2 Showing Effects of Different Times of Creation and Severance of Shares

System of Allocation of Propei	Values of Shares Upon Death of Predeceasing Spouse			Inclusion Ratios Upon Death of Predeceasing Spouse			Values of Shares Upon Death of Survivi Spouse			Maximum Value of Share #1 That Can Have Inclusior Ratio of 0	Inclusion Ratios of Shares Upon Death of Surviving Spouse		System of Obtaininc Final Inclusion Ratic
	#1	#2	Total	#1	#2	Total	#1	#2	Total		#1	#2	
a	b	c	d	e	f	g	h	i	j	k	l	m	n
1) Creation of fractional shares upon death of surviving spouse (severance upon death of surviving spouse)	N/A	N/A	$ 100,000.00	N/A	N/A	0.3	$ 140,000.00	$ 60,000.00	$200,000.00	$ 140,000.00	0	1	Qualified severance per IRC 2642(a)(3)
2) Creation of fractional shares upon death of predeceasing spouse (severance upon death of surviving spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	N/A	N/A	0.3	$ 140,000.00	$ 60,000.00	$200,000.00	$ 140,000.00	0	1	Qualified severance per IRC 2642(a)(3)
3) Creation of separate trusts upon death of predeceasing spouse (severance upon death of predeceasing spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	0	1	N/A	$ 140,000.00	$ 60,000.00	$200,000.00	$ 140,000.00	0	1	Preservation of original allocations and ratios
4) Creation of fractional shares upon death of surviving spouse (severance upon death of surviving spouse)	N/A	N/A	$ 100,000.00	N/A	N/A	0.3	$ 122,500.00	$ 52,500.00	$175,000.00	$ 122,500.00	0	1	Qualified severance per IRC 2642(a)(3)
5) Creation of fractional shares upon death of predeceasing spouse (severance upon death of surviving spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	N/A	N/A	0.3	$ 122,500.00	$ 52,500.00	$175,000.00	$ 122,500.00	0	1	Qualified severance per IRC 2642(a)(3)
6) Creation of separate trusts upon death of predeceasing spouse (severance upon death of predeceasing spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	0	1	N/A	$ 122,500.00	$ 52,500.00	$175,000.00	$ 122,500.00	0	1	Preservation of original allocations and ratios
7) Creation of fractional shares upon death of surviving spouse (severance upon death of surviving spouse)	N/A	N/A	$ 100,000.00	N/A	N/A	0.3	$ 122,500.00	$ 52,500.00	$175,000.00	$ 122,500.00	0	1	Qualified severance per IRC 2642(a)(3)
8) Creation of fractional shares upon death of predeceasing spouse (severance upon death of surviving spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	N/A	N/A	0.3	$ 140,000.00	$ 35,000.00	$175,000.00	$ 122,500.00	0.1250	1	Qualified severance per IRC 2642(a)(3)
9) Creation of separate trusts upon death of predeceasing spouse (severance upon death of predeceasing spouse)	$ 70,000.00	$ 30,000.00	$ 100,000.00	0	1	N/A	$ 140,000.00	$ 35,000.00	$175,000.00	$ 140,000.00	0	1	Preservation of original allocations and ratios

Assume in all cases that values double during the survival of the surviving spouse. Assume in cases 1, 2, 4, 5, 7 and 8 that upon the death of the predeceasing spouse $70,0(unallocated GST exemption is allocated to the Disclaimer Trust. Assume in cases 3, 6 and 9 that upon the death of the predeceasing spouse $70,000 of unallocated GST exe allocated to Disclaimer Trust Number 1 and $0 of unallocated GST exemption is allocated to Disclaimer Trust Number 2. Assume in cases 1, 2 and 3 that no discretionary dis made. Assume in cases 4, 5 and 6 that all discretionary distributions are made prorata from the portion the name of which includes Number 1 and the portion the name of whi Number 2. Assume in cases 7, 8 and 9 that all discretionary distributions are made from the portion the name of which includes Number 2, thus altering the ratios of values be Fractional Share or Trust Number 1, on the one hand, and Fractional Share or Trust Number 2, on the other.

4.11 QUALIFIED TERMINABLE INTEREST PROPERTY

4.11(a) Partial Elections

Form 4.12

My personal representative shall elect according to the principles of Section 2056(b)(7) of the Code to qualify the trust estate of the Marital Trust for the marital deduction,

a ai [[at least to such extent (if any) as is necessary to minimize the United States estate tax payable because of my death, except that, to such extent (if any) as my wife requests my personal representative to elect to qualify a lesser portion]

aii [except that, to such extent, if any, as my wife requests my personal representative not to elect]

, my personal representative shall elect]

to such extent, if any, as my personal representative determines to be advisable. If less than all of the trust estate of the Marital Trust qualifies for the marital deduction, the portion that qualifies shall be known as the "Marital Portion," the portion that does not qualify shall be known as the "NonMarital Portion," and the Trustee (i) shall charge any payment of principal according to subsection (A)(2) of this Section to the Marital Portion until the Marital Portion is exhausted and (ii) at any time during the life of my wife before the end of the administration of my estate may divide the trust estate of the Marital Trust into separate trusts consisting, respectively, of the Marital Portion and the NonMarital Portion.

4.11(a)(1) Exception

Particularly if estate tax were equitably apportioned to nonelected QTIP and a failure to elect would maximize assets that would pass to descendants but reduce the QTIP by the amount of the tax, **variable a** would protect a second spouse against a decision of the executor of the deceased spouse not to elect. Use **variable ai** if (i) the spouse is a second spouse and (ii) the marital trust can consist of a larger-than-optimal amount (as, for example, when a nonformula, pecuniary gift is used). Use **variable aii** if (i) the spouse is a second spouse and (ii) the marital trust consists of the optimal marital amount or fraction.

4.11(a)(2) Allocation of Charges; Severance of Portions

If a partial election is made to qualify a disposition as QTIP, the disposition will have a marital portion and a nonmarital portion. Optimally, any distribution to the spouse should consist solely of the marital portion, to cause each distribution to reduce the marital portion (and perhaps the amount that is includable in the gross estate of the spouse) pro tanto. The regulations permit the governing instrument to charge distributions to a particular portion of the trust. Treas. Reg. §§20.2044-1(d)(3) and (e) Example (4) and 20.2056(b)-7(h) Example (9). The regulations also permit a separation of the two portions into separate trusts. The governing instrument or local law must require the fiduciary to make the separation according to the fair market value of each portion (i.e., the fraction of the whole represented by each portion, multiplied by the fair market value of the whole) at the time of the separation. Treas. Reg. §20.2056(b)-7(b)(2)(ii)(C), and (h) Example (14). Separation into two trusts will facilitate administration of the two portions and permit separate investments.

4.11(b) Alternative Means of "Fine-tuning" the Election

Alternative methods are available to preserve tax flexibility and yet avoid charging distributions to a particular portion. Each involves causing a particular trust wholly to qualify for the marital deduction or wholly not to qualify for it.

First, consider creating more than one trust, each to be funded by a specified fraction of the optimum marital amount, and to elect that each, in toto, does or does not qualify for the marital deduction. Each arguably is a separate interest that is subject to a separate election.

Second, consider creating more than one trust, each to be funded by one or more specific items of property, and to elect that each does or does not qualify for the marital deduction. See TAM 8603007.

Third, consider severing a trust fractionally into separate, identical marital and nonmarital trusts. See Treas. Reg. §§20.2044-1(d) and (e) Example (4), 20.2056(b)-7(b) and 20.2056(b)-7(h) Example (9). Either the governing instrument or state law must require the fiduciary to make the division on the basis of the fair market values of the assets at the time of division. The severance must occur before the end of the administration of the estate of the deceased spouse.

Fourth, consider creating separate and identical marital and nonmarital trusts at the outset and allocating to each a fractional portion of all property that is available for allocation.

Fifth, consider creating separate and identical marital and nonmarital trusts at the outset and providing that all property with respect to which the executor makes the election shall be allocated to one and all other property shall be allocated to the other. Technical Advice Memorandum 8603007 specifically approved this arrangement in the particular case, notwithstanding that it enabled the executor to obtain tax benefits by failing to elect and thus allocating to the nonmarital trust the property that most had appreciated in value before the executor was required to make the election.

Sixth, consider qualifying the entire trust but relying upon a disclaimer by the surviving spouse to control its size, including the size of any portion that is subject to a right to withdraw which applies to a specified fraction of the trust.

Additionally, according to Treasury regulations section 20.2056(b)-7(d)(3)(i) and example (6) at Treasury regulations section 20.2056(b)-7(h), a property owner can establish a trust and provide that his or her spouse is entitled to receive the income from any portion of the trust which the executor elects to treat as qualified terminable interest property. This type of arrangement is known informally as a "Clayton QTIP," as the planning is similar to planning that appeared in Clayton v. Commissioner, 97 T.C. 327 (1991), reversed, 976 F.2d 1486 (5th Cir. 1992).

4.11(c) Using "Clayton QTIPS" to Defer Decoupled State Death Taxes

During the four-year period beginning with 2002, EGTRRA eliminates the credit of Code Section 2011 against United States estate tax for payments of state death taxes. Also, in phases, EGTRRA includes modest reductions of rates and drastic increases of exemptions. These changes portend large reductions of revenue to states. Reacting to the impending reductions, and perhaps also to begin to fill the vacuum that any elimination or drastic reduction of the United States estate tax will leave, many states have "decoupled" their estate taxes from the United States estate tax. The primary methods are to ignore some or all of the applicable or unified credit (i.e., estate tax exemption) and to ignore some or all of the reductions of the credit for state death tax.

By permitting a QTIP election to qualify more for the marital deduction than the amount that is necessary to reduce United States estate tax to zero, a married person can permit his or her executor to defer at least some of the increases of state death taxes until the death of the surviving spouse.

Deferral of the increases is not necessarily desirable. First, if the election cannot apply for state purposes unless the election also applies for United States purposes, the deferral of the state increases can increase United States estate tax much more than the deferral can reduce state death taxes. Second, even if an election is possible exclusively for state purposes, any election solely for state purposes will tend to involve complexity.

The best result can depend upon facts that are impossible to know in advance. The unknowables include the actual and anticipated complexions of the laws at and after the death of the predeceasing spouse, including whether qualification for purposes of state death taxes requires qualification, also, for purposes of United States estate tax. The unknowables also include the life expectancy of the surviving spouse. The apparent solution of choice is to attempt to permit deferral of increases and *also* to attempt to permit deferral of decisions about deferral.

The QTIP format best permits both types of deferrals. However, QTIP is not necessarily the dispositive method of choice for property that is not to qualify for the marital deduction. Particularly, QTIP is not necessarily the format of choice for property that the executor would not qualify for United States purposes if the executor were not seeking to qualify for state purposes. What is needed is a system that has the format of QTIP to any extent that a QTIP election is made but that does not have the format of QTIP to any extent that a QTIP election is not made. This arrangement describes the Clayton QTIP, which is based upon Treasury regulations section 20.2056(b)-7(d)(3)(i) and example 6 at Treasury regulations section 20.2056(b)-7(h).

An alternative technique could consist of an outright bequest to a surviving spouse with the spouse having the ability, by means of a disclaimer, to transform the bequest into an interest in a disclaimer vehicle, outside the gross estate of the disclaimant but nevertheless for the benefit of the disclaimant. Compared to the Clayton QTIP, the disclaimer vehicle would seem both rigid and prone to being ignored by surviving spouses. See 4.09 and 4.10 with respect to the disclaimer technique. See *Form 4.13* with respect to the Clayton QTIP.

4.11(c)(1) "Clayton QTIP"

Form 4.13

(C) Remainder Marital Trust. Notwithstanding the preceding portion of this Section, if my wife survives me or there is no sufficient evidence that we died other than simultaneously (in which event my wife conclusively shall be presumed to have survived me), the Trustee as of my death shall set apart, in a separate trust to be known as the "Remainder Marital Trust" and to be administered as provided in this subsection (C), so much or all, if any, of what absent this subsection (C) would be the trust estate of the Remainder Trust as my personal representative elects to qualify for the marital deduction for purposes of determining any estate tax payable because of my death. My personal representative shall make such election, if any, with respect to so much or all, if any, of what absent this subsection (C) would be the trust estate of the Remainder Trust as the Independent Trustee in its sole and absolute discretion directs. The Remainder Marital Trust shall be identical to the Remainder Trust, except that (i) subsection (A) of Section 6.02 shall apply, (ii)

a [subsection (A)(1) of this Section shall not apply and instead]

the Trustee shall pay the net income to my wife quarter-annually, (iii) upon the death of my wife the Trustee shall distribute any undistributed or accrued income to her estate and (iv) the Trustee shall not pay any of the trust estate to other than my wife during her life.

* * *

(12) To exercise tax elections; provided, in the case of what absent the election would be the trust estate of the Remainder Trust created according to the Trust described in Section 2.04, my Executor shall elect to qualify for the marital deduction for purposes of determining any estate tax payable because of my death so much or all, if any (and only so much or all, if any), as the Independent Trustee directs according to authority explicitly granted to the Independent Trustee in the Trust.

A surviving spouse who as the executor of the will of the predeceasing spouse has an unfettered ability to constitute property in the format of QTIP by making a QTIP election appears to possess and thus (by forgoing the election) to have the ability to release a general power to appoint an income interest. Therefore, no person who possesses a beneficial interest should have the ability to constitute property in the format of QTIP by means of a QTIP election. Rather, only an independent fiduciary should possess this type of election discretion. The method that the writer selects is to vest the election discretion in an independent trustee, rather than in an independent executor, and to direct the executor to comply with any direction of the independent trustee. The reason for this mechanism is that the trust includes an elaborate mechanism for the appointment and service of an independent trustee and the writer prefers to avoid repeating it in the will. The first paragraph of *Form 4.13* creates the Clayton QTIP in the trust instrument. The second paragraph of *Form 4.13* creates the mandate in the will.

Notwithstanding that for United States purposes any partial election must relate to a fractional or percentile share of the property and that the Treasury regulations refer to a "portion," the quantum of property with respect to which the QTIP is created in *Form 4.13* is expressed, in the idiom that the writer uses for other purposes, as "so much or all, if any," not as "such portion or all, if any," of the trust estate as my personal representative elects. See Treas. Reg. §§20.2056(b)-7(b), 20.2056(b)-7(d)(3)(i) and 20.2056(b)-7(h) Example 6. Even though any election must adhere to the "portion" concept for United States purposes, the requirement is not a governing instrument requirement. Use **variable a** in order to omit from the Clayton QTIP any Give-Me-Five, unitrust or annuity interest that is included in the trust to which reference is directed.

CHAPTER 5

INCREASE OF BASIS DURING REPEAL

During the repeal of the estate tax, Code Section 1022 will permit bases improvements for income tax purposes.

5.01 CODE SECTION 1022(b) INCREASE

Code Section 1022(b) will permit bases improvements of $1,300,000 for property which passes from a taxpayer at death. The chief requirement is that the value of the property at the death of the taxpayer must exceed the bases by at least as much as the permissible increase, i.e., $1,300,000.

5.02 CODE SECTION 1022(c) INCREASE

Code Section 1022(c) will permit additional improvements of $3,000,000 in bases for property which passes from a taxpayer outright to, or in a QTIP-style trust for the benefit of, the surviving spouse of the taxpayer.

5.03 SHADES OF MARITAL DEDUCTION?

Bases improvements according to Code Section 1022(c) might require that the disposition benefit the surviving spouse similarly to how property which qualifies for the marital deduction must benefit a surviving spouse. Among other things, this requirement might invoke Revenue Procedure 64-19, 1964-1 C.B. 682.

5.04 QUESTIONABLE POLICY

Bases improvements according to Code Section 1022(c) appear to reflect highly questionable policy. The marital deduction tends to permit a married person to defer tax. The marital deduction also tends to permit a married couple to use exemptions that, but for the marriage, the less wealthy spouse might have insufficient assets to use. By contrast, the basis increase according to Code Section 1022(c) is a permanent saving of tax and is available only for assets that pass to, or in certain trusts for, the spouse of a married person. Therefore, marriage immediately before death is the sine qua non of a very large and permanent saving of tax.

5.05 DRAFT NOW FOR CODE SECTION 1022

To protect against incapacity, inertia and (in plans in which the exemption shelter benefits anyone other than the surviving spouse) distortion, consider drafting all dispositive documents to include mechanisms for bases increases according to Code Section 1022, notwithstanding that the increases are available only for taxpayers who die after 2009.

5.06 CODE SECTION 1022(b) IS PREFERABLE TO CODE SECTION 1022(c)

The dispositive instrument usually should fund dispositions that use all of the 1022(b) increase before the instrument funds any disposition that uses any of the 1022(c) increase.

The basis increase according to Code Section 1022(b) will not, but the basis increase according to Code Section 1022(c) will, require a particular format for the disposition. The required format, consisting of an outright gift or a QTIP-style trust, inherently forces property (i.e., the income) into the hands of the surviving spouse and, therefore, is inferior to other formats from the perspective of efficiency of shelter of the property for transfer tax purposes. If the taxpayer has an insufficient amount of appreciation to use both the 1022(c) increase and the 1022(b) increase, use of formats that produce Code Section 1022(b) increases in full before use of any format that is necessary to produce Code Section 1022(c) increases at all (i) will minimize a disposition the only reason for which is to maximize increases in bases and (ii) will maximize a disposition which is favored dispositively.

5.07 DRAFTING FOR BASES INCREASES

The drafting of dispositions for the primary purpose of facilitating bases increases is challenging. Perhaps the first step is to abandon certain mindsets that accompany drafting of formulae for the marital deduction.

5.07(a) Basis-Increase QTIP per Code Section 1022

Form 5.1

> **If (i) my wife survives me or there is no sufficient evidence that we died other than simultaneously (in which event my wife conclusively shall be presumed for purposes of this Section to have survived me) and (ii) the United States estate tax is not in effect at my death, the Trustee as of my death shall set apart, in a separate trust to be known as the "Marital Trust" and to be administered as provided in this Section,**

A [[#A] of the trust estate that remains after satisfaction of all dispositions and payments under prior provisions of this instrument.]

B [the Permissible Property that at my death had the smallest value sufficient to maximize the basis increase according to Section 1022 of the Code because of my death

BI [, after excluding the Permissible Property that at my death had the smallest value sufficient to maximize the basis increase according to Section 1022(b) of the Code because of my death].]

C [Permissible Property which

CI [the Independent Trustee selects, which]
is sufficient to maximize the basis increase according to Section 1022

CII [(c)]
of the Code because of my death and which at the respective dates of distribution to the Marital Trust has an aggregate value of no less than, and to the extent practicable no more than, the

CIII [amount (if any) by which (a) the]
value at my death of the Permissible Property that at my death had the smallest value sufficient to maximize the basis increase according to Section 1022 of the Code because of my death

CIV [exceeds (b) the value at my death of the Permissible Property that at my death had the smallest value sufficient to maximize the basis increase according to Section 1022(b) of the Code because of my death].]

D ["Permissible Property" shall mean such property (or its proceeds) in the trust estate as is not specifically given according to prior provisions and, if allocated to the Marital Trust, would permit a basis increase according to Section 1022

DI [(c)]
of the Code

DII [but, except to such extent (if any) as is necessary to enable the increase, shall not include [#B]].]

5.07(a)(1) Purpose and Drafting

Use **variable A** if the assets needed to maximize a basis increase according to Code Section 1022(c) will leave a small residue or no residue or if the Marital Trust is to consist in any event of a fixed fraction less than "all."

Variable B produces a specific gift determined by a formula. Add **variable BI** to minimize this disposition by passing the Code Section 1022(b) portion to the residue. Delete **variable BI** to cause the Marital Trust to serve as a receptacle according to *both* Code Section 1022(c) *and* Code Section 1022(b).

Variable C produces a "minimum-worth, specific gift, collective-assets type. Add **variables CII**, **CIII** and **CIV** to minimize this disposition by passing the Code Section 1022(b) portion to the residue. Delete these variables to cause the Marital Trust to serve as a receptacle according to *both* Code Section 1022(c) *and* Code Section 1022(b).

Use **variable D** if **variable B** or **variable C** is used. Use **variable DI** if **variable BI** or **variable CII** is used. **Variable DII** is usable to exclude specific assets.

5.07(b) Specific Gift of Appreciated Assets

Consider using a specific gift of assets that are defined in the governing instrument as the appreciated assets which in the aggregate have the smallest value which can maximize the basis increase. See **variables B** and **D** in *Form* 5.1. The gift will not produce any gain upon funding. The gift will rise and fall in value during the period of administration prior to funding. Unlike a gift of a pecuniary amount, which will define an amount but not assure that the most appreciated property that had this value at the death of the taxpayer can satisfy it, and unlike a gift of a fractional share, which will tend not to use the property that at the death of the taxpayer was the most appreciated, this type of gift will minimize the probable value and also will maximize the basis increase. The great disadvantage of this type of gift is that it appears quite inflexible.

5.07(c) Minimum-Worth Gift

Perhaps a more attractive vehicle is a "minimum-worth" gift, collective assets type. See **variables C** and **D** in *Form* 5.1. This type of gift is more flexible than the specific gift described above. This type of gift will require the least value, and permit but not require more than the least value, that at the time of allocation can maximize the basis increase according to Code Section 1022(c). Compared to the specific gift described above, this type of gift grants discretion to a fiduciary to determine the assets to allocate. By its terms, the gift might have to require funding with assets that both (i) enable the maximization of basis and (ii) assure the surviving spouse a requisite amount of value. Arguably, no gain occurs upon funding. Loss appears reckoned only upon complete funding. This type of gift presents the problem of a fiduciary's duty to limit value.

5.07(d) Do Not Use Pecuniary Gift

Do not use a true pecuniary gift, i.e., a gift that is expressed in terms of the smallest number of dollars that if satisfied in kind with the most appreciated assets at death will maximize the basis increase but that is satisfiable in kind at values current at dates of satisfaction. Indeed, a pecuniary gift in this context is an apparent misnomer. A basis increase according to Code Section 1022 requires that the gift consist solely of appreciated assets, not, for example, cash. Therefore, the pecuniary amount determines only the value at the time of allocation of the assets that are allocated in kind.

More importantly, a true pecuniary gift (i.e., a pecuniary gift which is satisfied in kind at values current at dates of distribution) appears incapable of assuring both maximization of basis and the use of the smallest amount of date-of-death value to accomplish the maximization. If the assets that determine the pecuniary amount depreciate after the death of the taxpayer and before the satisfaction of the pecuniary amount, the assets that at the date of allocation have the requisite appreciation will not have sufficient value to satisfy the pecuniary amount. Therefore, the gift might require an infusion of additional assets (but not an infusion of an addition of pre-death excess of value over basis). Contrariwise, if the assets that determine the pecuniary amount appreciate after the death of the taxpayer and before the satisfaction of the pecuniary amount, the assets that at the date of allocation have the requisite value will not have the requisite appreciation. Therefore, the assets that satisfy the gift will not permit a maximum increase in basis.

5.07(e) Tend Not to Use Fractional-Share Gift

Tend not to craft a basis-increase disposition in terms of a fractional share of residue. A fractional share does seem capable of enabling a maximum increase in basis. However, if, as generally is true, the fraction applies to some assets that at the death of the taxpayer had less excess of value over basis than other assets, this method will not minimize the value that is allocable to this disposition.

CHAPTER 8

SPECIAL DISPOSITIVE PROVISIONS

* * *

8.03 GIFTS DURING INCAPACITY

Form 8.10

(C) Gifts.

(1) During the time described in subsection (B) of this Section, the Trustee shall pay to any one or more of my wife and my descendants, without any duty of equalization, so much or all, if any, of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time for me to make

a [gifts.]

b [(i) gifts that are (or, if split between my wife and me according to Section 2513(a) of the Code, would be) excludable (because of Section 2503(b) of the Code including, without limitation, because of Section 2503(c) of the Code and rights to withdraw) from the total amount of my gifts under the Code or deductible (because of the marital deduction according to Section 2523 of the Code) for purposes of computing my taxable gifts under the Code and (ii) gifts that because of Section 2503(e) of the Code are not treated as transfers by gift for purposes of Chapter 12 of the Code. If the United States gift tax is not in effect, the preceding sentence shall apply as if the United States gift tax as it last existed were in effect.]

(2) If on or after the date of this instrument I create a power of attorney, the Trustee shall pay to the attorney in fact so much or all, if any, of the trust estate as the attorney in fact determines for me to make gifts according to specific authority in the power of attorney.

* * *

15. To give to any one or more of my wife and my descendants, without any duty of equalization, regardless of whether a donee is serving, alone or with any one or more others, as the Attorney, so much or all, if any, of my estate as the Attorney in its sole and absolute discretion determines to be advisable from time to time for me to make (i) gifts that are (or, except in the case of any unmarried donee who is serving alone or with any one or more others as the Attorney, if split between my spouse and me according to Section 2513(a) of the Internal Revenue Code ("Code"), would be) excludable (because of Section 2503(b) of the Code including, without limitation, because of Section 2503(c) of the Code and rights to withdraw) from the total amount of my gifts under the Code and (ii) except on behalf or in discharge of any legal obligation of any individual who is serving alone or with any one or more others as the Attorney, gifts that because of Section 2503(e) of the Code are not treated as transfers by gift for purposes of Chapter 12 of the Code.

c [Notwithstanding the preceding portion of this paragraph, no individual shall possess, or participate in the exercise of, any power that absent this sentence would cause the individual to possess a general power of appointment (as defined in Section 2041 or Section 2514 of the Code) to any extent that (assuming that gifts are split between spouses to the maximum extent according to Section 2513(a) of the Code) the release during the life of the individual would constitute a gift (other than a gift that would be excluded according to Section 2503(b) of the Code) for

United States gift tax purposes, or a transfer for United States estate tax purposes, by the individual.]

If the United States gift tax is not in effect, the preceding portion of this paragraph shall apply as if the United States gift tax as it last existed were in effect.

d **[I specifically authorize the Attorney to require the Trustee of the Trust to pay to the Attorney so much (if any) of the trust estate of the Trust as is necessary to permit the Attorney to make gifts and qualified transfers according to this paragraph.]**

8.03(a) Purpose and Drafting

State law often precludes agents and trustees from making gifts on behalf of their grantors and principals absent specific authority in the governing instruments. The form illustrates a gift-giving system that includes specific authority and the integration of a revocable trust and a power of attorney. The ability of agents and trustees to make gifts can present issues of tax sensitivity. The issues can arise if a power holder can use the authority (i) to benefit himself or herself personally or (ii) to transfer property to another under circumstances in which absent the transfer the property would or could benefit the power holder personally.

The first paragraph of the form avoids the tax issues that are discussed in the balance of this 8.03(a). It gives the gift-giving power to an independent person who has no beneficial interest and cannot use the power to benefit himself or herself. Use **variable a** and delete **variable b** to give the independent trustee unlimited authority. Delete **variable a** and use **variable b** to limit the authority.

The second paragraph of the form is designed to facilitate gifts according to a power of attorney under circumstances in which the attorney in fact might hold insufficient funds to make the described gifts according to the power of attorney but the trustee of the trust might hold sufficient funds according to the trust.

The portion of the form that appears below the asterisks is intended for inclusion in the power of attorney. It is designed to prevent or at least mitigate tax sensitivity if a beneficiary serves as attorney in fact and a gift-giving power is regarded as a general power of appointment or as a power that Treasury regulations section 25.2511-1(g)(2) implies is taxable. **Variable c** is a savings clause. It might not accomplish its purpose. See, e.g., Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), 44-1 USTC ¶10,110, cert. denied, 323 U.S. 756 (1944). Also, it might facilitate contention about the validity of certain gifts. Although it applies directly to the issue of the existence of a general power of appointment, it applies only indirectly (by purporting to reduce the "beneficial interest" of the holder) to the issue of a gift according to Treasury regulations section 25.2511-1(g)(2). The last sentence specifically authorizes the agent to "call" upon the trust to the extent provided in the power of attorney. State law might require a grant of specific authority to enable the agent to "call" upon the trust. See, e.g., 755 ILCS 45/2-9. However, consider whether the second paragraph of the form, which specifically directs the trustee to comply with the "call" by the agent, might eliminate the need for the specific authority.

Can a power of a beneficially-interested agent to make gifts for his or her principal constitute a general power of appointment or a power to make gifts according to Treasury regulations section 25.2511-1(g)(2)? A first (and arguably sufficient) response to an argument that an attorney in fact who has authority to make gifts for his or her principal has a tax-sensitive power is that the ability of the principal to revoke, coupled with inclusion in the transfer tax base of the principal, prevents prior inclusion in the transfer tax base of anyone other than the principal. See Boeving v. United States, 81-2 USTC ¶13,415 (8th Cir. 1981), and Gilchrist v. Commissioner, 80-2 USTC

¶13,378 (5th Cir. 1980). According to the theory of these cases, the principal always should be regarded as possessing a power to revoke, even if the principal is incapacitated. Even if the power otherwise were a general power of appointment, an ability of the principal to revoke would appear to classify the power within Code Section 2041(b)(1)(C) and, therefore, as not a general power.

If the power were a general power of appointment, any release of the power arguably would constitute a present-interest gift to the principal. If the general power of appointment were to consist of the ability of the power holder to pay annual-exclusion gifts to the power holder from the assets of the principal, at least one-half and, depending upon the availability to the power holder of the gift-splitting rules of Code Section 2513(a), possibly all, of the release arguably would qualify for an annual exclusion. Even if the release of the power were to constitute a release of the subject property to the grantor-principal subject to the trust and the agency, the release arguably would constitute an outright transfer, and thus a gift of a present interest, to the grantor-principal for gift tax purposes. The deemed ability of the grantor-principal to revoke the trust and the agency arguably would transform any gift into a gift of a present interest. If the agent were the spouse of the principal, the release might qualify for the marital deduction. However, note the possible absence of an income interest for life. See Estate of Mackie v. Commissioner, 545 F. 2d 833 (4th Cir. 1976), and Estate of Neugass v. Commissioner, 77-1 USTC ¶13,192 (2d Cir. 1977).

Also, again if the power were a general power of appointment, the five-percent "leg" of the "5+5" rule of Code Section 2514(e) arguably would compare the lapse to the pool of assets from which the agent could have satisfied the gift. Thus, the rule would tend to prevent a gift from occurring upon a lapse of a power to make an annual-exclusion gift to oneself.

Can the exercise of the power constitute a gift according to the theory of Treasury regulations section 25.2511-1(g)(2)? This issue relates to the payment by a power holder to another person of property in which the power holder has a beneficial interest. Thus, although the analyses appear similar, this issue is not the same as whether the power holder possesses a general power of appointment. Arguably, the deemed ability of the principal to revoke attenuates the relationship between the holder of the power and the property sufficiently so that the power holder does not possess a "beneficial interest" and, therefore, the answer to the posited question is no. Also, as a matter of concept, can a gift by a principal do double duty by also constituting, at the same time, a gift by another according to Treasury regulations section 25.2511-1(g)(2)?

A gift according to Treasury regulations section 25.2511-1(g)(2) requires an *exercise* of the power. Mere possession is insufficient. Therefore, a person always can avoid the 25.2511-1(g)(2) problem by limiting his or her exercise or by declining entirely to serve. Contrariwise, mere *possession* of a requisite type of power is sufficient to cause a general power of appointment to exist. However, the power of the attorney in fact arguably is not the requisite power. Even if it is, the limitations that appear in the form arguably preclude most releases from constituting transfers for gift tax and estate tax purposes.

Assume, for purposes of analysis, that the power of the agent to make gifts on behalf of the principal does cause the agent to possess a general power of appointment for gift and estate tax purposes and does constitute a power to make gifts for gift tax purposes according to the theory of Treasury regulations section 25.2511-1(g)(2). What are the amounts of gifts that the power enables the agent personally to make?

The amount that the agent can pay to himself or herself by means of the exercise of the power limits both the general power of appointment and the amount of release. The form limits these amounts to the annual-exclusion gift that the principal could give to the agent by means of the agency. If (but only if) both the principal and the agent are married, the form provides for determination of this amount according to the gift-splitting rules of Code Section 2513(a). The amount of the taxable gift that the agent could make by means of a lapse of the power appears to depend upon (i) whether the gift upon release would be a gift of a present interest and (ii) the amount (if any) of any other annual-exclusion gifts by the *agent to the principal* during the year.

Arguably (and only arguably), at any particular time, the "beneficial interest" of the agent within the meaning of Treasury regulations section 25.2511-1(g)(2) cannot exceed the amount that the agent then can pay to himself or herself. Arguably, this amount is the limit of the gift that the agent can make by exercising the power in favor of other than himself or herself. Conceivably, however, the beneficial interest also could include amounts that the agent could pay to himself or herself in future years or even amounts that he or she could receive upon or after the death of the principal.

* * *

8.08 RESIDENCES

8.08(a) Outright Gift

Form 8.18

Section 2.02. Real Property. I give

a [all real property used by my wife and me as a residence]

b [[#X]]

(including all improvements, appurtenances and related insurance), subject to any mortgage indebtedness and unpaid real estate taxes and assessments,

c [to my Executor]

d [to my wife if she survives me].

e [My Executor shall not take possession of any real property disposed by this Section.]

8.08(a)(1) Drafting

A reference to "real property used by [the testator or the testator and the testator's spouse] as a residence" is not particularly clear. See **variable a** of *Form 8.18*. However, a more specific description might require frequent rewriting of the will or fail to dispose the real property that the testator wishes to dispose. See **variable b** of *Form 8.18*.

8.08(a)(2) Income Tax Results

Various income tax results are available. The draftsperson purposely should seek desired results and not accept less desirable results by default. If title to the real property passes to the executor according to state law, the satisfaction of a residuary devise will, but the satisfaction of a specific devise will not, carry distributable net income from the estate to the devisee. Code §§661, 662 and 663(a)(1). However, if title passes directly to the devisee according to state law, the satisfaction of the devise (whether specific or residuary) will require the executor to relinquish possession but not to "distribute" the property itself. Therefore, the satisfaction will not carry distributable net income from the estate to the devisee. The draftsperson can avoid this result by using a specific devise to the executor and a residuary devise to the ultimate taker. See **variable c** of *Form 8.18*. A specific devise to the executor will pass title to the executor, and the executor's satisfaction of the residuary gift will require the executor to "distribute" the real property rather than merely relinquish possession of it.

Income for income tax purposes inures to the entity that possesses the real property when the income is received. According to 755 ILCS 5/20-1(a), unless the testator varies the rule, possession of all of the real property, except any real property in which the devisee resides, passes to the executor. By depriving the executor of possession and granting possession instead to the devisee to whom title passes as a matter of law, the testator can cause income (and expense) for income tax purposes to inure to the devisee. See **variable e** of *Form 8.18*.

8.08(b) Retention in Trust

Form 8.19

Section 4.07. Residence.

a **[Upon my death, if the Trustee owns any interest in a residence of a beneficiary who has attained thirty years of age and I have not provided otherwise, the Trustee shall allocate the interest, based upon fair market values at the time of the allocation, to any one or more of any outright disposition to the beneficiary and the trust estates of any one or more trusts of which, at the time of the allocation, the beneficiary is the only person to whom the Trustee can pay any of the trust estate.]**

If, at the time of a direction described in this sentence, the Trustee owns any interest in a residence of a beneficiary who has attained thirty years of age and the beneficiary is the only person to whom the Trustee can pay any of the trust estate, the Trustee shall sell the interest, apply proceeds to a replacement and sell any replacement, all at fair market value, as the beneficiary directs. The beneficiary shall have the right, to the extent of the beneficial interest of the beneficiary in the trust, determined according to other provisions of this instrument, to occupy the residence free of rent.

8.08(b)(1) Purpose and Drafting

Use **variable a** only in a revocable trust. Concerning the principles that are invoked to control the allocation of a residence to a particular disposition, see Revenue Procedure 64-19, 1964-1 C.B. 682, Treasury regulations section 20.2056(b)-7(b)(2)(C) and the pick-and-choose-asset-allocation provision of the trust.

8.08(b)(1)(A) Accommodation of Residence in (i) Pay-All-Income Trust, (ii) Discretionary Trust, (iii) Ascertainable-Standard Trust and (iv) Give-Me-Five Unitrust

A right to the use of a residence appears to be an analogue to a right to receive all of the income of a trust of which the only asset is the residence. Accordingly, if a residence is allocated to a trust that mandates the current payment of all income to the primary beneficiary, the primary beneficiary should possess the right to the rent-free use of the residence. Nevertheless, to avoid the beneficiary having to pay rent which recycles through the trust and back to the beneficiary (and into the gross income of the trust and the beneficiary), the draftsperson should include authority (described in the last sentence of the form) for the trustee to allow the beneficiary to use the residence rent-free to such extent (if any) as is consistent with the beneficial interest of the beneficiary granted according to the dispositive provisions of the governing instrument. The authority should relieve the trustee, to this extent, of any obligation to rent or sell. Thus, the authority and the dispositive provisions should resolve the nontax issue of the extent (if any) to which the trustee is obliged to charge, and the beneficiary is obliged to pay, rent. They also should resolve the tax issue of the extent (if any) to which rent is includible in the gross income of the trust and perhaps, in turn, also in the gross income of the beneficiary. Cf. Code §7872.

What mechanisms are available to avoid the charging and paying of rent in the case of a trust that does not mandate the current payment of income?

1. If an independent trustee has broad discretion to distribute any or all of the trust estate to the primary beneficiary or to a pay-all-income trust for the primary benefit of the primary beneficiary, the independent trustee might transform the situation into a pay-all-income format or its equivalent (i) by directing that the primary beneficiary shall have the right to use the residence without paying rent or (ii) by conveying the residence to the pay-all-income trust.

2. Similarly, any trustee (including the primary beneficiary himself or herself) who has a power to pay the trust estate to the primary beneficiary for the support of the primary beneficiary might have an ability to direct that the primary beneficiary shall have the right to use the residence without paying rent.

3. Assume that during a calendar year the donee of the alternative version of a Give-Me-Five power (see variable **c** of *Form 3.31*) incurs an obligation to pay rent for the use of a residence which is part of the trust estate of the trust and that the donee exercises the power by withdrawing the obligation to the extent that the power permits. If, as arguably is the case, the payer and the payee (or, more accurately, the obligor and the obligee) are the same, this scenario should not generate any income. Can recognition of income occur when the trust "transfers" the receivable to the obligor upon the exercise of the Give-Me-Five power? Arguably, the transferee already owned the portion of the obligation that the donee received and, therefore, the answer is no. The apparent limitation upon this planning is that the power probably is insufficient to accommodate all of the obligation.

8.08(b)(1)(B) Rental Value as Income

Arguably, the value that a beneficiary receives from his or her rent-free occupancy of a residence which is part of a trust estate is not income for income tax purposes under circumstances in which the beneficial interest includes the rent-free use of the residence. The view of the writer is that Commissioner v. Plant, 76 F.2d 8 (2d Cir. 1935); Hillman v. Commissioner, 71 F.2d 688 (3d Cir. 1934); Alfred I. duPont Testamentary Trust v. Commissioner, 66 T.C. 761 (1976), affirmed per curiam, 574 F.2d 1332 (5th Cir. 1978); and Sparrow v. Commissioner, 18 B.T.A. 1 (1929), enlighten but do not conclusively resolve the position that is asserted in the preceding sentence. The issue appears to have only academic importance, in any event, in two situations that occur, or can occur, frequently. First, if the residence is the only asset of the trust, the trustee has no income to distribute. Second, if the trust mandates the current payment of all income to the person who occupies the residence, the beneficiary receives all of the income regardless of whether, in other circumstances, the rent-free use of a residence would constitute an indirect distribution that would carry distributable net income to the beneficiary.

8.08(b)(1)(C) Marital Deduction

Neither permission for, nor direction to, a trustee to retain or purchase a residence for a surviving spouse should disqualify for the marital deduction any trust that would qualify absent the direction or permission. Treas. Reg. §20.2056(b)-5(f)(4).

8.08(b)(1)(D) Effect Upon Mortgage Debt

According to 12 USC §1701-j3(d)(8),

> With respect to a real property loan secured by a lien on residential real property containing less than five dwelling units, including a lien on the stock allocated to a dwelling unit in a cooperative housing corporation, or on a residential manufactured home, a lender may not exercise its option pursuant to a due-on-sale clause upon -- . . . a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property . . . .

* * *

CHAPTER 10

ACCOMMODATION OF SPECIAL ASSETS

SUBCHAPTER A:
CODE SECTIONS 2032A AND 2057

10A.01 THE ISSUE

Any property that is to qualify for special use valuation must pass to one or more qualified heirs. Treasury regulations section 20.2032A-8(a)(2) applies this rule to successive interests by stating that the property must not be able, in any event or under any circumstance, to pass to or for any person who is not a qualified heir, before the property passes to a qualified heir or is subject to inclusion in the gross estate for estate tax purposes of a qualified heir. Code Section 2057 imposes a similar requirement. Code §2057(b)(2). See Code §§2032A(b)(1)(A)(ii), 2032A(b)(1)(B) and 2032A(g), Treas. Reg. §20.2032A-8(a)(2), Rev. Rul. 81-220, 1981-2 C.B. 175, Rev. Rul 82-140, 1982-2 C.B. 208, Ltr. Rul. 8146020, Ltr. Rul. 8209004 and Ltr. Rul. 8203011. Cf. Treas. Reg. §20.2032A-3(c) and Ltr. Rul. 8020011. However, a number of cases have held Treasury regulations section 20.2032A-8(a)(2) invalid. Generally, they enunciate a "wait-and-see" approach according to which a mere possibility of passage of a successive interest to other than a qualified heir before the property is included in the gross estate of a qualified heir does not preclude eligibility but actual passage within the period during which tax savings are subject to recapture does trigger recapture. Smoot v. United States, 90-1 USTC ¶60,002 (7th Cir. 1989), Estate of Thompson v. Commissioner, 864 F. 2d 1128 (4th Cir. 1989), Kunze v. United States, 1988 U.S. Dist. LEXIS 16642 (Dist. KS 1988), Estate of Clinard v. Commissioner, 86 T.C. 1180 (1986), Estate of Davis v. Commissioner, 86 T.C. 1156 (1986), and Pliske v. Commissioner, T.C. Memo. 1986-311 (1986). The Internal Revenue Service never has acquiesced in these decisions. Although it did not find the regulation invalid, TAM 8643005 held that the mere remote possibility of passage to other than a qualified heir did not preclude eligibility. As a practical matter, current law possibly consists of the "wait-and-see" approach. The wait-and-see approach is workable and supports the policy that underlies the statute.

10A.02 PROBLEMS AND SOLUTIONS

Usually, a nonmarital trust that is well-drafted will not vest any interest unless and until the interest becomes possessory. Therefore, the orthodox nonmarital trust usually will present at least some possibility that the property will pass to a person who is not a qualified heir.

Form 10.1

Section 4.08. Code Section

a **[s 2032A and]**
2057. "Special Property" shall mean all property that, if the property were Special Property to which subsections (A) and (B) of this Section would apply, would be eligible for application of

b **[either or each of Section 2032A of the Code and]**
Section 2057 of the Code for purposes of determining the United States estate tax payable because of my death or the death of my wife. Notwithstanding any provision of this instrument to the contrary,

c **[if (but only if), before the filing of the return of United States estate tax payable because of my death (or, as the case may be, the death of my wife), legal counsel (other than any person who is not an Independent Person) for my personal representative (or, in the case of the death of my wife, the personal representative of my wife) so directs, subsections (A) and (B) (or, in the case of the death of my wife, only (A) and (B)(2)) of this Section shall apply.]**

(A) No power of appointment granted in this instrument shall be exercisable, directly or indirectly, to appoint Special Property in any manner that could permit the property to benefit any person who is not a qualified heir with respect to the property, as defined in Section 2032A(e)(1) of the Code, before the property passes to or otherwise is subject to inclusion in the gross estate (for estate tax purposes) of a qualified heir with respect to the property.

(B)

d di **[[(1)]**
If my wife survives me and either my wife survives all of my descendants or there is no sufficient evidence that my wife and the survivor of my descendants died other than simultaneously, upon the death of the survivor of my descendants (or upon my death if no descendant of mine survives me) the Trustee shall distribute all Special Property to my wife.]

e ei **[[(2)]**
Any of the Special Property that is not distributable according to the prior provisions of this instrument,

eii **[including subsection (1) of this subsection (B) but]**
excluding Section 4.03, shall be distributed to the estate of my last-surviving descendant who is living after my death or, if no descendant of mine is living after my death, according to Section 4.03.]

10A.02(a) First Problem

Assume the existence of a trust that mandates the current payment of all income to the surviving spouse of the testator during the life of the surviving spouse, remainder either (i) to the descendants, per stirpes, of the testator who survive the survivor of the testator and the spouse of the testator or (ii) as provided in the Second Problem. If no descendant survives the spouse, the property might pass to other than a qualified heir.

10A.02(b) Possible Solution

If the client is unwilling to risk the existence of the wait-and-see test, a possible solution to the First Problem is to provide that the property shall pass outright to the spouse if no descendant survives the spouse. This solution will permit the spouse to enjoy outright ownership of the property during any time that no descendant is living. After the death of the survivor of the testator and the last-surviving descendant of the testator, usually no overwhelming reason will exist to avoid including the property in the gross estate of the spouse of the testator. This solution will permit the spouse, rather than, for example (as in the Second Problem), a last-surviving descendant (probably a child), to dispose of the property. The spouse might dispose of the property similarly to how the testator might have disposed of it. A deceased descendant, on the other hand, probably will leave the property to his or her spouse, and the spouse of the descendant probably will dispose of it randomly (as far as the testator is concerned).

10A.02(c) Second Problem

Assume that upon the death of the testator or upon the termination of the trust for the benefit of the surviving spouse described in the First Problem, the testator allocates the property with respect to the descendants of the testator then living, per stirpes, with a separate trust for each child until the child attains a stated age or sooner dies, with the share of any deceased child to pass to the descendants of the child then living, per stirpes, or, if none, to the descendants of the testator then living, per stirpes, or, if none, to some person or charity that is not a qualified heir. If any child survives the testator or, as the case may be, the survivor of the testator and the spouse of the testator but no descendant of the testator survives the termination of a trust for a child, the property might pass to other than a qualified heir.

10A.02(d) Possible Solution

If the client is unwilling to risk the existence of the wait-and-see test, a possible solution to the Second Problem is to provide that, in lieu of the gift to some person or charity that is not a qualified heir, the trust estate of the trust of a deceased child shall pass to the estate of the last-surviving descendant of the testator.

10A.02(e) Third Problem

Assume that the spouse of the testator in the First Problem, or the child of the testator in the Second Problem, has a nongeneral power of appointment which permits the donee to appoint to other than a qualified heir. Treas. Reg. §20.2032A-8(a)(2). See Rev. Rul. 82-140, 1982-2 C.B. 208, and Ltr. Rul. 8146020. However, Smoot v. United States, 90-1 USTC ¶60,002 (7th Cir. 1989), Estate of Thompson v. Commissioner, 864 F. 2d 1128 (4th Cir. 1989), Kunze v. United States, 1988 U.S. Dist. LEXIS 16642 (Dist. KS 1988), and Estate of Clinard v. Commissioner, 86 T.C. 1180 (1986), have held Treasury regulations section 20.2032A-8(a)(2) to be invalid to the extent that the mere existence (as opposed to the use) of a nongeneral power of appointment of a qualified heir would prevent special use valuation.

10A.02(f) Drafting

If an election according to Code Section 2032A or Code Section 2057 might be attractive, consider the necessity of assuring that each contingent remainder will pass to a qualified heir and not to someone who is not a qualified heir.

According to Treasury regulations section 20.2056(b)-7(d)(3), promulgated because of Clayton v. Commissioner, 92-2 USTC ¶60,121 (5th Cir. 1992), property that has the format of qualified terminable interest property only if a QTIP election is made can qualify for the marital deduction. By analogy, can Code Section 2032A and Code Section 2057 apply to property that, because of *Form 10.1*, passes to a qualified heir only if a person so directs after the death of the testator and before the delivery of the election? **Variable c** is usable only if the answer is affirmative. If the required passage to a qualified heir were conditioned upon an actual election, a beneficially interested person who would possess the power to elect might possess a general power of appointment and, by failing to elect, release the power and make a gift for gift tax purposes. **Variable c** addresses this issue by conditioning the passage to a qualified heir upon the exercise of discretion to direct and by vesting the discretion in an independent person. Even if the service of an independent person were optional and a beneficiary were able to prevent the service of an independent person, the beneficiary would not possess the power that the independent person, if appointed, would possess. Because only a direction, not a failure to direct, can increase the interest of the beneficiary (by adding a remainder interest), a power to prevent the direction by preventing the service of an independent person, under circumstances in which the beneficiary could not force an independent person to direct, would not seem sensitive. Cf. United States v. Winchell, 61-1 USTC ¶12,015 (9th Cir. 1961). According to Code Section 2041(b)(1)(C)(ii), a power that a person only can exercise with the concurrence of a person who has an adverse interest is not a general power of appointment. However, even if *Form 10.1* were written so that passage to a qualified heir were conditioned upon an actual election, the protection of this rule would seem unavailable. Arguably, the persons who actually sign a 2032A agreement are not adverse.

Use **variable d** to vest in the spouse of the settlor if any marital disposition is not outright and the spouse survives or dies simultaneously with the last-surviving descendant of the settlor.

Use **variable e** to vest in the last-surviving descendant of the settlor if (i) **variable d** is used and a descendant survives the spouse and otherwise the plan does not provide for outright disposition to a descendant at the death of the spouse or (ii) **variable d** is not used and the trust estate does not pass entirely outright to a descendant at the death of the settlor. Use **variable eii** if **variable d** is used.

"Appointive Portion" in subsection (A) of *Form 10.1* is a reference to a general power of appointment that is installed for the purpose of avoiding a generation-skipping transfer.

* * *

CHAPTER 13

PERPETUITIES AND POWER-OF-APPOINTMENT ISSUES

The presence and absence of rules against perpetuities create opportunities and pitfalls.

First, even if the jurisdiction that governs the governing instrument has no rule against perpetuities, the rule of a jurisdiction in which real property is located can govern the disposition of the real property. Accordingly, the draftsperson should consider using a savings clause that can accommodate multiple regimes.

Second, the absence of a rule against perpetuities might cause an unintentional fall into the "Delaware Tax Trap." According to Code Section 2041(a)(3), a nongeneral power of appointment that is exercised to create a power of appointment which is exercisable without reference to the date of the creation of the exercised power is treated as a general power of appointment. Therefore, the Delaware Tax Trap presents the potential pitfall of unnecessary exposure to estate tax. However, the Delaware Tax Trap also presents the potential benefit of subjection of property to an estate tax at a lower rate rather than to a generation-skipping tax at a higher rate. Accordingly, the donee should use the Trap purposefully rather than inadvertently.

Each of *Form 13.1*, *Form 13.2* and *Form 13.3* appears usable if, except for an intentional invocation of the Delaware Tax Trap, each power and trust is subject to the same, or no, period of rule against perpetuities. If, except for an intentional invocation of Code Section 2041(a)(3), any power or trust is to have a different (including no) limitation (from any other power or trust) because the settlor is exercising a power of appointment, (i) install in the document of exercise (see *Form 13.8*) protection against Code Section 2041(a)(3) and (ii) use *Form 13.4* (rather than *Form 13.1*, *Form 13.2* and *Form 13.3*) in order to acknowledge (and, if necessary, to permit) the difference.

13.01 COMMON-LAW RULE

Form 13.1

Section 4.02. Limitation of Duration. Anything to the contrary notwithstanding, each trust

a **[(other than the Charitable Trust under Section 3.02)]**

that is created by this instrument (or, directly or indirectly, by exercise of any power of appointment granted in this instrument, other than any exercise that commences a new period of applicable rule against perpetuities) and not sooner terminated shall terminate twenty-one years after the death of the last to die of

b **[the beneficiaries in being at my death]**

c **[me, my wife and the beneficiaries in being at the death of the first to die of my wife and me]**

d **[me and the beneficiaries in being at the date of this instrument]**

, and the Trustee shall distribute the trust estate of the trust according to the terms of the trust or, to any extent the terms do not provide for distribution upon the termination, to the members of the group that consists exclusively of the persons to whom, immediately before the termination, the Trustee must or may pay income, in proportion to those interests or, to any extent indefinite, in equal shares.

13.01(a) Drafting

Use **variable a** with trusts for charitable objects. The "other than" clause that follows **variable a** and precedes **variable b** is designed to permit invocation of Code Section 2041(a)(3). Use **variable b** in a revocable trust. **Variable c** facilitates consolidation of identical trusts established by spouses. Use **variable d** in an irrevocable trust.

13.02 "ELECT-OUT" JURISDICTION

Form 13.2

Section 4.02. Limitation of Duration. The rule against perpetuities does not and shall not, and (to the maximum extent possible) all other rules of law limiting the duration of trusts do not and shall not, apply to any trust that is created by this instrument or, directly or indirectly, by exercise of any power of

appointment granted in this instrument. Without limiting the generality of the preceding sentence, the Trustee (or other person to whom the power properly is granted or delegated) has the power to sell, lease and mortgage property for any period of time beyond the period of the rule against perpetuities and (to the maximum extent possible) beyond the period of the limitation of all other rules of law limiting the duration of trusts. Each trust that is created by this instrument or, directly or indirectly, by exercise of any power of appointment granted in this instrument is a qualified perpetual trust (within the meaning of the Statute Concerning Perpetuities (765 ILCS 305)). Solely to such extent (if any) as, notwithstanding the preceding portion of this Section, applicable law limits the duration of any trust that is created by this instrument (or, directly or indirectly, by exercise of any power of appointment granted in this instrument) and that is not terminated before the end of the period of the limitation, the trust shall terminate at the end of the period of the limitation, and the Trustee shall distribute the trust estate of the trust according to the terms of the trust or, to any extent the terms do not provide for distribution upon the termination, to the members of the group that consists exclusively of the persons to whom, immediately before the termination, the Trustee must or may pay income, in proportion to those interests or, to any extent indefinite, in equal shares, and if the period of the limitation is measured in whole or in part by the lives of individuals living at a particular time, the measuring lives shall consist (to such extent as the law permits) of

a [the beneficiaries in being at my death]
b [me, my wife and the beneficiaries in being at the death of the first to die of my wife and me]
c [me and the beneficiaries in being at the date of this instrument].

Nothing in this Section shall prevent the exercise of any power of appointment from limiting the duration of any power, interest or trust.

13.02(a) Drafting

Some jurisdictions, such as Illinois, permit the settlor to elect that no rule applies. Use **variable a** in a revocable trust. **Variable b** facilitates consolidation of identical trusts established by spouses. Use **variable c** in an irrevocable trust.

13.03 OTHER JURISDICTIONS

Form 13.3

Section 4.02. Limitation of Duration. To the maximum extent possible, rules of law limiting the duration of trusts including without limitation the rule against perpetuities do not and shall not apply to any trust that is created by this instrument or, directly or indirectly, by exercise of any power of appointment granted in this instrument. Without limiting the generality of the preceding sentence, the Trustee (or other person to whom the power properly is granted or delegated) has the power to sell, lease and mortgage property for any period of time beyond the period of the rule against perpetuities and (to the maximum extent possible) beyond the period of the limitation of all other rules of law limiting the duration of trusts. Solely to such extent (if any) as, notwithstanding the preceding portion of this Section, applicable law limits the duration of any trust that is created by this instrument (or, directly or indirectly, by exercise of any power of appointment granted in this instrument) and that is not terminated before the end of the period of the limitation, the trust shall terminate at the end of the period of the limitation, and the Trustee shall distribute the trust estate of the trust according to the terms of the trust or, to any extent the terms do not provide for distribution upon the termination, to the members of the group that

consists exclusively of the persons to whom, immediately before the termination, the Trustee must or may pay income, in proportion to those interests or, to any extent indefinite, in equal shares, and if the period of the limitation is measured in whole or in part by the lives of individuals living at a particular time, the measuring lives shall consist (to such extent as the law permits) of

a [the beneficiaries in being at my death]

b [me, my wife and the beneficiaries in being at the death of the first to die of my wife and me]

c [me and the beneficiaries in being at the date of this instrument].

Nothing in this Section shall prevent the exercise of any power of appointment from limiting the duration of any power, interest or trust.

13.03(a) Drafting

Use **variable a** in a revocable trust. **Variable b** facilitates consolidation of identical trusts established by spouses. Use **variable c** in an irrevocable trust.

13.04 SAVINGS CLAUSE FOR DIFFERENT PERIODS

Form 13.4

(A) Anything to the contrary notwithstanding, each trust that is created by this instrument (or, directly or indirectly, by exercise of any power of appointment granted in this instrument) with respect to property (or proceeds of property) that, according to my Will, I appointed to the Trustee of the Portion Three Family Trust, and with respect to property (or proceeds of property) that, according to my Will, I appointed to the Trustee of the Portion Four Family Trust, and not sooner terminated, shall terminate twenty-one years after the death of the last to die of me and the beneficiaries in being at the death of my father, JOHN H. SMITH, on January 15, 1990, and the Trustee shall distribute the trust estate of the trust according to the terms of the trust or, to any extent the terms do not provide for distribution upon the termination, to the members of the group that consists exclusively of the persons to whom, immediately before the termination, the Trustee must or may pay income, in proportion to those interests or, to any extent indefinite, in equal shares.

(B) Anything to the contrary notwithstanding, except as provided in subsection (A) of this Section,

[continue with conventional savings clause, e.g., *Form 13.1*, *Form 13.2* or *Form 13.3*]

13.04(a) Purpose

Form 13.4 is intended to apply to powers and trusts that are created according to the same instrument but that as a matter of law are subject to different periods of rule against perpetuities (including none). *Form 13.4* is an alternative to a provision in the will of the donee. Whenever possible, use this provision in the trust of the donee rather than in the will of the donee.

13.05 SAVINGS CLAUSE FOR APPOINTIVE PROPERTY SUBJECT TO GENERAL POWER TO APPOINT BY WILL

Form 13.5

(A) Anything to the contrary notwithstanding, each trust that is created by this instrument (or, directly or indirectly, by exercise of any power of appointment granted in this instrument) and not sooner terminated, to such extent (if any) as the trust estate of the trust consists of property (or proceeds of property) distributed to the Trustee under this instrument pursuant to my exercise at Section 2.03 of my Will of the power of appointment granted to me in the Will of my husband, JOHN H. SMITH, shall terminate twenty-one years after the death of the last to die of me and the beneficiaries in being at the death of JOHN H. SMITH on January 15, 1990, and the Trustee shall distribute the trust estate of any terminated portion of the trust according to the terms of the trust or, to any extent the terms do not provide for distribution upon the termination, to the members of the group that consists exclusively of the persons to whom, immediately before the termination, the Trustee must or may pay income, in proportion to those interests or, to any extent indefinite, in equal shares.

13.05(a) Purpose and Drafting

Form 13.5 is includable in the trust document of the donee of the power. *Form 13.5* is usable in lieu of subsection (A) of *Form 13.4* for appointed property which (a) was subject to a testamentary *general* power of appointment and remains subject to a preexisting rule against perpetuities and (b) is not segregated into a separate trust. The period of the rule against perpetuities with respect to this type of power continues to date from the creation of the power. See Northern Trust Company v. Porter, 13 N.E.2d 487 (Ill. 1938). Normally, segregation would interfere with the normal, tax-oriented operation of the trust document, such as in the application of a marital formula. Nonsegregation presents the issue of the dilution of the effect of GST exemption by shortening the potential duration of the portion of the trust to which the GST exemption is applied. However, if the subject property is no more important than any other property to retain in trust, the use of pick-and-choose authority to divert this property from the exempt portion seems a possible answer.

13.06 SEPARATE RECEPTACLES FOR APPOINTIVE PROPERTY SUBJECT TO DIFFERENT PERIODS

Form 13.6

(A) Allocation to Portions. The Trustee shall allocate the trust estate of the Family Trust, and other assets, to four portions, to be known, respectively, as "Portion One," "Portion Two," "Portion Three" and "Portion Four," according to this subsection (A).

a **[If any property passes to the Trustee of the Family Trust upon the death of the survivor of my wife and me or upon the occurrence of any other event other than my death, the Trustee shall allocate it among "Portion One," "Portion Two," "Portion Three" and "Portion Four" by taking into account all prior allocations.]**

* * *

(3) Portion Three. Portion Three shall consist of all property distributed to the Trustee of the Portion Three Family Trust pursuant to my exercise at Section 2.05 of my Will of the power of appointment granted to me at Section 3.06 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989.

(4) Portion Four. Portion Four shall consist of all property distributed to the Trustee of the Portion Four Family Trust pursuant to my exercise at Section 2.05 of my Will of the power of appointment granted to

me at Section 3.07 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989.

* * *

(B) Administration of Portions. The Trustee shall administer Portion One as provided in Section 3.06. The Trustee shall administer Portion Two as provided in Section 3.07. The Trustee shall administer Portion Three as provided in Section 3.08. The Trustee shall administer Portion Four as provided in Section 3.09.

* * *

Section 3.07. Portion Three Family Trust. The Trustee shall set apart, in a separate trust to be known as the "Portion Three Family Trust" and to be administered as provided in this Section, (i) all property distributed to the Trustee of the Portion Three Family Trust pursuant to my exercise at Section 2.05 of my Will of the power of appointment granted to me at Section 3.06 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989, and (ii) all property distributed to the Trustee of the Portion Three Family Trust pursuant to Section 3.08 of this instrument.

* * *

Section 3.08. Portion Four Family Trust. The Trustee shall set apart, in a separate trust to be known as the "Portion Four Family Trust" and to be administered as provided in this Section, all property distributed to the Trustee of the Portion Four Family Trust pursuant to my exercise at Section 2.05 of my Will of the power of appointment granted to me at Section 3.07 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989. The Trustee shall distribute to the Trustee of the Portion Three Family Trust created according to Section 3.07 a fractional portion of the trust estate of the Portion Four Family Trust. The numerator of the fraction is the amount (if any) by which my GST exemption that is unallocated immediately before my death exceeds the value (for purposes of determining the United States estate tax payable because of my death) of the trust estate of the Portion One Family Trust. The denominator is the value (for purposes of determining the United States estate tax payable because of my death) of the trust estate of the Portion Four Family Trust. Notwithstanding the preceding portion of this Section, if the United States generation-skipping tax is not in effect at my death, the Trustee shall distribute to the Trustee of the Portion Three Family Trust created according to Section 3.07 all of the trust estate of the Portion Four Family Trust. The succeeding portion of this Section is subject to the preceding portion.

13.06(a) Purpose

The purpose of *Form 13.6* is to create receptacles for GST-significant assets with respect to which a power of appointment is exercised. Portion Four "pours" to Portion Three any property, such as, for example, the trust estate of a GST-nonexempt-marital-deduction trust, that the GST exemption of the donee of the power can exempt. The purpose of the last sentence of *Form 13.6* is to "convert" to a full shelter if the generation-skipping tax is not in effect when the exercise of the power becomes effective.

13.07 CONTINGENT DISPOSITION OF APPOINTED PROPERTY

Form 13.7

> **Any of the trust estate of the Portion Three Family Trust, and any of the trust estate of the Portion Four Family Trust, that is not distributable according to the prior provisions of this instrument and that consists of property (or proceeds of property) with respect to which I exercised a power of appointment granted to me by JOHN H. SMITH shall be distributed according to the instrument that created the power. Any balance**
>
> **[continue with usual contingent disposition clause]**

13.07(a) Purpose

Form 13.7 is includable in the trust of the donee of the power at the beginning of the contingent disposition clause. The scope of the exercised power defines the exercise, but in Massachusetts (see 191 M.G.L. §1B) and Illinois (see 755 ILCS 5/4-2 and 765 ILCS 320/1) the scope of the exercised power does not limit the scope of any new power that the exercised power creates. However, the contingent disposition that appears in the will or trust of the donee of the original power does *not* result from the exercise of the new power. Rather, the contingent disposition occurs only because of a failure to exercise the new power. Therefore, the contingent disposition seems governed by the creator, and not the donee, of the original power. Stated differently, by exercise, the donee of the new power, but not the donee of the original power, seems able to create a contingent disposition.

13.08 EXERCISE OF POWER

Form 13.8

> **Section 2.05. Property Subject to Certain Powers of Appointment. I am granted a power of appointment ("First Power") at Section 3.06 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989, with respect to the trust estate of the Portion One Family Trust named for me. I am granted a power of appointment ("Second Power") at Section 3.07 of the Declaration of Trust of JOHN H. SMITH dated January 15, 1989, with respect to the trust estate of the Portion Two Family Trust named for me. If any descendant of John H. Smith survives me, I exercise the First Power by directing that, upon my death, all property subject to the First Power shall be distributed to the Trustee of the Portion Three Family Trust created according to Section 3.08 of the Trust described in Section 2.04 of this Will. If any descendant of John H. Smith survives me, I exercise the Second Power by directing that, upon my death, all property subject to the Second Power shall be distributed to the Trustee of the Portion Four Family Trust created according to Section 3.09 of the Trust described in Section 2.04 of this Will. Notwithstanding anything to the contrary, if my exercise of any power of appointment ("exercised power")**
> a **[, other than the power of appointment granted to me at [#A] of [#B],]**
> **creates another power of appointment ("other power"), the other power shall not be exercisable or exercised, directly or indirectly, to postpone the vesting of any estate or interest in, or suspend the absolute ownership or power of alienation of, any property (or any proceeds of any property) with respect to which I exercised the exercised power, for longer than twenty-one years after the death of the last to die of me and the beneficiaries in being at the creation of the exercised power**
> b **[; provided, (1) if (a) no rule against perpetuities would apply absent my exercise of the exercised power and (b) any period of years that begins with the creation of**

the exercised power and continues for more than one hundred ten is not regarded, for purposes of determining United States estate tax immediately before my death, as a period ascertainable without regard to the date of the creation of the exercised power, I substitute for the period described in the portion of this sentence that precedes this provisory clause the shorter of (a)
bi [three hundred sixty]
bii [one thousand]
years after the creation of the exercised power and (b) the longest period of years that begins with the creation of the exercised power and is not regarded, for purposes of determining the United States estate tax payable because of my death, as a period ascertainable without regard to the date of the creation of the exercised power and (2) the preceding portion of this sentence shall not limit the other power with respect to any property (or any proceeds of any property) that is includable in my gross estate (for purposes of determining the United States estate tax payable because of my death) without regard to whether I exercised the exercised power].

13.08(a) Purpose and Drafting

Form 13.8 is includable in the will of the donee of the power.

The last sentence is a savings provision that is designed to avoid the Delaware Tax Trap of Code Section 2041(a)(3) by avoiding the creation of a power which is exercisable without regard to the date of the creation of the exercised power. The problem that the last sentence addresses can occur if (i) the donee of a nongeneral power of appointment exercises the power to create a presently exercisable general power of appointment ("PEG power") that is not limited by any rule against perpetuities or that is limited by a new period of rule against perpetuities or (ii) the donee exercises a nongeneral power of appointment that itself is not limited by any rule against perpetuities to create a new power that similarly is not limited.

A person who wants to exercise an existing power that is not limited by the common law rule confronts the risks that imposition of the common law rule unnecessarily limits the duration of the new power, that invocation (in the style of recent legislation in Florida, Alaska, Utah and Wyoming) of a limit of a period of years in gross that begins with the date of the creation of the exercised power is unproven and that declination to exercise the power is probably unnecessary and inappropriate. A donee of an existing power who is considering using *Form 13.8* should consider the effect of Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), 44-1 USTC ¶10,110, certiorari denied, 323 U.S. 756 (1944), and related authority.

Use **variable a** to identify any power that the testator affirmatively wants to exercise to create a PEG power and to flunk the Code Section 2041(a)(3) test.

Arguably, deletion of **variable b** brings the exercise within the "safe harbor" of the common law rule. Delete **variable b** if (i) the common law rule controls absent **variable b** or (ii) the common law rule does not control absent **variable b** and the safe harbor of the common law rule is sought.

Arguably, **variable b** with **variable bi** included and **variable bii** deleted brings the exercise within the "safe harbor" of Florida. Generally use **variable bi** if no rule against perpetuities applied to the exercised power.

Arguably, **variable b** with **variable bii** included and **variable bi** deleted brings the exercise within the "safe harbor" of Alaska, Utah and Wyoming.

CHAPTER 14

TRUST MANAGEMENT

SUBCHAPTER A:
GENERAL LIMITATIONS

14A.01 POTENTIAL PROBLEMS

If the exercise of a power permits the power holder to shift beneficial enjoyment to or from himself or herself, the power can present tax issues, *even if* the power is labelled as an administrative power. One concern is that the mere existence of the power can be a general power of appointment or a power exercisable solely by the power holder to vest income or corpus in himself or herself. Code §678(a)(1) and Treas. Reg. §§20.2041-1(b)(1), 25.2514-1(b)(1), 20.2056(b)-5(f) and 25.2523(e)-1(f). Another concern is that the exercise or lapse of the power in favor of other than the power holder can produce a taxable gift. Treas. Reg. §25.2511-1(g)(2) and Code §2514.

Particularly capable of permitting shifts of enjoyment are powers:

(i) to retain, dispose and invest property when particular types of income are allocated to particular beneficiaries,

(ii) to retain or invest in unproductive or underproductive property (especially if the governing instrument waives the application of state law that otherwise requires adjustments in favor of income),

(iii) to allocate receipts and expenses between income and principal,

(iv) to lend without adequate security or interest,

(v) to exchange property with the trustee,

(vi) to release a trustee or accept the trustee's account,

(vii) to distribute in nonprorata shares without regard to unrealized gain for tax purposes and

(viii) to pay (or cause payment of) death costs (i.e., debts, costs of administration and taxes) from one fund rather than another.

An administrative power seems not to present any problem unless the administrative power permits the holder to change the amount that the holder will receive. The ability of a holder of an administrative power to use it to this effect depends upon the complexions of both (i) the administrative power and (ii) the dispositive arrangement. For example, if a fiduciary has a power to pay (or cause payment of) death costs from either the residuary estate of a decedent or a trust to which all of the residuary estate "pours over," the power seems not to permit the fiduciary to shift beneficial enjoyment. However, if a fractional share of the residuary estate passes to the trust from which the fiduciary can pay (or direct payment) and the balance of the residuary estate passes elsewhere, the power might enable the fiduciary to enhance or to reduce the beneficial interest that he or she possesses personally.

14A.02 POSSIBLE SOLUTIONS

First, if the administrative power is not coupled with any dispositive provision that mandates the distribution of income or principal, the drafting of dispositive powers in accordance with the analysis in Chapter 3 should eliminate all tax vulnerability. To such extent as an ascertainable standard limits a dispositive power that is exercisable in favor of a holder of an administrative power or in favor of another distributee, the ascertainable standard also limits the extent to which a holder of an administrative power can use the administrative power to benefit the power holder or the other person. If all ability to distribute property to the power holder is described in Code Sections 2041(b)(1)(A) and 2514(c)(1) and all ability to distribute property to other than the power holder is described in Treasury regulations section 25.2511-1(g)(2) and the power holder cannot distribute trust property in discharge of his or her legal obligation, these limitations should prevent (i) any administrative power from being a general power of appointment and (ii) the exercise of, or the failure to exercise, any administrative power from being a taxable gift of the beneficial interest of the power holder.

Second, if the administrative power is coupled with a dispositive provision that mandates the distribution of income or principal, the draftsperson might have to eliminate or limit the administrative power. Whereas administrative powers that are coupled with discretionary powers to distribute seem to command orthodox solutions previously discussed, a power of administration that is coupled with a dispositive provision that mandates a distribution seems capable, absent sufficient limitation, of *being* a dispositive power. If, for example, the governing instrument requires the trustee to pay income currently to the power holder or another person, an administrative power to retain or to invest in unproductive or underproductive property might enable the power holder, unlimited as provided in Code Sections 2041(b)(1)(A) and 2514(c)(1) and Treasury regulations section 25.2511-1(g)(2), to increase or reduce the stream of income to the distributee. If the power holder is the income beneficiary, the concern is that the power holder might possess and release a general power of appointment over any forgone income. If the power holder is a remainder person rather than the income beneficiary and the power holder maximizes income and thus reduces the potential value of the remainder, the concern is that the power holder might be deemed to give the forgone value to the income beneficiary.

If each holder of an administrative power has a beneficial interest and the administrative power is coupled with a dispositive provision that mandates a distribution, general precautions are appropriate to prevent the use of the administrative power for dispositive purposes. The governing instrument clearly should cause all administrative powers to be fiduciary powers. The draftsperson should design all administrative powers cautiously and conservatively. The draftsperson should avoid exculpatory clauses and should eliminate any discretion that arguably is sensitive. Consider reposing any otherwise-sensitive power jointly in more than one holder. Code §§678(a)(1), 2041(b)(1)(C)(ii) and 2514(c)(3)(B).

SUBCHAPTER B:
SELECTION AND SUCCESSION OF TRUSTEES

14B.01 POWER TO RESUME OFFICE AFTER RESIGNATION

Form 14.1

> **During any time my wife is unable or unwilling to serve, my brother, ROBERT, shall serve. My wife and my brother, Robert, if at any time or from time to time unable or unwilling to serve, may, when able and willing, assume or (as the case may be) resume office, in lieu of any trustee for which this Section prescribes a tenure consisting of any period of inability or unwillingness.**

14B.01(a) Purpose

Most governing instruments do not permit a person to interrupt and resume service as trustee. Accordingly, they present an all-or-nothing-at-all decision: (i) relinquish the trusteeship permanently or (ii) retain it. The power to resume office provides an additional possibility. It seems particularly useful in the hands of family members.

14B.02 POWER TO REMOVE TRUSTEE

Form 14.2: Alternative #1

> **At any time and from time to time, the Holder of the Power of Removal may remove any trustee that is an Independent Person, by written instrument delivered to the trustee to be removed. The Individual Trustee shall be the Holder of the Power of Removal. No one shall have any responsibility for any failure to exercise any authority granted in this subsection (E). The powers of the Holder of the Power of Removal are, and shall be exercised as, fiduciary powers subject to all the restrictions and limitations to which the Trustee would be subject if the Trustee possessed the powers.**

Form 14.3: Alternative #2

> **At any time and from time to time, the Holder of the Power of Removal may remove any trustee, by written instrument delivered to the trustee to be removed. The Holder of the Power of Removal at any particular time shall consist of the majority in interest, or, if indefinite, in number, of the persons to whom the Trustee then must or may pay any of the trust estate. No one shall have any responsibility for any failure to exercise any authority granted in this subsection (E). The powers of the Holder of the Power of Removal are, and shall be exercised as, fiduciary powers subject to all the restrictions and limitations to which the Trustee would be subject if the Trustee possessed the powers.**

Form 14.4: Alternative #3

> **At any time and from time to time, the Holder of the Power of Removal may remove any trustee that is an Independent Person, by written instrument delivered to the trustee to be removed. The Holder of the Power of Removal at all times shall be an Independent Person that is not serving as a trustee. The Holder of the Power of Removal at any particular time shall consist of the Holder of the Power of Removal that then is serving. If no Holder of the Power of Removal then is serving, the Holder of the Power of Removal (if any) shall consist of such eligible appointee as the Holder of the Power of Removal most recently selected, for future effect, or,**

if no Holder of the Power of Removal so is appointed, such eligible appointee as the NonIndependent Trustee selects (or most recently selected, for future effect), or, if no Holder of the Power of Removal so is appointed, such eligible appointee as the majority in interest, or, if indefinite, in number, of the persons to whom at the time of the appointment the Trustee must or may pay any of the trust estate selects, or, if no Holder of the Power of Removal so is appointed, such eligible appointee as a court of competent jurisdiction, upon the application of any person having any interest, after such notice to the party or parties in interest (except such as may not be sui juris) as the court shall deem necessary or proper, selects. An individual's inability to serve may be determined by the written certification of the individual's personal physician. No one shall have any responsibility for any failure to exercise any authority granted in this subsection (E). The powers of the Holder of the Power of Removal are, and shall be exercised as, fiduciary powers subject to all the restrictions and limitations to which the Trustee would be subject if the Trustee possessed the powers.

14B.02(a) Problems and Solutions

Revenue Ruling 95-58, 1995-2 C.B. 191, revoked Revenue Ruling 79-353, 1979-2 C.B. 325, and Revenue Ruling 81-51, 1981-1 C.B. 458. According to Revenue Ruling 79-353, modified by Revenue Ruling 81-51, the power of a grantor to remove and replace a trustee caused the grantor to be deemed to possess the powers that the trustee actually possessed. In Wall v. Commissioner, 101 T.C. 300 (1993), the Tax Court disagreed with Revenue Ruling 79-353 and refused to apply it.

If the powers of the trustee to distribute or accumulate income and to distribute principal were not ascertainable-standard-limited and the grantor had a power to remove and replace the trustee, Revenue Ruling 79-353 would have attributed to the grantor a retained power described in Code Sections 2036(a)(2) and 2038(a)(1). Similarly, if the trustee had a power to discharge a legal obligation of the grantor and the grantor had a power to remove and replace the trustee, Revenue Ruling 79-353 would have attributed to the grantor a retained power described in Code Section 2036(a)(1). If, on the other hand, the powers of the trustee to distribute or accumulate income and to distribute principal were ascertainable-standard-limited, the grantor would not have had a power described in Code Section 2036(a)(2) or Code Section 2038(a)(1). See Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), 47-1 USTC ¶10,551. Similarly, if the trustee did not have any power to discharge any legal obligation of the grantor, the grantor would not have had a power described in Code Section 2036(a)(1).

According to an extension of the theory of Revenue Ruling 79-353, any person who could remove and replace a trustee was deemed to possess the powers that the trustee actually possessed. Accordingly, if the discretion of the trustee to distribute or accumulate income or to distribute principal were not limited by an ascertainable standard described in Code Section 2041(b)(1)(A), Revenue Ruling 79-353 would have attributed a general power of appointment to any permissible distributee who had a power to remove and replace the trustee. Similarly, if the trustee could have discharged (according to a power that would not have been within Code Section 2041(b)(1)(A) if the obligor were to have possessed the power) the legal obligation of a person who had a power to remove and replace the trustee, Revenue Ruling 79-353 would have attributed a general power of appointment to the person.

Revenue Ruling 95-58 not only revoked Revenue Ruling 79-353. It also stated that if the holder of a power of removal cannot replace the trustee with a related or subordinate party (within the meaning of Code Section 672(c)), the power of removal will not cause attribution of any power of the trustee.

If (i) the trustee cannot discharge any legal obligation of any person who can remove and replace the trustee, and the trustee cannot make any distribution, other than according to an ascertainable standard, to any person who can remove and replace the trustee, or (ii) no holder of the power of removal can replace the trustee with a related or subordinate party, each of the three alternatives, depicted in the forms, is appropriate. If (i) any holder of the power of removal can replace the trustee with a related or subordinate party and (ii) either (a) the powers of the trustee to make distributions to the holder of the power to remove and replace are not ascertainable-standard-limited or (b) the trustee can discharge a legal obligation of the holder of the power to remove and replace, or both (a) and (b), the first and second alternatives are inappropriate and the third alternative is appropriate. The third alternative uses a portion of the definition of Independent Trustee to invest the removal power in an independent person. See *Form 14.6*. Because, according to the form, the removal power is a fiduciary power, this writer has some concern that, but for the sentence that exonerates the holder of the power from responsibility for failure to exercise the power, the holder of the power might have a duty to initiate a removal and, therefore, a duty to observe the administration of the trust. See *Form 14.6* for the definition of "NonIndependent Trustee."

14B.03 DEFERRED NAMING OF INDEPENDENT TRUSTEE

Form 14.5: Alternative #1

"Corporate Trustee" shall mean the Trustee but shall not include any trustee that is neither a corporation nor a limited liability company
a **[and shall not include any trustee that does not have more than $100,000,000 of trust assets under its supervision].**
"Independent Trustee" shall mean the Corporate Trustee.

Form 14.6: Alternative #2

(D) Trustee. "Trustee" with respect to any trust shall mean the one or more trustees of the trust. "Individual Trustee" shall mean the Trustee but shall not include any trustee that is not an individual.
a **["Corporate Trustee" shall mean the Trustee but shall not include any trustee that is neither a corporation nor a limited liability company**
ai **[and shall not include any trustee that does not have more than $100,000,000 of trust assets under its supervision].]**
"Independent Trustee" shall mean the
a **[Corporate]**
Trustee but shall not include any trustee that is not an Independent Person. "NonIndependent Trustee" shall mean the Trustee but shall not include any trustee that is an Independent Person. "Independent Person" at any particular time with respect to any trust shall mean any person that

(i) has no beneficial interest (other than as a potential appointee under a power of appointment held by another), present or future, vested or contingent, direct or indirect, in the trust,

(ii) cannot be benefitted, to any extent gratuitously, by the exercise or nonexercise of any power given a trustee by this instrument or by law,

(iii) is not (a) a contributor, (b) a beneficiary, (c) a spouse, former spouse, ancestor, descendant, sibling or employee of a contributor or beneficiary (or of a spouse or former spouse of a contributor or beneficiary), (d) a corporation or other person, or an employee of a

corporation or other person, in which the stock or other holdings of a contributor (or beneficiary, or a spouse or former spouse of a contributor or beneficiary) and the trust are significant from the viewpoint of voting or other control, (e) a subordinate employee of a corporation or other person in which a contributor or beneficiary (or a spouse or former spouse of a contributor or beneficiary) is an executive or (f) any party, not described in (a) through (e) of this clause (iii), that is, or, if nonadverse (within the meaning of Section 672(b) of the Code), would be, a "related or subordinate party," with respect to a contributor or a beneficiary (as if the beneficiary were a contributor), within the meaning of Section 672(c) (after application of Section 672(e)) of the Code,

(iv) is not controlled, directly or indirectly, within the contemplation of income or any transfer tax, by any person that, according to the portion of this sentence preceding this clause (iv), is ineligible to be an Independent Person and

(v) under the United States internal revenue laws in effect at such time can alone (as though the only trustee), to such extent as some person (described in the portion of this sentence preceding this clause (v)) could alone (as though the only trustee), possess and exercise each power given a trustee by this instrument or by law

(a) without causing any attribution of the trust estate of the trust to any person (whether personally or as deemed transferor or otherwise) for purposes of income or any transfer (including without limitation gift, estate and generation-skipping) tax before the person becomes entitled to receive it outright (or, because of a power granted in or according to this instrument to the person as a beneficiary, the person becomes entitled to pay it to the person or the estate, creditors or creditors of the estate of the person) or it is paid to, or for the benefit of, the person,

(b) without otherwise causing any generation-skipping transfer and

(c) without causing any deemed sale or exchange, or transfer to a foreign trust, of any of the trust estate.

14B.03(a) Problems and Solutions

The decision that seems most to prevent, or at least delay, the signing of trust arrangements is the selection of an independent trustee. This decision is paramount if the trust arrangement requires the service of an independent trustee at some time. It is important, if not paramount, even if the independent trustee is to be only a contingent successor or addition.

Providing for selection of an independent trustee according to a formula can avoid the necessity of selecting the trustee unless and until the need for its service occurs. Therefore, it can facilitate the creation of the trust and can permit selection based upon considerations at the time an independent trustee is needed or wanted. The formula can define "Independent Trustee," state when an Independent Trustee is permitted or required and provide an appointment procedure. If the governing instrument requires the independent trustee always to be a corporation, the definition can use the concept of a corporation of a requisite, specified size, larger than the client (or any beneficiary) can control. See *Form 14.5*. If the governing instrument permits the independent trustee to be other than a corporation (or requires it to be a corporation but the gross estate of the client or any beneficiary is very substantial), the definition can use the concept of a person (human or not) that (i) has no beneficial interest, (ii) cannot exercise any power to benefit itself, (iii) is not related or subordinate to any contributor or beneficiary, (iv) is not subject to the control of anyone that is not an independent person and (v) does not, for purposes of income or any transfer tax, cause attribution of any property to any person before the person receives (or becomes entitled to receive) the property. See *Form 14.6.*

14B.04 DIFFERENT TRUSTEES FOR DIFFERENT TRUSTS

Form 14.7

Section 6.03. Trustee.

(A) Number. The Trustee of each trust may but need not be the same and shall consist of such trustees, not less than one or more than four, as are appointed from time to time according to this Section, applied separately to each trust.

14B.04(a) Problems

The use of different trustees for different trusts created according to a single document increases the complexity of drafting and administration. The governing instrument must provide for the appointment, removal and succession of each trustee of each trust, separately. Use of different trustees creates the possibility of disintegrated management.

14B.04(b) Purposes

Permissive (rather than required) use of different trustees facilitates customized administration of each trust. A power of a trustee to create new trusts from an existing trust might complement the use of different trustees for different trusts. The permissive use of different trustees can facilitate separate investment strategies and permit creation of separate trusts solely for investment reasons.

14B.05 PRIMARY BENEFICIARY CAN SERVE; TRUSTEE CAN APPOINT SUCCESSOR; TRUSTEE IN DEFAULT OF CONTRARY DESIGNATION CONSISTS OF INDEPENDENT TRUSTEE OR SUCCESSOR BENEFICIARIES

Form 14.8

(C) Succession; Selection of Additional Trustee. During any time my descendant with respect to whom the trust is created is unable or unwilling to serve, such eligible appointee as the Trustee most recently selected, for future effect, shall serve. If a successor trustee is required and no successor is appointed according to the preceding portion of this subsection (C), an Independent Trustee shall serve; provided, if my descendant with respect to whom the trust is created is deceased and any descendant of mine with respect to whom a succeeding trust is created is able and willing to serve, each descendant of mine with respect to whom a succeeding trust is created, who is able and willing, shall serve.

SUBCHAPTER C:
ALLOCATION OF POWERS AMONG TRUSTEES

14C.01 DELEGATION

Form 14.9

(1) At any time and from time to time, any trustee

a **[who is an individual]**

may delegate to any

b **[other]**

trustee

a **[that is a corporation]**

, by written instrument, any or all of the trustee's powers (except those, if any, not exercisable by the other trustee). Any person dealing in good faith with any trustee may rely without inquiry upon its certificate with respect to any delegation.

14C.01(a) Purpose

This provision permits trustees freely to delegate powers among themselves subject only to other provisions of the governing instrument that preclude a particular trustee from possessing a particular power.

14C.02 ADDITION OF INDEPENDENT TRUSTEE

As mentioned in 3A.04(c), the writer often uses "two tiers" of dispositive powers, with some but not all of the powers granted solely to an independent trustee, and he particularly uses a variation in which an independent trustee is not required always to serve and is only a permissible or mandatory addition, or a required successor, to one or more beneficially interested trustees. See the drafting issues that are discussed at 3A.04(c).

Form 14.10

(A) Number. The Trustee of each trust may but need not be the same and shall consist of such trustees, not less than one or more than three, as are appointed from time to time according to this Section, applied separately to each trust.

a **[The Trustee shall include an Independent Trustee during any time in which, if no Independent Trustee were serving, applicable law or a limitation set forth in Section 6.02 would cause no trustee to possess a particular power (other than a power that this instrument explicitly grants exclusively to the Independent Trustee) that the Independent Trustee, if serving, would possess.]**

(B) Initial Appointment; Additional Trustee.

(1) Initial Appointment. My wife initially shall be the Trustee.

(2) Additional Trustee.

a **[If at any time an Independent Trustee is required according to subsection (A) of this Section but no Independent Trustee is serving and no Independent Trustee is to commence to serve according to subsection (C) of this Section, an Independent Trustee (to be selected according to subsection (C) of this Section) shall be added.]**

b **[If at any time no Independent Trustee is serving and no Independent Trustee is required to serve, any Independent Person may direct the addition of an Independent Trustee (to be selected according to subsection (C) of this Section).]**

14C.02(a) Drafting

Use **variable a** to provide for the mandatory addition of an independent trustee. Use **variable b** to provide for the discretionary addition of an independent trustee. Use **variable a** and **variable b**, together, to include both systems.

14C.02(b) Purpose

Provision for the discretionary addition of an independent trustee creates an additional option. The nonindependent trustee can serve alone. The nonindependent trustee can resign and cause succession. A person who has discretion to add an independent trustee can direct the addition of a co-trustee.

A power of a beneficially interested person to direct the addition of an independent trustee permits the beneficially interested person to activate powers that only the independent trustee can possess. If a person to whom the independent trustee, if serving, can distribute trust property can direct the addition of an independent trustee and, thus, can activate any powers that only the independent trustee can possess, *but cannot require any increase in the amount he or she will receive and cannot require or permit any decrease in the amount that, absent the addition, he or she will receive*, neither the existence nor the exercise of the power should present any problem. The appointment mechanism illustrated in *Form 14.10* should avoid the problem in any event.

Provision for the mandatory addition of an independent trustee might be useful if the governing instrument permits one or more beneficially interested persons to serve alone as trustee(s). If the mandatory addition is used with a provision such as *Form 14.15* and *Form 14.16*, that extinguishes a power in the hands of a person in whose hands the power would be sensitive, the mandatory addition allocates the power to a person in whose hands the power will not be sensitive.

If a particular power would be tax-sensitive in the hands of each beneficially interested trustee and the governing instrument provides that no beneficially interested trustee will possess it, either (i) the power (and thus the corresponding interest) will not exist or (ii) the governing instrument must provide for the addition of an independent trustee to possess the power. To require the addition of an independent trustee when the tax sensitivity is inadvertent probably will serve the intentions of the grantor better than to cause the sensitive powers (and thus the corresponding interests) not to exist. Additionally, this approach will avoid the risks that might inhere in some shifting interests. See Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20th Ann. Inst. Est. Plg. ¶507.1 (Matthew Bender, 1986). Further, co-trustees can use delegation authority to mitigate the effect of the addition of an independent trustee. Although an independent trustee is added, the independent trustee can delegate to the beneficially interested trustee all powers that are not tax-sensitive.

See 3A.04(c), *Form 14.13* and *Form 14.14* concerning a system embellishment that would permit a beneficially interested trustee to possess certain powers exclusively, notwithstanding the discretionary or mandatory addition of an independent trustee.

14C.03 ALLOCATION TO INDEPENDENT TRUSTEE

14C.03(a) Always

Form 14.11

(1) Only the Independent Trustee shall possess, and participate in the exercise of, any discretion that, but for this sentence, a trustee would have to pay any of the trust estate to or for any beneficiary, pursuant to this instrument, as if each grant of the discretion were exclusively to the Independent Trustee.

14C.03(a)(1) Drafting

Generally, the writer does not rely solely upon *Form 14.11* to allocate dispositive powers. Rather, the writer couples *Form 14.11* with a specific grant of each sensitive power solely to the independent trustee in the dispositive part of the instrument.

14C.03(a)(2) Purpose

Form 14.11 is usable when (i) a trustee that is not an independent trustee (as defined in *Form 14.5* or *Form 14.6*) might serve and (ii) no nonindependent trustee ever is to possess any dispositive power. Will and trust forms distributed by banks often use a variation of this approach. They effectively invest all dispositive powers solely in the independent trustee. Typically, they accomplish this by providing that no person serving as a trustee shall possess or participate in the exercise of any discretion to affect his or her interest or the interest of any person to whom he or she is legally obligated. The bank-supplied forms, of course, contemplate trusts as to which the bank (i.e., independent trustee) *always* will serve (at least when the grantor is not serving). Cf. *Form 14.12*. When allocating powers for these reasons, the writer prefers to allocate the powers directly, rather than by reference to the effect of any power in the hands of a particular person.

* * *

14C.04 ALLOCATION TO NONINDEPENDENT TRUSTEE

Form 14.13

(1) During any time that the Trustee includes both an Independent Trustee and a NonIndependent Trustee, except to any extent the NonIndependent Trustee notifies the Independent Trustee in writing to the contrary, only the NonIndependent Trustee shall possess, and participate in the exercise of, any powers that the NonIndependent Trustee possesses pursuant to this instrument, as if each grant of those powers were exclusively to the NonIndependent Trustee. During any time that because of the preceding sentence any power reposes solely in the NonIndependent Trustee, the Independent Trustee shall have only such duties and responsibilities, if any, as correspond to and coincide with any powers that, notwithstanding the preceding sentence or because of a notification according to the preceding sentence, the Independent Trustee does possess.

Form 14.14

(1) A majority of the trustees that possess a power shall control the exercise and nonexercise of the power; provided, if at any time the Independent Trustee and the NonIndependent Trustee disagree, the NonIndependent Trustee shall

control. A dissenting trustee shall assist to implement, but shall have no responsibility for, any exercise or nonexercise from which the trustee dissents.

See *Form 14.6* for the definition of "NonIndependent Trustee."

14C.05 DIVERSION OF "SENSITIVE" POWERS

Form 14.15

(2) If at any particular time under the United States internal revenue laws in effect at such time any trustee cannot alone (as though the only trustee), but an Independent Person could alone (as though the only trustee), possess and exercise a particular power given a trustee by this instrument or by law with respect to any trust

(a) without causing any attribution of the trust estate of the trust to any person (whether personally or as deemed transferor or otherwise) for purposes of income or any transfer (including without limitation gift, estate and generation-skipping) tax before the person becomes entitled to receive it outright (or, because of a power granted in or according to this instrument to the person as a beneficiary, the person becomes entitled to pay it to the person or the estate, creditors or creditors of the estate of the person) or it is paid to, or for the benefit of, the person,

(b) without otherwise causing any generation-skipping transfer and

(c) without causing any deemed sale or exchange, or transfer to a foreign trust, of any of the trust estate,

the trustee shall not possess the power or participate in its exercise.

14C.05(a) Powers Described in Code Section 2041(b)(1)(A) and Treasury Regulations Section 25.2511-1(g)(2)

Form 14.16

(1) No trustee shall possess, or participate in the exercise of, any power that, but for this paragraph (1), the trustee would have to make any determination with respect to

(a) any payment which would discharge any legal obligation of the trustee personally or

(b) any payment to, or for the benefit of, the trustee personally (neither the preceding portion of this paragraph (1) nor any otherwise-applicable rule of law shall limit the trustee's possession or participation in the exercise of any power (or severable portion of any power) granted in this instrument to the trustee to consume, invade or appropriate property for the benefit of the trustee personally which is limited by an ascertainable standard relating to the health, education, support or maintenance of the trustee personally) or

(c) any power to pay to, or for the benefit of, the estate or the creditors of the estate of the trustee personally or

(d) any payment to, or for the benefit of, other than the trustee personally of any property in which the trustee personally has any beneficial interest (neither this subparagraph (d) nor any otherwise-applicable rule of law shall limit the trustee's possession or participation in the exercise of any fiduciary power (or severable portion of any fiduciary power) granted in this instrument to the trustee to make any payment to, or for the benefit of, other than the trustee personally the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in this instrument).

As used in this paragraph (1), "trustee personally" includes any person who because of control over the trustee is deemed for purposes of any transfer tax to possess any power of the trustee.

14C.05(a)(1) Purpose

Form 14.16 does not grant any power. Rather, it only limits powers that are granted elsewhere. The limitations are the least necessary to assure that (i) a general power of appointment does not exist because of the ability of a person to discharge a legal obligation by paying property to another person, (ii) a general power of appointment does not exist because of the ability of a person to pay property to himself or herself, (iii) a general power of appointment does not exist because of the ability of a person to pay property to his or her estate and (iv) a taxable gift does not occur because of a trustee's payment to another of property in which the trustee personally has a beneficial interest. See 3A.03.

Subparagraph (a) of the form effectuates the planning discussed at 3A.03(c)(2). Subparagraph (b) of the form permits the power holder to have a power, *granted elsewhere in the instrument* and described in subparagraph (a) or subparagraph (b) of the form, if the power is described in Code Section 2041(b)(1)(A). Subparagraph (c) of the form prevents the power holder from having a power, *granted elsewhere in the instrument*, to grant himself or herself a general power to appoint by will. Subparagraph (d) of the form permits the power holder to have a power, *granted elsewhere in the instrument* and described in subparagraph (d) of the form, if the power is described in Treasury regulations section 25.2511-1(g)(2).

MEDIATION IN ESTATE DISPUTES

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SECTION J

MEDIATION IN ESTATE DISPUTES

INTRODUCTION J-1

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INTRODUCTION

As in all phases of civil litigation, mediation is becoming more and more common in disputes arising from or related to estate or will matters. The value of mediation in estate disputes is no less than that in other matters, advancing the interests of economical resolution of disputes, preservation of family relationships, (or at least the avoidance of such grievous wounds as would destroy any possibility of future family harmony), saving the costs of litigation and removing the cloud of litigation over the emotional and mental health of all those involved. In these respects, it is difficult to delineate or distinguish mediation in the estate context from mediation in any other context. However, clearly, mediation of estate disputes does pose some unique challenges.

This paper will attempt first, to address the legal background and basis for mediation generally. Next it will address mediation techniques both generally and with respect to specific types of common estate disputes, and finally make some suggestions regarding possible benefits of mediation in other settings, such as estate planning, trust administration, and others not generally considered as subjects of mediation.

I. Legal Background for Mediation

Technically no specific authorization is required for mediation of any dispute which the parties agree to attempt to resolve thereby. Since mediation is therefore a voluntary process, and one in which settlement is only achieved by mutual agreement, not by imposition by the mediator, there has never been any legal restriction upon the ability of the parties to mediate disputes.

The exponential increase in mediation has occurred, first of all because the rising cost and delay of litigation has compelled more and more litigants in that direction, and secondly because trial courts, similarly struggling with congested dockets, have adopted rules, procedures and occasionally standing orders strongly encouraging, if not requiring, mediation.

In Jefferson County, the Circuit and District Courts collectively have adopted specific provisions as a portion of the Local Rules of Court. These are found as Rule 14, "Alternative Dispute Resolution." Rule 14.03 specifically authorizes the court on its own motion or on motion of any party to refer a case for mediation. It also provides certain criteria which the court shall consider in determining whether to do so. These include the stage of the litigation, the extent of discovery, the nature of the issues, the willingness to mediate and whether the parties have attempted to settle the case or otherwise resolve their disputes. Mediation does not effectuate a stay of the proceedings so that discovery or other pre-trial action may continue. However, as a practical matter, parties normally suspend such activities pending mediation.

The Jefferson County Rules further provide general guidelines for the appointment and compensation of the mediator, the procedures at mediation, confidentiality issues and the preparation of an appropriate settlement agreement if reached. Rule 14.10 requires the mediator to report the results of the mediation to the court.

In Fayette County, Local Rule 29 "Mediation" makes similar provisions. The Fayette County Rules are, if anything, somewhat more mandatory than the Jefferson County Rules in that Rule 29 B(1) specifically authorizes the court to order mediation even without the consent of the parties. Rules are also provided for confidentiality and for reporting to the Court.

Boone, Campbell, Gallatin and Kenton Counties have adopted uniform Local Rules which also contain provisions regarding alternative dispute resolution. However the process provided for in those Rules is denominated "arbitration." The circuit court may order any case to be heard by a "Board of Arbitration" of not more than three members of the Northern Kentucky

Bar Association. Specific provisions are provided for those taking exception to the arbitration or the selection of the arbitrators. Hearings are held at which the arbitration board receives sworn testimony and documentary evidence. The arbitrators are authorized to issue subpoenas and require production of documents. The actions of the arbitrators remain subject to supervision of the court with respect to the proceedings. After the hearing, the arbitrators are to file a report and award. In other words, unlike traditional mediation, the arbitrators actually decide the case. In all the foregoing respects, the Northern Kentucky procedures are quite similar to arbitration in the usual sense rather than mediation. The significant difference however, is that unlike most arbitrated matters, a right of appeal is provided for persons aggrieved by the decision. In the event of an appeal, the case is essentially tried de novo, by the court, with or without a jury. In essence, therefore, the Northern Kentucky procedure functions something like a mock trial. But the net effect is still basically voluntary, like mediation, in that in any event in which a party does not wish to settle their case (and loses at arbitration), they may still obtain a trial by the court.

Thus, local variations on the central theme of mediation abound. However, one of the best things about mediation is that parties to a dispute, even in cases which are not yet in litigation, may set their own rules and mediate in any fashion which meets their mutual approval. In other words, there are no set ground rules. The Rules of Court cited above are enabling, but not mandatory. Obviously the parties may agree on a mechanism to resolve their differences at any time and in any manner. The effectiveness of mediation, therefore, lies as much in its flexibility as in any other aspect.

II. Mediation Techniques

For those who have participated in mediation, the usual format is probably well known.

However, for the benefit of those who may not have participated, the standard format which most mediators employ involves something like this, in a chronological sequence:

1. Agreement to mediation and selection of mediator.

2. Agreement as to the time and place of mediation.

3. Preparation and service upon the mediator of a pre-hearing or position statement setting forth in summary form the facts of the dispute, the issues involved, the status of any previous settlement discussions and the points which the parties expect to discuss at mediation. (Please note that the mediation statements are not always exchanged with opposing parties so that the parties can be as candid as possible in their communications with the mediator before the session has even begun. The exchange of position statements is however, normally a matter which the parties, rather than the mediator, dictate).

4. The mediation session itself. The session usually begins with a joint meeting at which the mediator explains and reiterates to the opposing parties the rationale for mediation, the mediator's role and a general outline of the process. The mediator then invites the parties or their counsel to make opening statements. If the mediator has questions which he believes are beneficially discussed at the joint session, he may inquire. The parties then normally break into separate groups. The mediator begins discussing the case with each group separately. At some point, the mediator will encourage one of the parties to make an offer to settle the matter. He will then convey it to the adverse party and encourage a counter-proposal. The session continues in this fashion with the mediator essentially engaging in "shuttle diplomacy" until either settlement is reached or the parties are at an impasse.

5. At the conclusion of the mediation session, the mediator, with the assistance and input of the settling parties drafts a settlement agreement which is signed by all parties and their

unwaveringly in their own positions. The mediator is often unable to do little more than spend a few hours in order to inform the parties that they have irreconcilable differences. However, the purely neutral mediator may also be more effective in cases which are not clear cut and in cases in which the parties are anxious to settle, and are willing to admit to themselves the uncertainty of their position. It may be unwise for the mediator to inject personal assessments in such situations.

The more authoritarian style of mediation has the obvious advantage of frequently placing sufficient pressure on the parties that they feel almost obligated to settle. The disadvantage of the authoritarian style is that if the opinion of the mediator is off the mark, it may become more difficult to settle the case because counsel will be advising the client that the mediator is simply wrong. Obviously this runs the risk of destroying the mediator's credibility, and thus spoiling the mediation session altogether.

Of course no mediator acts purely in one mode or the other. Most mediators adopt a hybrid approach, usually beginning on a purely neutral basis in both the initial joint session and the first few individual sessions, but as the parties draw closer, (and therefore, possibly more entrenched), moving to a more authoritarian style. The rationale is that the first half of the mediation is devoted to letting the parties ventilate their feelings; the second half is devoted to persuasively informing them of the desirability of settlement, the relative merits of their claims, and the likely outcomes in the event of trial.

Whatever style is pursued by a mediator, neutral, authoritarian or a hybrid, it is fair to say that the results of mediation are often surprising, both to the parties, their attorneys and even to the mediator. It is not uncommon for one or both of the lawyers to indicate prior to mediation their belief that because of hard feelings, great differences or other reasons, the case will counsel. If the case is not settled, the mediator simply informs the court (assuming litigation is in process at that point), of the failure to settle.

The nuts and bolts of mediation is of course as varied as individual mediators. Personal style and the personal experience of the mediator will largely dictate how he/she conducts the sessions. For purposes of this paper, discussion is limited to the activities of the usual mediator from a legal background, i.e., an attorney or retired Judge with possibly formal training, or at least, experience is settlement negotiations. There are two basic styles of mediation, but with numerous other permutations or hybrids.

The first style is that of a purely neutral intermediary. This describes a mediator who never takes a position about the relative merits of the case or the validity of the parties' positions. Such a mediator relies primarily upon his/her authority as an impeccably neutral person and, at most, encourages parties to review their own positions and the likely outcome of litigation if the case is not settled.

The other broad category of mediator style is that of the active commentator or "Dutch uncle." This type of mediator while still maintaining neutrality, will much more candidly express opinions about the merits of the case, its likely outcome and the validity of the parties' positions. In most legal settings, and in the case of most attorneys and retired Judges, this is the style of choice. That is because a mediator with a strong legal background is deemed more of an authority figure by opposing parties and even by their counsel. While the mediator will not have any real power, his/her persuasive status will greatly influence the ability of the parties to modify their positions so as to reach a compromise settlement.

Both basic styles have both advantages and drawbacks. In the case of the absolutely neutral mediator, little is usually accomplished when parties have dug in their heels, believing probably will not be settled. Nevertheless, mediation frequently settles those cases. Similarly, any experienced mediator can likewise cite examples where the parties initially express optimism that the mediation will undoubtedly succeed, and yet it fails.

In other words, the outcome of mediation is usually unpredictable. There are certain elements which enhance the likelihood of success or failure in the mediation process.

Some of the circumstances which tend to prevent success in mediation are as follows:

1. Personality problems, i.e., a person whose character and temperament simply will not admit of compromise, self-criticism or the ability to discard fixed ideas. The same is true for people who view their lawsuit as a moral crusade.

2. Asymmetry in settlement proposals, i.e., where one side simply refuses to budge from an opening position or budge only nominally.

3. Asymmetry in information or inadequate pre-trial discovery.

4. Addition or insertion of new issues at mediation.

5. Just plain stubbornness.

It is substantially more difficult to cite the factors which enhance the chances of a successful mediation, but the primary factor is simply adequate preparation by counsel. Where the attorneys know their case, the legal issues and the factual background mediation is almost always successful.

Of course mediation is designed to overcome those obstacles where possible. It does so in a remarkable percentage of cases. That is its essential beauty.

III. Mediation in Estate Disputes

At the present time, nearly all mediations involving estate related issues take place in the context of a pending legal proceeding, either a motion over which the Probate Court has jurisdiction, or an action pending or threatened in the Circuit Court such as will construction case, will contest case, claim against an estate, claim for removal of a fiduciary, claim for damages against a fiduciary or disputed claim of ownership of property. Each of these tends to have its own set of issues or problems. For example, the mediation of will contest cases has become somewhat more difficult because of the strongly pro-defense attitude expressed in the Supreme Court case of Bye v. Mattingly, Ky., 975 S.W.2d 451 (1998). That is, defense counsel and defendants in such cases are assuming that they have close to a pat hand and are therefore less likely to want to settle. Plaintiffs may be more willing to risk trial than settle cheaply.

Will construction cases are also frequently difficult to settle because of the inherent ambiguity in the instrument which gave rise to the litigation in the first place. It becomes extremely difficult to assess or evaluate the likelihood that the court will adopt interpretation A of a given clause, as opposed to interpretation B. In other words, cases which are primarily about legal, as opposed to factual, issues are harder to settle.

Disputes over tangible personal property are also difficult because of sentimental attachments and personal issues which frequently accompany these sorts of disputes. It is easier to compromise claims for money than for claims to unique or irreplaceable items. Unfortunately, estate disputes over tangible personal property are distressingly like domestic cases.

Claims for removal of fiduciaries are also difficult to resolve, because it is hard to compromise. A suggestion that one should resign as fiduciary to settle a case seems, despite any exculpatory language in the possible settlement agreement, to be an admission of wrongdoing which many parties are loath to agree to.

Another complicating factor in many estate disputes is the effect of death taxes. For example, in a situation in which the children of a first marriage are disputing the entitlement of the surviving spouse in an estate large enough to be subject to federal estate tax, the spouse usually holds the upper hand because every dollar paid to the spouse is deductible, whereas every dollar paid to a child or children may actually represent only fifty cents on the dollar after taxes. A frequent problem in mediation is if one of the two sides has failed to consider the estate tax implications of settlement or only begins to do so at the session itself. Such a situation, at best, frequently results in an adjournment until the unenlightened side has an opportunity to review tax consequences. In a worst case scenario, the lack of tax consideration may simply result in either a bad settlement or no settlement at all.

Nevertheless, there can be little doubt that estate disputes will be on the rise. A vast quantity of wealth will pass between generations over the next few decades. A scholarly study has estimated that between 1998 and 2052, assets ranging from a low figure of 41 *trillion* dollars to a high figure of 136 *trillion* dollars will pass by inheritance.[1] Even if only a tiny fraction of that sum passes through Kentucky estates and, in turn, even if only a small percentage of all Kentucky estates are contested, the litigation will involve billions of dollars. For example, if only one hundredth of one percent of the lower range figure represents the value of contested Kentucky estates, the amount in controversy would still be some 4.1 *billion* dollars.

With that much on the table, estate disputes are going to increase, which necessary means that mediation of these disputes will likewise increase, thereby providing even more impetus for a reasonably quick and reasonably inexpensive means of settling them short of full-blown litigation.

[1] Havens and Schervish, "Millionaires and the Millenium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy", Boston College Social Welfare Research Institute, 1999. (swri508 @ bc.edu).

IV. Mediation of Non-Traditional Issues

Mediation normally implies a pending lawsuit, or at least a seriously threatened lawsuit, as discussed in the preceding section of this paper.

However, there are a number of other contexts in which disputes arise which have not traditionally been considered as viable for mediation. There is, however, no reason why mediation cannot be expanded into these areas. Indeed, some of the literature currently available on mediation suggests that mediation will become a common method for resolving such disputes. A few of these unorthodox contexts are discussed below.

Trustees and beneficiaries often become at odds over administration of trusts. These types of disputes often involve disagreements over investment policy, disputes over the exercise or non-exercise of encroachment powers, trustee compensation or other trust expense issues, demands for the trustee to resign and occasionally even over the assignment to the trust account of a trust officer whose personality the beneficiary deems incompatible with his or her own. Normally these disputes are resolved at the discussion level, but occasionally there is enough involved to warrant, or at least threaten, litigation. However, mediation may represent a method of resolving both large and small disputes of this nature without litigation. See generally, Trustee-Beneficiary Mediation: Less Litigation and Better Trustee Image, Trusts and Estates, November 2000. It has also been suggested that differences of opinion involving family businesses, succession planning and the like, (far removed from outright litigation) may also be appropriate subjects for mediation. The mediator may serve a function as a truly neutral party in such disputes. This may be significant because even valued advisors such as corporate counsel, CPAs and non-family members of company management may be perceived as favoring one group or individual against others in the family. Mediation is also beneficial in allowing the parties to express in the context of mediation, resentments or other emotional beliefs which they may be reluctant to share with other family members or professional advisors. The ability to express such resentments, in any mediation situation, is frequently a large factor in a successful resolution. See Estate Planning and Family Business Mediation, Bachle, available on the Internet at mediate.com.

It has even been suggested that mediation may have a place in the estate planning process itself. See The CPA in Mediation and Arbitration, Gromala, The CPA Journal, September 2001. While the involvement of potentially disappointed beneficiaries in estate planning would seem an alien concept to most attorneys, Gromala stresses (very obviously and correctly) that such meetings should take place only with the approval of the clients. Realistically, estate planning by mediation still appears to be somewhat of a stretch, but in the right situation, it may have possibilities.

If mediation works in these situations, there would appear to be no reason why it could not be adopted in other somewhat related areas.

With the increase in prenuptial agreements, and the occasional impasse which results during their negotiation, mediation would appear to be a reasonable alternative.

Similarly, succession planning, even outside the family context, would appear to have merit to the same degree as discussed above with respect to the intra-family company.

It may also be possible to preclude or avert estate disputes which can be foreseen, such as claims for services which are expected to be made against the estate of a person who is still living, and possibly even Will contests themselves.

There is no clear reason why conservatorship disputes, claims of breach of duty by attorneys-in-fact, and the validity of gifts by impaired, but not adjudicated, persons should not be appropriate for mediation.

Again, that is the beauty of mediation. No matter what the nature of a dispute may be, as long as parties wish to resolve them, mediation will prove a useful tool, regardless of whether the dispute represents a currently justiciable issue or a currently pending lawsuit.

PLANNING WITH THE PHASE-OUT OF THE STATE DEATH TAX CREDIT: WORKING WITH THE CREDIT SHELTER BEQUEST AFTER EGTRRA

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SECTION K

PLANNING WITH THE PHASE-OUT OF THE STATE DEATH TAX CREDIT: WORKING WITH THE CREDIT SHELTER BEQUEST AFTER EGTRRA

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PLANNING WITH THE PHASE-OUT OF THE STATE DEATH TAX CREDIT: WORKING WITH THE CREDIT SHELTER BEQUEST AFTER EGTRRA

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June 2004

I. INTRODUCTION.

A. HISTORICAL APPROACH TO PLANNING FOR STATE DEATH TAXES. Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (June 7, 2001) ("EGTRRA"), most states had passed death tax laws which were based on the amount of the state death tax credit permitted on the Federal estate tax return. In these states, the amount of the state estate tax was equal to the maximum state death tax credit available to the estate and these taxes were variously called "pick-up taxes" or "sop taxes." Because pick-up taxes were fully coordinated with the Federal estate tax regime, little or no additional planning generally was necessary to take them into account - the primary focus of death tax planning was the Federal estate tax and planning for the use of the unified credit.

B. HISTORICAL APPROACH TO MARITAL DEDUCTION/CREDIT SHELTER ESTATE PLANNING. Since 1981, estate planners have used straightforward formulas for determining the amount of the credit shelter and marital portions of an estate. The issues they had to deal with concerned primarily what funding methods to use, the form in which to put the marital share, the structure of the credit shelter trust, and whether to suggest paying gift tax on *inter vivos* transfers or estate tax in the estate of the first spouse to die. For clients with moderately sized estates, planners needed to attend to whether clients had sufficient assets to warrant carving the credit shelter amount out of the marital share and how husbands and wives structured the ownership of assets between them. For high net worth clients, planners frequently developed plans which used all of the clients' applicable exclusion amount during life. Although at the time it may have seemed as though there were many unknown factors in developing estate plans, generally developing a plan for a client was manageable because of the relative certainty regarding the amount of the applicable exclusion and the rates of tax. Occasionally, planners resorted to the use of disclaimers and partial QTIP elections to preserve flexibility at the death of the first spouse, but this was generally the exception, rather than the rule. As most states moved to a "pick-up" or "sop" tax, the impact of the state death tax credit was substantially reduced. Even after the applicable exclusion amount began creeping up from $600,000 to $1 million, for moderately sized and high net worth individuals the choices were fairly simple. Then came EGTRRA.

C. STATE DEATH TAX CONSEQUENCES OF EGTRRA. Under EGTRRA, the state death tax credit is phased out and replaced by a deduction. As a result, either by legislative acts or by technical structure of their laws, many states now impose a state death tax which is not coordinated with the federal tax structure. Accordingly, it is once again necessary in many states to take state death taxes into account when developing estate plans.

D. A CONSTANTLY MOVING TARGET. EGTRRA has added more uncertainty to the transfer tax system than may have been believed possible prior to its enactment. Putting aside the difficulty of planning for a single year of estate and GST tax repeal and the subsequent reinstatement of both in the following year at rates equal to those prior to the enactment of EGTRRA, just assisting clients with planning for the changing rates and credits is a daunting task. The usual uncertainties of not knowing the year in which a client will die, which of her family members will survive her, the value and character of her assets at the time of her death and so forth are exacerbated by not knowing the rates of estate tax that will be in effect at the time of her death (or at the time of the death of her survivors, even if they do not survive her by many years), the amount of the applicable exclusion amount at the time of her death, the amount of the generation-skipping transfer ("GST") tax exemption at the time of her death, whether it is prudent to pay state estate tax at the death of the first spouse to die, or even whether there will be an estate tax or GST tax at the time of her death or the death of her spouse.

E. LEGISLATIVE UNCERTAINTY. Many Congressional elections and two presidential elections will occur during the phase in of the provisions of EGTRRA and its subsequent sunset. Under the Byrd Amendment (the rule which requires a law that will cause a net revenue loss beyond the 10 years typically covered in a budget resolution to be passed by at least 60 Senators), the Senate has failed to obtain the required vote to make the provisions of EGTRRA permanent. However, the likelihood that a law repealing the estate tax and then reinstating it after one year will actually take effect is very low. The unpopularity and impracticality of such a scenario should prevent it from occurring. The question is whether the law will be changed by eliminating the repeal of the estate tax, making the repeal of the estate tax permanent (because the votes necessary to meet the

Byrd Amendment requirement can be obtained), extending the years of repeal for a few additional years (*e.g.*, through 2013), freezing the law as it exists at some point during the phase-in of EGTRRA (*e.g.*, in the year 2005 if a new President takes office), or passing some altogether different law to replace EGTRRA.

F. CHANGE IN FOCUS OF ESTATE PLANNING.

1. After the initial flurry of shock following the enactment of EGTRRA, many estate planners decided that the likelihood of repeal of the estate tax followed by its subsequent sunset was so low and the potential repeal so far in the future, that they would adopt a "wait and see" approach with regard to drafting for this eventuality. Estate planners acknowledged that their job had been altered, however, from developing estate plans to clearly implement the client's wishes in the most tax efficient manner to trying to create estate plans that will permit choices to be made after the client's death. Such choices must be based on the client's wishes, of course, under a variety of different scenarios which could be extant at the time of the client's death. This has meant, among other things, that many decisions which the client would normally make crystal clear in her Will or revocable trust now must be left in the hands of others to make following her death, taking into account the tax considerations at her death, if the flexibility to postpone the decisions can be built into her estate plan. In addition, for healthy clients, it is hard to recommend the making of taxable gifts that require gift tax to be paid since those assets might otherwise pass free of transfer tax if the client dies. Finally, the decision of whether to recommend that some state or Federal estate tax be paid in the estate of the first spouse to die is really a shot in the dark and, even if such a payment appears advisable, it may be difficult (and inadvisable) to persuade clients to take the risk.

2. Now, however, time has passed, the law is no more certain than it was, 2010 and 2011 are ever closer and many states' estate tax regimes do not permit full use of the Federal applicable credit without the payment of some state estate tax. Now it is time, even for the "wait and see" contingent, to take a serious look at their standard approaches to marital deduction/credit shelter planning and their standard forms to take into account the decoupling of the Federal and state estate taxes in the years prior to repeal and also to consider whether to incorporate a few provisions in the estate plans

currently being prepared to at least give a nod to the possibility that repeal under EGTRRA will occur.

II. CHANGES IN ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX RATES, APPLICABLE EXCLUSION AMOUNT, GENERATION-SKIPPING TRANSFER TAX EXEMPTION AMOUNT AND STATE DEATH TAX CREDIT.

A. GIFT, ESTATE AND GST TAX RATES AND APPLICABLE EXCLUSION AMOUNT. Beginning in 2002, the maximum estate, gift and GST tax rates began declining each year for 5 years and the applicable exclusion amount began increasing irregularly and sometimes dramatically through the year 2009.

1. Reduction in Rates of Tax.

a. Maximum estate tax rates. Under EGTRRA, the maximum estate tax rate gradually decreases over six years.

Year	Maximum Rate
2001	55%[1]
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%

b. Generation-skipping transfer tax rate. Although historically the GST tax was referred to as a flat 55% tax, in fact it is imposed at the maximum estate tax rate in effect at the time of the GST transfer, whether direct skip, taxable distribution or taxable termination. IRC § 2641(b).[2]

[1] For estates in excess of $10 million, an additional 5% tax applied to amounts between $10 million and $17,184,000 to recapture the effect of the graduated rates of tax and the unified credit. This tax "bubble" was repealed by EGTRRA.

[2] All references herein to "IRC" sections and to the "Code" are to the Internal Revenue Code of 1986, as amended, unless otherwise provided.

c. Gift tax rate. The gift tax rate continues to be the same as the estate tax rate through the year 2009. In 2010, when the estate tax is repealed, the gift tax is NOT repealed and, in effect, becomes a flat tax of 35%. In reality, the gift tax rates continue to be graduated but the applicable credit of $1 million will protect all taxable transfers at rates lower than the maximum rate of 35%.

(1) The legislative history of EGTRRA explains the use of the 35% maximum gift tax rate as equal to the top income tax rate then in effect, but the statutory language does not tie the gift tax rate to the maximum income tax rate.

(2) The relationship between the gift tax and the income tax rate was of some concern during the drafting of EGTRRA due to the possibility that a substantial portion of the tax on income and capital gain on assets could be reduced or eliminated by transferring assets to individuals in lower tax brackets and having those individuals then pay the income or proceeds from sale back to the donor if no gift tax applied to the transfers.

(3) In addition, the imposition of the gift tax on transfers in 2010 will prevent the anticipated tidal wave of transfers in that year to take advantage of what is currently no more than a very narrow window of opportunity.

2. Applicable Exclusion Amount through the Year 2009.

a. The applicable exclusion amount for years 2001 through 2009 is:

Year	Applicable Exclusion Amount
2001	$ 675,000
2002	1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000

b. Note, however, that under section 521(b) of EGTRRA, the applicable exclusion amount for gift tax purposes increased to $1 million in 2002 and remains at that level thereafter, including the year 2010. The amount of gift tax exclusion used during life still reduces the amount of applicable exclusion available at death, but beginning this year, 2004, the amount of the applicable exclusion (other than for gift tax purposes) exceeds $1 million and some portion of it will be available at death because it cannot be used during life. In effect, for 2004 through 2009, the applicable exclusion amount is limited to $1 million during life and an additional applicable exclusion amount (from $500,000 to $2.5 million) is available at death.

3. GST Tax Exemption through the Year 2009.

a. In general. Section 521 of EGTRRA modified the amount of the GST tax exemption to equal that of the applicable exclusion amount for generation-skipping transfers made after December 31, 2003. IRC § 2631(a) and (c). Beginning this year, the amount of the GST tax exemption is $1.5 million.

b. Coordination with exemption for gift tax purposes.

(1) Although GST tax planning could have been simplified because the amount of the GST tax exemption and the applicable exclusion amount are finally coordinated in 2004, this is not the case since the estate and gift taxes are no longer fully unified.

(2) Testamentary GST tax planning may be simplified for decedents who die in the years 2004 through 2009 (if one can say that *any* planning which requires that one identify the year in which a taxpayer will die is simplified) because the applicable exclusion amount is adequate to protect the full amount of the GST tax exemption (subject to reduction for lifetime transfers of up to $1 million). However, gift tax (but not GST tax) will be due on *inter vivos* generation skipping transfers in excess of $1 million (aggregated for all lifetime transfers, whether or not they are generation skipping transfers) made in the years 2004 through 2009. Thus, to avoid payment of transfer taxes on transfers to members of skip generations,

transfers of up to $1 million can be made during life, and testamentary generation skipping transfers of the excess of the applicable exclusion amount over $1 million can be made to take advantage of the remaining available GST exemption.

B. STATE DEATH TAX CREDIT.

1. Section 2011. Section 2011(a) allows a credit against the federal estate tax for "estate, inheritance, legacy or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate." The amount of the credit is calculated by the use of a graduated rate table in §2011(b), which refers to the "adjusted taxable estate."

2. Phase-Out of Credit.

a. As a result of EGTRRA, the amount of the maximum available state death tax credit is reduced from the otherwise applicable §2011(b) table amount by 25% for estates of decedents dying in 2002, by 50% for estates of decedents dying in 2003 and by 75% for estates of decedents dying in 2004. IRC §2011(b)(2).

b. This means the maximum federal credit for state death taxes decreased to 12% of a decedent's adjusted taxable estate for decedents dying in 2002, to 8% in 2003 and to 4% in 2004.

c. For estates of decedents dying in 2005 through 2009, the state death tax credit is eliminated. IRC §2011(f).

3. New Deduction for State Death Taxes Paid Under §2058.

a. In place of the credit, there will be a deduction for state death taxes paid with respect to decedents dying after December 31, 2004, under §2058. The deduction contains many of the same requirements as the credit under §2011. For example, the state death taxes must be actually paid to the state (or D.C.) within four years of the filing of the federal estate tax return (with certain exceptions applying in cases of notices of deficiency, claims for refunds, or extensions of time to pay tax under §§6161 or 6166.

b. The deduction is unlimited. The statute does not place any dollar limitation on the amount of the state death taxes that may be deducted.

c. The §2058 deduction is not as valuable as the pre-EGTRRA credit for state death taxes. However, because the credit is reduced to 25% of pre-EGTRRA amount in 2004, the deduction in 2005 will actually be more valuable than the credit in 2004.

d. A deductible state estate tax will reduce the taxable estate for federal tax purposes and therefore will not use up a portion of the applicable exclusion amount. Consequently, a credit shelter trust could equal the full applicable exclusion amount even though state death taxes are imposed.

4. The significance for marital/credit shelter planning of this change in the structure of the state death tax credit is not so much the effect of the reduction in rates, but more the impact of the amount of credit shelter protection afforded under various state laws. As a result of the change in the federal law, many states no longer mirror the amount of the federal protection and this decoupling of the federal and state tax systems may create a situation where the full use of the federal credit will require payment of state estate tax.

   a. For states like New York whose sop tax is tied to the federal law in effect in 1998, this is the first year in which the state credit protection will be limited to $1 million even though the federal applicable exclusion amount will be $1.5 million.[3]

   b. Two state death tax statutes impose a state tax equal to the amount of the "credit or deduction" allowed for state death taxes by the federal government. Because the deduction under §2058 is unlimited, the literal language of these states' statutes could be read to impose a state death tax equal to the value of the taxable estate.[4]

[3] *See* NY Tax Law §§ 951(a) and 952.

[4] *See* Code of Alabama §40-15-2 and Miss. Code §27-9-5.

5. Patterns of State Death Tax Regimes.[5]

a. Coupled.

In these states, the state estate tax remains a true "pick up" tax. The state estate tax is equal to the amount of the federal credit for state death taxes in effect in the year of death and this incorporates any change to the federal law. For decedents dying in 2005, under current federal law there will be no federal state death tax credit and consequently coupled states will have no state estate tax after 2005 and until 2011. There are 26 states in this category:

Alabama
Alaska
Arizona
Arkansas
California
Colorado
Delaware
Florida
Georgia
Hawaii
Idaho
Michigan
Mississippi
Missouri
Montana
Nevada
New Hampshire
New Mexico
North Carolina
North Dakota
South Carolina
South Dakota
Texas
Utah
West Virginia
Wyoming

b. Coupled with Separate Inheritance Tax.

In these states, the state estate tax remains a true "pick up" tax, but the state also imposes a separate estate or inheritance tax on some transfers at death. The estate or inheritance tax regimes vary from state to state, but no state currently imposes any estate or inheritance tax on transfers to a surviving spouse, provided the state requirements for qualification for the marital deduction are met. There are currently 8 states in this category:

[5] For ease of reference, the author has created easily discernible categories of state death tax regimes. However, in reality, the states do not divide quite so tidily. For example, the statute in Arkansas provides that state estate tax equals the federal credit allowable under the federal estate tax laws in effect on January 1, 2002; no state estate tax is imposed if no federal tax is imposed; and the statute is not operative for estates of decedents dying on or after January 1, 2005. A.C.A. §§ 26-59-106 and 26-59-103.

Connecticut
Indiana
Iowa
Kentucky
Louisiana
Oklahoma
Pennsylvania
Tennessee

c. Decoupled.

In these states, the estate tax regime is not a true "pick up" tax, because the state estate tax is not exactly equal to the amount of the federal credit for state death taxes for the year of death. In these cases, the state estate tax is equal to the state death tax credit as it would have been calculated in a prior year and the state statute has in effect "frozen" the reference to federal law by reference to the federal law in effect in a specific year. The word "decoupled" implies this derivative relationship. Because most "decoupled" states impose an estate tax equal to the federal credit for state death taxes as computed in a prior year, the maximum state estate tax rate in these states is generally 16% which was the maximum federal credit for state death taxes pre-EGTRRA. The amount of the applicable exclusion amount in decoupled states varies, however. Some states adopt EGTRRA's scheduled increases in the applicable exclusion amount, others apply the increases that were scheduled pre-EGTRRA (*i.e.,* under the Taxpayer Relief Act of 1997) and still others provide a fixed applicable exclusion amount. There are currently 12 states in this category:

Washington, D.C.
Illinois
Maine
Massachusetts
Minnesota
New York
Oregon
Vermont
Rhode Island
Virginia
Washington
Wisconsin

d. Decoupled with Separate Inheritance Tax.

In these states, the state estate tax is decoupled from the federal estate tax regime in one of the three ways described above and the state also imposes a separate estate or inheritance tax on transfers at death to certain beneficiaries. There are currently 5 states in this category:

Kansas
Maryland
Nebraska
New Jersey
Ohio

C. CARRYOVER BASIS. Under EGTRRA, during repeal of the estate tax, the basis adjustment to property subject to the estate tax generally available under current law is also repealed and beneficiaries will inherit property with the lesser of the decedent's adjusted basis or the fair market value of the property, subject to a few adjustments. An exhaustive explanation of these carryover basis provisions is beyond the scope of this outline. However, those provisions which estate planners may want to begin to consider in their current drafting are summarized below.

1. Limited Increase in Basis Allocated by Executor. Under new IRC § 1022, $1.3 million of basis increase is available for assets owned by and passing from the decedent and is allocated by the executor to specific assets in the decedent's estate. In addition, $3 million of basis increase is available for assets passing to the surviving spouse. Planning for foreign spouses continues to be treated separately to protect the fisc and thus increases to basis for nonresident foreign spouses is limited to $60,000. All of these amounts are indexed for inflation after 2009.

a. Note that this concept requires an entirely new view of the decedent's assets because it refers not to the value of the property, but to the increase from the decedent's basis to the property's fair market value at the time of the decedent's death. Thus, although the provision specifies the amount of basis increase available, the value of the property to which it applies may be substantially larger and will vary widely from one decedent's estate to another.

b. In effect, the provision provides for $1.3 million shelter from capital gains tax in the hands of the beneficiaries (plus $3 million shelter for spouses). Thus, a married individual who owned $4.3 million of property at death, all of which had a zero basis, could take advantage of the entire available increase, whereas, another individual who owned $10 million of property, all of which had a high basis at her death, might not be able to take full advantage of the entire increase.

2. Property to Which Basis Increase Can Be Allocated.

a. Property must be "owned" by the decedent to be eligible for basis increase. This includes property which is jointly-owned, property held in a revocable trust and property over which the decedent retained the right to control the beneficial enjoyment or the power to alter, amend or revoke the trust holding the property. Note that the decedent will not "own" property solely because the decedent held a special or general power of appointment over the property.

b. The special spousal increase in basis adjustment is available for property passing to the spouse outright or passing to a trust for the spouse which is structured similarly to a QTIP trust. Note that this means that property passing *to* a QTIP trust can receive basis increase, but property passing *from* a QTIP trust at the surviving spouse's death will not be eligible to receive increase in basis allocation by the surviving spouse's executor. The spouse must have assets outside of the QTIP to take advantage of the basis increase.

III. WHY PLANNING IS MORE DIFFICULT UNDER EGTRRA.

A. CREDIT SHELTER AMOUNT.

1. Two categories of issues arise in dealing with the credit shelter amount in the current planning environment.

a. Uncertainty as to amount. Under EGTRRA, the uncertainty in the amount of the applicable exclusion amount which will be available to the estate of the first spouse to die and to the estate of the second spouse to die makes determining the structure of the division of the estate between the marital and credit shelter shares extremely difficult. Potentially, these amounts range from $2 million if both spouses die in years after 2010 to $7 million if both spouses die in the year 2009, with a wide variety of permutations in between, depending on the particular years in which each spouse dies. This, of course, does not take into account the possibility that one spouse could die in the year 2010. Many combined estates fall into the range between $2 million and $7 million. In addition, a variety of proposed bills have suggested increasing the credit amount to even larger amounts for each spouse in lieu of repeal.

b. The effect of the increases in the applicable exclusion amount on formulas. Historically, the best way to deal with the fact that the amount of the applicable exclusion amount was unknown was to draft by formula. This accommodated not only the possibility that clients would use a portion of the credit during life, but also changes in the amount of the credit under the law. However, these formulas may have drastically undesirable effects as the amount of the exclusion increases or in the event of repeal. Thus, not only is it difficult to know whether credit shelter planning may be necessary in the estate of the first spouse to die, but also, under the traditional formulas, the property may not end up where expected.

2. These issues are difficult in unified first marriage families. They are even more troubling in the complex multiple marriage families of many clients.

B. GST EXEMPTION AMOUNT. To the extent that GST tax planning is coordinated with the use of the applicable exclusion amount and/or the QTIP trust, similar problems exist in planning for use of the GST exclusion amount.

C. STATE DECOUPLING ISSUES.

1. Applicable Exclusion Amount. To the extent that full use of the federal applicable exclusion amount will require payment of state estate tax, and given that it is impossible to know how much federal applicable exclusion amount will be available to the estate of the surviving spouse, for many estates it is difficult to determine whether full use of the federal credit in the estate of the first spouse to die will be advantageous. Even if flexible planning permits deferral of this decision until the death of the first spouse, the decision may not be any clearer then. Unlike the federal scheme, nonpayment of state estate tax at the death of the first spouse to die may not be deferral of the tax, but actual avoidance: surviving spouses may flock to Florida and other states which impose no state estate tax.

2. GST Tax Exemption and Taxes. As a result of decoupling, it is important to work through what happens under state GST tax regimes when the federal GST tax exemption amounts increase and the rates of GST tax are decreased.

D. REPEAL OF THE ESTATE TAX.

1. Carryover Basis. The planning necessary to take advantage of the permissible increases in basis under the carryover basis regime during repeal is inconsistent with the traditional planning necessary to take advantage of the marital deduction and applicable exclusion amount.

2. Formulas. Some protection to ensure that formulas used to take advantage of the applicable credit and marital deduction do not disrupt the entire estate plan under repeal seems warranted.

3. Use of Trusts. Planners disagree on the best strategy with regard to the use of trusts in the event of repeal: one school favors terminating trusts if the estate tax is repealed and the other favors so-called dynasty trusts to ensure that assets will not be subject to the estate tax if it returns.

4. Cost and Complexity of the Plan. Finally, despite the wisdom of including provisions to address the possibility of repeal in current estate planning documents, clients have only so much tolerance for complexity and are willing to pay only so much to guard against an event which may never occur. The question remains nevertheless to what extent these provisions are necessary to guard against the possibility that the client may be incompetent and unable to revise her estate plan in the event of a major overhaul of the transfer tax system, potentially including permanent repeal.

IV. MARITAL DEDUCTION/CREDIT SHELTER PLANNING.

A. ESTATE PLANNING GOALS. Generally, the goals for estate planning can be broadly stated to include: implementing the client's goals to use her assets to provide for her loved ones and others, anticipating difficulties in the administration of the plan and incorporating techniques to eliminate or minimize them and doing all of this with the lowest possible federal and state death tax consequences. Estate planning generally encompasses two categories of techniques: lifetime giving and testamentary bequests. Although historically, lifetime giving has provided the most powerful method for reducing total transfer taxes imposed on a client's estate, the current deunification of the estate and gift tax regimes (with the attendant disincentive to make taxable lifetime gifts in excess of $1 million) has changed that picture. In addition, many clients do not wish to give their assets away during life or do not have estates of sufficient size to warrant substantial lifetime gifting programs. This section focuses on the backbone of testamentary estate planning to minimize estate tax - the combination of the marital deduction (IRC § 2056) and the applicable credit (formerly known as the unified credit)(IRC § 2010).[6] It should be noted that bequests to a surviving spouse who is not a U.S. Citizen, the unlimited marital deduction is available for bequests to the spouse only if his bequest is held in a "QDOT," a special marital trust designed to preserve the government's ability to collect estate tax on the assets at the death of the surviving spouse. *See* IRC § 2056(d)(2).

B. COMBINING MARITAL DEDUCTION AND APPLICABLE EXCLUSION AMOUNT PROVISIONS. Marital deduction and credit shelter planning takes advantage of two entirely unrelated provisions in the Internal Revenue Code, the marital deduction and the applicable exclusion amount. By combining these two provisions in one of several ways, it is possible to preserve the maximum wealth for both the surviving spouse and, at his death, the client's children or other beneficiaries. Needless to say, this technique is available only to married couples since only married couples can take advantage of the marital deduction. For simplicity in discussing this technique, the outline assumes that planning is being done for a married couple who wish to benefit each other and children (either theirs combined or from prior marriages). However, it can also be used to preserve wealth for beneficiaries other than children.

C. THE SIMPLE MARITAL DEDUCTION/CREDIT SHELTER PLAN.

1. In general. In its simplest form, the marital deduction/credit shelter plan carves out the amount of the client's available applicable exclusion amount and bequeaths it to a trust for the benefit of the surviving spouse and children. The trust can be structured in a variety of ways, the most flexible of which permits discretionary distributions of income and principal among the surviving spouse and children, and, at the death of the surviving spouse, passes to the couple's issue, *per stirpes*. The balance of the estate passes to or for the benefit of the surviving spouse in a manner that qualifies for the marital deduction (*e.g.*, an outright bequest or a bequest to a

[6] Section 2010 remains titled "Unified Credit Against Estate Tax" even though the credit is no longer "unified" and even though the text of IRC § 2010 no longer refers to the unified credit and instead refers to the "applicable credit amount" and the "applicable exclusion amount." Note that the term "applicable credit amount" refers to the actual amount of the credit against tax (the former unified credit). The "applicable exclusion amount" is the value of property which will be protected from tax by the applicable credit amount. *See* discussion below.

Qualified Terminable Interest Property ("QTIP") trust.[7] At the death of the first spouse to die, no estate tax is due because a portion of the estate is protected by the applicable credit and the balance is protected by the marital deduction. At the death of the surviving spouse, the credit shelter trust is not includible in the surviving spouse's estate (assuming he has no rights in the trust which would make it includible in his estate) and the surviving spouses' available applicable credit amount protects as much as possible of the surviving spouse's assets and, if a marital trust was used, the marital trust. Thus, the children receive the benefit of both spouse's applicable credits.

a. Because it is impossible to know how much applicable credit amount a client will have at the time of her death, both because she may have used some of it making taxable gifts during her life and because, as in the current climate, the amount of the credit may have changed since the plan was designed, it is prudent to express this bequest as a formula, rather than an exact number.

b. Marital deduction/credit shelter planning can be structured in one of three ways:

(1) Preresiduary (pecuniary) credit shelter trust with the residue to the spouse or a marital trust;

(2) Preresiduary (pecuniary) marital bequest (outright or to a marital trust) with the residue to a credit shelter trust; or

(3) Division of the residue into two fractional shares, one of which is the size of the decedent's available applicable exclusion amount which passes to a credit shelter trust and the other of which is the balance which passes to the spouse or a marital trust.

2. Marital Deduction Funding Methods.

a. Generally, the factors involved in choosing which funding method to use are not materially affected by the uncertainties of EGTRRA. However, where the pecuniary formula method is used, it is usually preferable for the smaller of the

[7] *See* IRC § 2056(b)(7).

credit shelter amount and the marital bequest to be the preresiduary (pecuniary) bequest to minimize recognition of any capital gain on funding. Where the applicable exclusion amount increases so substantially under EGTRRA, the relative size of these two shares may reverse over the next few years. For example, in an estate of $5 million, the credit shelter bequest will be smaller than the marital bequest from 2004 through 2008 and will be the larger amount in the year 2009. Since it is not practical to draft a Will to take this change into account, it may be advisable to consider avoiding the use of formulas except in very large estates and instead to use one of the techniques described below.

V. ESTATE PLANNING TECHNIQUES TO PERMIT FLEXIBILITY: PRE-MORTEM PLANNING FOR POST-MORTEM PLANNING

A. CAPPING THE CREDIT.

1. Issues Related to the Size of the Estate.

a. Due to the substantial increases scheduled to occur in the applicable exclusion amount under EGTRRA, using the formulas described above may result in a client's entire estate passing to the credit shelter trust. Such a result may effectively disinherit the spouse requiring him to elect against the Will. Even where the surviving spouse is the sole beneficiary of the credit shelter trust, a client may be uncomfortable leaving no assets outright to the surviving spouse (thus potentially requiring the spouse to rely heavily on the trustee for his support). In a "mixed marriage" situation, if the surviving spouse and children from the decedent's prior marriage are all beneficiaries of a single sprinkle trust, dissension may be unavoidable.

b. Moreover, as the amount of the credit increases, it may outstrip the size of the combined estates of the wife and husband to the point where the surviving spouse's credit could protect most, if not all of their assets. Under these circumstances, the client may want to modify the marital deduction/credit shelter formula to make the bequest to the credit shelter trust equal to the lesser of her available applicable exclusion amount or a particular dollar amount (*e.g.*, $1.5 million).

c. The cap can be expressed as a dollar amount or as a percentage or fraction of the value of the estate, *e.g.*, the amount of the available applicable exclusion amount at the time of the decedent's death, but in no event to exceed $2 million (or in no event to exceed 60% of the value of the estate as finally determined for federal estate tax purposes). These techniques can be used in combination to provide, *e.g.*, that the cap is the lesser (or greater) of $2 million or 60% of the value of the estate.

d. A disadvantage of this plan is that it requires frequent review to ensure that it remains adequate to protect the client's assets from estate tax as the value of the client's and client's spouse's assets fluctuate and changes in the law occur.

e. Note also that in smaller estates which use a preresiduary credit shelter plan, as the value of the applicable exclusion amount increases, an estate may end up with no residuary estate. Since estate expenses are generally paid from the residuary, under these circumstances it is prudent to include a provision in the Will directing where the expenses will be paid from in the event that the residuary is inadequate to cover them.

f. Because the use of a cap does not really enhance post-mortem flexibility, it will not usually be the technique of choice in a first marriage/no conflict of interest family, but it may be a critical factor in the estate plan of a client whose spouse and children do not have a unity of interest.

2. Capping the Credit to Address Decoupling Issues.

a. Regardless of the size of the estate, it may be prudent to make the default credit shelter formula one which caps the amount passing to the credit shelter trust to avoid automatic payment of state estate tax, *e.g.*, that amount which can pass free of *federal and state* estate tax by reason of the applicable exclusion amount, taking into account adjusted taxable gifts, other bequests under the Will, etc.

b. Additional provisions to permit the flexibility to decide whether to increase the amount passing to the credit shelter trust then should be included in the Will or revocable trust to permit a determination of whether to pay state estate tax at the death of the first spouse to die. Alternatively, a few states recognize a state QTIP election for qualifying bequests even when a federal QTIP election has not been made[8] and a bequest to a trust for the surviving spouse which qualifies for the state QTIP election but which is protected from the federal estate tax by the applicable credit amount should be considered. In such an estate, two trusts would qualify as credit shelter trusts (the typical "family trust" and a trust for the benefit of the surviving spouse). The balance of the estate could then be protected from federal and state estate tax by the marital deduction.

B. DISCLAIMERS. Although disclaimers have long been used to "fix up" an estate plan following a decedent's death and have been used as a planning technique in limited circumstances, the current situation is likely to make the use of disclaimers more important and more frequent than ever before. On the one hand, there is little new in the world of disclaimers: following the issuance of final regulations addressing disclaimers of jointly-held property on December 30, 1997, there have been no new statutory or regulatory developments. On the other hand, because disclaimers are so fact specific, the body of law in private letter rulings and cases continues to grow, indicating that this apparently simple technique may not be so simple to apply.

1. In general. Disclaimers are utilized to permit all or part of a bequest or other disposition to pass as though the designated beneficiary had predeceased the decedent. From a tax perspective, this permits the transfer of the disclaimed assets to someone other than the initial beneficiary without imposition of gift tax on the disclaiming beneficiary. To obtain this benefit for federal tax purposes, a disclaimer must be effective under state law, so state law requirements must always be considered first. Assuming state law requirements are met, federal law also imposes a series of requirements, as outlined below.

2. Federal Requirements for Qualified Disclaimers Vary Depending on When the Interest Being Disclaimed was Created.

a. For interests created before January 1, 1977, the rules are determined under case law, primarily *Jewett v. Comm'r.*, 455 U.S. 305 (1982), and *U.S. v. Irvine*, 114 S. Ct. 1473 (1994). Under *Jewett*, a disclaimer of a pre-1977 interest must be made

[8] For example, Massachusetts, Ohio, Indiana and Tennessee permit state QTIP elections to be made even when a federal QTIP election has not been made.

within a "reasonable" time of knowledge of the transfer which the created interest. Therefore, except for minors who come of age, it is probably too late to disclaim any pre-1977 interests.

b. For interests created thereafter, the rules of Code § 2518 apply to avoid taxable gift treatment of the transfer:

3. Requirements of Code § 2518.[9] There are four requirements which must be met in order for a disclaimer to be a qualified disclaimer for federal transfer tax purposes. Note that a disclaimer may be effective under state law to transfer property away from the disclaimant, but not qualify for the federal tax benefits of a qualified disclaimer. Each test will be discussed separately below.

a. No acceptance of benefits. This is usually the most difficult and troubling of the disclaimer requirements. A disclaimer must precede any acceptance of any benefit from the property.

(1) Acts of acceptance include:

(a) Use of the disclaimed property.

(b) Accepting dividends, interest, rents or other income from the property.

(c) Treating the property as though owned by the disclaimant, *e.g.*, directing others to take certain action with respect to the property, voting the stock, in the case of shares of stock, and withdrawing funds from a joint account.

(d) Receiving any consideration in return for the disclaimer.

(2) Note that when the disclaimant is the executor of the decedent's Will, actions taken as the executor do not constitute acceptance of the property to be disclaimed.

[9] Be aware of possible additional requirements under state law for a disclaimer is to be effective for state law purposes. *See, e.g.,* New York's requirements in EPTL 2-1.11.

(3) To help prevent the situation in which a surviving spouse will be treated as having accepted the benefits of property which is planned to be disclaimed, it may be prudent to include a preresiduary cash bequest to a surviving spouse to relieve any immediate need for cash. *See*, however, Reg. § 25-2518-3(d), Example 17, allowing a partial disclaimer after acceptance of a partial distribution.

b. Written refusal. A disclaimer must be in writing. The writing must state that the disclaimer is an irrevocable, unqualified refusal to accept the interest in the property to be disclaimed. The interest to be disclaimed must be adequately described. The documents must be dated and should include an acknowledgment of receipt by the proper party.

c. Nine month requirement. The disclaimer must be delivered to the transferor, legal representative or holder of title of the property to be disclaimed within nine months after the later of creation of the interest -- in most cases death of the testator -- or age 21.

(1) Lack of knowledge of the interest to be disclaimed does not extend the time limit.

(2) In the case of a remainderman under a general power of appointment marital trust, the nine-month period runs from the death of the surviving spouse, but in the case of the remainderman under a QTIP marital trust, the nine-month period runs from the death of the first spouse. Reg. § 25.2518-2(c)(3).

d. No direction requirement. Two separate rules apply under the "no direction" test.

(1) First, the disclaimant must not direct to whom the disclaimed property will pass or hold the power to determine to whom it will pass after the disclaimer is executed. The property must simply pass as it would have if the disclaimant had not been alive at the time of the transfer to the disclaimant or otherwise if so provided

by the testator in the Will (or revocable trust) and state law so permits.[10]

(a) Thus, under a Will or revocable trust, unless the testator specifies otherwise, the property must pass to whomever would have taken the property if the disclaimant had predeceased the decedent.

(b) In addition, this means that the disclaimant cannot serve as the trustee of a trust to which the disclaimed property will pass if the trustee holds any discretionary powers to make distributions from the trust. If the disclaimed property will pass to a foundation of which the disclaimant is a trustee or director, a similar issue arises, and the more prudent course may be for the disclaimant to resign from the position in the foundation.

(c) A common mistake made is that the surviving spouse who disclaims property that then passes to a credit shelter trust is given a special power of appointment over the trust property.

(2) In addition, except in the case of the decedent's spouse, the disclaimed interest must pass to someone other than the disclaimant.

(a) Thus, the surviving spouse can disclaim all or a portion of his interest in the marital trust created for his benefit, and if the Will or revocable trust so provides and state law permits direction of the disclaimed property under the Will or revocable trust, the property can thereby be shifted to the

[10] *See, e.g.*, under New York law, EPTL § 2-1.11(c) which provides "*[u]nless the creator of the disposition has otherwise provided*, the filing of a renunciation, as provided in this section, has the same effect with respect to the renounced interest as though the renouncing person had predeceased the creator or the decedent or, if the renounced interest is a future estate, as though the renouncing person had died at the time of filing or just prior to its becoming an estate in possession, whichever is earlier in time, and shall have the effect of accelerating the possession and enjoyment of subsequent interests, but shall have no effect upon the vesting of a future estate which by the terms of the disposition is limited upon a preceding estate other than the renounced interest." (*Emphasis added*).

credit shelter trust. The spouse can continue to be the income beneficiary of that trust, but cannot retain any power of appointment over the trust. (Note: An otherwise disqualifying power of appointment can be disclaimed.)

(b) This requirement makes it critical to track exactly where property will pass if it is disclaimed to ensure that the property will, in fact, end up where it is intended; a disclaimant (other than a spouse) may also need to disclaim her interest in an entity to which the property will then pass (including her intestate share) to effect a qualified disclaimer.

4. Who Can Disclaim.

a. Generally, any individual may refuse to accept a gift. Some states, however, may limit the power of the beneficiary of a spendthrift trust to disclaim.

b. Many states, including New York, allow a guardian of an incompetent or executor of the will of a decedent to disclaim, often after obtaining court approval.

5. Partial Disclaimers. Reg. § 25.2518-3 allows disclaimers of partial interests in property. Among the types of partial interests which may be disclaimed:

a. Severable property,

b. Powers of appointment,

c. Undivided fractional interests, and

d. Pecuniary amounts. Reg. § 25.2518-3(c) creates a trap for the unwary and requires that, following a disclaimer of a pecuniary amount, "the amount disclaimed and any income attributable to such amount must be segregated from the portion of the gift or bequest that was not disclaimed. Such segregation must be made on the basis of the fair market value of the assets on the date of the disclaimer or on a basis that is fairly representative of value changes between the date of transfer and the date of the disclaimer."

6. Successive Disclaimers.

a. In order to ensure that a disclaimer is qualified and that no part of the disclaimed interest passes to the disclaimant (if the disclaimant is not the spouse), it may be necessary for the disclaimant to disclaim several successive interests under the Will and ultimately under intestacy.

b. Consider whether a plan for successive disclaimers by a surviving spouse may be designed under the Will to provide several alternatives under the instrument for the disposition of the disclaimed property. For example, the Will could provide that the residuary passes to the spouse or, to the extent he disclaims this outright bequest, to a QTIP trust, or, to the extent he disclaims his interest in the QTIP trust, to a credit shelter trust.

7. Difference Between Planned and Remedial Disclaimers.

a. An estate plan that includes disclaimer planning as an intended form of post-mortem flexibility is very different from an estate plan which was not adequately planned to begin with and which must be "fixed up" through the use of disclaimers.

b. Without minimizing the power of disclaimers to make a silk purse out of a sow's ear, often a disclaimer plan not contemplated in the instrument will require cooperation of several generations of beneficiaries and may have unintended results.

8. Rules to Live By.

a. Never disclaim until it is certain to whom the property will pass after the disclaimer. Assume nothing!

b. Estate plans based on post-mortem disclaimers require that the client's family be educated about the requirements for a disclaimer and the "no acceptance of benefits" rule.

C. PARTIAL QTIP ELECTIONS.

1. QTIP Trusts - One Exception to the Terminable Interest Property Rule.[11]

[11] A number of exceptions to the terminable interest property rule exist. Trusts which qualify for the marital deduction are: estate trusts in which a trust for the surviving spouse pours into his estate at his death (Reg. § 20.2056(c)-2(b)(1)), general

a. The terminable interest property rule. In general, the unlimited marital deduction is available only for property passing from the decedent to her surviving spouse. IRC § 2056(a). The marital deduction acts as a deferral of estate tax until the death of the surviving spouse and is based on the premise that the assets for which the marital deduction was taken in the estate of the first spouse to die will be subject to estate tax in the estate of the surviving spouse. No marital deduction is allowed for bequests to a surviving spouse which may terminate or fail upon the passage of time or the occurrence of an event or which may benefit someone other than the surviving spouse. IRC § 2056(b)(1). Such interests, known as terminable interest property interests, generally include bequests to trusts for the surviving spouse.

b. Exceptions to the terminable interest property rule. In recognition of the many legitimate reasons a taxpayer may wish to leave property for her spouse in trust, Congress created exceptions to the terminable interest property rule, all of which ensure that the benefit of the property will accrue solely to the surviving spouse during his life (Congress did not want an interest to get the benefit of the marital deduction unless it truly was a bequest for the surviving spouse) and will be includible in the surviving spouse's estate at his death. One of these exceptions is the QTIP trust.

2. QTIP Trust - IRC § 2056(b)(7).

a. QTIP trusts were created specifically to address the problem that married testators, particularly those with children from a prior marriage, should not be faced with the dilemma of providing either for the surviving spouse who might not leave the property to the testator's children or for the children leaving the surviving spouse without maximum financial security.[12] Congress acknowledged that the first spouse to die may have a legitimate concern that the surviving spouse would exercise his power to dispose of the marital trust assets in a manner inconsistent with her estate plan, particularly in the case of second marriages where

power of appointment trusts (IRC § 2056(b)(5)), and QTIP trusts (IRC § 2056(b)(7)).

[12] *See, e.g.*, H. Rep. No. 97-201, 97th Cong., 1st Sess., at 159-60.

the surviving spouse has children from a first marriage. However, without a general power of appointment, the trust assets would not be includible in the surviving spouse's estate. Thus, Congress created a special category of trusts as an exception to the terminable interest property rule - qualified terminable interest property trusts. If a trust meets the requirements for a QTIP trust, the bequest to the trust will qualify for the marital deduction and is required to be included in the surviving spouse's estate under IRC § 2044.

(1) Requirements for a QTIP trust.

(a) The property must pass from the decedent.

(b) All of the income must be paid to the surviving spouse at least annually for his life. In addition, the spouse must have the right to make non-income producing property productive. Regs. §§ 20.2056(b)-7(d)(2) and 20.2056(b)-5(f)(4).

(c) No one, with or without the consent of the surviving spouse, can receive a distribution from the trust other than the surviving spouse during the surviving spouse's lifetime. *See* Regs. §§ 20.2056(b)-7(d)(1) and 20.2056(b)-7(d)(6).

(d) An irrevocable election to qualify the trust must be made by the executor on the estate tax return. IRC § 2056(b)(7)(B)(v).[13]

3. Partial Election.

a. QTIP trusts offer an opportunity not available to any other form of marital bequest: an executor may elect to qualify only a portion of the bequest for marital deduction treatment. The elected part must be a fractional or percentile share of the trust. The balance remains in trust for the surviving spouse, but is

[13] To reduce the number of returns on which the executor failed to "check the box" on Schedule M of Form 706, the IRS has administratively reversed the presumption of the election, and a trust which qualifies as "QTIP-able" listed on Schedule M for which a marital deduction is taken qualifies as a QTIP trust "unless the executor specifically identifies the trust (all or a fractional portion or percentage)... to be excluded from the election." *See* Form 706, Schedule M.

subject to estate tax in the estate of the first spouse to die and not in the estate of the surviving spouse.

b. The advantage of this flexibility is that it permits an executor to determine how large a marital deduction to take without changing the value of the assets passing from the estate for the surviving spouse's benefit. The executor can make an election which optimizes the marital deduction and takes full advantage of the applicable credit amount to protect the non-elected portion of the marital trust from estate tax. Alternatively, the executor can also decide whether it may be more advantageous to pay a portion of the estate tax that will be due on the combined estates of the wife and husband from each estate and thus take advantage of the lower tax bracket which may be available if all of the assets are not taxed in a single estate. Also, in an estate plan which includes a credit shelter bequest that is designed to avoid automatic payment of state estate tax if the federal credit is larger than that available under state law, the executor can determine whether it may be beneficial to take advantage of the larger federal credit and pay some state estate tax. This is possible because a trust which meets all of the requirements of a QTIP trust does not include any term which would make the trust includible in the surviving spouse's estate unless the election is made. Thus, any portion of a trust designed to be a QTIP trust for which no election is made will not be includible in the surviving spouse's estate. The use of a partial QTIP election to implement credit shelter planning also has substantial disadvantages, as described below.

c. Just as the division between the marital share and the credit shelter share may be defined by formula as described above, it is advantageous to make the partial QTIP election by formula. The formula should be expressed as a fraction of the total value of the trust, *e.g.*, "the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary trust (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate)".[14] In this event, if values of assets in the estate are adjusted on audit, the amount passing to the marital deduction portion of the trust for the benefit of the surviving spouse will self-adjust to obtain the desired tax result.

[14] Reg. § 20.2056(b)-7(h), Example 7.

Alternatively, if the QTIP election is not made for a fractional share or is made for a percentage of the trust for the benefit of the surviving spouse, changes in values on audit may result in estate tax being due.

4. The regulations permit the marital trust to be divided into two trusts if authorized by the instrument or governing law: one which qualifies for the estate tax marital deduction and one which does not. Reg. § 20.2056(b)-7(b)(2)(ii)(A). The trusts are identical in every respect except that the trust which is not elected to receive QTIP treatment is not includible in the surviving spouse's estate. This division facilitates accounting for the separate shares of the marital trust in the event that distributions from principal are made only from the portion of the trust that is includible in the surviving spouse's estate. Whenever a QTIP trust is included in the estate plan, the Will or revocable trust should include a provision authorizing division of the trust if a partial QTIP election is made.

5. Partial QTIP elections are also useful if it appears likely that the surviving spouse may die within a short time after the first spouse of if he in fact does die shortly after the first spouse to die. Under these circumstances, the executor can elect to qualify a smaller portion of the marital trust for QTIP treatment, pay estate tax in the estate of the first spouse to die and take advantage of the credit for tax paid on prior transfers under IRC § 2013 for the actuarially determined value of the surviving spouse's interest in the nonqualified portion of the marital trust even though the trust is not includible in the surviving spouse's estate. For this reason, it is generally a prudent practice to put the estate tax return on extension when a QTIP trust is utilized so that the executor has 15 months, rather than only nine months, to determine whether this credit will be available in the estate of the surviving spouse. The full amount of the credit is allowed if the surviving spouse dies within two years of the first spouse to die. Thereafter, the credit is reduced by 20% every two years, until it is exhausted at the end of ten years. Note that the value of the surviving spouse's interest is determined under IRC § 7520 which prohibits use of the valuation tables if the surviving spouse was terminally ill at the death of the first spouse.

6. The primary disadvantage of estate plans using partial QTIP elections is that all of the income from the non-elected trust must be distributed to the surviving spouse, thereby increasing his taxable estate and subjecting that income to estate tax before it passes to the children. Also, there can be no discretion to make distributions to children and other family members.

D. CLAYTON (OR CONTINGENT INCOME) TRUSTS.

1. These trusts, in many ways, utilize and combine the advantages of disclaimer credit shelter trusts and partial QTIP trusts.

2. A Clayton trust is a trust which starts life as a qualified trust for which a QTIP election could be made, but to the extent that the executor does not make the QTIP election, the non-elected portion becomes a separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust.[15]

a. Initially, the government was hostile to the concept of a trust designed to make the requirement that all of the income be paid to the surviving spouse contingent on whether the QTIP election was made.[16]

(1) For many years, the Service challenged this type of estate planning and the Tax Court supported the government's position.

(2) In *Estate of Clayton v. Comm'r.*, 976 F.2d 1486 (5th Cir. 1992), the government argued that the marital deduction was not available for the QTIP trust, despite the executor's proper and timely QTIP election on the estate's federal estate tax return, because the executor's power to divert assets from the trust qualifying for the marital deduction constituted an impermissible power to appoint property away from the spouse. Under the facts of this case, the decedent was survived by his second wife and four children from a prior marriage. The decedent's Will created a credit shelter trust and a marital

[15] Conceptually, for drafting purposes, there is no reason why the trust could not start out as family sprinkle trust which, if a QTIP election is made, becomes a marital trust for the spouse which meets all of the QTIP requirements. For ease of discussion, the author will assume the Clayton Trust is drafted as a marital trust which becomes a family trust.

[16] In TAM 8631005, the Service ruled that a marital deduction was available where the surviving spouse served as executor for an estate which included a QTIP-able trust which poured over to a nonQTIP-able trust because the election was in the hands of the surviving spouse. However, this position was reversed in subsequent rulings and audits and Reg. § 20.2056(b)-7(d)(3) took the position that such a trust did not qualify for the marital deduction.

trust. Under the terms of the Will, if the executors failed to make a QTIP election for the marital trust, any portion for which the election was not made would pass to the credit shelter trust. The Will also provided that, to the extent the surviving spouse disclaimed any portion of the marital trust, that portion would pass to a third trust with terms similar to the credit shelter trust.[17] The spouse elected to qualify an undivided interest in specified bonds, notes and cash as terminable interest property. In a carefully reasoned and thorough opinion, the Fifth Circuit held that from both a statutory analysis and a public policy analysis, such a power did not affect the deductibility of the value of any portion of the trust for which a QTIP election was made because (i) the property to which the statute applies is only the property for which an election is made, not all property for which an election could be made, and (ii) the election relates back to the decedent's death.

(3) After both the Sixth Circuit[18] and the Eighth Circuit[19] also reversed the Tax Court on this issue, the Tax Court, but not the Service, acceded to the decisions of the Courts of Appeal in *Estate of Clack v. Comm'r.*, 106 T.C. 131 (1996).

b. Ultimately, the government abandoned its position and reissued Reg. § 20.2056(b)-7(d)(3) to provide that an income interest which is contingent on the election of the executor will not fail to be a qualifying income interest for purposes of the marital deduction.

c. The non-marital alternative of the Clayton trust does not need to require that all of the income from the trust be distributed to the surviving spouse and can include income beneficiaries other than the surviving spouse. Indeed, the surviving spouse need not be a beneficiary of the non-marital portion of the Clayton trust.

[17] Note that the surviving spouse was appointed co-executor with a bank, which, in an effort to bolster the estate's position, did not take office as executor until after the Form 706 was filed.

[18] *Estate of Spencer v. Comm'r.*, 43 F.3d 226 (6th Cir. 1995).

[19] *Estate of Robertson v. Comm'r.*, 15 F.3d 779 (8th Cir. 1994).

3. Terminology.

a. Clayton trust. Because a Clayton trust is a chameleon of sorts, it is important to clarify the language used to refer to it in order to clarify exactly which aspect of it is being discussed. For purposes of this outline, a "Clayton trust" refers to the entire mutable entity of a QTIP-able trust which, to the extent that a QTIP election is not made, becomes a trust which contains provisions that would disqualify it as a QTIP trust. This second feature of a Clayton trust introduces a time element into the nature of the trust during which it has all of the features necessary to qualify as a QTIP trust but also includes latent features which would disqualify it if the QTIP election is not made.

(1) Marital component. In a sense, the "first" component of the trust provides that if the spouse survives the testator, the spouse will have a mandatory income interest and no one other than the surviving spouse will have the right to receive anything from the trust during the surviving spouse's lifetime (including through the exercise of a power of appointment). This QTIP-able component of the Clayton trust may or may not provide that the surviving spouse can receive distributions of principal. Not that the ancient laws of property are crystal clear, but perhaps it is helpful to think of the spouse's interest in the marital component of the Clayton trust as in place, subject to divestment by the failure to make the QTIP election.

(2) Non-marital or family component. Although usually drafted as a "separate" trust under the instrument to which the assets of the Clayton trust will flow to the extent that a QTIP election is not made, in fact this second trust which usually benefits the children and may or may not include the surviving spouse as a beneficiary is conceptually part of the Clayton trust. During the period when a QTIP election could but might not be made, this component of the Clayton trust has as much viability as the marital component, although it appears to be "waiting in the wings."

(3) Either the marital or non-marital component of a Clayton trust may never actually become operational, depending on the election that the executor makes. Alternatively, in

the case of a partial QTIP election, they will both be funded.

b. Clayton election. One hears reference to the making of the Clayton election. This is a misnomer since the only formal election involved in a Clayton trust is the QTIP election which, to the extent made, eliminates the non-marital component of the Clayton trust. The "election" which gives life to the non-marital component of a Clayton trust is actually the *absence* of a QTIP election and, in that sense, is not an affirmative act. Nevertheless, in some cases it is helpful to use the term "Clayton election" to refer to the decision not to QTIP and the filing of the return without the QTIP election.

4. Prior to the passage of EGTRRA, few estate planners utilized Clayton trust planning, preferring simply to rely on the traditional credit shelter/marital bequest (outright or in a marital trust) plan.

5. On first blush, the Clayton trust structure may seem identical to that of a bequest to a marital trust which provides that if the surviving spouse disclaims, the disclaimed portion will flow to a credit shelter or other family trust, except that the executor, rather than the spouse, makes the decision. However, in the case of a disclaimer structure, the surviving spouse's interest in the marital trust is fixed or complete. It may be changed by the surviving spouse's act of disclaiming, but no further act is necessary to vest the surviving spouse's interest in the marital trust. In a Clayton trust, the spouse's interest in the marital trust is contingent upon a final act which has not yet occurred, the making of the QTIP election.

6. The interesting challenge presented in drafting a Clayton trust is that it is created upon the *nonoccurrence* of an event. While the making of a QTIP election itself is irrevocable, the nonelection cannot always be said to have occurred with the same definiteness.

a. The issue raised here is that under Regs. §§ 20.2056(b)-7(b)(4) and (5), a QTIP election may be made or modified on a return until the final due date for the return, including extensions actually granted, or on the first late return.

b. Presumably, if the drafting language refers to a failure or refusal of the executor to elect the marital deduction for some portion (or all) of the marital trust under IRC § 2056(b)(7)(B)(ii)(V) on the last federal estate tax return filed for the estate on or before the due date of the return, including extensions, or if a timely return is not filed, the first estate tax return filed by the executor after the due date, as the triggering event for an alternate bequest to the credit shelter trust or some other bequest, this should be sufficient.

(1) The question arises, however, as to the status of the "Clayton election" where no timely federal estate return is filed.

(2) Query whether it is advantageous (and permissible) to obtain certainty as to the beneficiaries of the trust by providing in the Will that the trust will remain solely for the benefit of the surviving spouse if the election is or is not made within a specified time limit after the decedent's death. For example, perhaps the provision requiring any non-elected portion of the trust to pourover into a non-qualified trust should expire if not resolved within 15 months after the decedent's death. This would still permit a partial QTIP election to be made on a late filed return but would provide certainty as to the terms of the trust.

c. In this, as in all matters related to division of assets between marital and non-marital shares, consider making the election as a fractional formula to preserve the intended tax consequences in the event of revaluation of or newly discovered assets.

d. One disadvantage of the non-marital portion of the Clayton trust, as compared to the non-marital portion of a traditional partial QTIP trust, is that, if persons other than the surviving spouse are discretionary beneficiaries, the surviving spouse is unlikely to have an interest in the trust capable of actuarial valuation and no credit for tax paid on prior transfers will be available. However, this disadvantage is no greater than that of the traditional marital deduction/credit shelter plan which includes a discretionary credit shelter trust.

e. It is unclear whether a surviving spouse who serves as the sole executor of the estate may have adverse gift tax consequences as a result of his power to direct property away from himself without actually meeting the qualified disclaimer requirements. Arguably he is exercising his power to redirect trust assets as a fiduciary of the estate, but it is also true that he is directing assets away from himself for the benefit of others. Until some guidance has been issued, it may be more prudent not to name the surviving spouse as the sole executor of an estate where a

Clayton trust is included and to provide that an independent executor make the decision regarding the QTIP election. In most cases a co-executor could be appointed who would have no responsibility other than making or not making the QTIP election.

f. Use of a Clayton trust may be preferable to a disclaimer trust because (a) the executor has fifteen months instead of only nine months to make his decision and (b) the surviving spouse can have a special power of appointment over the non-elected trust.

E. TAX APPORTIONMENT ISSUES.

1. In a well thought-out marital deduction/credit shelter plan which uses a disclaimer of a portion of the residuary marital trust or residuary Clayton trust to take advantage of the decedent's applicable exclusion amount, the tax apportionment clause should include a provision to apportion any death tax due (*e.g.*, state estate tax) to the credit shelter trust or non-marital portion of the Clayton trust.

2. In the absence of such a provision, it may be necessary to take the payment of such death taxes into account in calculating the amount of the disclaimer or Clayton election to gross up the marital share for any death taxes to be paid from it.

F. OTHER ELECTIONS.

1. GST Tax Planning.

a. Generally, for wealthier clients, full use of the client's GST tax exemption has long been recommended. The biggest benefit from this type of planning for a client who could afford it was best accomplished through lifetime gifts which removed the future appreciation in the gifted assets from the donor's estate. Since the GST tax exemption has been larger than the applicable credit amount, clients often would make gifts of the full amount of the GST tax exemption and pay gift tax on the excess over the applicable exclusion amount.

b. Now that the amount of applicable exclusion available for lifetime giving has been limited to $1 million, it is less attractive to suggest that clients make taxable gifts and pay gift tax.

c. Consider that beginning this year, 2004, most clients will have both applicable credit and GST tax exemption available to use at death, even those clients who had intended to use their full GST exemption making lifetime gifts. For this reason, many of these clients currently have no GST planning in their Wills or revocable trusts. For the foreseeable future, testamentary planning for clients who are motivated to reduce total transfer tax costs should be sure to include testamentary GST planning as a matter of course.

d. Generally, GST planning should be done by formula - "I bequeath the amount of my available GST exemption to . . ." - but this now raises the same concerns as formula bequests to credit shelter trusts. In 2009, the GST exemption will be $3.5 million (if the law is not changed) and may be more than the client wants to pass to grandchildren and may leave the children with very little. Indeed, depending on the size of the estate, the $2 million GST exemption which takes effect in 2006 may be more than a client feels comfortable leaving to grandchildren.

G. TECHNIQUES RELATED TO PLANNING FOR REPEAL.

1. Use of Revocable Trusts to Increase Flexibility.

a. A revocable trust is a trust which the grantor creates during her lifetime and over which the grantor retains the right, exercisable alone or in conjunction with another person, to amend or revoke the trust. The assets can be distributed to the grantor's beneficiaries as the grantor directs in the revocable trust (acting as a Will substitute) and probate is avoided.

b. Sometimes the trust is not funded (or only partially funded) during the grantor's life and, at her death, her Will directs her executor to transfer her assets to the trustee of her revocable trust. The trust acts, in effect, as a Will substitute although probate is not avoided.

c. A revocable trust does not have any income or estate tax consequences during the grantor's lifetime because the grantor is treated as the owner of the trust for both income and estate tax purposes. If the revocable trust is properly drafted, it also should not have any gift tax consequences during the grantor's lifetime.

d. Most importantly in the post-EGTRRA world, use of a revocable trust may safeguard the ability to modify a client's estate plan to take whatever changes may occur in the tax laws into account in the event that the client becomes incapacitated prior to a significant change in the law. Generally, if a client becomes incapacitated, no one can modify her Will, not even her attorney-in-fact. However, under a revocable trust, depending on state law, it is possible for the grantor to give her trustee or another independent person the power to amend her trust, consistent with her testamentary plan, to take advantage of changes in the tax law. This is an extremely broad power and not one to be granted lightly. Nevertheless, assuming a client can identify someone whom she trusts with this power, it is a critical element of preserving a client's ability to respond to changes in the tax laws. Needless to say, the older the client, the more important it may be. Depending on state laws, it may also be possible for such revisions to a revocable trust to be made pursuant to a properly drafted power of attorney.

e. Issues raised by giving a third party the power to amend a revocable trust.

(1) Obviously, the most significant issue in granting the power to amend a revocable trust to someone other than the grantor is an issue of trust. If a client is not comfortable with giving this power to someone, then it should not be done. She may be the rare client who wishes to have her Will or revocable trust drafted to respond to all of the different tax environments currently possible under EGTRRA. However, the client should be made aware that if EGTRRA is replaced, as expected, with a different set of transfer tax laws, her Will or revocable trust may not "work" under the new regime.

(2) Assuming the grantor wants to give the power to amend her revocable trust to someone, several safeguards can be used.

(a) Require two people to agree unanimously on any changes to the trust.

(b) Specifically provide that changes may be made solely for the purpose of maximizing benefit as a result of changes in the tax law within the context of the grantor's existing estate plan and dispositive trust provisions.

(c) Give the power to amend to a person in her individual capacity, not as a trustee, so that if that individual ceases to serve as trustee, the power does not automatically pass to someone else.

(d) Limit the exercise of the power so that the person holding the power cannot benefit herself (mandatory) or her family (if possible).

2. Correction of Formula Bequests. For estate plans using formula bequests of the applicable exclusion amount, after repeal, the results under the formula may be uncertain. For example, a formula using the language, "the maximum amount which can pass free of federal estate tax by reason of the applicable credit amount," may yield nothing passing to the credit shelter trust because there is no applicable credit amount or everything because nothing is subject to the estate tax. Prudence dictates inclusion of a provision which provides that, notwithstanding anything else in the Will (or revocable trust), in the event there is no estate tax applicable to the estate at the decedent's death by reason of its repeal, the balance of the estate after specific bequests will pass to the residuary, either outright or in further trust, depending on the client's preference. *See* discussion of long-term trusts below. Note that a reference to the period "after the estate tax is repealed" would be inadvisable since, under current law, in the year 2011, the estate tax will apply to the estate even though the decedent will have died after repeal.

3. Design Trusts to Permit Use of Basis Adjustments.

a. Although in some cases, clients may prefer not to give trustees the power to make discretionary distributions of principal to the beneficiaries of the trust for any purpose (particularly the surviving second spouse), it may be time to begin including a provision in trusts which permits the trustee to distribute principal to be sure that beneficiaries can take advantage of the increase in basis available at their deaths during the period of repeal. This is particularly important in the case of a QTIP trust where the surviving spouse does not have substantial assets of his own. Note that the amount the trustee should be permitted to distribute is NOT the $3 million of basis allocation available to the surviving spouse's estate, but property sufficient to permit the surviving spouse to take advantage of $3 million of basis *increase*. The most flexible provision would not specify the amount the trustee can distribute, but rather include this purpose as one of the purposes for which the trustee can make distributions. Even in the case of trusts that permit totally discretionary distributions of principal, some reference to this purpose may be wise, if for no other reason than to flag the issue for the trustee.

b. Inclusion of such a provision may make it inadvisable for the surviving spouse to be the sole trustee of such a trust since the distribution power may not qualify as an ascertainable standard. The power, if held by the spouse, might in fact be construed as a general power, which would prevent the trust from qualifying for QTIP treatment.

4. Consider Use of Long-Term Trusts.

a. Commentators disagree about whether the specter of repeal means that (i) trusts should be designed to terminate (or not be created) if the estate tax is repealed or (ii) all of the decedent's property should be placed in trust so that it will not be subject to estate tax if the tax returns.

b. In either event, planning should take into account the fact that increases in basis are available only for property the decedent "owns" and attempt to ensure that this relief from capital gain tax is adequately addressed, balanced against the fact that the estate tax, if applicable, will probably be imposed at a rate much higher than the capital gain tax. This would suggest a general practice of planning to allocate basis to the lowest basis assets possible to minimize the total amount of property an individual must own to take advantage of the maximum permissible increase.

c. Generally, if the client is not uncomfortable with the selection of trustee and control issues, the ideal plan would maximize the amount passing in trust for the maximum period and give the trustee the powers to terminate trusts if this appears advisable and to make distributions of principal to take advantage of the beneficiary's basis increase, where appropriate. Long-term trusts raise many issues of their own, however, since it is very difficult to foresee the myriad of family, economic, tax and other legal issues which could arise over hundreds (never mind thousands) of years. Such trusts should always be drafted with the maximum possible flexibility. The powers suggested above are generally consistent with the flexibility which is desirable whenever long-term trusts are considered. Even where the client is comfortable with long-term trusts, the instrument should provide for the creation of a QTIP trust in an amount sufficient to permit full use of the decedent's $3 million basis adjustment.

VI. APPLICATION OF TECHNIQUES TO PERMIT FLEXIBLE POST-MORTEM PLANNING.

A. CAPPING THE CREDIT SHELTER BEQUEST. Whenever the client has chosen to limit the maximum amount to be protected by the applicable credit amount, it is generally good practice to provide additional flexibility in the estate plan to permit taking advantage of the applicable exclusion amount in excess of the cap, particularly where the cap is the amount protected from both federal and state estate tax in a decoupled state. This can be done by using a disclaimer provision, a partial QTIP election or a Clayton trust.

B. DISCLAIMERS.

1. Simple Credit Shelter Trust Disclaimer.

a. The following scenario illustrates a typical use of a disclaimer to effectuate a post-EGTRRA estate plan. The client, who has an estate valued at $4,000,000, currently has a standard credit shelter-based Will, that is, the exclusion amount passes to a discretionary trust for husband and issue, with the balance outright to husband, protected from estate tax by the marital deduction. The client is satisfied with how this plan worked and with a $1,000,000 exclusion amount, and perhaps even with a $1,500,000 exclusion amount, but she is concerned that with a larger exclusion amount (or estate tax repeal) the amount of the credit shelter trust might be disproportionate to the marital bequest.

b. Although a ceiling could be placed on the amount of the credit shelter bequest, this approach is inflexible with regard to future changes in financial circumstances. On the other hand, leaving the entire estate to the client's husband, with a provision in the Will or revocable trust that, in the event he disclaims any portion of his bequest, the disclaimed amount passes into the credit shelter trust, is a far more flexible plan. The husband can make a decision about how much should pass to the credit shelter trust based on the tax law and the financial circumstances applicable at the time of the client's death.

c. Note that utilizing a disclaimer trust approach will prohibit the client from giving her surviving husband a power of appointment or other control over the disposition of the trust. Note also that this sort of disclaimer planning is probably inappropriate when the client's surviving spouse and children do not have a unity of interest.

d. The primary weakness of this technique is that a surviving spouse may prefer not to have his assets held in trust and may choose not to disclaim. This distaste for trusts may not have been voiced during the planning process (or the spouse may not have realized he would feel this way). The decision whether to disclaim property for the purpose of saving taxes after the client's death rests entirely in the hands of the surviving spouse. Obviously, this problem is exacerbated if the remainder beneficiaries of the credit shelter trust are not the children of the surviving spouse.

e. Another difficulty with this technique is that clients often do not realize the significance of their actions and do things that constitute the acceptance of the property they plan to disclaim. Thereafter, those assets generally cannot be disclaimed, although a partial disclaimer may, under certain circumstances, still be possible. Even clients who have been educated during the estate planning process about not accepting benefits of the assets still take actions which prevent a qualified disclaimer. For couples who engage in disclaimer credit shelter trust planning, it is imperative that the surviving spouse seek legal assistance in administering the deceased spouse's estate as quickly as possible and not take any action with regard to assets owned by the deceased spouse or jointly with the deceased spouse until he has done so.

f. A third issue (which can get fairly technical but should not be overlooked) is that a pecuniary disclaimer, that is a disclaimer of a specific amount, likely will cause capital gain to be recognized in the assets transferred as a result of the disclaimer.

(1) Use of formula disclaimers is often advisable in order to ensure that the credit shelter amount is not over- or underfunded in the event that assets are revalued on audit. The formulas used in marital deduction/credit shelter disclaimers are the same as those used in drafting marital/credit shelter bequests in the Will. Generally, the disclaimer would be phrased as a preresiduary credit shelter amount, funded on a true worth or fairly representative basis, or as a fractional share of the residuary. The same advantages and disadvantages described above when drafting credit shelter/marital bequests in a Will apply to formula disclaimers.

(2) Since disclaimers to a credit shelter trust may be pecuniary disclaimers even if they are made by formula, it is generally good practice not to delay too long in making the decision to disclaim, particularly in a rising market. And remember to segregate the assets following the disclaimer if the disclaimer is of a pecuniary amount.

C. PARTIAL QTIP ELECTION.

1. Mechanics of Partial QTIP Election. To use a partial QTIP election instead of a disclaimer to a credit shelter trust, the Will or revocable trust bequeaths the residuary to a trust for the benefit of the surviving spouse (which meets the requirements for a QTIP election) rather than outright to him. The executor then makes a determination of the amount of the decedent's applicable credit to use, based on the values of the decedent's estate, the surviving spouse's estate and the applicable tax law in effect at the decedent's death. She may also make a determination about whether to pay some federal estate tax or some state estate tax. The executor makes a QTIP election on the decedent's federal estate tax return only for the portion of the estate which she determines to protect from estate tax with the marital deduction.

2. Advantages.

a. Depending on whom the decedent has named as executor, this decision need not be left to the control of the surviving spouse. Thus, in a situation where the decedent's children are not the children of the surviving spouse, the executor can be someone other than the surviving spouse and can make this decision based on a more objective analysis of the economic factors relevant at the decedent's death.

b. Even where the surviving spouse is named as the executor, the spouse is choosing between two alternatives, both of which hold the property in trust for him. Thus, any preference to own the assets outright is not a factor in determining how much should pass to a trust protected by the decedent's applicable credit.

c. There is no danger that the use of the decedent's applicable credit will be barred because the surviving spouse has inadvertently accepted the benefits of the property he planned to disclaim.

d. If the surviving spouse dies within 15 months of the decedent's death, the executor can maximize the benefit of the credit for previously taxed property under IRC § 2013 in the surviving spouse's estate by making a smaller (or no) QTIP election in the decedent's estate.

e. The decedent can be assured that, to the extent principal is not distributed to the surviving spouse, it will pass as she has directed, rather than to whomever the surviving spouse may determine (*e.g.*, his new wife).

f. The trust can be divided into two separate trusts, one includible in the surviving spouse's estate and the other not, to optimize tax-motivated administration of the trust. No gain or loss will be recognized when the two trusts are funded.

3. Disadvantages.

a. The two trusts for the benefit of the surviving spouse will be identical. Both will require distribution of all of the income from the trusts to the surviving spouse, thus unnecessarily subjecting income earned in the credit shelter trust to estate tax in the estate of the surviving spouse. The decedent's children will not be included as income beneficiaries of either trust.

b. When the two trusts are divided, all of the assets used to fund them must be divided on a fractional or percentage basis. Thus, it is not possible to select assets which are expected to appreciate to fund the credit shelter trust and assets which are not expected to appreciate to fund the marital trust.

4. Disclaimer of Outright Bequest to QTIP Trust.

a. Consider combining the disclaimer method with the partial QTIP method to permit the surviving spouse to disclaim an outright bequest to a QTIP trust instead of a credit shelter trust. The Will could provide that, if the surviving spouse disclaims, the disclaimed portion of the bequest will pass to a marital trust designed to qualify for the marital deduction.

(1) This could provide the executor with additional time, up to six months after the original due date of the return, to determine whether taking full or partial advantage of the marital deduction is advisable for the estate. The executor would then make or not make the QTIP election or not, based on an informed analysis regarding how large the marital deduction should be.

(2) In addition, if the decedent did not fully use her GST exemption, and if the trust were properly drafted, a reverse QTIP election could be made.

(3) Finally, If it appears advisable, the executor could make a partial QTIP election, qualifying only a portion of the disclaimed property for QTIP treatment, thus making the credit for previously taxed property available to the estate of the surviving spouse without including the assets of the trust for his benefit in his estate. Obviously, this benefit is not available if assets are owned directly by the surviving spouse.

D. CLAYTON TRUSTS.

1. Advantages.

a. Clayton trust planning has all the advantages of partial QTIP planning:

(1) Control is in the hands of the executor, who should not be the surviving spouse.

(2) There is no danger that the plan will be jeopardized by accidental acceptance of benefits by the surviving spouse of assets which were intended to be disclaimed.

(3) Income need not be distributed to the surviving spouse from the non-marital portion, thus avoiding unnecessarily enlarging his estate.

(4) No gain or loss is recognized on funding the trust.

b. In addition, the Clayton trust can be structured as a sprinkling credit shelter trust, just as with disclaimer credit shelter trusts, and can be held for the benefit of the surviving spouse and the decedent's children, with discretionary income and principal distributions to any of them.

c. The surviving spouse can have a special power of appointment over the trust.

2. Disadvantages.

a. Just as with a partial QTIP election, the assets must be divided between the two trusts on a fractional share basis.

b. If the two spouses die within a short period of time of each other, the estate of the surviving spouse will not qualify for the credit for previously taxed property under IRC § 2013. This is because a Clayton trust which does not require that the income from the non-marital portion be distributed to the surviving spouse (or which permits distributions to other people) does not give the surviving spouse an interest in the trust which is capable of being valued actuarially.

c. Note that the choices between structuring the estate plan to use a partial QTIP election or a Clayton trust are mutually exclusive because they are both triggered by the same event - it is not possible to draft a single marital trust which is QTIP-able and provide that, if an election to qualify the trust for the marital deduction is not made for any portion of the trust, then that portion may either stay as a nonqualified trust for the spouse or be distributed to a Clayton trust (*but see* section G below).

d. Query whether it would be possible to structure the disposition of the non-elected portion by providing in the Will that the first specified dollar amount or formula fraction of the trust for which the election was not made would pass to a sprinkle trust and any portion in excess of that amount for which an election was not made would remain in a non-qualified marital trust. Such a plan would permit taking full advantage of the decedent's available applicable exclusion amount, if desirable, in a discretionary sprinkle trust, and then permit use of the credit for previously taxed property for any amount in excess of that, if desirable. This could provide a compromise when the executor must decide between the attractiveness of the flexibility permitted in the credit shelter trust and the desirability of preserving the availability of the prior transfer credit in the event of both deaths within a short period of time.

E. PARTIAL MARITAL DISCLAIMER AND PARTIAL CLAYTON ALTERNATIVE.

1. Although it is often tempting to design estate plans that maximize tax planning results, a significant portion of the job of the successful estate planner is also to factor in how the parties who survive the decedent will

react to the plan and build in provisions to account for these reactions. Consider how the surviving spouse may feel when the decision about whether he will receive the full benefit of the marital trust or not is placed in someone else's hands.

2. A possible solution to this potential difficulty in larger estates may be to leave a portion of the assets outright to the surviving spouse and a portion in a marital trust. This may make the surviving spouse more comfortable with the concept of the marital trust. The Will would provide that if the surviving spouse disclaims any portion of his outright bequest, it will pass to a credit shelter type trust (but without a special power of appointment) and that if the executor does not elect to qualify the entire marital trust for QTIP treatment, the non-elected portion would pass to the credit shelter trust which could include a special power of appointment. Under these circumstances, the surviving spouse would be included in the analysis of how much federal applicable exclusion amount to use in the estate of the first spouse to die and he can influence the decision about whether he would rather take advantage of the asset protection feature afforded by having assets in the marital trust or rather have assets he owns directly. In addition, if the surviving spouse prefers to hold a special power of appointment over the redirected assets, he can allow the executor to make the Clayton election, rather than disclaiming. Thus the surviving spouse is involved in the decision, but the choice as to whether to take full advantage of the decedent's applicable exclusion amount is not left solely to his discretion.

F. DISCLAIMER IN COMBINATION WITH PARTIAL QTIP ELECTION.

1. In the case of older clients, one way of structuring the estate plan to permit use of a credit shelter-type trust and preserve the possibility of taking advantage of the credit for tax paid on previously taxed property is to bequeath the spousal share to a residuary marital trust that qualifies for QTIP treatment and provide that any portion of the trust disclaimed by the surviving spouse will pass to a credit shelter trust (without a special power of appointment). If the surviving spouse is alive and has a normal life expectancy as of nine months after the decedent's death, he could disclaim an amount adequate to take advantage of all or a portion of the decedent's applicable exclusion amount. If he has died (or is in poor health) at the nine month date (but was healthy enough at the decedent's death to have his interest in the marital trust valued under the tables), no disclaimer to a credit shelter trust will be made, and the executor (who may be the surviving spouse, if still alive) could elect to qualify only a portion of the marital trust for marital deduction treatment when making a QTIP election to take advantage of the credit for the tax paid on the non-elected portion of the marital trust at the death of the surviving

spouse. To increase the value of the surviving spouse's interest in the trust, the spouse should ordinarily be given a "5 & 5" withdrawal power over the trust, whereby the surviving spouse is permitted each year to withdraw $5,000 or five percent of the value of the trust.

2. Note that this plan leaves the possibility of funding the family-oriented credit shelter trust in the hands of the surviving spouse and thus may be inappropriate where the spouse and the remainder beneficiaries do not have a unity of interest.

G. DISCLAIMER IN COMBINATION WITH CLAYTON TRUST AND PARTIAL QTIP ELECTION.

1. Query whether another technique may make it possible to take advantage of either a partial QTIP election or a Clayton election, depending on the circumstances at the decedent's death: structuring the Will so that the property can be directed to different trusts either by disclaimer or by Clayton election. For example, the decedent leaves his estate to a residuary Clayton trust, so that if the executor makes a partial (or no) QTIP election for the property in this trust, the non-elected portion would pass to a credit shelter-type trust. The Will also provides that, if the spouse disclaims his interest in any portion of the Clayton trust, that portion of the trust would pass to a traditional QTIP trust which does not make the spouse's income interest contingent on the QTIP election. A partial QTIP election applied to this traditional QTIP trust would result in the surviving spouse receiving the income from both the marital and non-marital portions of the trust and the credit for tax paid on prior transfers would be available in the estate of the surviving spouse if he has died or dies within a few years. Needless to say, this gives the surviving spouse the power to defeat the Clayton trust and take all of the income for himself - even though he would not be making the election himself. Regardless of the executor's opinion about whether or not to qualify the full value of the Clayton trust for QTIP treatment, the spouse would be in a position to determine whether he would have all of the income interest from the trust or not through his power to disclaim. Note that a disadvantage of this plan would be that the determination of how much of the trust is subject to the Clayton election, and thus eligible to be passed to the credit shelter-type trust, must be made within nine months of the decedent's death, instead of 15 months.

2. On its face, this plan is similar to the preceding one involving a disclaimer from a QTIP trust to a credit shelter trust, but raises some fascinating issues not involved in the former structure.

   a. Can a surviving spouse disclaim from a Clayton trust?

(1) The nature of the surviving spouse's interest in a Clayton trust is similar to, but different from, a surviving spouse's interest in a traditional QTIP trust for which a partial QTIP election can be made. In the case of the partial QTIP, the surviving spouse has the same interest in the trust, whether or not the election is made. In the case of a Clayton trust, the surviving spouse might not even be a beneficiary of the non-marital portion of the trust.

(a) This question raises the issue of the essential nature of the potential beneficiaries' interests in the respective portions of a Clayton trust. On the one hand, the interests of the potential beneficiaries of the non-marital portion cannot be said to have a present interest in the Clayton trust because that would disqualify it for QTIP treatment. On the other hand, the spouse's interest in the Clayton trust, although described as current to qualify for the QTIP election, is not actually possessory and may never materialize. The court in *Clayton* based its analysis that the marital deduction is available for the portion of the trust for which an election is made on the fact that the QTIP rules apply only to the portion for which the election is made. The election itself is one of the requirements necessary to permit the marital deduction to apply. The fact that the balance of the Clayton trust does not meet the requirements for the marital deduction does not "contaminate" the entire trust because the rules apply only to the portion for which the election is made.

(b) Points in favor of permitting a spousal disclaimer from a Clayton trust.

i) The creation of the Clayton trust is predicated on the spouse's survival. If the spouse does not survive the testator, these provisions of the instrument would never become active. The fact that state laws permit the testator to direct the flow of property if the surviving spouse disclaims his interest in the Clayton trust should permit the testator's intention to be effective.

ii) Although the spouse's interest in the marital component of a Clayton trust is contingent on the QTIP election being made, the actual bequest under the instrument is to the marital component of Clayton trust. This must be the case in order for the executor to be in a position to make a QTIP election for the trust that otherwise qualifies for QTIP treatment. Thus, at the time that the spouse disclaims, only the marital component of the Clayton trust is "active." As the court in *Clayton* noted, "the election element of the definition is viewed in the past tense, i.e., that although the *effect* of the election is tested as of the instant of the testator's death, the definitional *eligibility* of the separate terminable interest under examination is tested as though the QTIP election had already been made."[20]

(c) Troubling issues in permitting a surviving spouse to disclaim from a Clayton trust.

i) Unlike a disclaimer from a QTIP trust, a disclaimer from a Clayton trust may disenfranchise other potential current beneficiaries and may not be considered a permissible disclaimer or renunciation under applicable state law.

ii) By analogy, this could be viewed as similar to a disclaimer provision in a credit shelter trust. Suppose the spouse is a discretionary beneficiary with the testator's children and the disclaimer provision provides that if the spouse disclaims, the property would flow to a

[20] *Estate of Clayton v. Comm'r.*, 976 F.2d at 1497.

QTIP trust solely for the benefit of the surviving spouse. Should this work?

(2) Possibility of the disclaimer being recharacterized as a special power of appointment. If the surviving spouse's interest in the marital component of the Clayton trust is considered to be as tenuous as those of the potential current beneficiaries of the non-marital component of the Clayton trust, one must ask what interest it is that the spouse is disclaiming. A disclaimer is a release of an interest. If the spouse does not have a substantial interest in the non-marital component of the Clayton trust, his ability to redirect the trust through a disclaimer could be viewed to be a narrow special power of appointment to appoint the trust property. If this were the case, it is possible that no part of the Clayton trust would qualify as a QTIP trust because the surviving spouse would have a power to appoint property to someone other than himself.[21]

b. Timing issues.

(1) Arguably, if the surviving spouse disclaims all or a portion of the Clayton trust, that disclaimer would take

[21] Note that it was the government's argument and the Tax Court's holding in *Estate of Clayton v. Comm'r.*, 97 T.C.327 (1991), *rev'd* 976 F.2d 1486 (5th Cir. 1992), *Estate of Robertson v. Comm'r.*, 98 T.C. 678, *rev'd* 15 F.3d 779 (8th Cir. 1994) and *Estate of Spencer v. Comm'r.*, T.C. Memo 1992-579, *rev'd* 43 F.3d 226 (6th Cir. 1995) that, "the surviving spouse did not have a qualifying income interest for life because the passage of an income interest in the property to the surviving spouse was contingent upon the executor's QTIP election as to such property and was therefore subject to the executor's power to appoint the property to someone other than the surviving spouse," *Estate of Clack v. Comm'r.*, 106 T.C. 131, 138 (1996). In reversing the Tax Court in these cases, the appellate courts focused upon the requirement of IRC § 2056(b)(7)(B)(i) that qualified terminable interest property is property, *inter alia*, for which an election *has been made*. *Estate of Clack v. Comm'r.*, 106 T.C. at 140-41. As the court in *Clayton* stated, "No reasonable reading or construction of the Will or the statute can validate the position of the Commissioner, as endorsed by the Tax Court, that the Independent Executrix's QTIP election itself is 'tantamount' to a power of appointment to the testator's children." *Estate of Clayton v. Comm'r.*, 976 F.2d at 1497. This reasoning, however, would not apply to whether a surviving spouse's power to disclaim should be considered "tantamount" to a power to appoint the property.

priority over the subsequent finality of the election by the executor to qualify (or non-election not to qualify) any portion of the Clayton trust for QTIP treatment. The disclaimer must occur within nine months of the decedent's death. Given that the QTIP election (or lack thereof) is revocable until the due date of the federal estate tax return, due nine months after the decedent's death if no requests for extensions are made, the disclaimer will have occurred prior to (or at best simultaneously with) the filing of the federal estate tax return.[22] If the disclaimer effectively directs the assets that would otherwise have flowed to the Clayton trust elsewhere, it is hard to see how the executor could make an election over assets no longer subject to the terms of the Clayton trust.

(2) It may be tempting to provide that the spouse's disclaimer could be contingent on the executor's election of QTIP treatment to ensure that the surviving spouse has a "disclaimable" interest in the Clayton trust (*e.g.*, the spouse disclaims his interest in any portion of the trust for which the executor makes the QTIP election). However, on a practical level, it is difficult to figure out how an estate tax return could be filed which lists the assets of the Clayton trust on Schedule M of the Form 706, makes a QTIP election for those assets qualifying them for the marital deduction and also indicates that the assets are in fact held in a separate trust protected from tax by the applicable credit amount (or subject to tax if the amount exceeds the amount of the available applicable credit amount). Alternatively, if the surviving spouse disclaims his interest without reference to whether the QTIP election is made and the executor believes the assets are no longer subject to the Clayton trust, the executor will not make a QTIP election for assets not in the Clayton trust. No QTIP election for the disclaimed assets would

[22] Although IRC § 2518(b)(2) provides that, to be qualified, a disclaimer must be made, *inter alia*, "not later than the date which is 9 months after the later of – (A) the date on which the transfer creating the interest in such person is made, or (B) the day on which such person attains age 21," the likelihood of the disclaiming surviving spouse being under the age of 21 is presumably small, making this provision of one of extremely rare applicability.

ever be made and the spouse's interest in the marital portion of Clayton trust would never be complete.

c. Gift Issues. Under the transaction described above, the surviving spouse has a greater interest in the disclaimer QTIP trust than in the Clayton trust, because the spouse has a secure income interest in the disclaimer QTIP as opposed to the Clayton trust. Query whether under a *Dickman*[23] analysis, the surviving spouse's failure to make a disclaimer, particularly if the executor then failed to make QTIP election, could be considered a gift from the surviving spouse to the other beneficiaries of the non-marital portion of the Clayton trust.

3. The bottom line is that it is not entirely clear what the tax result of including a disclaimer in a Clayton trust might be and the inclusion of such a provision in a Clayton trust should probably be reserved for those of your clients who have high risk tolerance, have aggressive tax personalities, and may be prepared to make law, if the numbers involved are large enough to warrant it. Fortunately, a similar benefit to that described through this technique could be obtained in other ways (*e.g.*, reverse the order of the trusts and disclaim from a traditional QTIP to a Clayton trust).

H. GST PLANNING.

1. Capping the Amount of the Exemption. Just as with credit shelter trusts, the amount of the GST bequest can be capped at a particular number if the client prefers, although this is an inflexible solution which will fail to take into account the client's assets and existing law at the time of her death.

2. Use of Disclaimers, Partial QTIPs and Clayton Trusts. Alternatively, it may be possible to structure the funding of the GST bequest through the use of disclaimers, partial QTIP elections and Clayton trusts.

(1) For example, a client's Will or revocable trust could include a bequest to a "reverse QTIP trust" in the full amount of the client's available GST exemption. This is a marital trust which meets the requirements for making the QTIP election, but permits a special election for GST purposes which will treat the decedent as the transferor

[23] *Dickman v. Comm'r.*, 465 U.S. 330 (1984) (holding that foregone interest on interest-free loans to decedent's children were gifts).

rather than the surviving spouse, even though the trust will be included in the surviving spouse's estate at his death. The remainder of this trust would pass to grandchildren. The decedent's GST exemption would be allocated to the trust to protect it from GST tax. If the surviving spouse disclaims a portion of the reverse QTIP trust, the amount disclaimed can then pass to the "regular" QTIP trust which has the children as beneficiaries. The marital deduction would be available for both trusts. Needless to say, the spouse could not have a special power of appointment over the regular QTIP trust.

(2) A simpler approach, however, assuming any unallocated GST exemption would otherwise not be used, would simply be to give the spouse a special power of appointment over the reverse QTIP trust to permit him to appoint between children and grandchildren. The executor would then allocate the decedent's entire unused GST exemption to the trust. If the spouse determines that a portion of the trust should pass to children, the GST exemption allocated to that portion will be wasted. But if the GST exemption was a larger percentage of the estate than seemed fair to give to grandchildren, there is no harm. The danger with this approach is that the surviving spouse may fail (or be unable) to redo his Will to exercise the special power of appointment prior to his death.

(3) Alternatively, in situations where it is not appropriate to give the surviving spouse the power to determine the size of the GST bequest, it is possible to link the GST bequest with a Clayton election made by the executor. In this case, the Clayton trust would use the decedent's available applicable credit, could be for the benefit of grandchildren and could have GST tax exemption allocated to it. The remaining portion of the marital trust would pass to children at the death of the surviving spouse. The difficulty with this approach is that it requires coordination of the use of the applicable credit with the use of the GST exemption to protect the trust from both estate and GST tax.

(4) A disadvantage of all of these approaches is that they require the existence of a surviving spouse. If there is no surviving spouse, the Will may simply contain a GST

bequest of the maximum amount and no elections or disclaimers will be possible unless the grandchildren themselves wish to disclaim. Under these circumstances, it may be prudent to make the bequest to a sprinkling trust for descendants, allocate the decedent's GST exemption to it, and give the trustee broad discretion to make distributions to children and grandchildren. Keep in mind that a trustee may be reluctant to make distributions to children from such a trust because it will waste GST tax exemption and the trustee may fear accusations to that effect from the grandchildren. Precatory language in the Will making the testator's intentions clear may be helpful here.

VII. CONCLUSION.

The techniques presented in this outline are focused on delaying the ultimate decisions regarding the disposition of a client's estate until after her death. Under normal circumstances, this is not a recommended approach to estate planning. Assuming that the law stabilizes to some extent in the not so distant future, the author recommends reducing the flexibility of the typical estate plan to some extent to ensure that a client can expect her estate plan to be administered as she designed it. In the meantime, it is a disservice to clients not to try to preserve the maximum flexibility possible in her estate plan. Even if the federal law does stabilize in the not too distant future, there is no guarantee states will change their laws to conform to it. Accordingly, for planning where state decoupling is an issue, deferring the decision on whether or not to pay state estate tax is always worth considering.

"BEYOND PRIVITY:
WHERE NO KENTUCKY ESTATE PLANNING LAWYER HAS GONE BEFORE - LIABILITY TO NON-CLIENTS"

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SECTION L

"BEYOND PRIVITY: WHERE NO KENTUCKY ESTATE PLANNING LAWYER HAS GONE BEFORE - LIABILITY TO NON-CLIENTS"

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"Beyond Privity: Where No Kentucky Estate Planning Lawyer Has Gone Before – Liability to Non-Clients"©

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University of Kentucky Office of Continuing Legal Education
by

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I. Introduction

- Malpractice claims in the area of estate, probate and trust practice (including claims arising from gift and estate tax matters) ranked 7th among the 25 practice areas tracked by the ABA. See, ABA Standing Committee on Lawyers' Professional Liability, *Legal Malpractice Claims in the 1990's.*

- The estate, probate and trust practice area experienced the sixth highest increase in the number of malpractice claims during the study period. *Id.*

- More than half of the malpractice complaints involved allegations of improper "document preparation" (40%) and "legal advice." *Id.*

- Less than 1% of the complaints resulted in a judgment for the plaintiff, but an additional 21% of the complaints settled before a suit was filed and 27% more settled after the filing of a lawsuit. *Id.*

- Of the claims paid, 64% were less than $1,000; 12.4% were between $1,001 and $5,000; 6.5% were between $5,001 and $10,000; 8.1% were between $10,001 and $25,000; 4.6% were between $25,001 and $50,000; 2.7% were between $50,001 and $100,000; and 1.8% were over $100,000. *Id.*

- Sixty-one per cent (61%) of the claims were against firms with five attorneys or fewer. *Id.*

II. ***Client*** Causes of Action Available for Attorney Wrongdoing

A. Professional Negligence

1. A violation of the standard of **care** owed by an attorney to a client.

2. Elements of the cause of action:

   a. Lawyer owed a duty of care and skill to the client (privity);

b. Lawyer failed to exercise the ordinary care of a reasonably competent attorney acting in the same or similar circumstances; and

c. Lawyer's failure to exercise ordinary care and skill was the proximate cause of the damage suffered by the client. *Marrs v. Kelly*, 95 S.W.3rd 856 (Ky. 2003); *Daugherty v. Runner,* Ky.App., 581 S.W.2d 12, 16 (1978); and *Stephens v. Denison*, 64 S.W.3d 297 (Ky.App. 2001).

B. Breach of Fiduciary Duty

1. A violation of the standard of **conduct** owed by an attorney to a client (fiduciary relationship).

2. Elements of the cause of action:

a. Lawyer owed fiduciary duties to a client;

i. Loyalty

ii. Confidentiality

b. Lawyer failed to exercise the most scrupulous honor, good faith and fidelity to the plaintiff's interests (See, *Daugherty v. Runner*, 581 S.W.2d 12 (Ky. 1979); and

c. Lawyer's failure to comply with a fiduciary obligation is the proximate cause of harm suffered by the plaintiff. "The Fiduciary Obligations – In General" in Mallen & Smith, *Legal Malpractice* Ch. 14 (West 2000).

3. Irrespective of whether a breach of fiduciary duty owed to a client caused the client actual damages, the lawyer may be required to forfeit all or part of h/er fee. *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999).

C. Breach of Contract

1. A violation of an express term of the contract between an attorney and the client.

a. In *Pancake House, Inc. v. Redmond*, 716 P.2d 575 (Kan. 1986) the court held that a client could maintain an action in contract for an attorney's wrongdoing only "[w]here the act complained of is a breach of specific terms of the contract without any reference to the legal duties imposed by law upon the relationship created. . . ." See, also *Hall v. Nichols*, 400 S.E.2d 901 (W.Va. 1990).

b. Some jurisdictions imply a promise to use due care and skill in every agreement to provide legal services. *Roehl v. Ralph*, 84 S.W.2d 405 (Mo. 1935). The test used for determining professional negligence is used to determine whether a breach of such an implied promise has occurred. Mallen & Smith, *Legal Malpractice* §8.5 (West 2000).

c. In Kentucky, whether a civil action arising out of any act or omission in the rendering, or failing to render, professional services is brought in tort or contract, it is subject to the same statute of limitations (one year from the date of the occurrence or from the date when the cause of action was, or reasonably should have been, discovered). *KRS §413.245.*

2. Elements of the cause of action:

a. Lawyer undertook a specific performance obligation or warranted a particular level of performance; and

b. Lawyer did not fulfill that contractual obligation. Anderson & Steele, *Fiduciary Duty, Tort and Contract: A Primer on the Legal Malpractice Puzzle*, 47 SMU L. Rev. 235 (1994).

D. Breach of Rules of Professional Conduct

1. A violation of an ethical or disciplinary rule or statute regulating lawyer's conduct.

2. The sole method of remedying a violation of the Kentucky Rules of Professional Conduct is the imposition of disciplinary measures by the Board of Governors of the Kentucky Bar Association. The Rules of Professional Conduct do not, in and of themselves, create a private cause of action for civil liability. *Hill v. Willmott*, 561 S.W.2d 331 (Ky. 1978)

3. However, since rules of professional conduct do establish standards of conduct for lawyers, a lawyer's violation of an ethical rule may be evidence of breach of the applicable standard of conduct. *Woodruff v. Tomlin*, 616 F.2d 924 (6th Cir. 1979). Restatement Third, The Law Governing Lawyers §52 (2000).

III. Pro's and Con's of Extending Liability to Non-Clients for Wrongdoing by Estate Planning Attorneys

A. Pro's

1. Beginning almost 100 years ago, the defense of lack of privity has been rejected in almost all other areas of tort liability. See,

MacPherson v. Buick Motor Co., 217 N.Y. 382 (1916)(products liability case). It was first rejected as a defense in a professional negligence lawsuit in the estate planning context in 1961. *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961). Kentucky's highest court eliminated the privity requirement in a professional negligence lawsuit by a prospective purchaser of land against the lawyer who negligently conducted a title search for the lender-client. *Siegle v. Jasper*, 867 S.W.2d 476 (Ky. 1993).

2. Disallowing a cause of action to non-clients (intended beneficiaries or disappointed heirs) effectively results in a grant of immunity to estate planning attorneys for their wrongdoing.

   a. In all likelihood, the client will not be able to maintain a cause of action because s/he will be dead when the wrongful act or omission is discovered.

   b. If the misfeasance or malfeasance causes damage to the intended beneficiaries or disappointed heirs, but not to the client's estate (e.g., improper will execution causes the client to die intestate), then there is no cause of action to which the client's estate may succeed because the estate has suffered no damages. *Espinosa v. Sparber*, 586 So.2d 1221 (Fla.Dist.Ct. App. 1991).

3. Disallowing a cause of action to non-clients (intended will beneficiaries or disappointed heirs) violates the basic principle of tort law that losses should be allocated in accordance with the parties' negligence. *Barcelo v. Elliott*, 923 S.W.2d 575 (Tex. 1996)(Cornyn & Abbott dissenting). The innocent beneficiary bears the loss.

4. The possibility of liability to intended will beneficiaries or disappointed heirs encourages estate planning attorneys to be more careful thereby improving the quality of representation provided by estate planning lawyers. *Auric v. Continental Cas. Co.,* 331 N.W.2d 325 (Wis. 1983).

5. Estate planning lawyers are engaged in transactional work not litigation. Therefore, a different set of rules, expanding liability to some non-clients, may be appropriate. Hazard, "The Privity Requirement Reconsidered," 37 S.Tex. Law Rev. 967 (1996).

B. Con's

1. A duty of care running to the client's adversary is fundamentally at odds with the nature of the objects of legal representation. The practice of law is adversarial and injury to a non-client is often the intended outcome of the representation. Curtis, "Changing

Standards of Third-Party Liability in Estate Planning," 66 U. of Missouri-KC Law Rev. 863, 866 (1998).

2. Non-client liability would result in the imposition of indeterminate liability on estate planning lawyers thereby imposing an undue burden on the profession. Id.

3. Non-client liability creates a potential for dividing the attorney's loyalties between the client and intended will beneficiaries or disappointed heirs. *Pizel v. Suspann*, 705 P.2d 42 (Kan. 1990).

4. Non-client beneficiaries and heirs become hidden participants in the attorney-client relationship even though their interests may not be co-terminus with the testator's interests. Fogel, "Estate Planning Malpractice," 17 Prop. & Prob. Journal 20 (July/Aug. 2003).

5. Potential liability to non-client beneficiaries and heirs creates a perverse incentive for attorneys to propose estate plans that are most beneficial to the beneficiaries. Id.

IV. **Non-Client** Causes of Action for Attorney Wrongdoing

A. Professional Negligence

1. Majority Rule - Privity Not Required

i. See cases collected in "What Constitutes Negligence Sufficient to Render Attorney Liable to Person Other That Immediate Client," 61 A.L.R.4th 464 (2004); and Mallen & Smith, 4 Legal Malpractice §32.4, n. 15 (2000).

ii. Multi-factor Balancing Test Approach – *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961), *cert. denied*, 368 U.S. 987 (1962)

a) the extent to which the transaction was intended to affect the plaintiff;

b) the foreseeability of harm to the plaintiff;

c) the degree of certainty the plaintiff suffered injury; and

d) the policy of preventing future harm.

iii. Florida-Iowa Rule – *Espinosa v. Sparber, Shevin, Shapo, Rosen & Heilbronner*, 612 So.2d 1378 (Fla. 1993) and *Schreiner v. Scoville*, 410 N.W.2d 679 (Iowa 1987).

a) A non-client has a cause of action only if the testator's intent as expressed in the will is thwarted by the attorney's professional negligence.

b) Only execution errors are actionable.

c) Followed in Michigan and Colorado. See, *Miera v. DeBona*, 550 N.W.2d 202 (Mich. 1996) and *Glover v. Southard*, 894 P.2 21 (Colo.Ct.App. 1994).

d) Rationale: The rule is consistent with generally applicable rules that prohibit the introduction of extrinsic evidence to vary the intention of the testator as expressed within the 4-corners of the will.

2. Minority – Strict Privity Required

i. Alabama – *Peterson v. Anderson*, 719 So.2d 216 (Ala.App. 1997)(action by residuary beneficiaries alleging breach of fiduciary duty owed by attorney to testator based on claims that testator lacked testamentary capacity and was under undue influence of others at time of will execution).

ii. Maryland – *Noble v. Bruce*, 709 A.2d 164 (Md. 1998)(action by disappointed will beneficiary who lost a will gift because an heir successfully challenged the will on the grounds of undue influence and lack of testamentary capacity).

iii. Nebraska – *Lilyhorn v. Dier*, 335 N.W.2d 554 (Neb. 1983)(action by disappointed will beneficiary who was left a devise of land in which testator had only a life estate); and *St. Mary's Church v. Tomek*, 325 N.W.2d 164 (1982)(action by disappointed will beneficiary who did not receive the entire residuary estate because the residuary clause was ambiguous).

iv. New York – *Viscardi v. Lerner*, 510 N.Y.S.2d 183 (App.Div.2d 1986)(action by disappointed residuary beneficiary who received nothing because of a will provision granting the entire estate to the testator's wife).

v. Ohio – *Simon v. Zipperstein*, 512 N.E.2d 636 (Ohio 1987)(action by disappointed will beneficiary who received a smaller bequest when the surviving spouse was permitted to take under both an antenuptial agreement and a will provision that did not expressly state that it was in satisfaction of the antenuptial agreement).

vi. Texas - *Guest v. Cochran*, 993 S.W.2d 397 (Tex.App. 1999)(action by disappointed will beneficiaries who received a smaller inheritance because the will did not employ certain available tax saving mechanisms).

vii. Virginia – *Copenhaver v. Rogers*, 384 S.E.2d 593 (Va. 1989)(action by disappointed will beneficiaries who received a small inheritance because of allegedly negligent tax advice given by attorney to their grandparents)

3. Restatement (Third), The Law Governing Lawyers §51 (West 2000).

i. Section 51(3) - A lawyer owes a duty to use due care to a non-client when and to the extent that:

a) The lawyer knows that a client intends as one of the primary objectives of the representation that the lawyer's services benefit the non-client;

b) Such a duty would not significantly impair the lawyer's performance of obligations to the client; and

c) The absence of such duty would make enforcement of those obligations to the client unlikely.

ii. Comment *f* – Non-client claiming a different intent than one actually expressed in the will.

a) Non-client must meet a higher level of proof to be successful.

b) Non-client must produce "clear and convincing" evidence that the attorney's client communicated to the attorney an intent that is different than the one actually expressed in the will.

iii. If an attorney is held liable to a non-client as outlined above, the Restatement suggests that "applicable principles of law may provide that Lawyer may recover from the unintended recipients the estate assets that should have gone to Nonclient." Id. at 362.

B. Breach of Contract – Third Party Beneficiary Theory

1. A few states create an exception to the no-cause-of-action-because-of-lack-of-privity rule for a non-client who qualifies as a third-party beneficiary of the contract of representation between

the attorney and the client. See, e.g., *McLane v. Russell*, 546 N.E.2d 499 (Ill. 1989); *Hale v. Groce*, 744 P.2d 1289 (Or. 1987); and *Guy v. Liederbach*, 459 A.2d 744 (Pa. 1983).

2. If "the primary or direct purpose" of the attorney-client contract was to benefit the non-client, the non-client may recover damages from the attorney for breach of the implied promise to use reasonable care and skill. *Pelham v. Griesheimer*, 440 N.E.2d 96 (Ill. 1982).

3. The multi-factor balancing test, *supra* at IV.A.1.ii., and the third party beneficiary test are practically indistinguishable because the primary focus of inquiry is on the testator's purpose for entering into an attorney-client relationship. *Trask v. Butler*, 872 P.2d 1080 (Wash. 1994).

C. Breach of Fiduciary Duty

1. The erosion or elimination of the privity requirement resulting in liability for estate planning lawyers to non-clients for professional negligence and/or breach of contract has not resulted in the creation of a cause of action for non-clients based on alleged breaches of fiduciary obligations owed by the attorney to the client. Mallen & Smith, 2 Legal Malpractice §14.3 (5th ed. 2000). See, also, Restatment (3rd), The Law Governing Lawyers §§48 – 51. (West 2000)

2. To hold otherwise could interfere with the attorney's performance of the fiduciary duties that the attorney owes to the client in order to avoid liability to a non-client. See, *American Continental Insurance Co. v. Weber & Rose*, 997 S.W.2d 12 (Ky.App. 1999).

D. Breach of Rules of Professional Conduct

1. Violation of an ethics rule by an attorney does not create a private cause of action for the client. *Supra* at II. D.

2. Therefore, a breach of a disciplinary rule does not create a private cause of action for a non-client.

V. Kentucky Cases Concerning Attorney Liability to **Non-Clients**

A. *Williams v. Osborne*, 2003 WL 22927708 (Ky.App. 2003)(unpublished).

1. Father, who posted bail for his son, sued son's attorney for breach of contract, negligence, negligent misrepresentation, fraud, and breach of fiduciary duty in defending the son.

2. As the attorney-client relationship existed only between the son and his attorney, the father's complaint was dismissed. He could not predicate a cause of action based on alleged breaches of duties owed by the attorney to his son.

B. *American Continental Insurance Co. v. Weber & Rose*, 997 S.W.2d 12 (Ky.App. 1999).

1. Excess liability insurer could not recover for the alleged professional negligence of an attorney who represented the insured based upon the theory of equitable subrogation.

2. The Court found that recognizing a direct duty owed by the insured's attorney to the excess insurer would be "tantamount to saying that insurance defense attorneys do not owe their duty of loyalty and zealous representation to the insured client alone." Id. at 14 (quoting *American Employers' Insurance Co. v. Medical Protective Co.*, 419 N.W.2d 447 (1987)).

3. The Court also rejected the insurer's argument that it was intended to benefit from the attorney's services.

C. *Seigel v. Jasper*, 867 S.W.2d 476 (Ky.App. 1993).

1. Property purchasers who paid the lender's attorney to prepare a title examination could maintain a cause of action for alleged professional negligence of the attorney in its preparation.

2. The Court acknowledged that there were no published Kentucky cases concerning an attorney's liability to parties who did not stand in privity of contract with a title abstractor.

3. In finding that the abstractor's duty to exercise ordinary care in the performance of the title examination extended to the purchasers, the Court accepted the holding in *First American Title Insurance Co. v. First Title Service Co.*, 457 So.2d 467, 473 (Fl. 1984) that: "Where the abstractor knows, or should know that his customer wants the abstract for the use of a prospective purchaser, and the prospect purchases the land relying on the abstract, the abstractor's duty of care runs . . . not only to his [*sic*] customer but to the purchaser. Moreover, others involved in the transaction through their relationship to the purchaser – such as lender-mortgagees, tenants and title insurers - will also be protected where the purchaser's reliance was known or should have been known to the abstracter. But a party into whose hands the abstract falls in connection with a subsequent transaction is not among those to whom the abstracter owes a duty of care."

D. *Hill v. Willmott*, 561 S.W.2d 331 (Ky. 1978).

1. The Court expressly stated that Kentucky's law is accurately summarized in *Donald v. Garry*, 97 Cal.Rptr. 191 (Cal. 191), that: "An attorney may be liable for damage caused by his [*sic*] negligence to a person intended to be benefited by his [*sic*] performance irrespective of any lack of privity . . . ."

2. However, the trial court's dismissal of the action by a non-client physician against an attorney alleging that the lawyer was negligent in instituting a malpractice action against the physician on behalf of the attorney's client was sustained. The Court found that the physician was not the intended beneficiary of the attorney's services.

3. The Court also held that an alleged violation by the attorney of a rule of professional responsibility could not provide an independent basis for a finding that the attorney owed a "duty" to the non-client physician. The sole remedy for unethical conduct is the imposition of disciplinary measures by the Board of Governors of the Kentucky Bar Association.

4. The Court stated that the non-client physician could only attempt to vindicate the alleged wrong by bringing an action for malicious prosecution against the attorney.

E. *Rose v. Davis*, 157 S.W.2d 284 (Ky. 1941).

1. The non-client plaintiff sued the attorney who represent his wife in a divorce proceeding to recover the amount the plaintiff had paid as alimony pursuant to judgment granting the husband and wife a divorce from bed and board. That judgment was reversed on appeal on the grounds that the marriage was bigamous and void as the "wife" had a living husband at the time of her purported marriage to plaintiff.

2. In affirming the trial court's decision dismissing the non-client's lawsuit, the Court said: "An attorney is not ordinarily liable to third persons for his acts committed in representing a client. It is only where his acts are fraudulent or tortuous and result in injury to third persons that he is liable."

3. The Court reasoned that to hold an attorney responsible for the damages caused by an erroneous judicial order obtained by the attorney without fraud or malice "would make the practice of law one of such financial hazard that few men [*sic*] would care to incur the risk of its practice."

NB: *Sparks v. Craft*, 75 F.3d 257 (6th Cir. 1996)

1. The mother of a motorist who died in an automobile accident had standing to bring a professional negligence action, in her individual capacity, against the attorney who allowed the statute of limitations to run on the child's estate's cause of action against the other driver.

2. Despite stating that Kentucky does not have a privity requirement for legal malpractice actions, the Court's holding was predicated on its finding that the mother, individually, and the son's estate were both clients of the attorney.

VI. Aphorisms for Avoiding Liability to Non-Clients (as well as to Clients)[1]

A. Don't Be A Know-It-All

1. Estate, trust and probate law is commonly recognized as a specialty area of practice. An attorney should know and respect the limits of h/er legal knowledge.

2. An attorney who engages in estate planning (even for so-called "small" estates) must be knowledgeable about the laws concerning wills, property, future interests, trust, probate and taxation. These laws vary widely from state to state.

3. The lawyer's knowledge of the relevant law must be complemented by strong drafting skills.

4. Clients with issues outside of the attorney's area of expertise should be referred to a lawyer with the appropriate degree of knowledge and level of skill.

B. If You Sleep, You'll Weep

1. Attorneys have an almost absolute responsibility to education themselves about legal propositions that are considered settled. See, *Berman v. Rubin*, 227 S.E.2d 802 (Ga.App. 1976).

2. A legal proposition is considered settled if it is clearly defined and published so that it is generally known to the profession. *Id*.

3. A principle is generally known to the legal profession if it can be found in textbooks, published court decisions, statutes, or in general legal literature. *Hill v. Mynatt*, 59 S.W. 163 (Tenn.Ch.App. 1900).

[1] See, Pennell, "Ethics, Professionalism, and Malpractice Issues in Estate Planning and Administration," SHO92 ALI-ABA Course of Study 1063 (2003); and Fogel, "Estate Planning Malpractice, 17 Prop. & Prob. Journal 20 (July/Aug. 2003).

4. Attorneys practicing in the area of estate planning must regularly update their knowledge base.

C. By The Book

1. Establish (and follow) procedures for recurring matters such as client in-take, conflicts checks, engagement letters, communications to and from client, will execution ritual, etc..

2. A will should be executed in a form that satisfies the most stringent execution requirement even if the state has a laxer one. For example, even though the jurisdiction only requires the testator to "sign" the will, the testator's signature should be affixed at the "end" of the will.

3. All wills should be made self-proving.

4. After execution, review the document one more time. A mistake detected while the testator is still alive may be embarrassing to admit, but it can be remedied.

D. Haste Makes Waste

1. Don't wait until the last minute to draft a client's will, trust and/or other estate planning documents.

2. Provide a draft to your client for review prior to meeting to discuss it.

3. Proofread all documents prior to execution to guard against errors caused by malfunctioning technology (e.g., printer error that causes the omission of an sentence, paragraph or page).

E. Things Aren't Always As They Seem

1. If possible, have another attorney review the final draft of a will, trust or other estate planning document (e.g., antenuptial agreement) to determine if it actually says what the drafter intended it to say. This is particularly important if the document contains any unusual or complex provisions.

2. If review by another attorney isn't possible, put the draft aside for a sufficient period of time so that the drafter can return to it with a fresh set of eyes.

3. Check the final draft against the notes during meetings (in-person, over the phone or by e-mail) with the client to insure that all of the client's directions have been included in the document.

4. Make sure that the terms of the document cover all the possible ways that events can play out. For example, if the survivorship is required to a particular point in time, include an alternative disposition in case the requirement is not met.

5. Check, and check again, that all documents relevant to the client's estate plan are integrated and compatible so that provisions in one do not contradict provisions in another.

F. No Will Has a Sibling, Let Alone A Twin

1. Don't just copy, cut and paste to create an estate planning document.

2. All material from outside sources (e.g., firm forms, other wills, practice guides) should be tailored to accomplish the particular client's objectives.

3. Pay attention to the words used in the source document. For example, the words "children" and "issue" are not synonymous.

4. If you don't know the purpose of a provision that appears in another document, don't include it in the one you're drafting.

G. First-In-Time Doesn't Necessarily Make It Right

1. Proposals of new methods for avoiding or reducing tax liability should be viewed with some degree of skepticism.

2. Initial explanations of the meaning of recently enacted changes in any body of law (but, particularly tax law) should be taken with a grain of salt.

H. Mark a Trail with Bread Crumbs

1. Document, document, document.

2. When taking notes concerning the client's intentions, make sure the notes clearly indicate the final (as opposed to tentative) instructions of the client.

3. Communicate in writing with your client explaining the proposed estate plan. The degree of detail and depth of explanation should be determined in light of the circumstances of the particular client.

4. Use a protective letter to confirm the choices actually made by the client.

I. Play Well With Others

1. Don't forget this lesson taught in kindergarten.

2. Attorneys who are prompt in the delivery of their services as well as responsive and polite to their clients are less likely to be sued for professional negligence that those attorneys who are not.