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14th ANNUAL
SEMINAR
ON

ESTATE PLANNING

JULY 17-18, 1987

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14th ANNUAL SEMINAR ON

ESTATE PLANNING

JULY 17-18, 1987

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

In Cooperation with the
KENTUCKY BAR ASSOCIATION

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The University of Kentucky, College of Law, Office of Continuing Legal Education, was organized in Fall of 1973, as the first permanently staffed, full-time continuing legal education program in the Commonwealth of Kentucky. It endures with the threefold purpose of assisting Kentucky lawyers: to keep abreast of changes in the law resulting from statutory enactments, court decisions and administrative rulings; to develop and sustain practical lawyering and litigation skills; and to maintain a high degree of professional competence in the various areas of the practice of law.

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PROGRAM

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Friday, July 17, 1987

- 8:00 a.m. **LATE REGISTRATION**, Main Courtroom, College of Law
- 8:55 a.m. **WELCOME REMARKS**, Todd B. Eberle, Associate Dean and Director of Continuing Legal Education, University of Kentucky, College of Law.
- 9:00 a.m. **REVIEW OF RECENT CASES AND RULINGS WITH ESTATE PLANNING IMPACT**, John R. Cummins, Greenebaum Doll and McDonald, Louisville, Kentucky.
- 9:50 a.m. **ESTATE PLANNING FOR THE S CORPORATION**, Sheldon G. Gilman, Lynch, Cox & Gilman, P.S.C., Louisville, Kentucky.
- 10:40 a.m. **COFFEE BREAK**
- 10:55 a.m. **REPRESENTING THE AGING AND INCAPACITATED CLIENT**, Homer J. Parrent, Parrent and Parrent, Louisville, Kentucky
- 11:45 a.m. **ESTATE PLANNING FOR RETIREMENT AND RETIREES**, Edward A. Rothschild, Washer, Kaplan, Rothschild, Aberson and Miller, Louisville, Kentucky.
- 12:35 p.m. **LUNCH ON YOUR OWN**
- 2:00 p.m. **ESTATE PLANNING TECHNIQUES FOR GENERATION SKIPPING TRANSFERS**, William F. Rigsby, Bulleit, Kinkead, Irvin and Reinhardt, Lexington, Kentucky.
- 2:50 p.m. **CHARITABLE GIVING IN ESTATE PLANNING**, K. Sidney Neuman, Buchanon Ingersoll, Pittsburg, Pennsylvania.
- 3:40 p.m. **BREAK**
- 3:55 p.m. **POST MORTEM ESTATE PLANNING UNDER THE 1986 INTERNAL REVENUE CODE**, John T. Bondurant, Brown, Todd and Heyburn, Louisville, Kentucky.
- 4:45 p.m. **ADJOURN**

Saturday, July 18, 1987

9:00 a.m. **CONFLICTING INTERESTS IN REPRESENTATION OF ESTATE PLANNING CLIENTS,** Gary B. Houston, Whitlow, Roberts, Houston and Russell, Paducah, Kentucky.

9:50 a.m. **FORMS OF HOLDING AND METHODS OF ACQUIRING TITLE,** James Bremer, Glassie, Pewett, Dudley, Beebe and Shanks, Washington, D.C.

10:40 a.m. **BREAK**

10:55 a.m. **INSURANCE PRODUCTS UNDER TAX REFORM AND DEVELOPMENTS IN IRREVOCABLE LIFE INSURANCE TRUSTS,** Daniel B. Santos, CLU, New York Life, Louisville, Kentucky.

11:45 a.m. **ADJOURN**

REVIEW OF
RECENT DEVELOPMENTS IN ESTATE PLANNING

By

John R. Cummins
Greenebaum Doll & McDonald
Louisville, Kentucky

Section A

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The author wishes to acknowledge the substantial contributions of Turney P. Berry in compiling this outline.

I. TAX REFORM ACT OF 1986

A. Income Taxation of Trusts and Estates

1. General Rules

The Act revises the tax rate schedules for nongrantor trusts and estates. For taxable years commencing after December 31, 1986, all trusts and estates (including existing trusts and estates) are subject to rate brackets which are compressed when compared with individual rate brackets. Under the revised rates, the first $5,000 of taxable income of trust will be taxed at 15 percent. Taxable trust income over $5,000 will be taxed at 28 percent. The maximum annual benefit available from having income taxed to a trust or estate is, therefore, $5,000 times 13%, which is $650.

In addition, the benefit of the low 15% bracket is phased out as taxable income increases from $13,000 to $26,000. This is done through an additional 5% tax on taxable income above $13,000 and below $26,000.

The income tax schedule for estates and trusts for 1987 has 5 brackets, as follows:

If taxable income is--

Not over $500	11% of taxable income
Over $500 but not over $4,700	$55 plus 15% of the excess over $500
Over $4,700 but not over $7,550	$685 plus 28% of the excess over $4,700
Over $7,550 but not over $15,150	$1,483 plus 35% of the excess over $7,550
Over $15,150	$4,143 plus 38.5% of the excess over $15,150

The compressed rate brackets reduce the benefits of estate and trust accumulations substantially, but "trapping" strategies to split income among an estate and

its trust beneficiaries may still prove worthwhile. The compressed brackets were proposed by the ABA as a simple alternative to proposals for radical Subchapter J reform.

Neither estates nor trusts have a zero bracket amount or a standard deduction. Estates are entitled to a deduction of $600. Trusts which must distribute all of their income currently are entitled to a $300 deduction and all other trusts are entitled to a $100 deduction. An unlimited charitable deduction is available.

No intentional changes were made in the taxation of distributions to beneficiaries. There was some question whether the 2% floor on deductible expenses applied to the distribution deduction; the 1987 Technical Corrections Bill would clarify that the distribution deduction is not subject to the 2% floor. Thus, distributions to beneficiaries will continue to be taxed to beneficiaries and deducted by the trust, to the extent of the distributable net income (DNI) of the trust. DNI is allocated first to distributions required to be made from income for the year, and second to distributions made to charity from the trust income, and finally to other distributions.

Accumulation distribution rules (or "throwback rules") are still applied, without change, to the taxation of beneficiaries of a trust where the trust distributes income, excluding capital gain, that had been taxed previously to the trust.

No change is made in the taxation of multiple trusts. For federal income tax purposes, two or more trusts will be treated as one trust if either of those trusts has substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries or a principal purpose of such trust is the avoidance of federal income tax.

2. **Taxable Years of Trusts**

Under the Act, all trusts, including existing trusts, must use a calendar taxable year, commencing with

taxable years beginning after December 31, 1986, except for tax-exempt trusts under Section 501(a) and wholly-charitable trusts under Section 4947(a)(1). The Kentucky Revenue Cabinet has advised that this change will be effective for Kentucky trusts, without legislative action, because Kentucky income tax law requires taxpayers to report income on the same calendar or fiscal year as required for federal income tax purposes. See 6 Kentucky Tax Alert 2 (Feb. 1987).

So, for example, if a trust has used a June 30 fiscal year, it will now file a return for July 1, 1986 through June 30, 1987 and will be required to file a second return for July 1, 1987 through December 31, 1987. Thereafter, the trust tax year will be the calendar year.

There is a transition rule in the new Act which allows a trust beneficiary to include distributions of current income from the trust during its short year in his gross income in equal amounts over four taxable year periods beginning with 1987. This rule does not apply to income retained by and taxed to trusts during the second, short 1987 tax year, nor does it apply to accumulation distributions made during the short year, nor does it apply in the final trust year.

An important note is that estates may continue to use taxable periods other than the calendar year. Thus, deferral possibilities remain. Estates can choose January as a fiscal year and achieve deferred taxation with "trapping" distributions of principal to trusts on a calendar year.

3. **Trusts and Estates Required To Make Estimated Income Tax Payments.**

Estimated tax payments are required by all trusts and estates for taxable years commencing after December 31, 1986 except that estates are exempt from estimated tax requirements for their first two taxable years. In addition, the Act repealed Section 6152 which allowed an estate to pay its income tax in four installments beginning with the due date of the return, for taxable years beginning after December 31, 1986.

Trustees may assign any amounts of a trust's quarterly payments to the beneficiaries in <u>any</u> manner the trustee chooses. This election may only be made on a tax return of the trust filed within 65 days of the close of the trust's taxable year. If the election is made, the amount of the credits assigned to the beneficiaries will be considered a distribution under the 65-day rule of Section 663, so that the beneficiaries will be deemed to have received the distribution on the last day of the trust's taxable year. The amount deemed distributed should not be treated as a payment of the trust's estimated tax, but rather will be treated as a payment of the beneficiary's estimated tax on January 15th following the tax year. This election will be available only to the extent that the trust's total estimated tax payments for the year exceeds its own tax liability. Nevertheless, the Committee report indicates that the recipient beneficiaries will still treat the credits as received at the time the election is made for purposes of computing their estimated taxes.

4. **Grantor Trust Rules Revised.**

Clifford trusts and spousal remainder trusts are abolished by the new Act, for all practical purposes. Section 673, which applies to reversionary interests, is amended by the Act to treat the grantor as the owner of any portion of a trust in which the grantor has a reversionary interest, in either corpus or income, if at the inception of the trust the value of such interest exceeds 5% of the value of the trust. There is an exception if the trust is for a descendant of the grantor and if the reversionary interest takes effect on the death of the beneficiary before the beneficiary attains age 21. The revised Section 673 applies to transfers made to trusts after March 1, 1986.

Section 672 was also amended by the Act. If a grantor's spouse is living with the grantor at the time of the creation of any power or interest in the spouse, the grantor is treated as holding such power or interest. A

person is treated as a spouse of the grantor who is living with the grantor if that person and the grantor are eligible to file a joint return with respect to the period in which the transfer is made. The status of a person holding a power or interest as a spouse of the grantor with whom the grantor is living is to be determined at the time of the transfer of the property to the trust. This change applies to transfers and trusts made after March 1, 1986 as well.

5. **Administration Expenses and Other Deductions.**

Individuals are now subject to a 2% floor on miscellaneous deductions. Trusts and estates are not subject to this limitation as to expenses which would not have been incurred except for the existence of the trust or estate. Administration expenses, for example, legal fees, executor's and trustee's commissions, should continue to be deductible by the estate or trust in computing its taxable income.

A fully revocable trust will be ignored for income tax purposes and the 2% limitation for individuals will apply. If a trust beneficiary has a limited power of withdrawal and is taxed on a part of the trust income under Section 678, the 2% limitation may apply but the result is unclear at this time. The 1987 Technical Corrections bill clarifies that the Section 642(c) charitable deduction is not subject to the 2% limitation.

6. **Passive Activity Rules.**

a. Estates and trusts subject at entity level--not "pass through" level.

b. Material participation for a trust must be by the trustee or fiduciary; material participation for an estate must be by the executor or administrator.

c. The special $25,000 rental activity loss rule is applicable to estates for their first two tax years if the decedent actively participated.

d. Effective for tax years beginning after December 31, 1986.

7. **Planning Points for Estate and Trust Income Taxation.**

(a) Some commentators believe that, trustees will have to file federal trust income tax returns, and pay the tax, for the short taxable year ending December 31, 1987 in accordance with Section 443, dealing with returns for a period of less than 12 months when the taxpayer changes his annual accounting period with IRS approval. The Section is not clearly applicable, however, because in the literal sense a trustee will change the taxable year of trust not with IRS approval but as a result of a change in the tax law.

(b) The transition rule that allows a beneficiary who must include in his gross income in the first taxable year beginning after 1986 amounts of DNI attributable to the trusts short taxable year ending December 31, 1987 to include such amounts ratably over a four-year period commencing with the beneficiary's first taxable year beginning after 1986 is not elective. It applies only to distributions of the trust's DNI for the short taxable year ending December 31, 1987 and does not apply to any accumulation distributions occurring during the short taxable year. Because any accumulation distributions made by the trusts to the beneficiary during the short taxable year would not qualify for the four-year spread under the transition rule, they will be taxable to the beneficiary in 1987 under the throw-back rules.

(c) Most likely, the trustee should consider maximizing the trust's DNI for the short taxable year ending December 31, 1987 in order to maximize the amount qualifying for the four-year spread. DNI for the short taxable year may be maximized, to the extent possible, by deferring income from the full fiscal taxable year ending in 1987 to the short taxable year and by accelerating deductions from the short taxable year to the full fiscal taxable year ending in 1987. Likewise, to the extent possible, income should be accelerated from the 1988 taxable year to the short taxable year ending December 31, 1987 and deductions should be deferred from the short taxable year to the 1988 taxable year.

(d) The trustee should consider distributing the entire short year DNI in order to maximize the amount qualifying for the beneficiaries four-year spread. If the trustee has discretion as to the amount of income to be distributed among beneficiaries in different income tax brackets, the trustee should consider maximizing distributions during the short year to high bracket beneficiaries, because they will realize greater tax benefits under the transition rule than low bracket beneficiaries.

(e) If the trustee contemplates terminating the trust and distributing the trust property during 1987, he should consider delaying such action until 1988, if that is acceptable from a non-tax standpoint. DNI distributed to a beneficiary during the short year ending December 31, 1987 on account of the termination of the trust will not qualify for the four-year spread.

(f) If a testamentary or non-grantor trust was funded in 1986, the trustee should consider adopting, on the trust's first income tax return, a fiscal taxable year beginning in 1986 and ending in 1987 in order to allow the beneficiaries of the trust to take advantage of the four-year spread with respect to distributions of short year DNI. This is a good strategy despite the fact that the trust must comply with the calendar taxable year requirement with respect to its first taxable year beginning after 1986.

(g) Using a funded inter vivos trust may present income tax disadvantages if the grantor-beneficiary dies after 1986. The inter vivos trust must adopt a calendar taxable year upon the death of a grantor-beneficiary and thus will be unable to achieve the same deferral of income tax at the beneficiary level as an estate could achieve.

(h) Funded inter vivos trusts which are used to avoid probate upon the death of the grantor-beneficiary will not benefit from the two-year exception from the estimated tax rules available to estates. Only estates receive the two-year deferral.

(i) An important point concerning estimated taxes is that trusts and estates are, technically, not required to make estimated tax payments. Rather, the rules subject trusts and estates to penalties for underpayment of estimated income taxes unless the amount of each "required installment" is 25% of the "required annual payment." With respect to calendar year taxpayers, the "required installments" are due April 15, June 15 and September 15 of the taxable year and January 15 of the following taxable year. The "required annual payment" is the lesser of (i) 90% of the tax shown on the current year's return (or, if no return is filed, 90% of the tax for the current year) (the "90% safe harbor rule,") (increased from 80% by the new Act), or (ii) 100% of the tax shown on the previous year's return, if a return was filed for the previous taxable year and such year consisted of 12 months (the "100% safe harbor rule").

(j) Section 6654(d)(2) provides an alternative method of computing each required installment which is known as the annualized income method. This method may be used if it results in a lower required installment than either the 90% or 100% safe harbor rules. Under the method, the fiduciary determines the annualized income installment for the installment periods set forth above by annualizing taxable income for the months ending before the installment due date, computing the tax on the annualized taxable income, and paying certain percentages of such tax, less any installment payments previously made. The percentages are: 22.5% for the first installment payment, 45% for the second, 67.5% for the third and 90% for the fourth.

(k) Internal Revenue Service Notice 87-32, I.R.B. 1987-17, provides that, until further guidance is given, trusts and estates should not consider alternative minimum taxable income for purposes of complying with the estimated tax rulings. Further, the Notice states that the Service will waive the penalty for underpayment of estimated tax for installments due before July 1, 1987 if the fiduciary computes

the required installments under either the 90% safe harbor rule or the annualized income method, and if the fiduciary makes a good faith effort to determine accurately the amount of the required installment and timely pays the amount of the installment. Note also that the Service has released the 1987 Form 1041-ES, Estimated Income Tax for Fiduciaries.

(l) Notice 87-32 describes how a fiduciary may use the 100% safe harbor rule to compute the minimum required estimated tax payments for both the short taxable year ending December 31, 1987 and the 1988 taxable year. For the short year ending December 31, 1987, the fiduciary may compute the required annual payment by dividing by 12 the tax shown on the return for the preceding taxable year and multiplying the resulting quotient by the number of months in the short taxable year. An exception to the general rule is that the 100% safe harbor rule may not be used if the preceding taxable year consisted of fewer than 12 months. A trust with a short taxable year ending December 31, 1987 may use the 100% safe harbor rule for the 1988 taxable year if the short year was preceded by a taxable year of 12 months. The tax shown on the return for the short year ending December 31, 1987 is increased for this purpose by dividing the tax by the number of months in the short year and multiplying the resulting quotient by twelve.

(m) No provision in the new Act requires the trustee to assign the excess estimated tax payments to trust beneficiaries in the same proportions as income was distributed. In fact, neither the new Act nor the Conference Report addresses this issue.

B. **Income of Minor Children**

New Section 1(j) of the Act taxes the "net unearned income" of a child under age 14 at the parent's tax rate, even if the child received the money or other property before 1987.

Children Under the Age of 14. Net unearned income, including income derived from gifts made prior to 1987, will

be taxed at the child's parent's rate for regular income tax purposes, and, under the 1987 Technical Corrections bill, for alternative minimum tax purposes as well. The minimum tax is computed on the sum of the child's unearned alternative minimum taxable income and the parents'; if the alternative minimum tax computed on this sum exceeds the sum of the child's and the parents' regular tax, the minimum tax is the excess. Wages and other earned income are exempt from these under-14 rules.

Child age 14 or over. Generally, all income, earned or unearned, is taxed at the child's rate.

The new rules apply if the child has not attained age 14 prior to the close of the tax year and either parent of the child is alive at the close of the tax year.

Calculation of tax. The tax equals the greater of: (1) the tax that would be imposed on the child's income if there were no special rules concerning the child's unearned income; or (2) the sum of the tax that would be payable if the child had not received unearned income and the child's share of the parental-source tax. The definition of Net Unearned Income is the child's unearned income minus the sum of $500 and the greater of $500 of standard deduction or $500 of itemized deductions, or the deductions allowed the child that are directly connected with the production of the child's income. Thus, in general, the child will be taxed on unearned income in excess of $1,000.

These examples were taken from the General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation.

Example 1: If the child has $400 of unearned income and no earned income, the child's standard deduction is $400 which is allocated against the child's unearned income so that the child has no federal income tax liability.

Example 2: If the child has $900 of unearned income and no earned income, the child's standard deduction is $500 which is allocated against the first $500 of unearned

income. The child's remaining unearned income is $400. Because the child's net unearned income is less than $500, the remaining unearned income is taxed at the child's rate.

Example 3: If a child has $1,300 of unearned income and no earned income, the child's standard deduction is $500, which is allocated against unearned income. The child's remaining unearned income is equal to $800 of which the first $500 is taxed at the child's rate, and the remaining $300 of unearned income is taxed at the top rate of the parents.

Example 4: If a child has $700 of earned income and $300 of unearned income, the child's standard deduction is $700 of which $300 is allocated against unearned income and $400 allocated against earned income. The child has no net unearned income and the remaining $300 of earned income is taxed at the child's rate.

Example 5: If a child has $800 of earned income and $900 of unearned income, the child's standard deduction is $800 of which $500 is allocated against unearned income and $300 is allocated against earned income. The child's remaining unearned income is $400. Because net unearned income is less than $500, the child's remaining unearned income is taxed at the child's rate. The remaining $500 of earned income is also taxed at the child's rate.

Example 6: Assume a child has $300 of earned income and $1,200 of unearned income, and itemized deductions of $400 (net of the 2% floor) which are directly connected with the production of the unearned income. The child has $400 of other deductions. Because the deductions directly connected with the production of the unearned income ($400) are less than the maximum amount of deductions ($500) which are allocated against unearned income, $500 of the $800 total deductions are allocated against unearned income. Therefore, the child's remaining unearned income is $700 ($1,200 of unearned income less $500) of which $500 is taxed at the child's rate and $200 is taxed at the parent's rate.

Example 7: Assume a child has $700 of earned income and $3,000 of unearned income, and itemized deductions of $800 (net of the 2% floor) which are directly connected with the production of the unearned income. The child has $200 of other deductions. The entire amount of deductions related to the production of unearned income is allocated against his unearned income, because this amount ($800) exceeds $500. Therefore, the child's remaining unearned income is equal to $2,200 ($3,000 of unearned income minus $800) of which $500 is taxed at the child's rate and $1,700 at the parent's top rate. The child has $200 of deductions which are allocated against earned income. The remaining $500 of earned income is taxed at the child's rate.

These new provisions are effective for taxable years beginning after February 22, 1986.

C. **Excise Tax on Excess Qualified Plan Distributions**

The Tax Reform Act of 1986 contains two amendments to employee benefit provisions that will have a significant impact on estate planners. The first amendment is that Section 1122 of the Act repeals capital gains treatment and changes ten-year forwarding averaging to five-year forwarding averaging.

Second, and more important for estate planning purposes, Section 1153 of the Act added a new section to the Internal Revenue Code. That section is Section 4981 (there was already another section by that number, therefore, this provision will most likely be redesignated as Section 4981A and it will be referred to by that designation here) which imposes a 15% excise tax on "excess distributions" from qualified retirement plans.

Generally, the rule applies an excise tax during life on distributions in excess of $112,500 (indexed for inflation) or $150,000 on a calendar year basis. However, Section 4981A(c)(5) allows the taxpayer to elect to grandfather amounts accumulated on August 1, 1986, in which event the annual limit is $112,500 (indexed for inflation). This

election must be made on an income tax return for 1987 or 1988.

As a deathtime equivalent of the excess distribution tax, Section 4981A(d) states that the estate tax imposed under Chapter 11 "shall be increased by an amount equal to 15% of the individual's excess retirement accumulation." Thereafter, the excess distribution tax does not apply. The "excess retirement accumulation" is the excess of all qualified retirement plan interests that are includible for federal estate tax purposes, over the discounted present value of an annual annuity of $150,000, payable for the life expectancy of the decedent, as computed immediately prior to the decedent's death. The annual annuity is presumably the greater of $112,500 (indexed for inflation) or $150,000 if the grandfather election is not made, and $112,500 (indexed for inflation) if the grandfather election is made. Presumably, the Section 72 life expectancy tables will be used and a 10% discount factor will be applied in making this computation; however, neither is specified.

No unified credit is available, nor is any charitable or marital deduction allowed, to reduce or eliminate the supplemental estate tax. However, the 1987 Technical Corrections Bill will permit a surviving spouse to elect to avoid the tax at the participant's death; if the election is made, the spouse remains subject to the excess distribution tax during lifetime and, perhaps, the excess retirement accumulation tax at his or her own death. Therefore, absent the spousal election, this supplemental estate tax must actually be paid and there will be no right of reimbursement permitted to the decedent's personal representative to collect taxes imposed on these benefits from the recipient beneficiary. The 1987 Technical Corrctions Bill does specify that an IRD deduction is allowed under Section 691 for the supplemental estate tax.

This provision is applicable to estates of decedents dying after December 31, 1986. As a planning point, it may

be better to incur the tax during life, in order to reduce the decedent's estate by the income taxes paid during life. The liability certainly affects marital deduction planning because "reduce to zero" formula marital deduction bequests may not work if taxes cannot be reduced to zero due to the supplemental estate tax. In determining whether sufficient estate liquidity exists, the new tax must be considered. It is unclear at this time whether the tax qualifies for Section 6161 deferral, although it appears that it does.

D. **Filing Estate Tax, Current Use Valuation Elections (Section 2032A of the Internal Revenue Code of 1986)**

The new Act retains Section 2032A which allows real property used in certain farming and other closely-held business activities to be valued at its current use, rather than fair market value, for estate tax purposes. Section 2032A is available only if it is properly elected on the first estate tax return filed, and only if the election substantially complies, when filed, with the requirements of the Treasury Department Regulations.

The estates of individuals dying prior to January 1, 1986 are now allowed to perfect defective current use elections within 90 days of being notified of errors by the Service, if several requirements are met. First, the election must substantially comply with the requirements enumerated on the Federal Estate Tax Return that was actually filed. Substantial compliance with the Regulations, or with the instructions for the return, is not required. Second, the original election must be timely filed within the meaning of Section 2032A(d)(1).

E. **Generation-Skipping Transfer Tax (Chapter 13 of the Internal Revenue Code of 1986)**

Substantial changes were made in the generation-skipping tax by the new Act. Those provisions will be covered in detail by a subsequent speaker so they will not be included in this outline.

F. **Section 2057: Sales of Employer Securities to ESOPS**

Section 2057 allows a deduction in computing a decedent's estate tax equal to 50% of the "proceeds of a qualified sale of employer's securities." Subsection (b) defines a "qualified sale" as any sale of employer securities by the executor of an estate to an employee stock ownership plan or an eligible worker-owned cooperative. Subsection (c) defines "qualified proceeds" as the amount received by the estate from the sale of employer securities at any time before the due date of the estate tax return. Certain securities are specifically disqualified by Section 2057(c)(2). Proceeds from the sale of employer securities will not be "qualified proceeds" if such securities were received by the decedent, (1) in a distribution from a plan exempt from tax under Section 501(a) which meets the requirements of Section 401(a); or (2) as a transfer pursuant to an option or other right to acquire stock to which Section 83, 422, 422A, 423 or 424 applies. In order to receive the deduction, the executor must file a written statement that either the employer whose employees were covered by the ESOP or EWOC consents to the application of Section 4979A with respect to such employer or cooperative. Such statement must be a statement of the employer or authorized officer, as the case may be, and it must be a verified, written statement. The term "employer securities" has the same meaning given such term by Section 409(l). A Section 2057 deduction is not available to any sale prior to October 23, 1986 or after December 31, 1991.

One important note is that the qualified sale must be made by an executor. A sale by a trustee of an irrevocable trust included in the decedent's-grantor's gross estate cannot be a qualified sale. A bill now before Congress, discussed *infra*, would eliminate retroactively this requirement.

An estate can profit from the sale of securities to an ESOP through the deduction even though the sale price is below the fair market value of the shares sold. If the

estate is paying tax at the 50% rate, a profit will be made if the sales price exceeds 80% of fair market value. That is, at 80%, the 40% deduction saves 20% (at the 50% rate) which equals the "lost" proceeds. At present, an estate can benefit even if the marital deduction eliminates the estate tax already. The will must create a "minimum" marital deduction pecuniary bequest to be funded at date of distribution values.. The reduction in the gross estate reduces the amount which must be placed in the marital share to reduce the estate tax to zero. This saves taxes at the surviving spouse's death.

Section 2057 does not require that the employer securities sold be owned by the decedent before death or included in the decedent's gross estate. However, IRS Notice 87-13 provides that the estate tax deduction under this Section will not be available unless: (1) the decedent directly owned the employer securities immediately before death; and (2) after the sale, the employer securities are allocated to plan participants or are held for future allocation in connection with an exempt loan under Section 4975 or in connection with a transfer of assets from a defined benefit plan under the rules of Section 4980(c)(3). The Service has determined that this Notice is an accurate statement of congressional intent and, therefore, clarification of the Notice is effective as if included in the Tax Reform Act of 1986.

The Technical Corrections Act would impose limits on how the ESOP allocates the stock purchased under Section 2056 to conform to the Section 1042 rules. This would prohibit the stock from being allocated to the decedent's family as defined in Section 267(b)(3) or 25% shareholders. The bill does permit the ESOP to allocate 5% of the purchased stock to the decedent's lineal descendants.

On February 26, 1987, a bill was introduced by Lloyd Bentsen in the Senate, with a parallel bill in the House, that makes substantial changes in Section 2057. The bill confirms that the IRS Notice is an accurate reflection

of congressional intent and so amends Section 2057 retroactively. The bill also makes a number of other substantial changes, as follows:

1. Tax-Credit Employee Stock Ownership Plans. The bill clarifies that the estate tax deduction is available in the case of sales of employer securities to tax-credit ESOPs under Section 409(a). This provision is effective as if included in the Tax Reform Act.

2. Non-Publicly Traded Stock. The bill limits the deduction to sales of employer securities which are issued by a domestic corporation that has no stock outstanding that is readily tradable on an established securities market. That is, only the stock of a closely-held corporation may be used to qualify for the Section 2057 deduction. The provision is effective with respect to sales after February 26, 1987.

3. Estate Requirements.

(a) Sale by Executor. The bill alters the requirement that the deduction applies only to sales by the executor of an estate. All sales of employer securities, to the extent the securities are includible in the gross estate, would qualify. Thus, assets held in trust would be eligible for the estate tax deduction to the extent includible in the gross estate. However, if the decedent owned a partnership interest, the value of the partnership interest is reported on the estate tax return and not the assets of the partnership. Therefore, even under the proposed bill, the assets of a partnership could not be sold in a transaction qualifying for the estate tax deduction, according to Senator Bentsen's introductory remarks. This change is effective from the day of passage of the Tax Reform Act.

(b) Limitation of Deduction. Congressional intent was not to eliminate estate tax liability totally. Therefore, the amount of the deduction allowable under Section 2057 would be limited to 50% of the taxable estate (determined without regard to Section 2057), and the amount of

the estate taxes imposed by Section 2001 (prior to credits) cannot be reduced by more than $750,000 through use of the deduction. This limitation would be effective with respect to sales of employer securities to an ESOP after the date of introduction of the bill. Sales prior to the date of introduction of the bill would not be subject to this limitation but would be taken into account in determining whether the limitation is met with respect to post-effective date sales.

(c) Holding Period Requirement. In order to further congressional intent that deathbed stock purchases be prevented, the bill would impose a holding period requirement. In order for the estate tax deduction to be available, the securities must be assets that would be assets of the estate reported on the estate tax return if the decedent had died at any time during the shorter of (i) the five-year period ending on the date of death, or (ii) the period beginning October 22, 1986 and ending on the date of death. For purposes of determining whether the holding period has been satisifed, securities which would be includible in the gross estate of the spouse of a decedent are treated as securities includible in the gross estate of the decedent during such period. The period for which a decedent is considered to have held the stock would be reduced under the bill for any period for which the holding period is reduced under Section 246(c)(4), which relates to periods during which the risk of loss is diminished. The provision is effective with respect to sales to an ESOP after the date of introduction of the bill.

(d) Assets Transferred From Other Plans. The estate tax deduction would not apply under the bill to the extent that the employer securities are acquired by and ESOP with transferred assets. "Transferred assets" are assets of an ESOP which are attributable to assets held by another qualified plan maintained by the employer (other than another ESOP) or assets attributable to a period of time when the plan was not an ESOP. Assets held by the ESOP on the date

of introduction of the bill are not "transferred assets," regardless of their source. The denial of the deduction would extend to assets which are transferred directly from one plan to another (e.g., pursuant to Section 4980(c)(3)), assets which are rolled over from another plan, assets which result from a conversion of another plan into an ESOP, and assets which are merged into an ESOP from another plan. The bill imposes an excise tax if a loan payment is made with transferred assets. This is to prevent an employer from acquiring securities in a 2057 transaction with the proceeds of the loan and then using transferred assets to make payments on the loan. The tax is imposed on the employer maintaining the ESOP, but it is equal to 30% of the amount paid on the loan, including both principal and interest payments. The provision is effective with respect to sales to an ESOP after the date of introduction and transferred assets after the date of introduction in the case of transfers used to make payments on a loan.

4. ESOP Allocation Requirements and Substitution Prohibition.

(a) Dispositions Within One Year Preceding Sale. Under the bill, an ESOP would be prohibited from selling employer securities and using the proceeds to acquire substitute employer securities in a Section 2057 transaction. In addition, the bill modifies the rule currently reflected in the IRS Notice to provide that the deduction would be available with respect to proceeds from a sale to an ESOP only to the extent that the proceeds are greater than the excess of the proceeds from the disposition of employer securities during the one-year period preceding the sale minus the cost of employer securities purchased by the plan during such one-year period. For purposes of the rule, all ESOPs of the employer would be treated as one plan. To determine the proceeds of the plan from dispositions of employer securities, certain dispositions would not be considered. Dispositions required to meet diversification

requirements under Section 401(a)(28) would not be considered. In addition, distributions made because of the death or disability of the employee, or the retirement of the employee after he attains the age of 59 1/2, or a separation from service of the employee which results in a one-year break of service will also not be considered. This provision is effective with respect to sales to an ESOP after the date of introduction of the bill.

(b) Dispositions Within Three Years Following Sale. An excise tax would be imposed on an employer maintaining an ESOP if the ESOP disposed of qualified securities within three years of the date of sale qualifying for the estate tax deduction. The tax would be equal to 30% of the amount realized on the disposition. The provision would be effective with respect to dispositions by the ESOP after the date of introduction of the bill. The 30% excise tax would not apply to dispositions of securities with respect to which the estate tax deduction is denied due to a failure to meet the non-substitution requirement.

(c) Failure to Allocate. An excise tax would be imposed on an employer maintaining the ESOP in the event of a failure to allocate securities required in a Section 2057 transaction. The tax would be equal to 30% of the amount realized on the disposition of qualified employer securities before the securities are allocated to the accounts of plan participants if the proceeds from such disposition are not so allocated. This provision would apply to failures to allocate employer securities occurring after the date of introduction of the bill. The 30% excise tax would not apply to dispositions of securities with respect to which the estate tax deduction is denied due to a failure to meet the non-substitution requirement. In addition, the excise tax would be coordinated with the excise tax on distribution within three years following the sale, so that both taxes should not apply to the same transaction.

II. Final Disclaimer Regulations

The Internal Revenue Service issued final disclaimer regulations under Section 2518 in August, 1986. The most important point to be made about the final regulations is that they permit disclaimers of a "separate interest" in income or principal without requiring that other separate interests be disclaimed. Thus, a special testamentary power of appointment over corpus may be effectively disclaimed while a right to receive corpus during life is retained. Other important points about the final regulations include:

(1) A surviving spouse may have a $5,000 or 5% withdrawal power, and an ascertainable standard withdrawal power, over a nonmarital trust into which disclaimed marital deduction property passes and the disclaimer will be a qualified disclaimer, [See §25.2518-2(e)(5), examples (6) and (7)]; (2) a "reduce estate tax-to-zero" formula disclaimer may be used to reduce the surviving spouse's share and minimize estate tax at his or her subsequent death, [See §25.2518-3(d), example (20)]; (3) a remainder interest in a Q-TIP marital trust must be disclaimed within nine months after the death of the creating spouse rather than the death of the surviving spouse--Q-TIP trusts are treated differently than general-power marital trusts, [See §25.2518-2(c)(3)]; (4) defective Q-TIP trusts may be cured by non-spouse beneficiaries who disclaim their interests which exist during the spouse's lifetime, without such beneficiary being required to disclaim interests arising after the spouse's death. [See example (11) to §25.2518(3)(d)]; (5) the exercise, or lapse, of a general power of appointment starts a new disclaimer period, but a generation-skipping taxable distribution or taxable termination does not begin a new disclaimer period, [See §25.2518-2(c)(3) and (5), examples (2) and (3)].

To be a qualified disclaimer, five general requirements must be met:

(1) The disclaimer must be irrevocable and unqualified;

(2) The disclaimer must be in writing;

(3) The writing must be delivered to the tranferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of such property, within nine months after the later of (a) the date on which the transfer creating the interest in the disclaimant is made, or (b) the date on which the disclaimant attains age 21;

(4) The disclaimant must not have accepted the interest disclaimed or any of its benefits; and

(5) The interest disclaimed must pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer.

The final regulations contain extensive treatment of when the nine month time limit begins to run in various situations. See §25.2518-2(c). The position taken by the Service is that the time for making an effective disclaimer is creation of an interest, meaning when the transfer was regarded as complete for gift tax purposes, even if the property transferred is subsequently included in the donor's estate at death. This rule also applies even if the property is later includible in the estate of another beneficiary. Regulation 25.2518-2(c)(3) provides that a new nine-month period is applicable following either the lapse or exercise of a general power of appointment. In addition, the final regulations discuss the requirement that the disclaimer be made prior to an acceptance of benefits and that the disclaimed property pass without direction by the disclaimant. See §25.2518-2(d) and §25.2518-2(e). Regulation 25.2518-2(e) provides that continued retention of fiduciary powers over disclaimed property will be ignored for purposes of testing whether a qualified disclaimer has been made, provided that the power is limited by an ascertainable standard.

A disclaimed interest, if it is to be part of a qualified disclaimer, must be one of the following interests:

(1) the disclaimant's entire interest in the property; (2) an undivided portion (fractional share) of the disclaimant's entire interest, [*See* §25.2518-3(b)]; (3) a separate interest in property if (a) the separate interest was created by the transferor, or (b) the separate interest consists of severable property, [*See* §25.2518-3(a)(1)(i) and (ii)]; (4) an undivided portion (fractional share) of such a separate interest, [See §25.2518-3(a) and (b)]; and (5) a pecuniary amount if certain requirements are met, [See §25.2518-3(c)].

Certain changes have been made in the disclaimer regulations relating to joint tenancy property. The Comments appended to the Regulations indicate that the drafters considered whether a joint tenant may disclaim the so-called "accretive share" of jointly held property (being the amount by which that tenant's share increases by virtue of another tenant's death) but rejected the suggestion, so that a surviving joint tenant does *not* have a new nine-month period within which to disclaim even that accretive portion. However, for tenancies in real property created between spouses before 1982, and for which no Section 2515 election was made, Regulation 20.2518-2(c)(4)(iii) provides special rules for the timing of a qualified disclaimer by a surviving spouse as the surviving joint tenant. The Regulations also provide that for residential real property held in joint tenancy, a joint tenant is not considered to have accepted the joint interest merely by virtue of having resided on the property prior to the disclaimer. Also, the new Regulations provide that no qualified disclaimer may be made with respect to any portion of jointly-held property that is attributable to contributions by the disclaimant.

The most interesting part of the new regulation is §25.2518-3, "Disclaimer of Less Than an Entire Interest." §25.2518-3(a)(1)(i) contains the general separate interest rule:

> In general, each interest in property that is separately created by the transferor is treated as a separate interest. For example, if an income

interest in securities is bequeathed to A for life, then to B for life, with the remainder interest in such securities bequeathed to A's estate, and if the remaining requirements of §25.2518(b) are met, A could make a qualified disclaimer of either the income interest or the remainder, or an undivided portion of either interest. A could not, however, make a qualified disclaimer of the income interest for a certain number of years. Further, where local law merges interests separately created by the transferor, a qualified disclaimer will be allowed only if there is a disclaimer of the entire merged interest or an undivided portion of such merged interest. See example (12) and Paragraph (d) of this Section. See §25.2518-3(b) for rules relating to the disclaimer of an undivided portion. Where the merger of separate interests would occur but for the creation by the transferor of a nominal interest (as defined in Paragraph (a)(1)(v) of this Section), a qualified disclaimer will be allowed only if there is a disclaimer of all the separate interests, or an undivided portion of all such interests, which would have merged but for the nominal interest.

§25.2518-3(a)(1)(iv) defines "nominal interest" as an interest in property created by the transferor that (1) has an actuarial value (as determined under §20.2031-10) of less than 5% of the total value of the property at the time of taxable transfer creating the interest; (2) prevents the merger under local law or two or more other interests created by the transferor; and (3) can be clearly shown from all the facts and circumstances to have been created primarily for the purpose of preventing the merger of such other interests. The Regulation goes on to enumerate factors to be considered in determining whether an interest is created primarily for the purpose of preventing merger. Those factors will include, but will not be limited to, the following:

> The relationship between the transferor and the interest holder; the age difference between the interest holder and the beneficiary whose interests would have merged; the interest holder's state of health at the time of the taxable transfer; and in the case of a contingent remainder, any other factors which indicate that the possibility of the interest vesting as a fee simple is so remote as to be neglible.

A particular topic which must be addressed under the new regulation is disclaimers by a spouse. For the most part, the final regulations resolve the major uncertainties left by the proposed regulations concerning disclaimers by the surviving spouse.

Four examples are very important in understanding disclaimers by spouse. They are as follows:

> Example (4). B died testate on February 13, 1980. B's will established both a marital trust and a nonmarital trust. The decedent's surviving spouse, A, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. A is also an income beneficiary of the nonmarital trust, but has no power to appoint or invade the corpus. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the non-marital trust. A disclaimed 30% in the marital trust. (See §25.2518-3(b) for rules relating to the disclaimer of an undivided portion of an interest in property.) Pursuant to the will, this portion of the marital trust property was transferred to the nonmarital trust without any direction on the part of A. This disclaimer by A satisfies §25.2518(b)(4).
>
> Example (5). Assume the same facts as in Example (4) except that A, the surviving spouse, has both an income interest in the nonmarital trust and a testamentary non-general power to appoint among designated beneficiaries. This power is not limited by an ascertainable standard. The requirements of §25.2518(b)(4) are not satisfied unless A also disclaims the non-general power to appoint the portion of the trust corpus that is attributable to the property that passed to the nonmarital trust as a result of A's disclaimer. Assuming that the fair market value of the disclaimed property on the date of the disclaimer is $250,000 and that the fair market value of the nonmarital trust (including the disclaimed property) immediately after the disclaimer is $750,000, A must disclaim the power to appoint one-third of the nonmarital trust's corpus. The result is the same regardless of whether the non-general power is testamentary or inter vivos.
>
> Example (6). Assume the same facts as in Example (4) except that A has both an income interest in the nonmarital trust and a power to in-

vade corpus if needed for A's health or maintenance. In addition, an independent trustee has power to distribute to A any portion of the corpus which the trustee determines to be desirable for A's happiness. Assuming the other requirements of §25.2518 are satisified, A may make a qualified disclaimer of interests in the marital trust without disclaiming any of A's interests in the nonmarital trust.

Example (7). B died testate on June 1, 1980. B's will created both a marital trust and a nonmarital trust. The decedent's surviving spouse, C, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. C is an income beneficiary of a nonmarital trust, and additionally has a noncumulative right to withdraw yearly the greater of $5,000 or five percent of the aggregate value of the principal. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the nonmarital trust. C disclaims 50% of the marital trust corpus. Pursuant to the will, this amount is transferred to the nonmarital trust. Assuming the remaining requirements of §25.2518(b) are satisfied, C is qualified as a qualified disclaimer.

In Example (4), the decedent's will created marital and nonmarital trusts. The decedent's surviving spouse is entitled to the income from and has a general testamentary power of appointment over the marital trust and is an income beneficiary of the nonmarital trust. A disclaimer properly executed under the marital trust causes the disclaimed property to be added to the nonmarital trust. A qualified disclaimer from the marital trust could be made.

The facts in Example (5) are the same as in Example (4), except that the spouse has a special power of appointment over the nonmarital trust. Therefore, a qualified disclaimer cannot be made of an interest in the corpus of the marital trust, unless the spouse <u>also</u> disclaims the special power over the property passing from the marital trust to the nonmarital trust. The reason is that the disclaimed interest must pass without any direction by the spouse.

Example (6) is also the same as Example (4), except for the addition in the nonmarital trust of a power of the spouse to invade corpus for the spouse's health or maintenance, and the power of an independent trustee to distribute corpus to the spouse for the spouse's happiness. These powers are limited by an ascertainable standard. A qualified disclaimer of the spouse's interest in the marital trust may be made.

Example (7) gives the spouse a $5,000 and 5% noncumulative power of withdrawal over the nonmarital trust. The result turns out to be the same as in Example (6). While the spouse may choose whether or not to exercise her power for each year, the exercise of that discretion possibility is not considered a direction by the spouse even though it permits a part of the property subject to the power to pass to other beneficiaries. Apparently, this result is reached because an exercise of the power would not result in a transfer to "another person."

Another important issue is using disclaimers to secure an effective Q-TIP trust. In certain cases, a Q-TIP election under §2056(b)(7) is desirable for a trust which is ineligible for the election because income or principal can be distributed to someone else during the life of the spouse. If all the trust income is required to be distributed, the spouse is one of the income beneficiaries, and the "defect" is only that the income or principal can be distributed to another person also. If that is the case, then the trust can be converted into a "Q-TIP" trust if the other beneficiaries disclaim the right to receive any distributions during the spouse's life.

The proposed regulations seemed to indicate that this procedure would be improper, at least if the disclaimer involved principal, because the disclaimant was not disclaiming his right to receive distributions after the spouse's death and was therefore not disclaiming all of his interest in principal as required by the proposed regulations. However, private letter rulings approved such disclaimers despite the

proposed regulations. Two different theories were used by different letter rulings, but the confusion has now been cleared up by the final regulations.

Example (11) of §25.2518-3(d) indicates that the technique will work under the final regulations. That example provides as follows:

> Example (11): Under H's will, a trust is created from which W is to receive all of the income for life. The trustee has the power to invade the trust corpus for the support or maintenance of D during the life of W. The trust is to terminate at W's death, at which time the trust property is to be distributed to D. D makes a timely disclaimer of the right to corpus during W's lifetime, but does not disclaim the remainder interest. D's disclaimer is a qualified disclaimer assuming the remaining requirements of §2518 are met.

Despite the liberality of the final regulations, an outright legacy cannot be disclaimed into a Q-TIP marital trust of which the disclaimant is a remainderman. Such a disclaimer would violate the "pass-to-another" rule, because the disclaimant receives a remainder interest in the disclaimed proeprty. The separate interest rule will not apply to avoid this result where an outright bequest is involved.

Another important point is that the "problem" beneficiary of the defective Q-TIP may be a minor who is unable to disclaim on his own. Under §2518(b)(2)(d), the minor may disclaim himself, without a guardian, within nine months after reaching age 21. Distributions to a minor prior to age 21 will not prevent a qualified disclaimer after age 21 nor do the final regulations appear to require that the amounts received by the minor beneficiary prior to age 21 be returned by the disclaiming beneficiary after he reaches age 21. See §25.2518-2(d)(3) and (d)(4), examples (9), (10) and (11).

III. FEDERAL TAX CASES, RULINGS AND MISCELLANEOUS PROVISIONS

Section 55--Alternative Minimum Tax and Non-Alternative Tax Itemized Deductions.

Temporary Regulation Section 1.58-3T provides that itemized deductions (like state and local income taxes) which are not alternative tax itemized deductions must be apportioned among estates and trusts and their beneficiaries as if they were items of tax preference. The Temporary Regulation confirms Internal Revenue Service news release, I.R. 84-52, from 1984.

Section 72 and 453--Private Annuities and Installment Sales.

Private annuities and installment sales have different tax consequences. I.R.C. Section 453(b) defines an "installment sale" as "a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs." This definition may also encompass a private annuity.

General Counsel's Memorandum 39503 provides the first definitive guidance for determining whether I.R.C. Section 72 or 453 applies to the treatment of periodic payments received by a taxpayer who has transferred property in return for a right to receive payments for a period not exceeding the remainder of his life. The G.C.M. stated:

> When the terms of a property transaction are structured so that there is a stated *maximum payout* that will be achieved *in a period less than the life expectancy of the transferor* (as determined at the time of the transaction in accordance with Table 1, Treasury Regulations Section 172-9), then the transaction will be characterized as an installment sale with a contingent sales price, and will be treated in accordance with the installment sale rules. (Emphasis added.)

The G.C.M. discussed three situations. In the first, A transfers property to B in return for B's promise to make annual payments of $10,000 to A until A's death. The G.C.M. states that this is a private annuity and the payments are governed by I.R.C. Section 72.

Second, A transfers property to B in return for B's promise to make annual payments of $10,000 to A until $100,000 is paid or until A's death, whichever occurs first, A's life expectancy under Treasury Regulations Section 1.72-9 is 9.1 years. Because there is no stated maximum payout that will be achieved in the period less than the life expectancy of A, the situation will be governed by I.R.C. Section 72 as a private annuity.

Third, the same situation is as in situation two above, except that A's life expectancy is 11 years. Here, A's life expectancy, at the time of the sales agreement, is 11 years and the maximum stated sales price will be reached in 10 years. Therefore, the transaction will be termed an installment sale rather than an annuity.

The G.C.M. also dealt with the consequences of the payee's death on income taxation. An installment sale which provides that payments cease at the seller's death generally gives rise to immediate income tax to the Seller at his or her death on the foregone income.

Section 691--Income In Respect of a Decedent.

The case of Apkin v. Commissioner, 86 T.C. 692, involves accrued interest on United States savings bonds. There, the mother of the taxpayer purchased Series E United States Savings Bonds in her name and in the taxpayer's name as co-owners. The mother did not file income tax returns prior to her death because she did not have sufficient income to require filing. She could have elected to accrue the interest on the bonds annually under I.R.C.'s Section 454(a), and presumably paid little or no tax. After his mother's death, the son redeemed the bonds. The Tax Court held that the interest on the bonds accrued prior to the mother's death was income in respect of a decedent under I.R.C. Section 691(a)(1) and therefore was taxable to the son when he redeemed the bonds. The Tax Court found that because Section 454(a) requires that an election under the Section be made on the taxpayer's

tax return, and the mother did not file a return in any year after the purchase of the first savings bond, she did not make an effective election. In short, by remaining silent, she made an election to have the interest included in her reportable income in the year or years of maturity or of redemption if such occurred prior to maturity.

Section 2011--State Death Tax Credit.

Revenue Ruling 86-38, IRB 1986-11 at 22, concerns the allowance of a state death tax credit when the estate elects to defer the payment of state death tax. The general rule, contained in I.R.C. Section 2011(c)(i), allows the credit for "only such taxes as were actually paid and credit therefor claimed within four years" after the estate tax return is filed. If the estate elects to pay the federal estate tax in ten annual installments, then the estate will qualify ultimately for the Section 2011 credit for all state death taxes paid during the federal deferral period. However, when the estate tax return is filed, only the state death tax actually paid at that time will qualify for the Section 2011 credit on the estate tax return. The recomputation procedure described in Revenue Procedure 81-27 is used whenever the estate submits certification of payment of additional state death tax. The recomputation would allow the Section 2011 credit that may be allowed for any state death tax installment paid by the estate. After all state death taxes have been paid, a claim for refund may be made, if necessary, for an overpayment of tax; however, such a claim may be made only after the federal estate tax liability has been paid in full.

Section 2031-Definition of Gross Estate

In Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306 (1987), a decedent owned a limited partnership interest that, during life, included a right to force dissolution and liquidation of the partnership. The right expired at the

decedent's death. It was stipulated that the value of the partnership interest immediately before the decedent's death was $59,555,000; immediately after decedent's death, that is, after expiration of the right, the partnership interest was deemed to be worth $33,000,000. The Tax Court adopted the $33,000,000 value for Section 2031 purposes. The Court's rationale was that this was the total value that the decedent could transfer at death. The IRS stipulated that the value of the other partnership interests did not change by virtue of decedent's death, and the gift tax consequences of the total transaction were not involved, although the Court did state that the decedent received adequate consideration for the property he contributed to the partnership.

Another case involving a successful planning technique was Doran v. United States, 86-2 U.S.T.C. ¶13,701 (W.D.P.A. 1986), in which the decedent gave options to her children and grandchildren which allowed them to purchase publicly traded stock the decedent owned. The option price was the fair market value of the stock at the time of the gift. The Court found that the clear intent was to freeze the value of the stock by a gift transfer of all of decedent's rights to the future appreciation in the stock, subject to the transferred options. Apparently, no gift tax return was ever filed to reflect the gift, nor was there an indication of what the value of the options would be for gift tax purposes. Even so, the Court found that the value of the stock for estate tax purposes was the option price, which was the value frozen at the time the option was delivered.

Completion of Gifts. McCarthy v. U.S., 86-2 USTC, ¶13,700 (7th Cir. 1986), concerned a decedent who in the week before her death wrote nine $3,000 checks which she intended to be gifts to various relatives. The issue was whether the checks were includible in her estate. The Seventh Circuit held that the $27,000 should be included in the decedent's estate because under applicable state law the gifts were not complete. This was because the donor had the power

to stop payment on the checks up until the time the checks were cashed, and the checks were not cashed until after the decedent's death.

Section 2032--Alternate Valuation Date.

The Fifth Circuit, in Estate of Johnston v. United States, 779 F.2d 1123 (1986), reversed the lower court and held that the proceeds from oil and gas interests received between the date of death and the alternate valuation date will be includible in the decedent's gross estate even if, for valuation purposes, the alternate valuation date election is made. Further, the Fifth Circuit held that the value of the oil and gas interests is the "in place value of that oil and gas on the date of its severance." The lower court had ruled that post-death production was excludible from value on the alternate valuation date.

Section 2032A--Special Use Value.

One of the requirements for special use value qualification is that the farm property must have been used by the decedent or a member of his family for a qualified use. The legislative history of the Section indicates that indicates this requirement should be met if income from the rental of the property is substantially dependent upon production. The Seventh Circuit, in Schuneman v. United States, 783 F.2d 694 (1986), applied this test to the following facts. The decedent entered into a lease under which the tenant would pay rent in cash of $32,600 if certain grain production and price levels were met. If, after the harvest, the gross income was below $51,600, then the annual rent would be reduced to $26,080. In other words, the possible income of the decedent could fluctuate by up to $6,520, which was approximately 20% of the maximum rental income. The court examined the history of the farm and determined that in the four years previous to the year in question the actual income from the farm varied by 32% of the decedent's maximum income

during the period. In addition, during two of the four years examined, the price level of $51,600 was not achieved, so that the rent reduction clause could come into play under the lease. For these reasons, the court said that the rental income under the lease was substantially dependent upon production.

In another important case concerning Section 2032A, Estate of Davis v. Commissioner, 86 T.C. No. 67 (1986), the Tax Court held Treasury Regulation Section 2032A-8(a)(2) invalid to the extent it disqualified an election for special use evaluation because a remainder contingent disposition in a will named nonqualified beneficiaries. According to the Court, the will provision was added in this case to prevent intestacy in the unlikely event of a total failure of descendants. Because the provision was unlikely to apply, the Court invalidated the regulation to the extent it would have regarded this de minimis failure to comply with the qualified heir requirements of Section 2032A(a)(2) and (b)(1) as fatal to an effective election. Two additional Tax Court cases have already followed Davis. See Estate of Clinard v. Commissioner, 86 T.C. No. 68 (1986) (qualified heirs had non-general powers of appointment that would permit appointment to nonqualified heirs); Estate of Pliske v. Commissioner, 51 T.C.N. (CCH) 1543 (1986).

Sections 2036 and 2038--Retained Powers in an Inter Vivos Transfer.

Private Letter Ruling 8606002 involved a decedent who created a trust and remained a "supervisor" thereunder until his death. As supervisor, the decedent had the right to direct the trustee (1) to make those distributions of income or principal as "necessary for the emergency needs of the primary beneficiary or to maintain the primary beneficiary in the manner and style to which she had been accustomed, after taking into consideration any other support and income [she] may have"; (2) to distribute income not needed by the

beneficiary to charity; (3) to allocate receipts of disbursements between income and principal; and (4) to terminate the trust if necessary to avoid the destruction of trust property. The Ruling held that the retained power to control income and principal distributions was not limited by an ascertainable standard because of the reference to emergency needs. Unlike other cases in which distributions for "emergencies" related to specific needs of the beneficiary were allowed, in this situation the standard was emergencies <u>or</u> to maintain the beneficiary.

<u>Section 2036--Transfers With Retained Life Estate</u>. The Tax Court, in <u>Estate of Paxton v. Commissioner</u>, 86 T.C. 785, held that a trust was includable in the grantor's gross estate under I.R.C. Section 2036(a)(1) where the terms of the trust provided that the trustees could distribute income or principal to any person who added principal to the trust. The decedent and other persons contributed, subject to an understanding that the decedent would receive income and principal when he requested. Further, the decedent's creditors could reach his retained interest under the applicable state's laws, based on Section 156(2) of the Restatement of Trusts (Second), which states that the creditors of a grantor may reach the maximum amount which the trustee may distribute to him.

A recent letter ruling concerned the gift tax consequences of a trust similar to the one in <u>Paxton</u>. In P.L.R. 8617006, the Internal Revenue Service decided that there was a completed gift of a remainder interest even though the trustee at his discretion could pay principal to the grantor/income beneficiary for her "maintenance, support and comfort, any of the surviving trustor's legal obligations, and the preservation of her property." The trustee was authorized to consider other resources available to the beneficiary. The IRS ruled that if a grantor's own resources, when added to trust income, are adequate to cover his needs, then the ability of a grantor's creditors to reach trust principal may

be ignored for gift tax purposes, and most likely estate tax purposes as well.

Thus, the trust in these decisions can potentially result in double taxation--a completed gift for gift tax purposes, and full inclusion for estate tax purposes.

Sale of Remainder Interest. Gradow v. United States, 87-1 USTC ¶13,711 (C.L. Ct. 1987) involved a community property forced election. The deceased spouse created a trust that effectively settled a life estate in the decedent's share of community property to the surviving spouse in exchange for a remainder interest in the survivor's community property. The Court's decision did not turn on the type of consideration given for the transfer by the survivor of the remainder interest in the survivor's property. Therefore, it would seem that Gradow is important because it is relevant to all transfers of a remainder interest with retention of a life estate in the subject property. The taxpayer argued that Section 2036(a)(1) should not apply with respect to the retained life estate in the survivor's community property because the remainder was transferred for a full and accurate consideration in money or money's worth, thereby qualifying for the statutory exception to the application of Section 2036(a)(1). The Court rejected this contention because under Section 2036(a)(1) full and adequate consideration is measured by the full fair market value of the subject property, that is, the fee simple interest in the property, not by the value of the interest transferred. The Court addressed the question whether Section 2036(a)(1) required that the consideration be paid for the interest transferred or for the interest which would otherwise be included in the gross estate. The Court failed to grasp that when the life estate is expired, the remainder interest remains and would be includible in the surviving spouse's estate were it not for this sale. The Court was apparently confused because the remainder interest appears different when there is an intervening life estate standing between the remainder as seen at the death

of the surviving spouse and the remainder as seen at the time of sale; nevertheless, at the termination of the life estate, the remainder is all that is left. Thus, the value of the remainder interest determined at the surviving spouse's death is exactly the same amount that would be included in the survivor's estate if no transfer were made during life. The Court specifically examined a hypothetical the taxpayer had placed before the Court, the sale of a remainder interest while retaining the income interest and stated that the sale of a remainder interest in the conventional situation should be a retained interest as well.

Control of Partnership. Letter Ruling 8611004 dealt with the issue of whether a donor's ongoing voting control of a partnership as its general partner constituted a retained power under Section 2036(b). If so, there would be inclusion of the transferred interest under Section 2036(a)(2). The Internal Revenue Service ruled that such was not a retained power. Instead, the position of the general partner was analogized to that of a controlling shareholder of a closely-held corporation who would not be deemed to run afoul of Section 2036(b) unless voting control of the transferred shares was specifically retained. See also United States v. Byrum, 408 U.S. 125 (1972). Indirect control, by virtue of ownership of other shares of the corporation, will not cause Section 2036(b) to apply in the corporate setting and the Ruling establishes that such indirect, but not "retained," control will not cause exposure in the partnership setting either.

Section 2038--Gifts Under Non-Durable Power of Attorney.

Gifts made pursuant to a non-durable power of attorney by the agent while the principal was incompetent will be included in the gross estate of the principal-decedent. Because the transfers are avoidable as a matter of state trust law, they are irrevocable. Thus, I.R.C. Section 2038 will apply. See Letter Ruling 8623004.

Section 2041--General Power of Appointment.

In Letter Ruling 8601003, a decedent established a trust for the benefit of his spouse and named her as trustee. The will provided that the trustee could invade the corpus not only to maintain herself in the status in which she was accustomed but also to "pay for any special needs she may have." The issue was whether the wife had a general power of appointment over the trust property under I.R.C. Section 2041. The Ruling stated that because the additional powers to use principal for special needs were not limited to those standards of health, education, support or maintenance, as described in Section 2041(b)(1)(A), the powers are general.

A similar result was arrived at in Estate of Little v. Commissioner, 87 T.C. 34, in which the trustee could pay so much of income and principal as was necessary for the beneficiary's "proper support, maintenance, welfare, health and general happiness in the manner to which she is accustomed." The Tax Court found that "general happiness" is not within the scope of "health, education, support or maintenance." It is important to remember that these decision are decided under the applicable state law. In other words, presumably, if a standard such as "general happiness" were in fact within the scope of the 2041 ascertainable standards under applicable state law, then such language would not lead to inclusion under Section 2041.

In Goudy v. United States, 86-2 USTC, Paragraph 13,690 (D. Or. 1986), the decedent was the beneficiary of a testamentary trust created by his mother. The decedent was entitled to the income and he had a general testamentary power of appointment over the trust. Within nine months after his mother's death, the decedent restricted his power so that he could not appoint to himself, his creditors, the creditors of his estate, but could appoint to his spouse, his children and any descendants of a deceased child of his and to charities. The District Court of Oregon held that an

effective disclaimer was made of the general power pursuant to applicable state law and Treasury Regulation 20.2041-3(d)(6).

Section 2053--Administration Expense Deduction

In Letter Ruling 86361001, the Internal Revenue Service ruled that if a personal representative petitions the local probate court for approval of his fees, and the court consents, the court approval will be determinative of the reasonableness of the fees for purposes of claiming a Section 2053 deduction if either the court ruled on all the facts and circumstances surrounding the fee request and the determination was made in a genuinely adversarial proceeding involving those fees, or the court entered a consent decree that constitutes a bona fide settlement by the parties of a valid dispute or claim regarding fees. The Service said the court order will not necessarily bind the government in other situations, nor must the government accept a local court decree that is at variance with state law--if, for example, the awarded fees exceed statutory fees without special justification for the excess.

A somewhat different result was reached by United States v. White, 87-1 USTC ¶13,710 (W.D. N.Y. 1987) in which the Court held that the Internal Revenue Service, under Treasury Regulations Section 20.2053-1(b)(2), must accept the state court determination of fees unless there is prima facie evidence of fraud, over-reaching or some other reason to believe that the local court has not passed on the factors upon which deductibility depends. The Court also stated that the burden is on the government, particularly where the court determination considers all of the factors which the Internal Revenue Service would consider. The Court did not add a requirement that the determination be made in a genuinely adversarial proceeding nor that it be a bona fide settlement of a valid dispute regarding fees.

Section 2055--Charitable Deduction, Reformation of Defective Bequests

A Section 2055 reformation and deduction case, Flanagan v.United States, 810 F.2d 930 (10th Cir. 1987), and Letter Ruling 8706014, which involved a reformation in order to receive the Section 2056 marital deduction, present an interesting contrast. In Flanagan, the decedent created a non-qualified split-interest trust. The beneficiaries sought a court order reforming the trust in order to qualify for the charitable deduction. However, before the court could rule on the request to reform the trust, the beneficiaries settled the proceeding in consideration of outright distributions to both the charitable and the non-charitable beneficiaries. They then claimed a charitable deduction for the value of the charitable distributions based on the fact that there were no split-interest dispositions involved. The Internal Revenue Service disallowed the deduction. In rejecting the Service's denial of the charitable deduction, the 10th Circuit stated that Congress sought to encourage gifts to charity through Section 2055 and that the facts in Flanagan did not involve the abuses to which the split-interest rules were directed. Thus, the Court saw no reason to deny deduction for the actual benefit passing outright to the charity.

On the other hand, in the Letter Ruling, a lower state court had actually redefined the trust terms in a beneficiary's reformation suit so as to permit an otherwise defective trust to qualify for the marital deduction. Nevertheless, the Internal Revenue Service disallowed the claimed deduction because the reformation remedy available under state law was available only if proof of the settlor's intent was established by "the clearest and most satisfactory character," which the Service deemed to be missing.

It would seem that the difference in result between the two situations cannot be attributed to the procedures followed because Flanagan involved fewer safeguards than those applied

in the lower state court proceeding. Perhaps, Section 2055 entitles the beneficiaries to greater latitude because of Congressional intent to encourage charitable gifts. Or, perhaps, the Service is simply taking a more rigid position with respect to settlements than the case law would support. If so, litigation is the appropriate method to establish the right to reform an otherwise defective charitable or marital disposition.

Section 2056--Marital Deduction.

In Estate of William L. Reno, Jr., 51 TCM 909, the Tax Court considered whether under Virginia law the federal estate tax on Kentucky real property was to be charged to such Kentucky property or to be paid from non-probate property. The non-probate property passed to the decedent's spouse so that the payment of federal estate tax on the Kentucky real property from the non-probate property would cause the marital deduction to be reduced. Under the will, the spouse retained a legal life estate in the Kentucky real property and the tax apportionment provision provided that all death taxes on the Kentucky real property be paid out of estate assets other than the property. The value of such assets was insufficient to satisfy all the taxes payable.

Under the Virginia apportionment statute, all taxes are to be equitably apportioned. Thus, the estate argued that the taxes owed on the Kentucky real property should be paid from such property. The Tax Court rejected this argument because the Virginia apportionment statute provides that the testator may vary the statutory apportionment by will if he desires to do so. Therefore, the Tax Court held that the "provision in decedent's will directing that death duties on the Kentucky real estate be paid by his executrix out of assets other than said real estate thus overrides the Virginia apportionment statute, and causes the will to be administered as if the apportionment statute had never been enacted."

In Letter Ruling 8638004, the Internal Revenue Service allowed a trust to qualify for the marital deduction where the decedent's will authorized the trustee of a trust which would otherwise qualify for the marital deduction to retain property notwithstanding that the property might not be income producing. No provision of the will directed that the fiduciaries invest in productive property nor was the surviving spouse's consent required before the fiduciaries could hold unproductive property. The Service's ruling was based on state law that required consideration of probable income in making new investments and the fact that the estate consisted entirely of productive property.

Letter Ruling 8720008 considered the case of a decedent dying in 1986 with a will executed in 1957. The decedent was survived by several children and a spouse. The will provided that "[m]y purpose in establishing this trust is to take advantage of the maximum marital deduction, as that term is defined by the Internal Revenue Code of 1954, or similar, subsequent legislation." The Internal Revenue Service found on the basis of the quoted language that the decedent's intent was to take advantage of the changes to the marital deduction made after execution of the will and thereby give his spouse the benefit of any increase in the amount of the deduction. Therefore, the marital deduction will not be unlimited and the transition rule under ERTA limiting the deduction to the greater of $250,000 or 50% of the adjusted gross estate will not apply because of a contrary testamentary intent.

In Letter Rulings 8642007, 8648002 and 8649002, the Internal Revenue Service was asked to rule with respect to the qualification of residuary marital deduction estate plans. The Service cited Estate of Smith v. Commissioner, 66 T.C. 415 (1976), aff'd, 565 F.2d 455 (7th Cir. 1977), in the first two rulings and held that it is harmless that determination of the final amount of the marital residue is subject to contingencies based on asset valuation at the date or dates

of distribution. Instead, date of distribution funding, with asset fluctuations affecting the marital residue, were deemed to be fair to the marital residue, if state law requires impartiality for the personal representative in administration of the estate. Impartiality should be required by all states unless the trust instrument negates the requirement. So, while the possibilities of capital appreciation and depreciation, burdens and benefits taxes, and other windfalls and casualties are of concern to residuary legatees, these concerns do not rise to the level of a basis for disallowance in this context.

The third Letter Ruling stated that in Revenue Ruling 81-20 it is recognized that a situation similar to that addressed in Revenue Procedure 64-19 could occur, namely, where the claimed deductible interest is a residue following a pecuniary bequest and the executor has broad discretionary power with respect to funding the pecuniary bequest. The Service held in this context that the deduction was allowable based on several factors. The first of these factors was a representation by the executor that in satisfying the credit shelter pecuniary bequest he would act in a strictly impartial manner. Apparently, the Service asked for such a representation based on Revenue Ruling 81-20. Also, applicable state law prohibited the executor from acting in any manner that would defeat an otherwise available marital deduction if the obvious and expressed intent of the testator was to take advantage of the marital deduction. The Service concluded that if the executor's broad discretionary power with respect to funding was exercised in a manipulative manner, the marital deduction would be disallowed; therefore, the state statute must require the executor to exercise his power in an impartial manner with respect to all beneficiaries.

Another factor was that the will in question contained language specifying that it was the testator's intention that the marital deduction be allowed and that all powers and authority granted in the will to the executor should be

interpreted so that the estate would be entitled to the marital deduction.

Finally, the Service stated that income tax generated by any appreciation in the value of the residue will not change the reality of date of death valuation and, therefore, the deductibility of the marital trust would not be affected.

Section 2501--Gift Tax, Savings Clauses

Savings Clauses Deemed Invalid. In Revenue Ruling 86-41, 1986-12 I.R.B. 9, two different savings clauses, each relating to a transfer of realty, were deemed invalid. In the first clause, the deed of transfer purported to "reconvey" to the transferor that fractional share of the gifted property necessary to limit any gift on the original transfer to an amount not exceeding the gift tax annual exclusion. The second clause required the donee to pay the donor an amount equal to any excess of the value of the property transferred over the gift tax annual exclusion amount. Because both provisions were designed to prevent the transfer from constituting a gift if the government valued the transferred property in excess of the party's estimate, the Service ruled that both clauses were invalid. The Service stated that the purpose of the adjustment clause in both cases was not to preserve or implement the original, bona fide intent of the parties as might be the case if the clause had required a purchase price adjustment based on an appraisal by an independent third party retained for that purpose. Thus, perhaps there is an opening for planning purposes. If the object of a savings clause is to preserve or implement the original, bona fide intent of the parties in cases in which reevaluation is pursuant to an independent appraisal, the savings clause may be valid. If so, such a provision might serve the intended purpose and the Ruling may represent a sufficient opening through which additional savings clauses might pass in the future.

Revenue Ruling 86-41 was followed by the Tax Court decision in Ward v. Commissioner, 87 Tax Court 6 (1986). There, a father gave 25 shares of closely-held stock to two sons, while reserving the power to revoke part of the gift if, for federal gift tax purposes, it was finally determined that the fair market value was greater than $10,000. The Tax Court concluded that because the federal gift and estate taxes now comprise an unified transfer tax system, unlike the separate systems in effect when an early case, Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944,) cert. denied, 323 U.S. 756 (1944), was decided, that "savings clauses" are no longer valid. The court said:

> When Proctor was decided, the federal gift and estate taxes were separate taxes, each with its own rate schedule. If the donor could not recover the excess gift or if his right to revoke lapsed before his death, the excess gift would escape both gift and estate taxation. Now, transfers during life and at death are subject to a single unified rate schedule, and the rates are progressive on the basis of cumulative lifetime and deathtime transfers. It appears that in calculating the estate tax, incorrectly valued gifts may be revalued in determining "adjustable taxable gifts" for purposes of Section 2001(b), and when such gifts are cumulated with the taxable estate, any upward adjustment in the value of the gifts would result in an increase in the estate tax liability. However, we are not persuaded that the mere possibility of estate taxation is sufficient. If, at death, the Commissioner fails to challenge the gifts valuation, the excess value of the gift will pass from the donor's estate without ever being subject to the transfer tax, and in every case, the payment of the tax due on the excess gift is deferred.
>
> Furthermore, a condition that causes a part of a gift to lapse if it is determined for federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of "trifling with the judicial process" condemned in Proctor. If valid, such commission would compel us to issue, in effect, a declaratory judgment as to the stocks of value, while rendering the case moved as a consequence. Yet, there is no assurance that the petitioners will actually reclaim a portion of the

stock previously conveyed to their sons, and our decision on the question evaluation in a gift tax suit is not binding upon the sons, who were not parties to this action. The sons may yet enforce the gifts.

Gift Taxation of Death Benefit Only Payments. In Estate of DiMarco v. Commissioner, 87 T.C. No. 39, the Service asserted gift tax liability that the Service alleged was incurred as of the date of the decedent's employment but that was incomplete until decedent's death, with respect to the full value of a survivor's death benefit that became payable by virtue of the decedent's death. The benefit involved was an employee plan to which the decedent had made no contributions, had made no beneficiary designation and over which the decedent had no powers of any type. The benefit was fixed by the terms of the plan and was totally contingent on the plan being in effect at death and takers under the plan who survive the decedent being named.

The Service argued that the decedent made a gift of this benefit by accepting employment, but that the gift was incapable of valuation prior to death because the benefit was tied to factors that would not be until to the date of death. The taxpayer argued that there was no gift at all based on the fact that no transfer was ever made, no control ever existed, no power was ever exercised over the benefit and the arrangement was totally involuntary on the part of the decedent. The Court sided with the taxpayer. The Court stated that transfers of property are not incomplete for gift tax purposes simply because no realistic value could be placed on the property, and transfers of property do not become complete for gift tax purposes only when the value of the transferred property can be easily ascertained. The Court agreed with the taxpayer that the decedent never made a taxable gift of the property interest in the survivor's income benefit because no act by the decedent qualified as an act of "transfer" of an interest in property because the decedent's participation in the employee benefit plan was

involuntary and he had no powers over the plan or the benefit. Importantly, the Court expressly declined to express a view as to whether the survivor's income benefit was includible in the taxpayer's gross estate under Section 2039. The Service itself did not assert estate tax liability but rather argued soley that there had been a taxable gift.

<u>Gift Tax Impact of **Stock Purchase Agreements**</u>. Private Letter Ruling 8612001 concerns the potential gift tax consequences of a husband and wife who each owned 50% of a farming corporation. The spouses entered into an agreement with two main provisions. First, the stock could be transferred by will, intestacy or gift, only to spouses and descendants, but could be transferred by any means (e.g., sale) to any person approved by a majority in interest of the shareholders. Second, if a shareholder desired to dispose of certain shares, and was not able to secure majority consent, then the corporation could purchase the shares at their "reasonable" value. The "reasonable" value was to be determined annually by the corporation's board of directors. If the corporation did not exercise its option to purchase, then an option passed to the other shareholders in proportion to their interests. In addition to the husband and wife signing the agreement, their children signed the agreement and the agreement recited that "this agreement is binding upon our respective heirs, executors and assigns." According to the Letter Ruling, neither shareholder made a gift, because they each owned the same number of shares and received contract rights equal in value so that property rights were transferred for adequate and full consideration in money, or money's worth, in accordance with I.R.C. Section 2512(b). The children did not make a gift because the promises each made were void because none of the children were shareholders and none of them furnished consideration for the agreement.

Passing Dividends on Preferred Stock

Technical Advice Memorandum 8723007 concerned a controlling shareholder of a corporation who possessed only preferred

stock; a trust for the benefit of the shareholder's grandchildren held all of the corporation's common stock. The shareholder was considered to have made a gift to the common stock shareholders by virtue of his relinquishment of his right to non-cumulative preferred dividends. The Service found that by foregoing his preferred dividend, the shareholder waived his right as a preferred shareholder to his fair share of earned surplus, which resulted in a steady and progressive shift in value from the shareholder's interest to the interest of the common stock shareholders. The Service went on to say that, even if there were sufficient business reasons not to pay dividends, the controlling shareholder could have taken various steps to avoid this result. First, he could have caused the corporation to declare and pay a dividend and then he could have loaned the money back to the corporation. Second, he could have required the corporation to distribute its promissory note to him. Third, he could have caused the corporation to declare, but not pay, the dividend to him. Under any of these options, the shareholder would have become the corporation's creditor, but, as the Service suggested, he could have agreed to subordinate his claim to other creditors so that the corporation's ability to borrow from others would not have been impaired by the debt to the shareholder. Because the shareholder did not demand the dividend or take any of these steps, the Service held that the shareholder irrevocably lost the ability to assert his right to at least a major part of the waived dividends. Thus, the shareholder was considered to have made indirect gifts to the other stockholders, whose stock interests were enhanced in value.

Section 2512--Valuation Tables Use in a Grantor Retained Income Trust Disallowed.

In Letter Ruling 8642028, the Internal Revenue Service refused to allow use of the 10% actuarial valuation tables in the gift tax regulations to value the grantor's retained interest in a trust for a specified term of years because

property with a long history of low-income yield was transferred to the trust, and the trust expressly relieved the trustee of the fiduciary duty to make all trust property productive. The Ruling provided as follows:

> Thus, even though yearly dividends for X Corporation may increase in the coming years, the present value of the cash flow of dividends for the trust may be expected to be only a small fraction of what the trust income would be in a trust arrangement that more closely conforms to state standards relating to a fair rate of return for a trust income beneficiary. You, as settlor of the trust have given away (in a special provision of the trust instrument) your state law right as a trust income beneficiary to compel the trustee to make the trust more fairly productive. Where provisions in the trust instrument alter the value of an income beneficiary's interest to this extent, the ordinary term certain income factors from the regulations table cannot be used to value the donor's retained interest for gift tax purposes.

The IRS also ruled that the grantor's right to receive the trust property if he died during his income term did not reduce the value of his gift. The trust included a clause providing that the grantor's income interest could be terminated at any time by the payment to the grantor of the then actuarial value of his remaining income interest. The IRS reasoned that this commutation power would be exercised so as to prevent the trust from reverting to the grantor, so his reversion had no value.

Section 2518--Disclaimers

In Letter Ruling 8701001, the decedent had two minor grandchildren. Those grandchildren, through their parents, who were also their court appointed guardians, disclaimed an interest in certain property inherited from their deceased grandparent. The result was that the amount passing to the decedent's spouse was increased and, because of the marital deduction, the disclaimer created a substantial savings of estate tax. The central issue in the Letter Ruling concerned

whether the grandchildren had accepted an interest in the disclaimed property. The Internal Revenue Service found that despite significant estate tax savings resulting from the disclaimer, those savings did not benefit the grandchildren directly enough to constitute an acceptance of benefits in the disclaimed property. It was pure speculation by the IRS that the grandchildren would ultimately inherit the amount by which the estate had been increased through the disclaimer.

Procedural Rulings

1. **Notice of Fiduciary Relation.** By Announcement 86-78, 1986-26 I.R.B. 35, the Internal Revenue Service revised Form 56, Notice Concerning Fiduciary Relationship, to incorporate the Section 6036 notice requirements for qualification as an executor.

2. **New Form 1041S for Simple Trusts.** A simplified version of Form 1041 (Fiduciary Income Tax Return) has been promulgated by Announcement 86-88, 1986-30 I.R.B. 16, for simple trusts that (a) have no gains or losses for the taxable year and (b) for which the Section 651 distribution deduction equals the amount of income the trust was required to distribute annually. Certain items of taxable income, other than capital gains, may be allocated to corpus under state law or the terms of the trust instrument, and thereby cause even a simple trust to be taxable--even if both requirements for use of Form 1041S are met. Therefore, presumably the new form is not limited to use by trusts that owe no tax even though the form itself is entitled "U.S. Fiduciary Income Tax Return for Nontaxable Simple Trusts". The new form is available for filing for tax years beginning after 1985 and is optional. The traditional Form 1041 may still be used.

3. **Trust Not Considered an Association Taxable as a Corporation.** In Bedell v. Commissioner, 86 T.C. No. 70 (1986), the Tax Court found that no association which was taxable as a corporation existed. The case involved a testamentary

trust engaged in the conduct of business and was widely regarded as a test case for the Internal Revenue Service. While the Court stated that the case "should not be regarded as authority for the conclusion that no testamentary trust can be classified as an association," on these particular facts the Court concluded that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust were not transferrable, and only a few of whom participated as trustees in the trust affairs, were not associates and their trust is not an association.

4. **Distribution Not Properly Credited to Generate Deduction**. In Estate of Johnson v. Commissioner, 88 T.C. No. 14, the Tax Court denied a Section 661(a)(2) distribution deduction to the estate. The decedent's estate was faced with significant contingent liabilities preventing it from concluding administration and making a final distribution of estate assets. The liabilities prompted the personal representative to make what were merely bookkeeping entries on its annual work papers to reflect the "income distributions" to various beneficiaries, but no income was actually distributed due to the perceived need to retain funds until all liabilities were settled. The Tax Court found that the amounts represented as credited to the beneficiaries were not so definitively allocated as to be beyond recall by the estate nor were the amounts beyond the reach of the creditors of the estate. The Court did say that actual physical segregation or payment is not required to support the distribution deduction, and that in some cases book entries might be adequate; the Court did not elaborate on exactly what would have sufficed in this particular case.

IV. KENTUCKY PROBATE AND TRUST CASES

Aufenkamp v. First Kentucky Trust Co., 705 S.W.2d 943 (Ky. Ct. App. 1986).

Decedent created a testamentary trust for the benefit of his wife for her lifetime. The trust provided for the remainder to pass in equal shares to the decedent's brothers, per stirpes, upon the death of the decedent's wife. Both brothers survived the decedent but predeceased decedent's wife. One brother was survived by a daughter and the other brother was survived by two sons. Both sons also predeceased decedent's wife. One son granted his wife (appellant) a life estate in his share of the estate. Upon decedent's wife's death, appellant filed suit for one-half of the trust assets. The Court of Appeals reversed the trial court, holding that the remainder interest to decedent's brothers vested upon decedent's death and only the enjoyment of the gift was postponed until decedent's wife's death. Therefore, appellant was entitled to one-half of the remaining trust due her through her husband's will. The Court noted that when the decedent's intent is not obvious from the four corners of the instrument, the law favors early vesting of remainder interests. Since no language of survivorship was evident in the instrument, the remainder interest vested upon decedent's death and was not contingent upon survivorship.

Hall v. Arnett, 709 S.W.2d 850 (Ky. Ct. App. 1986).

Decedent died testate with a holographic will which was admitted to probate. The will was recopied in error into the will book and the name of one of the beneficiaries, "Wonita" (Juanita), was transposed to Wanda. Relying upon the transposition, Wanda took the position that certain real property had been left to her. Juanita, the decedent's incompetent daughter, brought an action to quiet title. The circuit court entered judgment for decedent's daughter who was designated in the holographic will. Affirming the lower court's decision, the Court of Appeals held that appellee's

action to quiet title was not a collateral attack on the public record because the subject matter of the suit involved title to real estate. The Court also held that a limitation period of ten years had no application in an action where the beneficiary was an incompetent. Finally, the Court held that parol evidence was admissible as applied to the public record. Although the general rule excludes parol evidence when it is introduced to alter judicial documents, the Court noted that a record of a will could be attacked as not being a correct copy.

Justice v. Conn, 724 S.W.2d 227 (Ky. Ct. App. 1986).

The Kentucky Court of Appeals ruled that a failure to file notice of a will contest in accordance with KRS 394.240(2) does not strip the circuit court of its jurisdiction over the case. The purpose of the filing statute is to provide notice to potential bona fide purchasers that a decedent's property is subject to litigation. Jurisdiction of a circuit court is invoked by filing according to Kentucky Civil Procedure Rule 3 and not on whether the notice requirements of KRS 394.240(2) are met.

Smith v. Baker, 715 S.W.2d 890 (Ky. Ct. App. 1986).

The two principals of a closely-held corporation each purchased a life policy on the life of another. In addition, the parties allegedly entered into a stock purchase agreement whereby the life insurance proceeds were to be used to purchase the one-half interest in the business from the other upon the death of either. There was no written stock purchase agreement or memorandum of such. At the death of one principal, his widow sought to enforce the alleged agreement. KRS 355.8-319 requires that contracts for the sale of securities are not enforceable unless in writing. The widow argued that the stock in the closely-held business was not a "security" under the definition of KRS 355.8-102 because the stock was not the type of stock which would be dealt in com-

monly upon security markets. The trial court held that the stock was a security because stock certificates in closely-held corporations are "normally" thought of as securities and could be traded by a broker.

Luck v. Luck, 711 S.W.2d 860 (Ky. Ct. App. 1986).

Decedent and administratrix entered into an antenuptial agreement. The agreement purported to be temporary until a permanent marriage contract could be drafted. Decedent died intestate 20 years later and the contemplated permanent marriage agreement was never drafted. The trial court held that the agreement was valid. The Court of Appeals disagreed. First, the Appellate Court found that the agreement was not made with full disclosure of all assets by each party. That alone would have invalidated the agreement. In addition, the Court held that the language of the agreement represented merely an agreement to agree in the future rather than a binding contract with present terms and conditions.

Lawson v. Lawson, 34 K.L.S. 5, p. 4 (Ky. App. 1987).

The will of decedent directed that if any of her children cared for her during her last years those children should be paid an extra minimum wage. Decedent's son sought payment under the will for his service on the grounds that the payment was a bequest. The trial court denied the beneficiary's request because it was not timely filed and lacked proper verification. KRS 396.010(2) requires that a claim be verified by a person other than the claimant. KRS 396.025 requires that claims against a decedent's estate be filed within one year of the appointment of a personal representative. The Court of Appeals affirmed, holding that the son's demand for payment was in fact a claim against the estate, rather than a bequest, and therefore the failure to comply with KRS 396.025 and KRS 396.010(2) was fatal to the beneficiary's claim.

Cruse v. Leary, 727 S.W.2d 408 (Ky. App. 1987)

Decedent executed a will in 1977, leaving her estate to her son. In 1983, she executed an Irrevocable Trust Agreement providing that the income be distributed to her for life and, at her death, for the principal to be distributed equally to her son and grandchildren. Several weeks after executing the Trust Agreement, the decedent-settlor requested the trustee to return the trust property to her because as settlor she had not been advised that the trust was irrevocable. The trustee complied. Just prior to the request to the trustee, the decedent executed another will which purported to revoke all previous wills and which divided the estate among her son and grandchildren. In 1985, while in the hospital, the decedent executed, with appropriate legal formalities, a codicil reaffirming her 1977 will and revoking all testamentary documents executed after the 1977 will. After her death, an executed copy of her 1977 will could not be found. The 1985 codicil, and the 1977 will, as a lost document, were admitted to probate. The decedent's granddaughter filed a complaint in which she sought to establish the validity of the 1983 will and Trust Agreement by showing that the 1985 codicil was executed when decedent lacked testamentary capacity and that the 1977 will was not proven sufficiently. The trial court dismissed the granddaughter's complaint on summary judgment, holding that no genuine issue of material fact was present. The Court of Appeals reversed because the granddaughter raised several issues which might be submissible to a jury. A question of fact remained whether settlor-decedent could have revoked her 1983 "irrevocable" trust, and, the Court said, the granddaughter should be allowed the opportunity to present the jury with evidence on the issues of decedent's testamentary capacity and the existence or destruction of a lost will.

Cecil v. Cecil, 712 S.W.2d 353 (Ky. Ct. App. 1986).

Beneficiary filed suit against trustees to set aside an Agreement terminating her future interest in a trust. The

trial court dismissed the beneficiary's complaint because the action was barred under KRS 386.735. This statute provides that a beneficiary must commence an action against a trustee for breach of his fiduciary duty within six months after receipt of a final accounting, unless the final accounting does not fully disclose all relevant information, in which case the beneficiary has three years within which to bring an action. The trial court held that the agreement served as a complete final accounting, thus triggering the statute of limitations under KRS 386.735. The Appellate Court affirmed the trial court's opinion. The Court of Appeals also stated that because the beneficiary had an opportunity to read the Agreement and ascertain its contents before signing, she could not rely on the trustee's oral misrepresentations to set aside the agreement.

Morris v. Brien, 712 S.W.2d 347 (Ky. Ct. App. 1986).

District court ordered the removal of an estate's executor on the grounds of a conflict of interest resulting from the executor's excessive indebtedness to the estate. Rather than seeking appellate review, the executor brought a collateral action in circuit court claiming that the issue of his removal was an adversarial matter beyond the jurisdiction of the District Court. The circuit court dismissed the action.

On appeal, the Kentucky Court of Appeals held that pursuant to KRS 395.160(1), the District Court had jurisdiction to remove the executor if he was incapable of discharging his fiduciary obligations. The Court stated that a long line of Kentucky precedent supports the executor's removal for conflicts of interest under KRS 395.160(1). The Court found that there was undisputed evidence of the executor's indebtedness so that a conflict of interest was evident as a matter of law and, therefore, the District Court proceeding was not adversarial. Thus, the dismissal of the original action filed by the executor in circuit court was upheld.

Watkins v. Liberty National Bank & Trust Co., 34 K.L.S. 4, p. 7 (Ky. App. 1987).

The decedent created three trusts designating both income and principal to go to his daughter and "the issue of her body, which embraces her children and descendants at any period. . .," with the remainder over to the "heirs of her body." The trial court held that an adopted grandchild was not a beneficiary of the trusts. On appeal, the Kentucky Court of Appeals upheld the lower court's decision. The Court stated that given the specific language used by the decedent, he intended the beneficiaries of the trusts to be limited to his natural descendants, with any adopted children excluded. The Court noted that Kentucky law presumes an adopted child should be included as a beneficiary under a will or trust unless a contrary intention is apparent from the language of the instrument. Here, the decedent in creating the trust instruments clearly intended to exclude adopted children by way of using the language "issue of the body" and "heirs of the body." The Court further noted, had testator used the words "issue" or "lawful heirs" by themselves, the adopted child would have qualified as a beneficiary.

Cabinet for Human Resources v. SRJ, 706 S.W.2d 431 (Ky. Ct. App. 1986).

Expenses incurred by a guardian ad litem in preparing a future negligence action were not recoverable during an unrelated proceeding. The Court stated that the powers of a guardian ad litem are not as broad as those of a general guardian. The limited role of a guardian ad litem is to represent the child in the litigation at hand, not incur expenses in preparation of future unrelated actions.

V. **KENTUCKY ESTATE TAX**

KRS 140.130 creates an estate tax in Kentucky in addition to the usual inheritance tax. If an estate is required to file a federal estate tax return and the allowable credit for state death taxes exceeds the inheritance tax, then the statute provides that the difference between the allowable credit and the inheritance tax must be paid to Kentucky as an estate tax.

At issue in a recent Indiana case was the meaning of Indiana's estate tax statute. The case of Estate of Andrea v. Eberbach v. State of Indiana, Department of Revenue, Indiana Tax Court Dec. No. 87-09995, April 24, 1987, considered the issue of whether the Indiana estate tax equals the maximum credit permitted under I.R.C. Section 2011(b) or only such amount as is actually used by the estate.

The decedent's will left a formula minimum marital bequest, equal to the least amount necessary to reduce federal estate tax to zero, after taking into account available credits. The formula further provided that the state death tax credit was not to be used to the extent its use increased state death taxes payable. The court held that the Indiana estate tax applied only to that part of the credit for state death taxes as provided by Section 2011 as may be finally allowed against the federal estate tax, to the extent same exceeds the total of the state death taxes actually paid as a result of the decedent's death. Since the formula clause here operated to use the federal estate death tax credit only to the extent of Indiana inheritance tax, no Indiana estate tax was payable.

The same result should be obtained under the Kentucky state tax statute, KRS 140.130.

ESTATE PLANNING FOR THE S CORPORATION

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Section B

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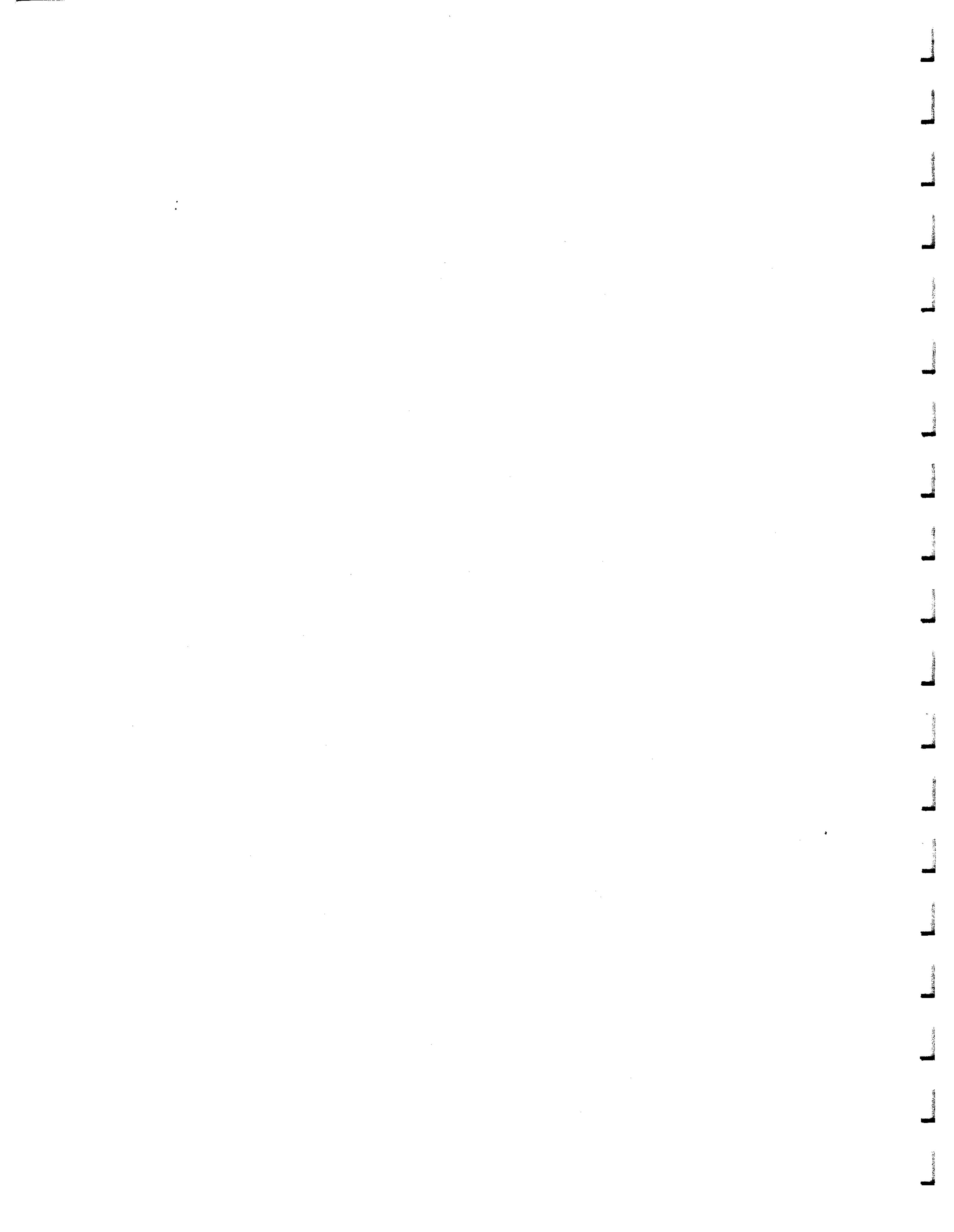

ESTATE PLANNING FOR S CORPORATIONS

By
Sheldon G. Gilman

I. <u>EFFECTS OF TAX REFORM ACT OF 1986</u>.

A. <u>General</u>. The Tax Reform Act of 1986 makes several fundamental changes in the income taxation of businesses and individuals. Although the Act makes few direct changes to the S corporation rules, contained in Code Sections 1361-1379, many of the Act's provisions have a substantial indirect effect on S corporations and their shareholders.

1. Rate Reductions.

a. For taxable years beginning in 1988, there will nominally be only two rates for individuals, 15% and 28%. At certain income levels, the new law phases out the benefit of the 15% tax bracket, and the personal exemption by imposing a 5% surtax on income above certain amounts.

b. The top marginal rate for C corporations is reduced from 46% to 34% for taxable years beginning after June 30, 1987. The revised rate schedule taxes corporate income of up to $50,000 at 15%; taxable income exceeding $50,000, but less than $75,000 at 25%; and taxable income exceeding $75,000 at 34%. The 15% rates and the reduction of the highest individual marginal rate to below the highest corporate marginal rate.

2. Use of Calendar Year. The 1986 Act requires that all partnerships, S corporations and personal service corporations conform their taxable years to the taxable years of their owners unless they have established to the satisfaction of the IRS a business purpose for having a different taxable year.

B. <u>Repeal of "General Utilities" Doctrine.</u>

1. Application of New Rule. The 1986 TRA overturns the long-standing doctrine of <u>General Utilities and Operating Co. vs. Helvering</u>, 296 U.S. 200 (1939), and pre-1986 TRA Code Section 336 that a liquidating corporation recognizes no gain or loss on its distribution of assets in liquidation. Generally, the new law provides that gain and losses on assets distributed by a liquidating corporation are to be recognized by the liquidating corporation as if

those assets had been sold to the distributee shareholders at their fair market value. Accordingly, distributions of appreciated property by C corporations in either liquidation or redemption will be subject to double taxation.

a. Transitional relief from the effect of the repeal of the <u>General Utilities</u> doctrine for "qualified" corporations that completely liquidate before January 1, 1989, is available.

b. Distributions by S corporations, provided they are not covered by the new special rule taxing "built-in gains" of former C corporations, will be taxed only once because the gain is passed through to the shareholders, whose bases are increased pursuant to Section 1367(a)(1) by the amount of the gain recognized.

2. "Built-In Gains" of S Corporations. In order to prevent shareholders of closely held C corporations from circumventing the corporate tax on liquidating distributions by converting their corporations to S corporation status, waiting three years, and then liquidating, TRA 1986 revises Section 1374 to impose a tax on the "built-in gain" of former C corporations during the first 10 years after the S corporation election is made.

a. Under Section 1374, a tax equal to the highest rate of corporate tax is imposed on the taxable sale, exchange or disposition within 10 years after electing S corporation status for any asset held by the corporation on the election date to the extent of the appreciation in value of such asset as of the election date.

b. The amount of recognized built-in gain subject to this tax is limited by the amount of taxable income that the corporation would have had during the taxable year of disposition if it had been a C corporation. Thus, losses from other activities and transactions during the year can prevent the imposition of this tax. The amount of built-in gain subject to this tax can also be reduced by NOL carryforwards from the corporation's C corporation years.

c. The tax does not apply to corporations that have been S corporations during each of their taxable years.

C. <u>Alternative Minimum Tax</u>. S corporations, as pass-through entities, are not subject to the alternative minimum tax; however, changes in the alternative minimum tax may affect the decision to make or continue an S corporation election. The "book income/earnings and profits" adjustment in the revised AMT computation for C corporations effectively requires such

corporations to keep two separate sets of records for tax purposes; accordingly, the S corporation becomes more attractive.

D. Preference For S Corporations. Although some of the provisions of the TRA, such as the restrictions on fiscal year selection, have a negative impact on S corporations and their shareholders, the TRA's general effect is to make the S corporation an attractive form of doing business in more situations than under pre-1986 TRA law. As a result of rate changes, the repeal of the "General Utilities" doctrine, and the imposition of the alternative minimum tax, many taxpayers may find that doing business through a pass-through entity such as an S corporation will be more attractive than before the TRA.

E. Preference For C Corporations. The S election is not warranted for highly profitable personal service organizations with a substantial number of shareholders where most of the profits are passed through to the employee-shareholders in the form of compensation and retirement benefits. Also, it is inappropriate where the loss of fringe benefits to two percent or greater shareholders exceed any other tax savings. Also, it may not be appropriate in corporations where the income before any compensation to employee-shareholders is less than $100,000 per year, or where the corporation has significant net operating losses which cannot be used against S corporation earnings.

II. THE S CORPORATION.

A. The Subchapter S Corporation. Subchapter S was enacted into law in 1958, and Congress, rather than just applying the rules of partnership taxation to eligible corporations, devised a unique scheme for eliminating the double taxation of corporate income. An electing small business corporation was generally exempt from all corporate income taxes, but its income was taxed currently at the shareholder level whether or not distributed. The amounts included in income by the shareholders generally were taxed as ordinary dividend income. Capital gains and net operating losses retained their character and flowed through directly to shareholders.

1. Problems of Subchapter S Corporation. The former subchapter S corporation was burdened with a number of "traps" for the unwary; including the following.

a. Precise technical requirements for making a valid election.

b. Investment credit recapture at the corporate level when making a former subchapter S election unless the corporation and its shareholders agree to share the liability for any recapture for subsequent dispositions of assets.

c. Excessive passive investment income terminated the corporation's former subchapter S status retroactively.

d. Net operating loss in excess of shareholder stock bases was lost without any carryforward.

e. Undistributed taxable income was in effect "locked in" the former subchapter S corporation if not distributed on a current basis.

f. Inadvertent termination of former subchapter S status by violating one of the technical requirements to retain status.

2. New Subchapter S Enacted. Congress enacted the Subchapter S Revision Act in 1982, and repealed the former subchapter S corporation rules. The new provisions simplified S corporation taxation by eliminating some unintended tax traps and benefits, and by eliminating some unwarranted differences between the subchapter S and partnership provisions. The S corporation is a flow-through entity similar to the partnership, it is still a corporation, and therefore, a hybrid entity for tax purposes.

B. <u>Qualification as a Small Business Corporation</u>.

1. Domestic Corporation Requirement. A corporation organized and existing under the laws of a foreign jurisdiction cannot qualify as an S corporation even though all of its business activities are conducted in the United States. The term "corporation" includes associations that are taxable as corporations; accordingly, an unincorporated enterprise, such as a limited partnership, that is treated as an "association" for tax purposes could elect S corporation status if it is otherwise eligible.

2. Ineligible Corporations. Certain types of corporations are "ineligible" for S corporation status regardless of whether they would otherwise qualify as "small business corporations."

a. Members of an Affiliated Group. A corporation may not elect S corporation status if it is a member of an affiliated group as determined under Section 1504. Although Code Section 1504 defines the term "affiliated group" primarily for determining eligibility to file consolidated returns, the filing (or lack of filing) of such returns is irrelevant for purposes of the S corporation affiliated group rules. The affiliated group restriction generally prevents an S corporation from owning 80% or more of the stock of another corporation; however, the two exceptions to this rule

are: (1) the subsidiary has not begun business and does not have gross income, and (2) a subchapter S corporation's momentary ownership of all the stock of another corporation, i.e., a transitory subsidiary, does not cause a termination of the subchapter S election. Although an S corporation cannot be a member of an affiliated group, nothing precludes an S corporation from being in a "controlled group" under Code Section 1563. Also, the affiliated group rules can be avoided by shifting ownership of second classes of stock and by shifting stock values.

b. Other excluded corporations are: financial institutions, insurance companies, possessions corporations, DISCs or former DISCs.

3. No More Than 35 Shareholders.

a. General. The 35 shareholder limit corresponds to the private placement exception under Federal Securities Law. An S corporation does not exceed the 35 shareholder limit unless it has more than 35 shareholders "at any particular time" during the taxable year. See Rev. Rul. 78-390, 1978-2 CB 220. Forming separate corporations to avoid the 35 shareholder limit is not be permitted. In Rev. Rul. 77-220, 1977-1 CB 263, the IRS ruled that three separate corporations, which formed a partnership for the operation of a single business, would not be eligible to elect S corporation treatment.

b. Rules for Counting Shareholders. The stock attribution rules do not apply in determining the number of shareholders. Therefore, except for husbands and wives, and their estates, related individuals owning stock are each counted separately. See Rev. Rul. 59-187;, 1959-1 CB 224. Reg. Section 1.1371-1(d)(1) provides that if stock in a corporation is held by a nominee, agent, guardian, or custodian, the person or persons for whom the stock is held, and not the nominee, agent, guardian or custodian is considered to be the shareholder. Therefore, if a custodian holds shares for two or more minors, each minor is counted as a shareholder. In the case where an estate is the shareholder, the number of the estate's beneficiaries will not affect the treatment of the estate as one shareholder for determining the number of S corporation shareholders.

4. Eligible Shareholders.

a. General. The former rules provided that a subchapter S corporation could not have as a shareholder a person (other than an estate) who is not

an individual. It was not possible for a corporation, partnership or trust to qualify as an eligible shareholder. The rules have been modified substantially; eligible trust shareholders include the following:

(1) Trusts treated as owned by a U.S. citizen or resident individual under Sections 671-678;

(2) Trusts whose deemed owners have died are eligible shareholders for 60 days, and trusts entirely included in the deemed owner's gross estate are eligible for a maximum of two years;

(3) Trusts to which stock has been transferred by a will, but only for 60 days;

(4) Voting trusts; and

(5) Qualified subchapter S trusts under Section 1361(d)(QSSTs).

b. ESOP Exclusion. An ESOP is not an eligible shareholder of an S corporation. Section 1361(c) and (d) sets forth the rules regarding eligible shareholders, and because the ESOP cannot meet these definitional rules, its status as an S corporation shareholder would terminate the corporation's election.

c. Grantor and Section 678 Trusts. Section 1361(c)(2)(A) provides that a trust <u>all</u> of which is owned by an individual grantor or beneficiary under Section 671 through 679 may be a shareholder of an S corporation. The deemed owner of the trust, and not the trust itself, is treated as the S corporation shareholder for purposes of the eligible shareholder rules. Another type of eligible trust is one in which the deemed owner of the grantor or Section 678 trust dies. In this situation, the trust is permitted to remain as an eligible shareholder for 60 days after the deemed owner's death. If the entire corpus of the trust is included in the deemed owner's estate, then the trust can remain a shareholder for up to two years; however, this provision applies only if the trust's status as a grantor trust terminates as a result of the death of the grantor. It does not apply if such status is terminated as a result of the relinquishment by the grantor of the powers which caused the trust to be a grantor trust.

(1) The IRS has issued many private letter rulings where it approved certain trusts as qualifying under Section 1361(c)(2)(A)(i),

including: PLR 8613054, in which identical irrevocable trusts, all of which allow the trustees to accumulate income, and provided the beneficiaries with a Crummey withdrawal power, qualified as S corporation shareholders; in PLR 8425067, the IRS ruled that a testamentary trust qualified where the trust's beneficiary had an income interest during life and the power to appoint the remainder.

(2) Under Section 1361(c)(2)(A)(iii) any trust may be a shareholder in an S corporation where it acquires the stock in the corporation pursuant to the terms of a will; however, the eligibility of the trust extends for a period of only 60 days after the trust acquires the stock. Thereafter, the trust becomes an ineligible shareholder, and retention of the stock beyond the 60-day period will cause a termination of S corporation status. In Fulk & Needham, Inc. vs. U.S. 411 F.2d 1403 (4th Cir. 1969), a corporation was found not to qualify for subchapter S status because one of its shareholders was a testamentary trust, even though the trustees and beneficiaries disregarded the existence of the trust.

d. Voting trusts. A trust created primarily to exercise the voting power of stock transferred to it may be a shareholder of an S corporation. Section 1361(c)(2)(A)((iv). Proposed regulations provide that the voting trust must be represented by a written agreement which: (i) delegates to one or more trustees the right to vote, (ii) requires all distributions with respect to the stock of the corporation to be paid to, or on behalf of, the beneficial owners of the stock, (iii) requires title and possession of the stock to be delivered to the beneficial owners upon termination of the trust, and (iv) must terminate, under its terms or by State law, on or before a specific date or event.

e. Qualified Subchapter S Trust (QSST).

(1) Defined. Under Section 1361(d)(3)(A) a QSST is a trust that requires:

(a) There can only be one income beneficiary at a time (a spray trust for multiple beneficiaries does not qualify);

(b) Principal distributions during the current income beneficiary's life can only be made to that beneficiary;

(c) The current income beneficiary's income interest must terminate on the earliest of the beneficiary's death or the termination of the trust;

(d) If the trust terminates <u>during</u> the current income beneficiary's life, the trust's assets are all distributed to the current income beneficiary; and

(e) All of the trust's income must be either distributed, or required to be distributed, currently to only one individual who is a citizen or resident of the United States.

(2) Election. The current income beneficiary of a QSST must make a separate election for each corporation in which the trust owns S corporation stock. The beneficiary of the trust will be treated as the deemed owner under Section 678(a) of that portion of the trust consisting of S corporation stock for which an election is made; therefore, the rule implies that a QSST can own stock in other corporations (not just S corporations) and other property. The election may be made up to 2-1/2 months after the trust becomes a shareholder or 2-1/2 months after the beginning of the first taxable year in which the S corporation election is to be effective. Problems could arise for an S corporation with a QSST because the S corporation election must be filed before making the QSST election. If the QSST election is made before the S corporation election, the S corporation's election would be invalid, because the trust would not be qualified. If the election is not made within the prescribed 2-1/2 month period, an extension of time to do so cannot be granted by the IRS.

(a) In PLR 8506029, two beneficiaries of QSSTs failed to make the election to treat the trusts as QSSTs. The Service ruled that the S corporation election was invalid even though both beneficiaries had signed the corporation's Form 2553 and they had argued substantial compliance with the Section 1361(d)(2) election requirement.

(b) In PLR 8608006, where QSST elections were not filed, the Service ruled, under Section 1362(f) that an inadvertent termination had occurred and it reinstated S corporation status under its waiver

authority; however, the problem with this ruling is that the S corporation election may never have been valid because the "QSSTs" were initial shareholders. The effect of this ruling is a retroactive validation of an ineffective S corporation election.

(3) Successive Income Beneficiaries. Successive beneficiaries of an QSST are treated as consenting to the original trust election; however, a successive income beneficiary can affirmatively refuse to consent to the election within 60 days of becoming the income beneficiary. Under Section 1362(d)(1)(B) shareholders holding more than one-half of the shares of stock of an S corporation must consent to revocation of the S corporation status. Affirmative refusal to consent to the election on the part of a new shareholder will not terminate the corporation's status. However, a successive income beneficiary, whether or not a more than 50% shareholder, can effectively terminate the corporation's status by affirmatively refusing to consent to the QSST's status.

(4) Revocation. A QSST election is irrevocable unless the revocation of the trust's status is made with IRS consent.

(5) Planning. QSSTs can be used to shift income in the appreciating value in an S corporation without vesting control in junior shareholders. The IRS has issued a number of QSST private letter rulings. Some of the more interesting are summarized below:

(a) PLR 8613054 - trusts with Crummey powers qualified as QSSTs.

(b) PLR 8529060 - a marital deduction trust and a residual trust created under a will qualified as QSSTs.

(c) PLR 8527081 - the IRS ruled that each separate share of a trust qualified as a QSST.

(d) PLR 8435153 - the IRS ruled that the provision to pay income and principal to the current beneficiary's court-appointed guardian, for the use and benefit of the beneficiary if the beneficiary was disabled, did not disqualify the trust as a QSST.

(e) PLR 8336018 - the IRS ruled that a trust did not qualify as a QSST because the income beneficiary with a Crummey power was treated as owning a portion of, and not the entire, principal.

f. Estates. An "estate" is an eligible shareholder of an S corporation. Section 1361(b)(2). An estate can make an initial S corporation election. In PLR 7951131, the IRS ruled that an estate, which owned two apartment complexes, could form a separate corporation for each complex, and then have the corporations elect subchapter S status with the consent of the estate as the sole shareholder. An S corporation election could provide a means of getting cash out of a corporation without double taxation; also, if the estate has income from other sources, an S corporation election for its closely held corporation will allow any net operating losses to offset other income.

5. Single Class of Stock.

a. General. A corporation having more than one class of stock does not qualify as an S corporation. Section 1361(b)(1)(D). In determining whether a corporation has more than one class of stock, only stock which is issued and outstanding is considered; therefore, treasury stock and unissued stock of a different class will not disqualify a corporation. A corporation will be considered to have more than one class of stock if the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation. Thus, a difference as to dividend rights or liquidation preferences of outstanding stock will disqualify a corporation.

b. Stock Purchase Agreements. The Service has ruled that a stock purchase agreement between an S corporation and one of its shareholders does not create a second class of stock where the agreement does not affect the shareholder's rights to the corporation's profits and assets. In the ruling, an S corporation had two classes of common stock which were identical in all respects except for voting rights and a restriction on the non-voting shareholder's right to dispose of the stock. The shareholder was allowed to transfer his stock only with the consent of the owners of the voting shares; without this consent, he could only sell the stock to the corporation or to the other shareholders at book value. Upon the non-voting shareholder's death, disability, or termination of employment, the corporation or the other shareholders had the right to purchase his stock. The Service explained that since the agreement restricting the transfer of the stock does not affect the shareholder's interest in corporate profits or assets while he is a shareholder, the corporation did not have more than one class of stock.

Rev. Rul 85-161, 1985-41 IRB 22. Buy-sell agreements that impose restrictions on stock generally do not create a second class of stock. See PLR 8506114 and 8528049.

c. Voting Rights. An S corporation may have only one class of stock; however, Section 1361(c)(4) specifically provides that an S corporation will not be treated as having more than one class of stock solely because there are differences in voting rights between shares of common stock. With differences in voting rights now permitted, a senior generation can retain control of an S corporation while shifting appreciation in non-voting stock to a junior generation. Further, some shares may be eligible to vote only for Class A directors, while all other shares are entitled to vote for Class B directors, or some shares might have two votes while others have only one.

d. Disproportionate Distributions. S corporation income and loss items must be allocated on a pro rata basis to shareholders as required by Section 1377(a). However, there is nothing in the statute that literally requires distributions to be made on a proportionate basis to shareholders. Reg. Section 1.1371-1(g) requires that disproportionate distributions not be made.

e. Debt as a Second Class of Stock. If debt can be reclassified as a second class of stock, S corporation status terminates.

(1) Straight-Debt Safe Harbor. Under the safe harbor rule of Section 1361(c)(5) a debt instrument without equity characteristics will not be treated as a second class of stock. To qualify as straight debt, the following requirements must be met:

(a) A written unconditional promise to pay on demand, or on a specified date, a sum certain in money;

(b) An interest rate and interest payment dates not contingent on profits, the borrower's discretion, or similar factors;

(c) The debt instrument cannot be convertible, directly or indirectly, into stock; and

(d) The creditor must be an individual, estate, or trust which would be eligible to hold stock in an S corporation.

(2) General Debt vs. Equity Rule. In a subchapter S case, the Tax Court held that where the debt obligations were in the same proportion as the stock as to face amount and ownership, such obligations constituted stock, but not a second class of stock. See Gamman vs. Comr., T.C. Memo 1966-159, 25 T.C.M. 844.

C. Electing S Corporation Status.

1. Corporate and Shareholder Action. The corporation must timely file a proper election form and all the shareholders must consent in writing to such election. These consents must be filed with the IRS. Consents are required by beneficial owners of an S corporation, as well as any person treated as a shareholder by virtue of the shareholder trust rules. The Code and Regulations are silent as to whether a consent form signed by a designated representative under a power of attorney is valid. The S corporation election must be filed on a timely basis, no later than during the first two months and 15 days of the election year. An extension of time for filing cannot be obtained. Rev. Rul. 60-183, 1960-1 CB 625.

2. New Election After Termination. If an S corporation's status is terminated, the corporation, or any successor corporation, cannot reelect S corporation status until completion of four taxable years after the taxable year of termination, unless the IRS grants permission to do so under Section 1362(g).

3. Loss of The S Election. Under prior law a new shareholder could affirmatively refuse to consent to the election and cause the loss of the S election. The new law revises the election process to require that all shareholders consent to the initial election; thereafter, the holders of more than 50% of the stock must consent to a revocation of the election. The revocation of the election must be distinguished, however, from a termination of the election which occurs whenever the conditions for qualification are no longer met.

a. Example: If a one-percent shareholder in an S corporation which has 34 shareholders transfers his stock to his two children, with the result that the corporation then has 36 shareholders, the election is terminated automatically.

b. To protect shareholders from an inadvertent or unwanted loss of the S election, it may be desirable to require the shareholders to enter into a contract among themselves and with the corporation. See Article VI of this outline.

III. TAXATION OF THE S CORPORATION.

A. General. The S corporation is treated as a pass-through entity similar to the partnership. The corporation is not subject to any taxes; however, the S corporation may pay special taxes on its income in four situations; (1) if the corporation has subchapter C earnings and profits, and 25 percent of its gross receipts constitute passive investment income; (2) to the extent net capital gain of the corporation exceeds $25,000; (3) if the S corporation is subject to the capital gains tax, it may also be subject to the add-on tax for preference income; and (4) if investment credit property is disposed of prematurely and credit was allowed prior to the S corporation's election, investment tax credit recapture may apply.

1. Passive Income Problems. S corporations that do not have any accumulative earnings and profits from prior C corporation existence are not subject to any passive income limitations; therefore, these corporations do not need to monitor their receipt of passive income to retain S corporation status. Under former Section 1372(e)(5), a subchapter S corporation could not receive more than 20% of its gross receipts from passive income without terminating its subchapter S status. Although the passive income test has been eliminated for most S corporations, existing corporations with subchapter C earnings and profits that elect S corporation status are subject to different passive income rules, unless they are able to strip out their subchapter C earnings and profits. These S corporations need to monitor their passive income because: (1) if passive income for a taxable year exceeds 25 percent of gross receipts for the year, a tax on "excess net passive income" will be imposed; and (2) if the 25 percent limit is exceeded for three consecutive years, the S corporation's status will be terminated with the beginning of the next tax year. The passive income tax is at the highest corporate rate.

2. Capital Gains. In limited situations capital gains are taxed at the corporate level. Section 1374(a) imposes on an S corporation a tax at the corporate level if in any taxable year (1) its "net capital gain" exceeds $25,000 and also exceeds 50 percent of its taxable income for such year, and (2) if the taxable income of such corporation for such year exceeds $25,000. The sale of corporate assets could be structured as installment sales to help avoid the net capital gains tax. By limiting reportable net capital gain to $25,000, or to less than 50 percent of taxable income during the three-year exception period for existing S corporations the capital gains tax could be avoided.

B. Allocation of Income and Losses to Shareholders. S corporation income, deduction, loss and credit items, the separate treatment of which could affect a shareholder's tax

liability, pass through separately to shareholders on a pro rata basis and they retain their character. Because the S corporation rules allocate income and loss items on a pro rata basis to all shareholders who held stock during the corporation's taxable year, no matter if they actually hold stock on the last day of the corporation's taxable year, the transfer of stock between family members will not need to be as closely scrutinized as under the former subchapter S rules.

1. Prior Law. Losses were passed through to the shareholders on a per share, per day basis, while the corporation's income was passed through on a per share basis to those persons who owned the shares on the last day of the corporation's fiscal year.

2. New Law. Income and losses are passed through to shareholders on a per share, per day basis, sometimes referred to as the "full year's allocation" method. Under Section 1377(a), in the case of a shareholder who terminates his interest by sale, exchange, gift or death and all persons who are shareholders during the taxable year agree, the corporation's items may be allocated among the shareholders as if the corporation closed its books at the time of termination (the "interim closing of the books" method). This election applies to an allocation only "as if" the taxable year consisted of two taxable years, the first of which ends on the date the interest is terminated. This election does not require two corporate returns for the normal tax year, nor does it accelerate the time for filing a corporate or individual return.

C. Shareholder Basis in Stock. The initial basis of an S corporation shareholder in his stock is determined in the same manner as the basis of stock in a subchapter C corporation. The stock basis of each shareholder is increased by his pro rata share of each item of separately stated income. It does not make a difference whether the particular item is an item of ordinary income or of capital gain. The shareholder's basis is reduced by distributions by the corporation which are not includible in income; separately stated loss and deduction items, nonseparately computed loss; any expense of the corporation which is not deductible in computing taxable income and not properly chargeable to capital account. In any event, stock basis cannot be reduced below zero.

1. Basis and Indebtedness. The basis of a shareholder's loan to an S corporation will be the face amount of the loan; as principal payments are made on the loan the basis of the indebtedness will be decreased. After stock basis has been decreased to zero, the basis in loans can be reduced by loss and deduction items flowed through to shareholders. If there are subsequent increases in earnings after the basis and indebtedness has been reduced to zero,

these increases will first restore basis in the loans before basis in stock. See Section 1367(b)(2).

2. Basis Limitation and Carryover Period. The deductibility of excess loss and deduction items at the shareholder level is limited to the shareholder's adjusted basis in stock plus any adjusted basis in any corporation indebtedness to the shareholder. The S corporation rules, in comparison to the former subchapter S rules, change the basis limitation rule as it applies to the deductibility of net operating losses at the shareholder level. Unlike the former rules, losses that are not useable in the current year can be carried forward indefinitely and are allowed in any subsequent year in which the shareholder has adequate basis in stock or debt. Basis in stock or in indebtedness can be intentionally reduced to suspend losses indefinitely to years where there is sufficient other income to utilize the losses.

> <u>EXAMPLE</u> (1) The sole shareholder of an S corporation owns stock at the beginning of the taxable year which has a basis of zero. At the end of the year non-separately stated items yield net income of $50,000. There were long-term capital gains of $20,000 and a section 1231 loss of $75,000 as separately stated items. The basis of this stock is first adjusted upward to $70,000; then the $75,00 item is applied. Only $70,000 of the loss item is allowable. The remaining $5,000 would be carried over by the shareholder.
>
> (2) If the corporation distributed $10,000 to its sole shareholder, the extent to which such distribution is includible in income under Section 1368 depends on the shareholder's adjusted basis in his stock. After applying the $75,000 loss item, the shareholder's adjusted basis is reduced to zero. Thus, all of the $10,000 distribution is includible in in income as gain from the sale or exchange of a capital asset (assuming no accumulated earnings in profits).
>
> (3) If, in addition to his stock, the shareholder held corporate debt having a basis of $20,000, the $5000 which could not be absorbed by stock basis would have been allowed to this indebtedness. Thus, the $5000 loss is fully allowed, reducing the basis of the indebtedness to $15,000. This has no effect on the includibility of the $10,000 distribution in the shareholder's income.

3. Restoration of Basis in Indebtedness. Under the former subchapter S rules, if net operating losses reduced a shareholder's basis of a corporation's indebtedness to the

shareholder, any repayments of the debt by the corporation automatically resulted in taxable gain to the shareholder. The S corporation rules partially alleviate this problem by restoring basis in indebtedness with subsequent S corporation earnings. Where the shareholder's basis in indebtedness has been reduced, any of the items requiring an increase in the basis of stock that are passed through in a subsequent year will be applied first to restore basis in indebtedness. Only when the basis in indebtedness has been restored are items applied to increase basis in stock.

a. Gain Recognized On Repayment. When an S corporation repays its indebtedness to shareholders, generally it will not recognize any gain if the repayment is in cash. Repayments with appreciated property could, however, result in gain or loss at the corporate level. However, if the corporation repays low-basis indebtedness, the shareholders can recognize income; each loan payment is allocated partly to return of basis and partly to income when the basis of the note has not been reduced to zero. The character of the income recognized on a low-basis loan's repayment depends on the nature of the loan asset in the hands of the shareholders. Generally, only the "sale or exchange" of a capital asset results in capital gain.

b. New Shareholder Loans. New loans by shareholders to the corporation in the same year that earlier loans are repaid cannot be taken into account in determining basis on the repayment of earlier loans as long as there are separately identifiable notes.

4. Creating Basis. There are a number of ways to create basis in an S corporation to assure that shareholders have adequate basis to utilize losses flowed through to them. For example, the shareholder could (1) contribute cash or property to the corporation; (2) loan additional cash; (3) make a payment on the corporation's debt which was guaranteed by the shareholder; (4) substitute his note for guaranteed corporate debt; (5) borrow from lenders and relend the proceeds to the corporation, i.e., back-to-back loans; (6) acquire property which is totally mortgaged and then sell the property to the corporation under a wrap-around mortgage transaction; or (7) accelerate corporate income or defer corporate deductions.

a. Shareholder Guarantees. Under the former subchaper S rules, a shareholder could not guarantee corporate level debt and obtain an increase in the adjusted basis of corporate indebtedness owned to the shareholder; a mere guarantee is not considered to create indebtedness between the shareholder and the corporation. However, if the shareholder makes payment on indebtedness in satisfaction of the guarantee, then

the shareholder is subrogated for the third party creditor and <u>direct</u> indebtedness is created between the shareholder and the corporation. See Rev. Rul. 70-50 1970-1 CB 178.

b. Lack of Investment. No basis is acquired in an S corporation where there is no actual contribution of capital in the form of cash or property.

IV. TREATMENT OF S CORPORATION DISTRIBUTIONS.

A. Corporations With No Earnings and Profits. When an S corporation has no accumulated earnings and profits, its distributions to shareholders are nontaxable to the shareholders, but require downward adjustments in stock basis (and not corporate indebtedness) in the amount of the distributions. Distributions received after stock basis has been reduced to zero are treated as capital gain. Downward adjustments in stock basis for distributions will serve to neutralize upward adjustments made when the shareholders include S corporation income on their individual returns. S corporations having no accumulated earnings and profits are not required to maintain an accumulated adjustments (AA) account.

B. Corporations With Earnings and Profits. Distribution rules are considerably more complicated if the S corporation has accumulated earnings and profits. The rules ensure that distributions of accumulated earnings and profits will be taxed as dividends, but that distributions of income already taxed to shareholders either under the new S corporation rules or the former subchapter S corporation provisions will be recovered tax-free. Accumulated earnings and profits can be decreased for: (1) distributions to the extent made out of accumulated earnings and profits; (2) distributions resulting from redemptions, liquidations, and reorganizations; and (3) any investment credit recapture tax paid by the S corporation.

1. Accumulated Adjustments Account. For S corporations with accumulated earnings and profits, the accumulated adjustment (AA) account is key to making tax-free distributions to shareholders. The AA account represents all the earnings of the corporation for S corporation years which have been previously taxed to shareholders, less any amounts already distributed, i.e., the AA account is the accumulation of previously taxed, but undistributed, earnings of the S corporation. Accordingly, to the extent the corporation has a positive balance in the AA account, tax-free distributions can be made to shareholders.

a. Tax-exempt income, and deductions related thereto do not increase, or decrease the AA accounts; therefore, if the S corporation distributes all of its earnings, the shareholders will receive a dividend out

of any accumulated earnings and profits to the extent of the tax-exempt income. This rule assures that subchapter C corporations electing S corporation status will not be able to use their tax-exempt investments to bail out accumulated earnings and profits. Accordingly, S corporations with accumulated earnings and profits should avoid owning tax-exempt obligations.

b. Nondeductible items reduce the AA account. This results in more distributions being taxable as dividends to shareholders if the S corporation has accumulated earnings and profits because the AA account will reflect lower balances.

c. The AA account is an S corporation concept similar to earnings and profits of a regular corporation; therefore, it cannot be directly transferred to a new shareholder. However, unlike PTI of a former subchapter S corporation, it is not lost when a shareholder transfers his shares in an S corporation. In effect, the tax-free benefits of the AA account can be inherited by the new shareholders.

2. Dividends, Return of Capital, Capital Gain. Any amounts distributed in excess of the AA account will be treated as a dividend to the extent it does not exceed the corporation's accumulated earnings and profits, unless the corporation was a subchapter S corporation for its 1982 tax year, and has previously taxed income (PTI). After all accumulated earnings and profits have been distributed, any excess distributions are treated as a return of capital reducing stock basis, and if any excess, taxed as capital gain.

3. Distributions of Previously Taxed Income (PTI). If the corporation has previously undistributed taxable income (PTI) and distributions are made in cash, the amounts distributed in excess of the AA account will be treated as first coming out of PTI and then any excess distributions will be treated as coming out of accumulated earnings and profits. PTI can be distributed out only if the corporation was a subchapter S corporation for its last taxable year beginning before 1983, i.e., the year before the effective date of the Subchapter S Revision Act of 1982. Any problems with distributing out PTI from former subchapter S years on a tax-free basis have been minimized under the S corporation rules. A "locked in" problem exists, however, to the extent the corporation cannot make cash distributions to carry out the PTI. If the corporation is limited to property distributions, then PTI must remain in the corporation until cash can be distributed.

4. Election to Distribute Accumulated Earnings and Profits Before AA Account. An S corporation can elect, with

the consent of all its "affected" shareholders, not to make distributions out of its AA account. Paying out accumulated earnings and profits can help a corporation avoid the passive income tax or the passive income termination rule. Also, where the S corporation was a regular corporation during the immediately preceding year, and has encountered an accumulated earnings tax or a personal holding company problem, the election may facilitate a post-C corporation year distribution under Section 563 and serve to eliminate these problems. The election may not be necessary, however, if the corporation can qualify for the consent dividends procedure under Section 565.

5. Summary of Distribution Rules. In the case of an S corporation with accumulated earnings and profits, the ordering and treatment of distributions to shareholders is as follows.

a. A tax-free distribution to the extent of any undistributed taxable income earned in an immediately preceding former subchapter S year, but only if made in cash within 2-1/2 months after the close of that year.

b. A tax-free distribution to the extent of the S corporation's AA account determined under Section 1368(e). If the distribution exceeds stock basis, but not the AA account, capital gain will generally result.

c. A tax-free distribution to the extent of any previously taxed income earned in former subchapter S years, but only if made in cash.

d. A dividend to the extent of the corporation's accumulated earnings and profits.

e. A reduction in stock basis.

f. After stock basis is exhausted, taxation is capital gain.

C. Property Distributions.

1. Comparison of Prior Law and New Law. Under prior law, only cash distributions were considered to carry out PTI to the shareholders; distributions in kind did not do so. The new law permits PTI to be passed to shareholders by a distribution of corporate property in kind.

2. Effect on Corporation. Distributions of appreciated property by an S corporation result in gain recognized by the corporation in the same manner as if the property had been sold to the shareholders at its fair market value, and the gain recognized flows through to shareholders like other S corporation gain. The gain

recognized by the corporation will reflect the property's character in the hands of the corporation. S corporations do not recognize gain for distributions of property in complete liquidation or in reorganizations where the receipt of corporate stock is tax-free to shareholders.

V. DISPOSITION OF S CORPORATION STOCK.

A. General. The proper disposition of S corporation stock is essential to avoid inadvertent termination of the election. In addition, consideration should be given to the income tax consequences to the beneficiaries of the S corporation stock, as well as to the postmortem control and management of an S corporation.

B. Transfers During Life. Lifetime gifts of S corporation stock can be effective in shifting income among family members because the S corporation's net income is taxed to the shareholders on a pro rata basis. The gift of S corporation stock must be a bona fide transaction, and the donee must be the real owner of the stock after the gift; otherwise, the IRS may reallocate the corporation's income back to the donor. In addition, the new law added Section 1366(e) which allows the IRS to adjust items of income, deduction, loss or credit among family members who are S corporation shareholders if a family member renders services for or furnishes capital to the corporation without receiving reasonable compensation.

1. Allocation of Income. As the corporation's items of income, loss, deduction and credit are allocated on a per share, per day basis, the donor of S corporation stock is taxed on his pro rata share of the corporation's income before the gift, with the donee being taxed on his pro rata share of the income after the gift. Accordingly, a shareholer can no longer shift undistributed taxable income to lower bracket taxpayers by making gifts immediately prior to the end of the S corporation's taxable year.

2. Transfer of Shareholder's Basis. A shareholder's basis should be considered in making gifts of S corporation stock, because a shareholder cannot deduct his pro rata share of the corporation's losses and deductions in excess of the total of his adjusted basis in the S corporation stock plus any indebtedness of the corporation to him, although the losses and deductions may be carried forward. While a donee will acquire the donor's adjusted basis in the stock as of the date of the gift, the donee will not normally receive the donor's interest in the corporation's indebtedness to the donor shareholder. Accordingly, if the donor has a low basis in the shares and losses are anticipated, lifetime gifts of the stock may not be desirable. The donor should consider holding on to the stock until death, and then transferring it because the low

basis stock will receive a step-up to its fair market value for Federal estate tax purposes.

C. Outright Bequest of Stock. An outright bequest of S corporation stock should not jeopardize the election as long as the number of shareholders after the gift does not exceed 35.

D. Bequest To Marital Trust. A bequest of S corporation stock to a trust will terminate the election unless the the trust is an eligible shareholder. A qualified subchapter S trust (QSST) and a Section 678 trust may hold S corporation stock for an indefinite period of time, and either of these types of S corporation trusts can also qualify as a marital deduction trust under Section 2056.

1. QTIP Trust as a QSST. A QTIP trust requires that the surviving spouse be entitled to receive all the income from the property, payable annually or more frequently. This meets the QSST requirement that only one income beneficiary exist at any time and that all the income be distributed to that beneficiary. The QTIP trust requires that no person have a power of appointment over any part of the property other than the surviving spouse. The QSST trust provides that principal may be distributed only to the then current income beneficiary.

2. Elections for QTIP and QSST. If a trust qualifies both as a QTIP trust and a QSST trust, two separate elections must be made in connection with the trust. The executor must make the election under Section 2056(b)(7) to have the property treated as QTIP property. That election must be made on the estate tax return, and once made, it is irrevocable. In addition, the trust's income beneficiary must make the election under Section 1361(d)(2) to have the trust treated as a QSST. Once made, that election is revocable only with IRS consent.

3. Power of Appointment Trust. A power of appointment marital trust which meets the requirements of Section 2056(b)(5) can also qualify as a Section 678 trust eligible to hold S corporation stock. The surviving spouse must be given an inter vivos general power of appointment or right of withdrawal or other power which would cause the spouse to be treated as the deemed owner of the trust under Section 678. Such a power must be exercisable solely by the spouse to vest the principal and income in the spouse.

4. Marital Deduction Estate Trust. The estate marital deduction trust would not qualify either as a QSST or as a Section 678 trust eligible to hold S corporation stock because the estate trust is not required to make current distributions of income to the trust's beneficiary.

5. Income Requirement of Marital Trust. A qualifying marital deduction trust must have assets that are either income producing or give the surviving spouse the power to make the assets income producing. In the typical S corporation, dividends might not be paid on a regular basis, and the surviving spouse's right that the stock be made income producing may not be feasible.

E. Suggested Administrative Provisions. A will or trust which disposes of S corporation stock should contain certain administrative provisions to facilitate the executor's exercise of authority in discretion in dealing with the stock. The rights of the beneficiaries of such stock should be clearly set forth in the dispositive instrument.

1. Non-Pro Rata Distributions. The executor should be given the authority to make non-pro rata distributions in kind to avoid the possibility that the executor must distribute S corporation stock pro rata to all beneficiaries, with the result that the S corporation's eligibility might be jeopardized. While non-pro rata distributions could be made with the consent of all beneficiaries, the distribution may be deemed a taxable exchange among all of the beneficiaries. See Rev. Rul. 69-486, 1969-2 C.B. 159.

2. Disposition of Stock. The executor should be given specific authority to allocate S corporation stock away from a disqualifying trust, and make the distribution to a qualified trust or to an individual beneficiary outright. Because a disqualified testamentary trust can hold S corporation stock for up to 60 days, the power should include the authority to divest a funded trust. If a beneficiary of a trust holding S corporation stock is given a power of appointment, that power should be limited so that the beneficiary cannot unilaterlly terminate the corporation's S election by exercising the power of appointment in such a manner so as to exceed the 35 shareholder limit. If stock is to be distributed to a QSST, consideration should be given to putting language in the document directing the income beneficiary to make the QSST election. However, if the QSST is also intended to qualify as a marital deduction trust, the direction to the spouse to make the QSST election must be precatory and not a condition to the spouse's interest in the trust. Otherwise, the interest may not qualify for the marital deduction.

3. Income and Principal Distributions. If the S corporation stock is to be held by the estate for an extended period of time, or if the stock is to be distributed to a trust, consideration should be given to defining accounting "income" and "principal" to eliminate potential conflicts among beneficiaries and inadvertent termination of the election. For example, distributions

from the corporation may include both "income" (such as dividends) and "principal" (such as capital gains).

VI. REVIEW OF BUY AND SELL AGREEMENTS.

A. General. When designing a Buy and Sell Agreement for shareholders of an S corporation, there are numerous points that should be considered by the shareholders. The Agreement should include the following:

(1) A prohibition against the sale or transfer of shares which would increase the number of shareholders to more than 35;

(2) A prohibition against the sale or transfer of shares to a nonresident alien, corporation, partnership or any other person or entity disqualified as an S corporation shareholder; and

(3) The imposition of an affirmative duty upon the personal representatives of deceased shareholders to take no action to terminate the election without the unanimous consent of all of the shareholders.

B. Preserving The Election. The Agreement should require that the person contemplating a transfer to an ineligible shareholder (or other person) notify the corporation and the other shareholders, who then have the right of first refusal to purchase these shares. In lieu of first refusal, a mandatory buy-sell requirement upon the death of a shareholder can prevent a transfer to an ineligible shareholder. Further, the agreement could provide that any transfer to an ineligible shareholder is ineffective, and that title to the shares will automatically vest in the corporation upon the attempted transfer. When stock is owned by a QSST, the agreement should provide that if the beneficiary does not properly make the appropriate election within a stated time period, then either the other shareholders, or the corporation, should have the right to acquire the shares.

C. Action To Protect Shareholders.

1. Enforcement of S Election. Protection for the remaining shareholders from a violation of the prohibition mentioned above should include the right to specific enforcement. This would probably be better then a liquidated damages provision, which could invite termination of the S election, if the price was right. Accordingly, the agreement should address the precise reasons for making the S election, such as to pass through anticipated operating losses to the shareholders, avoid double taxation on substantial shareholder distributions, etc.

2. Required Distributions. If shareholders are to be prevented from terminating the S election, the agreement

should provide for adequate distributions to assist the shareholders in meeting tax liabilities on the net earnings passed through to them. Otherwise, the S election could be used by controlling shareholders to force other shareholders to sell their shares. Such a provision is useful on the death of a shareholder, when survivors might be cut off from the usual earnings of a shareholder. The required distributions formula should take into consideration federal and state income tax rates. The agreement should provide that distributions in respect of the S year be made no later than a date early in the calendar year following the close of the S year.

D. Cross Purchase vs. Stock Redemption. In a cross purchase, the consideration paid for the selling shareholder's shares will establish a new basis for the acquired shares. The benefit of basis increase is not available to the continuing shareholders in a redemption buy-out. However, to compare fairly the cross purchase and the redemption, it must be assumed that the shareholders' funds for a cross purchase came from the corporation. Because these funds are distributed to the continuing shareholders as a reduction in stock basis or as income to them, the basis of the purchased shares would not be acquired without economic consideration.

1. Affects of Life Insurance. If life insurance is used to fund a redemption agreement, the premiums paid for the insurance by the corporation would not be deductible and, because the premiums would not be an expense "properly chargeable to capital account" in whole or in part, their payment or accrual would decrease shareholder basis under Section 1367(a)(2)(D). Upon the death of the insured shareholder the life insurance proceeds would be received tax free, and would result in a pro rata increase in each shareholder's stock basis. An allocation of part of the basis increase would also be made to the shares owned by the estate of the deceased shareholder, if the estate owns an interest in the shares in the year in which the insurance proceeds are received (full year's allocation method) or part of such year (interim closing of books method). This basis increase to the estate will largely be wasted, in part because the step-up basis rules would have given a comparable increase. Therefore, when the redemption approach is used, the shares should be purchased in a year prior to the receipt of the insurance proceeds (if the full year's allocation method is used) or in that part of the year prior to such receipt (if the interim closing of books method is used), and the premium and proceeds should be accounted for under the cash method as permitted by Section 1377(a)(2). A comparable problem of wasted basis is not presented under the cross purchase method when life insurance proceeds are received by the continuing shareholders and used to purchase the stock.

2. Affects on AA Account and Earnings and Profits.

a. Redemption. A redemption requires a downward adjustment of the accumulated adjustments account. In the case of S corporations with accumulated earnings and profits this reduction in the AA account will accelerate the time when later distributions to the continuing shareholders will be deemed out of accumulated earnings and profits and, therefore, be treated as a dividend. However, part of the accumulated earnings and profits is also decreased by an exchange redemption. Thus, an exchange redemption may be useful in reducing accumulated earnings and profits and its potential for dividend treatment to the continuing shareholders from future distributions. Such a redemption may be useful in accelerating the time when, being without accumulated earnings and profits, the S corporation will be free of any restraints regarding passive investment income. In a redemption on the death of a shareholder, a step-up in basis under Section 1014 may relieve the deceased shareholder's estate from an offsetting income tax impact of the redemption.

b. Cross Purchase. A cross purchase arrangement will not affect the AA account or accumulated earnings and profits.

E. Special Valuation Factors. The method of establishing a price for the stock, such as an earnings multiple or book value approach will depend upon shareholder preference. If the value is to be determined by a multiple of earnings, then those earnings should be reduced by estimated corporate income taxes which would have been paid by a C corporation, and increased by the S corporation's taxes on capital gain and on excessive passive income. If book value is used, no such adjustments are justified.

1. Distributions. If the corporation at the time of the distribution has a positive AA account, reduction of the sales price by the amount of any distributions after the determination of the formula valuation, and prior to closing, will normally make the seller's gain the same as if no distribution had been made, because the distribution will have decreased the shareholder's basis of his stock to him. These alternatives will not give the same tax result if the distribution is covered by a Section 1368(e)(3) election to bypass the AA account. If the AA account bypass election is made, then it might be appropriate to compensate the selling shareholder for being taxed on accumulated earnings and profits which otherwise would be left behind.

2. Accumulated Adjustments Account. In a cross purchase arrangement, the corporation level AA account is not reduced, as it is in an exchange redemption. Therefore, in such transactions the selling shareholder's undivided "share" of AA account may be a benefit to the continuing shareholders if there are subsequent distributions. Should the seller be entitled to be paid extra for any "share" of the AA account that he left behind? Probably not. The AA account left behind by a seller will not benefit the continuing shareholders if it must be distributed to the buyers in order for them to pay for the stock.

REPRESENTING THE AGING AND INCAPACITATED CLIENT

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Section C

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REPRESENTING THE AGED AND INCAPACITATED CLIENT

Introduction: The purpose of this paper is to discuss a few of the common problems encountered by the planner or draftsman in connection with the estates of persons who are, or may be claimed to be, mentally impaired, as well as to discuss what techniques may be employed to meet their special needs. All powers discussed in this paper are "general" in nature, as opposed to "special" powers, which are sometimes granted for limited, specific purposes, and not as an aspect of estate planning.

I. The "Durable Power of Attorney"

A. The power of attorney is a device which has existed at common law for hundreds of years. Actually, it is but a more formalized version of a principal-agent relationship. The basic elements of the relationship may be summarized as follows:

1. A voluntary delegation to the agent (frequently referred to as the attorney-in-fact) of certain rights, powers and/or duties held by the principal.

2. The creation of fiduciary duties including those of loyalty, accounting, segregation of assets and the utmost good faith, all owed by the agent to the principal.

3. The right in the principal to control and direct the agent's conduct of his activities in the scope of the agency.

4. The power in the agent to affect the principal's legal rights and duties vis-a-vis third parties.

B. Since one of the elements of the relationship at common law was the absolute right of the principal to control the agent's activities, it was the universal rule that the principal's death or mental incapacity terminated the agent's authority, even if he had no actual notice of the matter. Thus the traditional form of the power attorney had the distinct disadvantage of becoming ineffectual just when it was most sorely needed, i.e., when the principal became unable to act for himself. Furthermore, in cases of severe physical

disability, such as stroke, where one's ability to speak or write may be limited or even lost altogether, questions may arise as to mental capacity which, even if not in fact involved, accordingly cast doubt upon the continued viability of the power of attorney.

C. Largely in response to these sorts of problems, a number of states enacted statutes providing for a power of attorney which would remain in effect regardless of the mental disability of the principal. Hence, the word, "durable" became attached to the nomenclature. Kentucky adopted a statute providing for the durable power of attorney in 1972, namely KRS 386.093, a copy of which is provided in the appendix.

D. Among the salient features of the Kentucky version are the following:

   1. It provides not just the ability to create a "durable" power, but a "stand-by" one as well. That is, a principal may create a power which first becomes effective in the event of disability as well as one which is effective at once and continues to be so if disability ensues.

2. All acts performed by the agent during a period of disability as well as a period of uncertainty as to the principal's death are binding. Thus not only is the common law rule abrogated as to mental disability, but also as to death where the agent lacks actual knowledge of it.

3. If a fiduciary, (a guardian, conservator or curator) is subsequently appointed by a court of competent jurisdiction, the power or attorney is terminated and the agent must account to the fiduciary for the principal's assets in his hands.

E. Problems frequently encountered.

1. Choice of agent.

a. The most usual candidates to serve as agent are, of course, the principal's family members and close friends. There is generally little problem with a married couple with children. The spouse is the obvious first choice, unless he or she is for some reason unsuitable. Frequently married couples fail to realize that a power of attorney may be a vital part of their personal planning because they hold all of their assets jointly. However, one

joint tenant of real estate or registered securities has no authority to sell or transfer such assets, for one example. Thus a power may still be advisable. If for any reason the spouse is not selected, one of the children may be deemed suitable for the task. Or, the power may appoint an alternate or successor agent . However, the power should be carefully drafted so that the succession of power is unambiguous. For example, the death of the first agent is a clearly defined event triggering the effectiveness of the appointment of the alternate or successor. However, the disability of the agent may be a matter of factual dispute. The power should state the specific criteria for the succession, e.g., a doctor's certificate, an adjudication of incompetence, etc. Even then, the additional criteria may complicate use of the power, in that third parties dealing with the successor may doubt the fulfillment of the conditions granting power to the successor. Another alternative is to grant powers to more than one person by separate documents; however that may also pose difficulties as discussed below.

b. An individual without close family members or close friends, or who simply does not choose to

select them to serve may ask the attorney to take on the task. While there is nothing inherently wrong with doing so, the attorney must weigh the request carefully. In most cases of principals with average means, the work required may not be compensable at the rate usually charged for straight legal work, lest it be an excessive drain on the principal's monthly income. Furthermore, almost all of the work will consist of book-keeping and banking. Unless the attorney has office staff capable of performing such tasks, or is willing to do it himself, the job may quickly become tedious.

c. Joint or conflicting appointments. There is no reason why one theoretically may not have as many attorneys-in-fact as one pleases. A later power unlike a will, does not automatically revoke former ones. As a practical matter, however, it is obvious that such conflicting appointments should be avoided. Joint appointments merit a similar caveat. What if the co-agents do not agree? In either case stalemate, or confusion may prevent third parties from honoring such powers.

d. The final choice in selecting the agent is, of course, the client's. But he or she deserves

to know the possible problems discussed above. Needless to say, the agent should be a trustworthy person who will observe his fiduciary duties. If the client cannot locate any suitable person willing to serve, then, despite all its advantages, the power of attorney is not the right choice .

2. Abuse of the power. Since the agent is not under the supervision of any court in the performance of his duties, the potential for abuse is great, especially given the frequently weakened condition of the principal. Also, since the agent will have possession of all documents and records, he can "cover his tracks" with ease, even should he come under scrutiny.

3. Triggering events for stand-by powers. As in the case of powers containing provisions for successor agents, stand-by powers may also cause problems if the agent deems the conditions sufficient to invoke the power, and the principal does not. Even a doctor's statement may not be conclusive unless carefully worded to conform to the precise criteria in the document. If the principal attempts to countermand or revoke the power, the result may be stalemate as discussed in the following section.

4. Disputed revocation. A competent principal may revoke a power of attorney at any time for any reason. But one who is in fact incompetent necessarily lacks capacity to revoke a durable power. Again, such capacity is a matter of factual dispute, and most parties with notice of revocation will refuse to honor a power absent a judicial determination that the principal lacks capacity to revoke.

5. Disputed creation. Although one may create a power which survives one's disability, one who is already mentally incapacitated cannot create a power. Hence, a person who objects to a power or its use can often deter third parties from honoring it by claiming that it is ineffective.

6. Use or powers to make gifts of the principal's property.

   a. Self-dealing and transfers to the agent. The law casts upon an agent a nearly total prohibition against using a power to transfer the principal's property to himself, and against transactions generally between the agent personally and himself as agent for the principal. See Beasley v. Trontz Ky.App.,677 SW2d 881 (1984), holding such trans-

actions voidable at the election of the principal, and Deaton v. Hale, Ky., 592 SW2d 127 (1979) which holds that the burden of accounting for and explaining any questionable transactions is on the agent.

b. Transfers to others. Aside from circumstances like those above described where the agent's motives may be inherently suspect, there are other instances in which transfers of the principal's property for little or no consideration may be attempted for reasons which are not at all nefarious or larcenous, and might well meet with the principal's wishes were he able to express them. Examples might be utilization of the annual gift tax exclusion, to assist ill or distressed family members, or to make charitable gifts for personal as well as taxation reasons. May an agent in the above or similar circumstances execute gifts of the principal's property? The answer appears generally to be no. The closest Kentucky case in point is Clinton v. Hibbs' Ex'r 202 Ky.304, 259 SW 356 (1924) holding that a power of attorney authorizing a wife to conduct all of her husband's business did not authorize her to obligate him as a surety on a note. However the following recent cases from other

jurisdictions re-affirm the traditional view that the power to give away the principal's property must be express, and will not be implied:

--Estate of Rolater, 542 P2d 219 (Okla. 1975), holding a power ineffective to make gifts of stock to the principal's brother.

--Johnson v. Fraccacreta, 348 So2d 570 (Fla. App. 1977) holding a power ineffective to convey the principal's real property to the principal and her spouse as tenants by the entirety.

c. Use of a power for estate planning. Clearly, a power cannot be utilized to write a will for the principal. Frequently an attempt is made, however, by an agent to establish a revocable trust for his principal. Clearly insofar as third parties are made beneficiaries as to either income or principal , no such authority exists unless expressed clearly in the power. However, where the sole beneficiary is the principal, and the corpus at his death reverts to his estate, the agent has done little more than arrange for professional management of his principal's assets. Hence, though no case has been located to

expressly approve the practice, it would seem within the scope of a normal general power. An express authorization to do so, however would remove any doubt.

II. Curatorship--KRS 387.320. (See appendix)

A. Comparison with power of attorney.

1. Curatorship is like a power of attorney in the following respects:

a. It is a voluntary undertaking by the principal.

b. It remains in force regardless of subsequent disability.

c. It requires sufficient mental capacity at the time of appointment

d. the curator stands in a fiduciary relationship as to the principal and his property.

2. Curatorship differs from a power in the following respects:

a. It is a court appointed and court supervised relationship.

b. The powers of the curator are limited to those of other court appointed fiduciaries.

c. It is uncertain whether a curator can be removed solely at the pleasure of the principal, or only for cause, as in the case of other statutory fiduciaries. No case law or statutory provision seems to address the issue. Presumably the Court if confronted with the problem has the right to use its discretion.

d. the curator is bonded and must make regular settlements.

e. A curator clearly lacks authority to make gifts of the principal's property under any circumstances.

B. Comments. Curatorship is rarely invoked. If an individual is aware of his need for some one else to look after his affairs, it is much simpler, quicker, easier and cheaper to appoint an attorney in fact. In addition, the curatorship is far less flexible in terms of the powers which the curator may exercise.

Also, the curatorship is a matter of public record, and many elderly people object to the open disclosure of their financial affairs, and the fact that they have admitted publicly that they are unable to manage their business.

III. The Stand-By Trust.

A. Description. A stand-by trust is merely a buzz word for an inter vivos revocable trust established by a settlor primarily for the management of his finances. The only real distinction between it and any other "living trust" is that it generally contains more closely defined duties for the trustee to perform in the event that the settlor becomes disabled. That is, rather than merely mandate a direct payout of income and corpus to the settlor, or at his direction, it authorizes the trustee, upon a finding of disability or impairment, to distribute funds directly to the settlor's creditors, or persons dependent on him for support. In essence, the trustee acts just as an attorney in fact would in managing the settlor's assets and paying his bills.

B. A specimen stand-by clause is provided in the appendix.

C. Comments. Obviously the stand-by trust is a device for persons of above average means. It is an excellent tool to provide for management of the affairs of elderly or infirm single people who are not really interested in handling their money before they become incapacitated. It can also be a planning device in that distribution on death provisions can be made directly to beneficiaries, thus avoiding probate. The only drawbacks are the amount of assets which must be transferred in trust to make it practical, the trustee fees which will be incurred, and the start-up expense in terms of attorney fees.

IV. Statutory Disability Proceedings.

A. When a person has become mentally incapacitated without designating anyone to manage his/her affairs in such event, the only remaining mechanism is to institute disability proceedings under the provisions of KRS 387.500 to 387.770. (See appendix)

B. Definition of disability. Disability is a legal, not a medical term and refers to a functional inability to make informed decisions to such an extent that one's personal or financial needs are unmet. The statute recognizes the possibility that one can meet

some but not all of such needs, and, hence permits a finding of partial disability. KRS 387.510 (8) and (9).

C. A disability proceeding is commenced by the filing of a Petition to determine disability along with a Petition for appointment as guardian.KRS 387.530.

D. <u>Emergency Appointments</u>. If there is a serious danger of impairment of health or safety, or of damage or dissipation of property, the Court may make an emergency appointment before the hearing in chief. KRS 387.740.

E. The statute requires that the Respondent be examined by a three person interdisciplinary team, consisting of a psychiatrist, psychologist and a social worker. KRS 387.540. Their report, and the required recommendations, are usually the heart of the case.

F. Trial

1. At the trial, the Commonwealth has the burden of proving the disability by clear and convincing proof. KRS 387.570 (5).

2. The Respondent has the right to counsel, including Court-appointed counsel, if he cannot afford otherwise. KRS 387.560.

3. The case must be tried to a jury; it cannot be waived. KRS 387.570 (1).

4. The jury must find, separately with respect to both personal matters and financial affairs, whether the Respondent is totally disabled, partially disabled, or not disabled at all. KRS 387.580 (1).

5. After the jury's verdict, if the Respondent is found to be disabled in any respect, the Court determines the type of fiduciary and the powers to be exercised by him/her. KRS 387.590.

   a. A guardian is appointed if the Respondent is totally disabled, both financially and personally.

   b. A limited guardian is appointed if the Respondent is found partially disabled in both respects, or only as to personal affairs.

   c. A conservator is appointed if the disability is total as to finances only.

d. A limited conservator is appointed if the disability is partial as to finances only.

e. The statute does not admit of the possibility that the Respondent can be found totally unable to handle personal affairs, but not disabled as to financial ones.

G. The Court then appoints a suitable person for the appropriate required role. The fiduciary is bonded, and must make two types of periodical reports:

1. An annual report on the ward's physical, social and medical condition; and

2. A biennial financial report, similar to a periodical settlement required of other fiduciaries.

H. <u>Comments</u>. It should be obvious from the foregoing description of the disability statute, that it is a cumbersome, slow and relatively expensive way to provide for the management of one's affairs in case of incapacity. The lesson, of course, is to make appropriate plans in advance. The usual answer is to have some form of durable power of attorney

prepared before the onset of mental decline.

V. Planning To Avoid Will Contests.

A. Introduction. In a will contest case, the most important potential witness is already dead. The contestants are therefore able to attempt to make out a case of incapacity, undue influence, improper execution or the like without the possibility of rebuttal by the testator himself. The scrivener of the will, or the attesting witnesses, if any, may not always be convincing, or even available. Hence, it may be advisable to consider some special approaches or techniques when preparing a will which may appear likely to be challenged because of its terms, the condition of the testator, or the temperament of potentially disgruntled beneficiaries. Such approaches may be classified as (a) defensive techniques whereby the integrity and validity of the process of preparation and execution of the will are secured, and (b) affirmative techniques designed to disarm or encumber potential contestants prospectively.

B. Defensive techniques.

1. Making the attorney/scrivener a good witness for

the will. In most cases the preparer should be in the best position to verify the testator's soundness of mind, and therefore should be a very effective witness, unless he has done or omitted to do something in connection with the will. The attorney-client privilege does not bar the attorney from so testifying. Stegman v. Miller, Ky., 515 SW2d 244 (1974), since it is presumed that the testator would consent, and since the privilege expires at death. However, the scrivener must be on guard to avoid actions, such as described below which may detract from the strength of the scrivener's testimony:

a. Representing the estate or the propounders at trial. Disciplionary Rule 5-101(B) of the Code of Professional Responsibility forbids acceptance of employment in cases where the attorney knows that he will be called as a witness unless the testimony is as to uncontested matters, is as to mere formalities, pertains to the value of legal services, or if absence of the testimony would work a hardship on the client because of the particular value of the lawyer's services. Rule 3.7 of the proposed Model Rules of Professional Conduct (not yet adopted in Kentucky) retains the same

essential posture. However, there is authority to the contrary in Kentucky case law. Adams v. Flora, Ky., 445 SW2d420 (1969); Duncan v. O'nan Ky., 451 SW2d 626 (1970).

Nevertheless, even if the ethical consideration did not exist, one must think very carefully about opening the door to the opponent's argument that the attorney/witness's testimony must be slanted in favor of his client's (and his wallet's) point of view.

b. Taking instructions from someone other than the testator. Obviously the scrivener's testimony has very little value to the parties seeking to uphold the will, if he has to admit that another (most likely a beneficiary) was in whole or in part the source of the instructions about the contents of the will. This would hold true even if the testator assents to the terms.

c. Beneficiary as source of attorney's fee for the will. Clearly an equally embarrassing admission– the jury is left to wonder who really was the client, and whose will was being expressed in the document.

d. Scrivener as beneficiary. Due to the confidential nature of the attorney client relationship, undue influence is nearly presumed in such cases

e. Failure to supervise execution. The attorney loses any ability to testify about what happened when the will was actually signed.

f. Failure to retain notes, drafts or correspondence. Some of the most important evidence in favor of a will can be the contemporaneous documents prepared by the scrivener in the course of preparation. Their absence may be seen as a sign of a hurried or careless effort. The scrivener may even want the testator to provide him with a statement in his own hand as to his wishes.

g. Failure to discuss the contents of the will. One of the defenses to a claim of undue influence is the theory of "independent advice" which holds that the chain of causation of prior coercion may be broken if it is shown that the testator discussed the will with an independent party, and after such discussion, still proceeded to make out the will. That is, the

b. Creating a record of the testator's condition.

(1) Presence of the witnesses throughout the entire conference, rather than merely at the time of signing.

(2) Questioning the testator in the presence of the witnesses as to orientation, purpose of the meeting, family members' identities, etc. Note that less mental capacity is needed to execute a will than to make a contract or perform other inter vivos acts. Creason v. Creason, Ky., 392 SW2d 69 (1965). The clear cut testimony of the attesting witnesses that the testator appeared to be in possession of his faculties at the time of execution permits the propounders to avail themselves of the "lucid interval" theory, which holds that even evidence of general senility or insanity does not invalidate a will if it appears to have been signed during a period when the testator was in fact lucid. See Warnick v. Childers, Ky., 282 SW2d 603 (1955)

(3) Making sure that the testator reads the will

(or has it read to him)

(4) No drugs, medication or alcohol.

c. Creating a record against a claim of undue influence.

(1) Absence of parties in confidential relationship or who may be asserted to have exercised control over the testator. One of the most commonly asserted elements of undue influence is the participation by the benefitted party in the preparation and execution of the will See Hollon's Ex'r v. Graham, Ky., 280 SW2d 544 (1955).

(2) Establish independent advice as to will's contents and testator's wishes as being correctly expressed in the will. The fact of independent advice has been held admissible as evidence against undue influence. See section B.1.g., supra.

d. Safeguarding the executed will. The best option is for either the executor or attorney to retain the instrument. Most trust companies are more than happy to do so. If the testator

desires to keep his will, the best location for it is his own safe deposit box. Despite the opinion of some commentators to the contrary, the difficulty of retrieving the will from the box after death is minor compared to the risk of inadvertent loss or destruction if kept elsewhere. In any event, the scrivener should always keep a copy of the document for his files in order to be able to prove the will's contents if it is lost or destroyed.

C. Affirmative techniques to deter will contests.

1. The in terrorem clause. The "no contest" clause is not against public policy and is enforceable in Kentucky. Andrews' Ex'r v. Spruill, Ky., 112 SW2d 402 (1938). The effect of such a clause is not to deprive the potential contestant of his day in court, but merely to increase the cost of losing the case. However, the clause does not apply so as to jeopardize one's inheritance by bringing a construction action.

2. Adoption. In some cases an adoption of a beneficiary can prevent a will contest by depriving collateral heirs of standing to maintain the action. One must normally be either

one of the testator's heirs, or take more under a prior will in order to have standing. Egbert v. Egbert, 186 Ky. 486, 217 SW 365 (1920). Adoptions of adults are valid if with the consent of the adoptee. KRS 405.390. However such an adoption is ineffective to qualify an adult adoptee as a remainderman under an existing trust. Minary v. Citizens Fidelity Bank, Ky., 419 SW2d 340 (1967). However compare Harper v. Martin, Ky., 552 SW2d 690 (1977).

3. Inter vivos transfers. A will contest only affects property which passes through the decedent's probatable estate. Accordingly, it is possible to arrange transfers which essentially take effect at death, but which remove the given property from the estate, thus requiring the contestant to overcome a double hurdle: not only must he succeed in setting aside the inter vivos transaction, but also must successfully contest the will, which, presumably vests the same beneficiary with the same or similar benefits. The drawbacks of such planning are that such transactions require careful draftsmanship to avoid disrupting estate plans or other unintended results. However, such transactions generally have the further benefit of creating additional sets of witnesses

to attest to the capacity of the deceased.

4. Use of recording devices. It is sometimes desirable to memorialize either a message of the testator's concerning his wishes as expressed in his will, or to tape the execution process as evidence of capacity, due execution or lack of coercion or undue influence. Such evidence, if available can be powerful proof in favor of the will. Care must be taken, however that "mistakes" not be similarly memorialized. It is also suggested that taping, once done, cannot be ethically concealed or altered. Such tampering, aside from the criminal aspect, would, if discovered have just the opposite of the intended effect. This technique, being thus relatively volatile, should be utilized only in cases where the chance of "goof-ups" by the testator is minimal.

APPENDIX

A. KRS 386.093

B. KRS 387.320

C. "STAND-BY " TRUST CLAUSE

D. KRS 387.500-387.770

386.093. When power of attorney not affected by disability. — When a principal designates another his attorney in fact or agent by a power of attorney in writing and the writing contains the words "This power of attorney shall not be affected by the disability of the principal," or "This power of attorney shall become effective upon the disability of the principal." or similar words showing the intent of the principal that the authority conferred shall be exercisable notwithstanding his disability, then the authority of the attorney in fact or agent is exercisable by him as provided in the power on behalf of the principal notwithstanding later disability or incapacity of the principal at law or later uncertainty as to whether the principal is dead or alive. All acts done by the attorney in fact or agent, pursuant to the power during any period of disability or incompetence or uncertainty as to whether the principal is dead or alive, have the same effect and inure to the benefit of and bind the principal or his heirs, devisees and personal representative as if the principal were alive, competent and not disabled. If a fiduciary is thereafter appointed by the court for the principal the power of the attorney in fact shall thereupon terminate and he shall account to the court's appointed fiduciary. (Enact. Acts 1972, ch. 168, § 1.)

387.320. Curator for property of aged or infirm person, appointed when — Bond. — (1) Whenever any person deems himself unfit by reason of advanced age or physical disability and weakness to properly and prudently manage or care for his real or personal property or manage his business with prudence and understanding, the district court may, upon his verified petition without notice or public hearing, appoint a curator to assume charge and management of his real or personal property or business, subject to the direction of the court.

(2) The court shall take bond with good surety from the person appointed curator for the full and faithful performance of the trust confided in him. (Enact. Acts 1966, ch. 253, §§ 1, 2; 1968, ch. 200, § 5; 1976 (Ex. Sess.), ch. 14, § 346, effective January 2, 1978.)

STAND-BY TRUST CLAUSE

In the event of the Grantor's incapacity, as determined by the Trustee in its sole and absolute discretion, the Trustee may use so much of the net income and principal as the Trustee may deem advisable to provide adequately and properly for his health, support, and maintenance and that of his wife and children.

Legislative Research Commission Note. Although 1980 Acts Chapter 396, which would have become operative on July 1, 1982, was repealed by 1982 Acts Chapter 141, Section 146, the latter is substantially the same bill and became operative on July 1, 1982.

387.500. Declaration of legislative purpose. — (1) It is the intent and purpose of the General Assembly to recognize that disabled persons have varying degrees of disability.

(2) Persons who are only partially disabled must be legally protected without a determination of total incompetency and without the attendant deprivation of civil and legal rights that such a determination requires.

(3) To this end, guardianship and conservatorship for disabled persons shall be utilized only as is necessary to promote their well-being, including protection from neglect, exploitation, and abuse; shall be designed to encourage the development of maximum self-reliance and independence in each person; and shall be ordered only to the extent necessitated by each person's actual mental and adaptive limitations.

(4) If the court determines that some form of guardianship or conservatorship is necessary, partial guardianship or partial conservatorship shall be the preferred form of protection and assistance for a disabled person. (Enact. Acts 1982, ch. 141, § 1, effective July 1, 1982.)

387.510. Definitions. — As used in KRS 387.500 to 387.770 and 387.990:

(1) "Conservator" means an individual, agency, or corporation appointed by the court to manage the financial resources of a disabled person.

(2) "Limited conservator" means an individual, agency, or corporation appointed by the court to assist in managing the financial resources of a partially disabled person and whose powers and duties have been specifically enumerated by court order.

(3) "Guardian" means an individual, agency, or corporation appointed by the court to have full care, custody, and control of a disabled person and to manage his financial resources.

(4) "Limited guardian" means a guardian who possesses fewer than all of the legal powers and duties of a full guardian, and whose powers and duties have been specifically enumerated by court order.

(5) "Standby" guardian or conservator means a person or entity designated by the court to assume the powers and duties assigned to a limited guardian, guardian, limited conservator, or conservator upon his death, resignation, removal, or incapacity.

(6) "Testamentary" guardian or conservator means an individual, agency, or corporation nominated in the will of a limited guardian, guardian, limited conservator, or conservator to succeed the testator in that capacity upon his death.

(7) "Developmental disability" means a severe, chronic disability of a person which:

(a) Is attributable to a mental or physical impairment or combination of mental and physical impairments;

(b) Is manifested before the person attains age twenty-two (22);

(c) Is likely to continue indefinitely;

(d) Results in substantial functional limitations in three (3) or more of the following areas of major life activity: (i) self-care; (ii) receptive and expressive language; (iii) learning; (iv) mobility; (v) self-direction; (vi) capacity for independent living; and (vii) economic self-sufficiency; and

(e) Reflects the person's need for a combination and sequence of special interdisciplinary or generic care, treatment or other services which are of lifelong or extended duration and are individually planned and coordinated.

(8) "Disabled" means a legal, not a medical disability, and is measured by functional inabilities. It refers to any person fourteen (14) years of age or older who is:

(a) Unable to make informed decisions with respect to his personal affairs to such an extent that he lacks the capacity to provide for his physical health and safety, including but not limited to health care, food, shelter, clothing, or personal hygiene; or

(b) Unable to make informed decisions with respect to his financial resources to such an extent that he lacks the capacity to manage his property effectively by those actions necessary to obtain, administer, and dispose of both real and personal property.

Such inability shall be evidenced by acts or occurrences within six (6) months prior to the filing of the petition for guardianship or conservatorship and shall not be evidenced solely by isolated instances of negligence, improvidence, or other behavior.

(9) "Partially disabled" refers to an individual who lacks the capacity to manage some of his personal affairs and/or financial resources as provided in subsection (8) of this section, but who cannot be found to be fully disabled as provided therein.

(10) "Mentally ill person" means a person with substantially impaired capacity to use self-control, judgment, or discretion in the conduct of his affairs and social relations, associated with maladaptive behavior or recognized emotional symptoms where impaired capacity, maladaptive behavior, or emotional symptoms can be related to physiological, psychological, or social factors.

(11) "Interdisciplinary evaluation report" means a report of an evaluation of a respondent performed pursuant to the provisions of KRS 387.540 to determine whether he is partially disabled or disabled as defined herein.

(12) "Interested person or entity" means an adult relative or friend of the respondent or ward, an official or representative of a public or private agency, corporation, or association concerned with that person's welfare, or any other person found suitable by the court.

(13) "Petitioner" means a person who institutes a proceeding under KRS 387.530.

(14) "Respondent" means an individual alleged to be a partially disabled or disabled person.

(15) "Ward" means a person for whom a limited guardian, guardian, limited conservator, or conservator has been appointed.

(16) "Committee" means a person appointed by the court prior to July 1, 1982, to have full care, custody, and control of a disabled person and his estate. (Enact. Acts 1982, ch. 141, § 2, effective July 1, 1982.)

387.520. Jurisdiction of district courts — Venue. — (1) The district courts shall have exclusive jurisdiction over all proceedings involving a determination of partial disability or disability, the modification of orders, the appointment and removal of guardians and conservators, and the management and settlement of their accounts.

(2) If the respondent or ward is a resident of this state, the venue for all proceedings under KRS 387.500 to 387.770 shall be:

(a) In the county where the respondent or ward resides;

(b) In the county of domicile of the respondent or ward; or

(c) In the county where the parent of the respondent or ward is domiciled if the respondent or ward is a minor. Nothing in this section shall preclude transfer of venue for good cause shown.

(3) If no local conservator has been appointed and no petition in a disability proceeding is pending in this state, a domiciliary foreign conservator may file with a court in this state in a county in which property belonging to the disabled person is located, authenticated copies of his appointment and of any official bond he has given. Thereafter, he may exercise as to assets in this state all powers of a local conservator and may maintain actions and proceedings in this state subject to any conditions imposed upon nonresident parties generally. (Enact. Acts 1982, ch. 141, § 3, effective July 1, 1982.)

387.530. Filing of petition — Contents — Application of person or entity desiring appointment. — (1) A petition for a determination of partial disability or disability and the appointment of a limited guardian, guardian, limited conservator, or conservator may be filed by any interested person or by an individual needing guardianship or conservatorship. The petition shall set forth the following:

(a) The name and address of the respondent;

(b) The date of birth of the respondent, if known;

(c) The nature and degree of the alleged disability of the respondent;

(d) The facts and reasons supporting the need for guardianship or conservatorship;

(e) A description and approximation of the value of the respondent's financial resources, including government benefits, insurance entitlements, and anticipated yearly income, if known;

(f) The names and addresses of the respondent's next of kin, if known;

(g) The name and address of the individual or facility, if any, having custody of the respondent;

(h) The name, address and interest of the petitioner; and

(i) The name and address of the petitioner's attorney, if any.

(2) The petition shall be accompanied by a verified application of the person or entity desiring appointment as limited guardian, guardian, limited conservator, or conservator. The application shall state the name, address and qualifications of the applicant and his relationship to the respondent. If it is proposed that a standby limited guardian, guardian, limited conservator, or conservator be designated, the petition shall also be accompanied by the application of the person or entity desiring to be so designated. Additional petitions may be filed prior to the date of the hearing by other persons desiring appointment. (Enact. Acts 1982, ch. 141, § 4, effective July 1, 1982.)

Opinions of Attorney General. There is no statute imposing upon the county attorney a positive duty to file the petition for determination of partial disability or disability. OAG 83-474.

387.540. Interdisciplinary evaluation report. — (1) Prior to a hearing on a petition for a determination of partial disability or disability and the appointment of a limited guardian, guardian, limited conservator, or conservator, an interdisciplinary evaluation report shall be filed with the court. The report shall be compiled by at least three (3) individuals, including a physician, a psychologist licensed or certified under the provisions of KRS Chapter 319, and a person licensed or certified as a social worker or an employe of the cabinet for human resources who meets the qualifications of KRS 335.080(1)(a), (b) and (c) or 335.090(1)(a), (b) and (c). The social worker shall, whenever possible, be chosen from among employes of the cabinet for human resources residing or working in the area, and there shall be no additional compensation for their service on the interdisciplinary evaluation team.

(2) At least one (1) person participating in the compilation of the report shall have knowledge of the particular disability which the respondent is alleged to have or knowledge of the skills required of the respondent to care for himself and his estate.

(3) If the respondent is alleged to be partially disabled or disabled due to mental illness, at least one (1) person participating in the compilation of the interdisciplinary evaluation report shall be a qualified mental health professional as defined in KRS 202A.011(11). If the respondent is alleged to be partially disabled or disabled due to mental retardation, at least one (1) person participating in the compilation of the evaluation report shall be a qualified mental retardation professional as defined in KRS 202B.010(3).

(4) The interdisciplinary evaluation report shall contain:

(a) A description of the nature and extent of the respondent's disabilities, if any;

(b) Current evaluations of the respondent's social, intellectual, physical, and educational condition, adaptive behavior, and social skills. Such evaluations may be based on prior evaluations not more than three (3) months old, except that evaluations of the respondent's intellectual condition may be based on individual intelligence test scores not more than one (1) year old;

(c) An opinion as to whether guardianship or conservatorship is needed, the type of guardianship or conservatorship needed, if any, and the reasons therefor;

(d) An opinion as to the length of time guardianship or conservatorship will be needed by the respondent, if at all, and the reasons therefor;

(e) If limited guardianship or conservatorship is recommended, a further recommendation as to the scope of the guardianship or conservatorship, specifying particularly the rights to be limited and the corresponding powers and duties of the limited guardian or limited conservator;

(f) A description of the social, educational, medical, and rehabilitative services currently being utilized by the respondent, if any;

(g) A determination whether alternatives to guardianship or conservatorship are available;

(h) A recommendation as to the most appropriate treatment or rehabilitation plan and living arrangement for the respondent and the reasons therefor;

(i) A listing of all medications the respondent is receiving, the dosage, and a description of the impact of the medication upon the respondent's mental and physical condition and behavior;

(j) An opinion whether attending a hearing on a petition filed under KRS 387.530 would subject the respondent to serious risk of harm;

(k) The names and addresses of all individuals who examined or interviewed the respondent or otherwise participated in the evaluation; and

(l) Any dissenting opinions or other comments by the evaluators.

(5) The evaluation report may be compiled by a community mental health-mental retardation center, a licensed facility for mentally ill or developmentally disabled persons, if the respondent is a resident of such facility, or a similar agency.

(6) In all cases where the respondent is a resident of a licensed facility for mentally ill or developmentally disabled persons and the petition is filed by an employe of that facility, the petition shall be accompanied by an interdisciplinary evaluation report prepared by the facility.

(7) Except as provided in subsection (6) of this section, the court shall order appropriate evaluations to be performed by qualified persons or a qualified agency. The report shall be prepared and filed with the court and copies mailed to the attorneys for both parties at least ten (10) days prior to the hearing. All items specified in subsection (4) of this section shall be included in the report.

(8) If the person evaluated is a poor person as defined in KRS 453.190, the examiners shall be paid by the county in which the petition is filed upon an order of allowance entered by the court. Payment shall be in an amount which is reasonable as determined by the court, except no payment shall be required of the county for an evaluation performed by a salaried employe of a state agency for an evaluation performed within the course of his employment. Additionally, no payment shall be required of the county for an evaluation performed by a salaried employe of a community mental health-mental retardation center or private facility or agency where the costs incurred by the center, facility, or agency are reimbursable through third-party payors. Affidavits or other competent evidence are admissible to prove the services rendered but not to prove their value.

(9) The respondent may file a response to the evaluation report no later than five (5) days prior to the hearing.

(10) The respondent may secure an independent evaluation. If the respondent is unable to pay for such evaluation, compensation for the independent evaluation may be paid by the county in an amount which is reasonable as determined by the court. (Enact. Acts 1982, ch. 141, § 5, effective July 1, 1982; 1984, ch. 18, § 1, effective July 13, 1984; 1984, ch. 111, § 155, effective July 13, 1984; 1984, ch. 395, § 1, effective July 13, 1984.)

Legislative Research Commission Note. This section was amended by three 1984 acts which do not appear to be in conflict and have been compiled together.

Opinions of Attorney General. The examiners' fees under subsection (8) of this section must be paid by the county in which the petition is filed, regardless of the wealth of the disabled person. OAG 83-328.

The term "third-party payors," in subsection (8) of this section refers to medical insurers. OAG 83-328.

The county is responsible for payment of the examiners' fees where a respondent dies after an examination is completed but prior to trial, and in cases where a jury determines the respondent not to be disabled since the mandatory language of subsection (8) of this section requires payment of the examiners' fees by the county in all cases. OAG 83-328.

387.550. Hearing date and place — Notice. — (1) If the petition is accompanied by an interdisciplinary evaluation report when filed, the court shall fix a date and a place for a hearing to be held within thirty (30) days after the filing of the petition. If no interdisciplinary evaluation report accompanies the petition when filed, the court shall fix a date and a place for a hearing to be held within sixty (60) days after the filing of the petition. The time for a hearing may be extended by the court, on motion of either party, for cause.

(2) Notice of the time and place of the hearing shall be given not less than fourteen (14) days prior to the hearing to the attorneys for both parties, all persons named in the petition, and the person proposed for appointment as limited guardian, guardian, limited conservator, or conservator. (Enact. Acts 1982, ch. 141, § 6, effective July 1, 1982; 1984, ch. 395, § 3, effective July 13, 1984.)

387.560. Appointment of counsel for respondent — Compensation — Duty of county attorney. — (1) Unless an appearance has been entered on behalf of the respondent, the court shall appoint counsel for the respondent within one (1) week of the filing of a petition for determination of disability under KRS 387.500 to 387.770.

(2) Appointed counsel shall be entitled to compensation for services. If counsel is appointed for a poor person as defined in KRS 453.190, the court shall prescribe reasonable compensation to be paid by the county in which the proceeding is held in accordance with the complexity of the issues, the time involved, and other relevant considerations, except that appointed counsel shall not be compensated at a rate higher than thirty-five dollars ($35.00) an hour for time spent in court and no higher than twenty-five dollars ($25.00) an hour for time spent out of court. If the petition is found to be frivolous or not brought in good faith, counsel fees shall be charged to the petitioner.

(3) In all proceedings under KRS 387.500 to 387.770, it shall be the duty of the county attorney to assist the petitioner, to represent the interest of the Commonwealth, and to assist the court in its inquiry by the presentation of evidence. (Enact. Acts 1982, ch. 141, § 7, effective July 1, 1982.)

Opinions of Attorney General. Based upon the provisions of KRS 387.600 and subsection (3) of this section, it is not the responsibility of the county attorney to advocate on behalf of the appointment of any person who has applied for appointment as guardian or conservator; subsection (3) of this section does not require the county attorney to represent any petitioner within the connotation of an adversary proceeding, but merely requires the county attorney to assist the petitioner in the preparation and filing of the petition. OAG 83-419.

There is no statute imposing upon the county attorney a positive duty to file the petition for determination of partial disability or disability. OAG 83-474.

The central role of the county attorney in disability determination proceedings is to represent the commonwealth and, should the interest of the commonwealth conflict with the interest of the petitioner at some stage of the proceedings, the county attorney must pursue the interest of the commonwealth. OAG 83-474.

387.570. Hearing — Burden of proof. — (1) At a hearing convened pursuant to KRS 387.500 to 387.770 for the purpose of determining the disability of a respondent, the respondent shall have a jury trial and shall have the right to present evidence and to confront and cross-examine all witnesses.

(2) The hearing may be closed to the public on request of the respondent or his counsel.

(3) The respondent shall be present at the hearing, and his presence may be waived only upon a determination of the court that his attendance would subject him to serious risk of harm. Such determination shall be evidence

only of the respondent's inability to attend the hearing and shall not be considered in determining the need for guardianship or conservatorship.

(4) The court may remove itself to the place of residence of the respondent to conduct the hearing in the presence of the respondent.

(5) The burden of proof shall be on the Commonwealth to prove the disability or partial disability of the respondent by clear and convincing evidence.

(6) The respondent will not be determined partially disabled or disabled unless at least one (1) of the persons who participated in the interdisciplinary evaluation required by KRS 387.540 testifies in person at the hearing. This section shall not be interpreted to preclude the respondent from requiring the testimony of more than one (1) person participating in the preparation of the evaluation report. (Enact. Acts 1982, ch. 141, § 8, effective July 1, 1982; 1984, ch. 395, § 2, effective July 13, 1984.)

DECISIONS UNDER PRIOR LAW

ANALYSIS

1. Instructions.
2. Verdict.

1. Instructions.

In inquest to determine mental capacity of alleged incompetent, instructions following the language of KRS 387.010 are sufficiently specific to guide jury. Sabin v. Commonwealth, 233 Ky. 636, 26 S.W.2d 506 (1930). See Downing v. Siddens, 247 Ky. 311, 57 S.W.2d 1 (1933), overruled on other grounds, Vitali v. Nolloth, 268 S.W.2d 950 (Ky. Ct. App. 1954).

2. Verdict.

Where only issue in inquest was whether defendant was incompetent due to infirmity and old age, verdict finding defendant incompetent without specifying cause was erroneous but not void and could be corrected by trial court on motion to specify cause. Higdon v. Commonwealth, 257 Ky. 69, 77 S.W.2d 400 (1934).

To give court jurisdiction to take from a person his estate upon the ground that he is incompetent to manage it, the reason or cause of the infirmity, as well as what is owned by the subject of the inquest, must be made to appear by the verdict. Menefee v. Ends, 97 Ky. 388, 17 K.L.R. 280, 30 S.W. 881 (1895).

387.580. Responsibilities of jury during a hearing — Court determinations upon finding of disability or partial disability. — (1) At a hearing convened under KRS 387.500 to 387.770 for a determination of partial disability or disability, the jury shall:

(a) Inquire into the nature and extent of the general intellectual functioning of the respondent;

(b) Inquire into the respondent's capacity to make informed decisions concerning his personal affairs and financial resources;

(c) Determine whether the respondent is disabled, partially disabled, or has no disability in relation to the management of his financial resources; and

(d) Determine whether the respondent is disabled, partially disabled, or has no disability in relation to the management of his personal affairs.

(2) If the respondent is found not to be disabled or partially disabled, the petition shall be dismissed.

(3) If the respondent is found to be disabled or partially disabled, the court shall, at the same hearing, without a jury, determine:

(a) The type of guardian or conservator to be appointed;

(b) The specific legal disabilities to which the respondent is subject, if the respondent has been determined to be partially disabled;

(c) The corresponding powers and duties of the limited guardian or limited conservator, if the respondent has been determined to be partially disabled;

(d) The individual or entity to be appointed by the court as limited guardian, guardian, limited conservator, or conservator;

(e) The individual or entity, if any, to be appointed as standby guardian or conservator; and

(f) The duration of the term of guardianship or conservatorship. (Enact. Acts 1982, ch. 141, § 9, effective July 1, 1982.)

387.590. Types of guardians and conservators to be appointed — Order of appointment — Filing of judgment and order — Legal disabilities. — (1) If the respondent is found partially disabled in managing his personal affairs, but not partially disabled or disabled in managing his financial resources, a limited guardian shall be appointed.

(2) If the respondent is found partially disabled in managing his financial resources, but not partially disabled or disabled in managing his personal affairs, a limited conservator shall be appointed.

(3) If the respondent is found partially disabled in managing both his personal affairs and financial resources, a limited guardian shall be appointed, unless the court considers it in the best interest of the ward to appoint both a limited guardian and a limited conservator.

(4) If the respondent is found disabled in managing his financial resources, but not partially disabled or disabled in managing his personal affairs, a conservator shall be appointed.

(5) If the respondent is found disabled in managing both his personal affairs and financial resources, a guardian shall be appointed, unless the court considers it in the best interest of the ward to appoint both a limited guardian and a conservator.

(6) The order of appointment of a limited guardian, guardian, limited conservator, or conservator shall specify:

(a) The type of guardianship or conservatorship to which the ward is subject;

(b) The name and address of the limited guardian, guardian, limited conservator, or conservator;

(c) The name and address of the standby guardian or conservator, if a standby guardian or conservator is designated;

(d) The specific legal disabilities to which the respondent is subject, if the respondent has been determined to be partially disabled;

(e) The corresponding powers and duties of the limited guardian or limited conservator, if the respondent has been determined to be partially disabled; and

(f) The duration of the term of guardianship or conservatorship.

(7) A limited guardian or limited conservator shall not be appointed for a term greater than five (5) years and may be appointed for a lesser period.

A guardian or conservator may be appointed for a period of unlimited duration.

(8) The judgment of partial disability or disability and the order of appointment shall be filed in the district court. The judgment shall be indexed by the county clerk in the book in which notices of actions and encumbrances are indexed. Unless such judgment is filed and indexed, it shall not constitute notice to any subsequent bona fide purchaser for value, mortgagee, or encumbrancer.

(9) If the respondent is determined to be disabled or partially disabled but no limited guardian, guardian, limited conservator, or conservator is appointed at the hearing, the determination shall have no legal effect.

(10) The rights of which a ward is legally deprived upon a determination of disability in managing his personal affairs and financial resources include, but are not limited to, the right to vote, dispose of property, execute instruments, enter into contractual relationships, determine his living arrangements, consent to medical procedures, and obtain a motor vehicle operator's license.

(11) A partially disabled or disabled person for whom a limited guardian, limited conservator, or conservator has been appointed retains all legal and civil rights except those which have by court order been designated as legal disabilities or which have been specifically granted to the limited guardian, limited conservator, or conservator. A person who is partially disabled may be subject to some but not all of the disabilities specified in subsection (10) of this section. (Enact. Acts 1982, ch. 141, § 10, effective July 1, 1982; 1984, ch. 206, § 1, effective July 13, 1984.)

Opinions of Attorney General. By the repeal of KRS Chapter 203, the General Assembly intended to place the filing of disability judgments and the indexing of same as a responsibility of the circuit clerk, instead of the county clerk. Thus on and after July 1, 1982, there is no statutory basis for filing disability judgments and indexing them in the county clerk's office. OAG 82-486.

The effect of subsection (8) of this section is that the judgment of disability or partial disability must be filed in the district court. Thus the circuit court-district court clerk must see to it that such judgments are filed in the clerk's office; and the circuit clerk must establish, on and after July 1, 1982, an index system covering such judgments collected in a book identifiable as involving notices of actions and encumbrances. OAG 82-486.

DECISIONS UNDER PRIOR LAW

1. **Action to Set Aside Deed.**

In action to set aside deed to bona fide purchasers on grounds of fraud, grantor must not only plead the judgment declaring him incompetent but must plead its filing and indexing with county clerk. Powell v. Winchester Bank, 551 S.W.2d 820 (Ky. Ct. App. 1977).

387.600. Appointment — Consideration of preference of respondent. — (1) The court may appoint as limited guardian, guardian, limited conservator, or conservator any suitable person or any entity, public or private, capable of conducting an active guardianship or conservatorship program. The court shall not ordinarily or customarily appoint the department for human resources or any other person or entity, public or private, that is directly providing services to the respondent unless no other suitable

person or entity is available and willing to be appointed. Appointment of the department for human resources shall be consistent with the provisions of KRS 210.290.

(2) Prior to the appointment, the court shall make a reasonable effort to question the respondent concerning his preference regarding the person or entity to be appointed limited guardian, guardian, limited conservator, or conservator, and any preference indicated shall be given due consideration. The court shall appoint the person or entity best qualified and willing to serve. (Enact. Acts 1982, ch. 141, § 11, effective July 1, 1982.)

Opinions of Attorney General. Based upon the provisions of KRS 387.560(3) and this section, it is not the responsibility of the county attorney to advocate on behalf of the appointment of any person who has applied for appointment as guardian or conservator; KRS 387.560(3) does not require the county attorney to represent any petitioner within the connotation of an adversary proceeding, but merely requires the county attorney to assist the petitioner in the preparation and filing of the petition. OAG 83-419.

387.605. Qualifications for court to consider when appointing a guardian or conservator. — The court shall give preference to people who meet the following qualifications when appointing a person as guardian or conservator:

(1) Kinship to respondent;

(2) Education and business experience of applicant;

(3) Capability to handle financial affairs; and

(4) Ability to carry out the requirements set forth in KRS 387.660 to 387.710 and 387.750. (Enact. Acts 1984, ch. 20, § 1, effective July 13, 1984.)

387.610. Petition for renewal of appointment — Accompanying affidavits. — Prior to the expiration of a term of guardianship or conservatorship, the limited guardian, guardian, limited conservator, or conservator may petition, pursuant to KRS 387.620, for a renewal of his appointment for a period not to exceed five (5) years. The petition shall be accompanied by verified affidavits of a physician, a psychologist licensed or certified under the provisions of KRS Chapter 319, and a person licensed or certified as a social worker or an employe of the cabinet for human resources who meets the qualifications of KRS 335.080(1)(a), (b) and (c) or 335.090(1)(a), (b) and (c) supporting the need for the continuation of the guardianship or conservatorship. (Enact. Acts 1982, ch. 141, § 12, effective July 1, 1982; 1984, ch. 395, § 4, effective July 13, 1984.)

387.620. Petition for relief — Hearing on petition — Judgment or modification. — (1) A partially disabled or disabled person, his limited guardian, guardian, limited conservator, or conservator, or any other interested person may petition the court for:

(a) Termination or modification of an order of partial disability or disability;

(b) Removal and/or replacement of a limited guardian, guardian, limited conservator or conservator; or

(c) Renewal of the appointment of a limited guardian, guardian, limited conservator, or conservator.

(2) Petitions pursuant to this section shall set forth:

(a) The name and address of the ward;

(b) The name and address of the limited guardian, guardian, limited conservator, or conservator;

(c) The name, address, and interest of the petitioner;

(d) The names and addresses of the ward's next of kin, if known;

(e) The name and address of the individual or facility, if any, having custody of the ward;

(f) The relief requested; and

(g) The facts and reasons supporting the request.

(3) A request under subsection (1) of this section, if made by the ward, may be communicated to the court by any means, including but not limited to oral communication or informal letter. If such a request is communicated by means other than a petition, the court shall appoint a suitable person who may, but need not be, an employe of the state, county, or court to prepare a written petition to be filed with the court within seven (7) days following the appointment.

(4) Within thirty (30) days after the filing of a petition, the court shall conduct a hearing at which the ward shall be entitled to counsel. The time for a hearing may be extended by the court, on motion of either party, for cause. Notice of the time and place of the hearing shall be given not less than fourteen (14) days prior to the hearing to both parties and all persons named in the petition.

(5) At the request of any party or on its own initiative, the court may order an interdisciplinary evaluation of the ward. The time period in which the court must review a petition may be extended for an appropriate period of time if such an evaluation is ordered by the court.

(6) Upon conclusion of the hearing, the court shall enter a written order setting forth the factual basis for its finding and may do any of the following:

(a) Dismiss the petition;

(b) Remove the guardian or conservator and dissolve the guardianship or conservatorship order;

(c) Remove the limited guardian, guardian, limited conservator, or conservator and appoint a successor;

(d) Modify the original guardianship or conservatorship order; or

(e) Make any other order which the court deems appropriate and in the best interest of the ward.

(7) If the original order is dissolved and no further order is issued, the ward shall be relieved of all legal disabilities. The court shall enter an order and judgment restoring to the person all of the rights and privileges of a citizen. The clerk shall note such judgment or modification in the book in which notices of actions and encumbrances are indexed.

(8) The clerk of the court shall transmit a certified copy of the restoration judgment or modification to the originating court, if the judgment or modification is ordered by a court other than the court in which the original judgment was entered. (Enact. Acts 1982, ch. 141, § 13, effective July 1, 1982; 1984, ch. 395, § 5, effective July 13, 1984.)

387.630. Committee to assume duties of guardian — Powers — Nullification of adjudication of incompetency. — (1) Any person appointed committee for an incompetent person prior to July 1, 1982, shall assume the duties of a guardian and shall be subject to all of the provisions of KRS 387.500 to 387.770 pertaining to guardians, including all reporting requirements. The committee shall, within one (1) year from July 1, 1982, petition for modification of the original order if a less restrictive guardianship or conservatorship would be more appropriate.

(2) In all instances where an adjudication of incompetency was entered prior to July 1, 1982, and no committee has been appointed or is serving on that date, the adjudication of incompetency shall be considered null and void if no guardian or conservator is appointed within one (1) year of July 1, 1982. (Enact. Acts 1982, ch. 141, § 14, effective July 1, 1982.)

387.640. Duties of limited guardian or guardian. — It shall be the general duty of the limited guardian or guardian to carry out diligently and in good faith the specific duties and powers assigned by the court and to:

(1) Assure that the personal, civil, and human rights of the ward are protected; and

(2) Encourage the ward to:

(a) Participate to the maximum extent of his abilities in all decisions which affect him;

(b) Act in his own behalf on all matters in which he is able to do so; and

(c) Develop or regain, to the maximum extent possible, his capacity to meet the essential requirements for his physical health or safety, and, if impaired, his capacity to manage his financial resources. (Enact. Acts 1982, ch. 141, § 15, effective July 1, 1982.)

387.650. Assignment of powers and duties to limited guardian by court — Reporting requirements. — The court may assign to a limited guardian any portion of the powers and duties specified in KRS 387.660. The court may assign other duties as are necessary to enhance the ward's safety and well being. A limited guardian shall comply with the reporting requirements specified by KRS 387.670 which pertain to his powers and duties as specified by the court, provided that all reports submitted shall include the information required by paragraphs (d) and (f) of KRS 387.670(1). (Enact. Acts 1982, ch. 141, § 16, effective July 1, 1982.)

387.660. Specific powers and duties of guardian. — A guardian of a disabled person shall have the following powers and duties, except as modified by order of the court:

(1) To take custody of the ward and to establish his place of abode within the state, except that, if at any time a guardian places a ward in a licensed residential facility for developmentally disabled persons, the guardian shall, within thirty (30) days of such placement, file with the court notice of the placement, stating with specificity the reasons for such placement, and an interdisciplinary evaluation report detailing the social, psychological, medical or other considerations on which such placement is predicated, a

description of the treatment or habilitation programs which will benefit the ward as a result of such placement, and a determination that such placement will provide appropriate treatment in the least restrictive available treatment and residential program. For purposes of this subsection, the interdisciplinary evaluation report may be one performed within two (2) months prior to the placement for purposes of determining whether such placement is necessary and appropriate, or may be an evaluation and assessment provided by the residential facility immediately after placement. Notice to the court shall not be required where the ward is transferred from one licensed residential facility to another.

(2) To make provision for the ward's care, comfort, and maintenance and arrange for such educational, social, vocational, and rehabilitation services as are appropriate and as will assist the ward in the development of maximum self-reliance and independence.

(3) To give any necessary consent or approval to enable the ward to receive medical or other professional care, counsel, treatment or service, except that a guardian may not consent on behalf of a ward to an abortion, sterilization, psychosurgery, removal of a bodily organ, or amputation of a limb unless the procedure is first approved by order of the court or is necessary, in an emergency situation, to preserve the life or prevent serious impairment of the physical health of the ward.

(4) To act with respect to the ward in a manner which limits the deprivation of civil rights and restricts his personal freedom only to the extent necessary to provide needed care and services to him.

(5) To expend sums from the financial resources of the ward reasonable and necessary to carry out the powers and duties assigned to him by the court and, unless a separate conservator has been appointed, to manage the financial resources of this ward.

If a separate limited conservator or conservator has been appointed for the ward, the expenditure of funds by the limited guardian shall be consistent with the duties assigned to and procedures and policies established by such limited conservator or conservator. Conflicts arising between a limited guardian and a limited conservator or conservator regarding the expenditure of funds which are unable to be otherwise resolved shall be submitted to the court for resolution. (Enact. Acts 1982, ch. 141, § 17, effective July 1, 1982.)

387.670. Annual report of guardian. — (1) A guardian shall file with the court at least annually a verified report stating:

(a) The ward's current mental, physical, and social condition;

(b) The address of every residence of the ward during the reporting period and length of stay at each residence;

(c) A summary of the medical, social, educational, vocational, and other professional services received by the ward during the reporting period;

(d) An outline of the guardian's visits with and activities on behalf of the ward;

(e) A recommendation as to the need for continued guardianship;

(f) A statement signed by the standby guardian, if one has been appointed, that the standby guardian continues to be willing to serve in the event of the death, resignation, removal, or incapacity of the guardian; and

(g) Other information requested by the court or useful in the opinion of the guardian.

(2) For the purpose of filing the report required by subsection (1) of this section, the guardian shall be given access to records pertaining to the ward held by public or private agencies which contain information necessary for the guardian to perform his duties.

(3) The court shall review the report required in subsection (1) of this section and take whatever action it considers necessary to enhance the well-being of the ward.

(4) In addition to the requirements of this section, a guardian shall comply with the reporting requirements of KRS 387.710 unless a separate conservator has been appointed. (Enact. Acts 1982, ch. 141, § 18, effective July 1, 1982.)

387.680. Duties of limited conservator or conservator. — It shall be the general duty of the limited conservator or conservator to carry out, diligently and in good faith, the specific duties and powers assigned by the court and to:

(1) Manage or assist in managing those financial resources placed under his supervision and/or control as would a prudent person managing his own resources and, if a conservator has special skills or is named conservator on the basis of representations of special skills or expertise, he shall use those skills; and

(2) Encourage the ward to:

(a) Participate, to the maximum extent of his abilities, in all decisions which affect him;

(b) Act on his own behalf on all matters in which he is able to do so; and

(c) Develop or regain, to the maximum extent possible, his capacity to manage his financial resources and, if impaired, his capacity to meet the essential requirements for his physical health or safety. (Enact. Acts 1982, ch. 141, § 19, effective July 1, 1982.)

387.690. Specific duties of limited conservator or conservator. — (1) A limited conservator or conservator shall expend or distribute, or authorize the expenditure or distribution of, or assist in the expenditure or distribution of, the principal or income from the financial resources placed under his supervision and control to assure that:

(a) The essential requirements for the physical health or safety of the ward are met;

(b) The rights of the ward are protected;

(c) The financial resources of the ward which are subject to the conservatorship are prudently managed;

(d) The ward has the opportunity to develop or regain the capacity to perform the functions listed in paragraphs (a), (b), and (c) of subsection (2) of KRS 387.680; and

(e) The limited guardian or guardian for the ward, if any, is able to carry out the duties and powers assigned to him by the court.

(2) In performing his duties, the limited conservator or conservator shall consider:

(a) The size of the financial resources under the limited conservator's or conservator's supervision or control;

(b) The probable duration of the conservatorship;

(c) The likelihood that the ward may be able to manage his financial resources in the future;

(d) The accustomed standard of living of the ward;

(e) Other funds or resources used for the support of the ward which have not been placed under the control or supervision of the limited conservator or conservator; and

(f) The requests of the ward and the ward's limited guardian or guardian, if any.

(3) In addition to the duties and powers listed in subsection (1) of this section, the court may assign to a limited conservator any of the duties and powers listed in KRS 387.700 which the partially disabled person lacks the ability to perform. (Enact. Acts 1982, ch. 141, § 20, effective July 1, 1982.)

387.700. Specific powers and duties of conservator. — (1) A conservator has all of the powers conferred herein and any additional powers conferred by law on trustees in this state. The conservator may take possession of the ward's real and personal property, and of all rents, incomes, and benefits therefrom, whether accruing before or after his appointment, and of the proceeds arising from the sale, mortgage, lease or exchange thereof. Subject to such possession the title of all such estate and to the increment and proceeds thereof shall be to the ward and not to the conservator. It is the duty of the conservator to protect and preserve the estate, to retain, sell and invest it as hereinafter provided, prosecute or defend actions, claims or proceedings in any jurisdiction for the protection of the estate's assets, to account for it faithfully, to perform all other duties required of him by law, and, at the termination of the conservatorship, to deliver the assets of the ward to the persons lawfully entitled thereto.

(2) The conservator shall apply the money and property for the payments of debts, taxes, claims, charges and expenses of the conservatorship and for the support, care, maintenance and education of the ward or his dependents.

(3) Any sale of realty of a ward shall be as provided in KRS Chapter 389A. (Enact. Acts 1982, ch. 141, § 21, effective July 1, 1982; 1982, ch. 277, § 3, effective July 15, 1982.)

Legislative Research Commission Note. This section was amended by two 1982 Acts which do not appear to be in conflict and have been compiled together.

387.710. Filing of inventory by limited conservator or conservator — Biennial report — Final report and account. — (1) Within sixty (60) days of appointment, the limited conservator or conservator shall file with the court a verified inventory of all the property of the ward which has come

to his possession or knowledge, including a statement of all encumbrances, liens, and other secured claims on any item, any claims against the estate of the ward, and any cause of action accruing to the ward. The limited conservator or conservator shall provide a copy thereof to the ward if he has sufficient mental capacity to understand it.

(2) A limited conservator or conservator shall file with the court a verified report and account biennially within sixty (60) days after the anniversary date of his appointment. Said report shall contain:

(a) The present personal status of the ward whose estate is managed by the conservator;

(b) The conservator's plan for preserving and maintaining the estate of which he has control or supervision;

(c) The need for continuation or cessation of the conservatorship; and

(d) The need for any alteration in the powers of the conservatorship.

The biennial report shall specify the amount and type of real and personal property received by the conservator and remaining in his control or invested by him, the nature of such investment, and expenditures made during the preceding year. Upon request of the court, the conservator shall produce for examination any information or documentation which the court may consider relevant to the accounting of the financial and property transactions of the estate.

(3) Upon the resignation, removal, or death of a limited conservator or conservator, or on the termination of the conservatorship, the limited conservator or conservator, or his personal representative, shall forthwith submit a final report and account to the court and to the former ward and to the successor limited conservator or conservator, or, if the ward is deceased, to his personal representative, and shall pay over the trust estate to the person entitled thereto. Upon approval of the report and account, the limited conservator or conservator shall be discharged and his surety, if any, released. (Enact. Acts 1982, ch. 141, § 22, effective July 1, 1982.)

387.720. Surety of limited conservator or conservator. — The court may require a limited conservator or conservator to provide surety on his bond consistent with the provisions of KRS 395.130. (Enact. Acts 1982, ch. 141, § 23, effective July 1, 1982.)

387.730. Testamentary guardian or conservator nomination — Review of nomination by court. — A parent, spouse or child of a partially disabled or disabled person who has been appointed as limited guardian, guardian, limited conservator, or conservator of that person may, by will, nominate an individual to succeed in that capacity upon the testator's death. Such nomination shall be reviewed by the court pursuant to KRS 387.620 upon admitting the will to probate if no other person is serving in that capacity at the time of the testator's death and no standby guardian or conservator has been appointed. (Enact. Acts 1982, ch. 141, § 24, effective July 1, 1982.)

387.740. Emergency powers of court — Petition and hearing on emergency appointment. — (1) The court may exercise the powers of a limited guardian or limited conservator or may appoint an individual or agency to exercise such powers if, during the pendency of a proceeding for a determination of partial disability or disability or an appeal therefrom, it appears that there is danger of serious impairment to the health or safety of the respondent or damage or dissipation to his property if immediate action is not taken.

(2) Prior to a hearing on the need for an emergency appointment of a limited guardian or limited conservator, a petition shall be filed which sets forth the following:

(a) The name, age, and address of the respondent;

(b) The danger alleged to be imminent;

(c) The type of appointment and the protection and assistance requested;

(d) The facts and reasons supporting the request;

(e) The name, address, and qualifications of the proposed limited guardian or limited conservator, if any;

(f) The name, address, and interest of the petitioner;

(g) The names and addresses of the respondent's next of kin, if known;

(h) The name and address of the individual or facility, if any, having custody of the respondent; and

(i) The date of filing of the petition for determination of disability or partial disability.

(3) Within one (1) week of the filing of a petition pursuant to this section, the court shall conduct a hearing at which the respondent shall be entitled to counsel. Notice of the time and place of the hearing shall be given not less than forty-eight (48) hours prior to the hearing to all persons named in the petition and to the county attorney.

(4) The burden shall be on the Commonwealth to prove by clear and convincing evidence the need for the emergency appointment of a limited guardian or conservator.

(5) If the court exercises the powers of a limited guardian or limited conservator or appoints another to do so in an emergency situation as set forth in subsection (1) of this section, the court shall state on the record findings of fact as to the danger determined to be imminent, the sources relied on in arriving at such determination, the type of assistance to be provided, and the powers and duties of the emergency guardian or conservator. The authority of the guardian or conservator shall expire upon resolution of the appeal or action. (Enact. Acts 1982, ch. 141, § 25, effective July 1, 1982.)

387.750. Standby appointee — Powers and duties. — (1) On appointment of a limited guardian, guardian, limited conservator, or conservator, or at any time thereafter, the court may designate another suitable person or entity to assume the powers and duties assigned to the limited guardian, guardian, limited conservator, or conservator upon his death, resignation, removal, or incapacity. Prior to such designation, the individual or entity to be designated shall file with the court a written application stating the

name, address, and qualifications of the applicant and his relationship, if any, to the respondent.

(2) The individual so designated shall file an acceptance with the court within ten (10) days of the death, resignation, or incapacity of his predecessor. Notice shall also be given to the ward and his nearest adult relative. An individual serving on a standby basis may exercise all the powers and duties assigned to his predecessor upon filing of his acceptance unless otherwise ordered by the court.

(3) In an emergency situation and in the absence and unavailability of the initially appointed guardian or conservator, the standby guardian or conservator may temporarily assume the powers and duties of the initially appointed guardian or conservator. (Enact. Acts 1982, ch. 141, § 26, effective July 1, 1982.)

387.760. Court costs — Compensation and reimbursement for expenses. — (1) No court costs shall be charged to a respondent or ward in any proceeding under KRS 387.500 to 387.770, if the respondent or ward is a poor person as defined in KRS 453.190.

(2) Limited guardians, guardians, limited conservators and conservators are entitled to reasonable compensation for services rendered and to reimbursement for reasonable and necessary expenses incurred in the exercise of their assigned guardianship or conservatorship duties and powers. Such compensation and reimbursement shall be paid from the financial resources of the ward. Compensation and reimbursement of guardians, limited conservators and conservators shall not exceed that provided for in KRS 386.180. (Enact. Acts 1982, ch. 141, § 27, effective July 1, 1982.)

387.770. Confidentiality of records — Expungement of records — Disclosure of information, log. — (1) All determinations of disability and orders of appointment, modification, and termination shall be filed as public records with the clerk of the court. All other court records of a respondent made in all proceedings under KRS 387.500 to 387.770 shall be confidential and shall not be open to the general public except as provided in subsection (3) of this section.

(2) Following the dismissal or withdrawal of a petition filed under this chapter or a determination that a respondent is no longer disabled, the respondent may at any time move to have all court records pertaining to the proceedings expunged from the files of the court, provided that he submits a full release of all claims arising from the proceedings.

(3) Any person seeking to obtain confidential information contained in the court files or the court records of proceedings under KRS 387.500 to 387.770 may file a written motion stating why the information is needed. The court may issue an order to disclose such information upon a showing that the disclosure is appropriate under the circumstances and in the best interest of the person or the public. The court shall maintain a log of the individuals and entities granted access to the file or records. (Enact. Acts 1982, ch. 141, § 28, effective July 1, 1982.)

ESTATE PLANNING
FOR
RETIREMENT AND RETIREES

By

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Section D

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ESTATE PLANNING FOR RETIREMENT AND RETIREES

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The determination of when and how to receive payments from qualified plans and social security benefits often are the most important estate and income tax planning decisions the about to be and the retired professional and business executive will make. I will discuss many alternatives and opportunities that many retirees should consider with their large and most complex investment.

I. PLANNING FOR PAYMENTS OF QUALIFIED PLAN BENEFITS:

A. Types of Plans

1. Qualified Plans:

(a) Pension Plans
(b) Profit Sharing Plans
(c) Stock Bonus Plans
(d) Annuity Plans

2. Other Forms of Qualified and Similar Tax Advantaged Plans

(a) Thrift or Savings Plans
(b) 401-K Plans
(c) Individual Retirement Plans (IRAs)
(d) Simplified Employee Pensions (SEPs)
(e) HR 10 (Keogh) Plans
(f) ESOPS, PAYSOPS and TRASOPS

B. Income Tax Considerations

1. Qualified and Other Tax Advantage Plans

(a) Annuity Payments
(b) Lump-sum Distributions
(c) Constructive Receipt Rules
(d) Rollovers

(i) Employee
(ii) Spouse

C. Joint and Survivor Annuities

1. Spouse's guaranteed interest. The Retirement Equity Act of 1984 contains provisions designed to guarantee that a surviving spouse will receive benefits from most qualified plans.

2. Plans Affected. The joint and Survivor Annuity requirements apply to Pension Plans (including defined contribution plans) and HR 10 Plans that are pension plans as well as profit sharing and stock bonus plans. <u>They do not apply to IRAs even if the IRA has received a rollover contribution from a plan that itself is affected by the mandatory provisions; nor do they apply to SEPs</u>.

D. Waiver by Participant - Consent by Spouse. A participant may elect a form of benefit for his spouse other than a qualified joint survivor annuity or qualified preretirement survivor annuity, hereinafter referred to as QJSA and QPSA, or elect a beneficiary other than the spouse (such as a trust) to receive some or all of the benefits.

1. Applicable Election Period.

(a) QPSA may be waived from the 1st day of the Plan Year in which participant is 35 until his death.

(b) QJSA may be waived only during the 90 days prior to the annuity starting date (417(f)(2)).

2. Consent by Spouse.

(a) The Participant's election is revocable during the election period.

(b) And either:

(i) The Participant's election must designate a beneficiary (or a form of benefit) which may not be changed without spousal consent; or

(ii) The spouse's consent permits designations by the Participant without any requirement of further consent by the spouse.

(c) Spouse consents in writing and consent is witnessed by a Plan Representative or a notary public.

(d) When a participant dies, unless the spouse expressly relinquishes that right, there are fixed right and will take precedent over any

other option that may be more favorable to the family unless action is taken before the annuities start to change the form of benefit.

(i) The accrued benefit payable to a vested Participant who does not die before the annuity starting date must be in the form of a "qualified joint and survivor annuity" (QJSA) Sect. 407(a)(11)(A) and Sect. 417(b).

(ii) If a vested Participant dies before the annuity starting date and has a surviving spouse, the spouse is to receive a "qualified preretirement survivor annuity" (QPSA).

3. Qualified Joint and Survivor Annuity is one in which the survivor's annuity is no less than 50% and not more than 100% of the annuity payable during the joint lives of the participant and spouse. Sect. 417(b).

4. Spouse may be limited by a plan provision to those persons who are married to the employee for at least one year before the annuity starting date (QJSA) or the employee's death (QPSA). Sect. 417(d).

5. Existing beneficiary designations (made before 8-23-84) that name a beneficiary other than the spouse are no longer valid in the eyes of the IRS.

6. A written explanation of the QJSA or QPSA of the spouse's rights is provided to the Participant.

7. Such waiver shall not be treated as a transfer of property by gift.

8. Disclaimer by Wife.

E. Minimum Distribution Rules.

1. The Employee's entire interest must be distributed either:

(a) <u>Outright</u> not later than the required beginning date.

(b) <u>In Installments</u> not later than the required beginning date and over a period of time that is:

(i) The employee's life;

(ii) The lives of the employee and a designated beneficiary; or

(iii) A term of years not longer than (i) or (ii).

2. Required beginning date means April 1, of the calendar year following the later of:

   (a) The calendar year in which the employee attains 70-1/2; or

   (b) The calendar year in which the employee retires.

      (i) Except that the rule in (b) above does not apply to an employee who is a 5% owner with respect to the plan year ending in the calendar year in which the Employee attains 70-1/2.

      (ii) Rule (a) applies to most everybody.

3. Distributions that begin after age 59-1/2 but before the later of the employee's retirement or age 70-1/2 do not have to comply with the minimum distribution rules.

F. Death of Employee before Entire Interest is Distributed

1. Installment payments that began before the Employee's death must be distributed at least as fast as under the method of distribution being used at date of death.

   (a) The distribution may be accelerated if the spouse or other beneficiary chooses a shorter payment period or a lump-sum distribution.

   (b) If the employee dies before reaching age 70-1/2, no payments are deemed to have been made before death and the rules described below in 2. are to apply.

2. No payments before death - the entire interest must be distributed within 5 years after death unless:

   (a) A portion of the employee's interest is payable to or for the benefit of a designated beneficiary; and

   (b) That portion will be distributed over the beneficiary's life or a period no longer than the beneficiary's life expectancy; and

(c) The distributions begin within 1 year after the Employee's death.

3. Surviving Spouse. The rules in F. 2. are modified if the designated beneficiary is the spouse:

(a) Distributions to the spouse do not have to begin until the date on which the employee would have been 70-1/2; and

(b) If the spouse dies before the distributions begin, the rules described in F. 2. apply as though the spouse was the employee.

G. New 15% Tax on Excess Distributions from Qualified Retirement Plans, Section 4981A.

1. TRA of 1986 added an entirely new tax in an effort to continue to limit the perceived discriminatory aspects of qualified plans. This tax is applied at either retirement (an income tax) or upon death (a Federal estate tax).

(a) The 1986 Tax Act imposes an additional 15% penalty tax to the Federal estate tax on an individual's excess retirement accumulations, IRC 4981(d) as added by Sect. 1133 of the 1986 Act at death. It applies to estate's of decedents who die after 1986.

(b) The unified credit cannot be used to offset this tax. Sect. 4981(d)(2).

(c) There is no marital deduction available to eliminate the tax - it will be payable even in estates whose estate tax has been reduced to zero by a formula.

(d) The tax is assessed if there is an excess retirement accumulation of the value of the decedent's interest in all qualified employer's plans and IRAs is greater than the present value of an annuity payable for a period of years equal to the decedent's life expectancy immediately before his death. The amount of the annual annuity used to make this calculation will vary, but in many cases, it will probably be at least $112,500 and may be at least $150,000.

(e) A distribution from a qualified plan for which a lump-sum election is made will include an excess distribution if it exceeds 5 times the annual limit. For example, 5 multiplied by $112,500 = $562,500. For individuals dying after 12/31/86, new Code Section 4983 also imposes an additional estate tax of 15% of the individual's "excess retirement accumulation" defined in Sub-Section 4981 A (d)(3). However, Sub-Section (c)(5) provides a grandfather clause for accrued benefits as of August 1, 1986, as follows:

(i) In general, if the employee elects on a return filed for a taxable year ending before 1-1-89, to have this paragraph apply, the portion of any retirement distribution which is attributable (as determined under rules prescribed by the Secretary) to the accrued benefit of an employee as of 8/1/86 shall be taken into account. However, no tax shall be imposed under this Section with respect to such portion of said distribution.

(ii) Limitation - An employee may not make an election under Sub-paragraph (i) unless the accrued benefit of such employee as of August 1, 1986, exceeds $562,500.

(iii) Taxpayer not making election - if an employee does not make the election, then $150,000 will be substituted for the $112,500 relative to the limitation or $750,000 on lump-sum distributions. It appears one must make the 5-year (or 10-year) averaging election to obtain the five times exclusion. There is some question as to whether the above election applies to Federal estate tax.

H. 10% Penalty Tax on Early Distribution

1. What is referred to as the "too early" penalty is the 10% tax that before 1987 applied only to distributions made prior to age 59-1/2 from IRAs and certain 5% owners under Section 408(F) and 72(M)(5)(A)(i). The early penalty tax now also applies to all qualified plans and annuities, including 401(k) Plans.

2. This 10% tax applied to the taxable portion of the distribution which includes:

(a) The amount attributable to Employer contributions;

(b) Income attributable to Employer and after tax Employee contributions to qualified plans; and

(c) For tax sheltered annuities, the amount attributable to those contributions.

3. Some early distributions however are not subject to the additional tax including:

(a) A payment to an employee who has attained age 55, terminated employment and met the plan's requirements for early retirement;

(b) A payment that is part of a scheduled series of substantially equal periodic payments (an annuity) for the life of the beneficiary;

(c) A payment for medical expenses which exceeds 7-1/2% of the employee's adjusted gross income; or

(d) A payment to a disabled employee. Sect. 72(M)(9)(F) 408(F) as amended by TRA 1986.

I. Lump-Sum Distributions

1. Qualifications:

(a) A lump sum need not be made in one payment, but it must be the payment of the entire plan balance to the credit of the employee within one taxable year of the recipient.

(b) The recipient may be someone other than the employee; for example, the employee's estate or chosen beneficiary may receive the proceeds.

(c) All trusts and annuities forming part of an employer's plan must be aggregated for purposes of determining the balance to the credit of the employee.

(d) In order to qualify as a lump sum, the distribution must be made on account of employee's death, separation from service, disability or after employee has attained the age of 59-1/2. Sect. 402(e)(4)(A).

2. Computation of Tax for Employees who Attained Age 50 prior to January 1, 1986:

(a) The recipient can elect any of 3 different options:

(i) The portion of the distribution attributable to the employee's participation in the plan before 1974 can be treated as long-term capital gains 402(a)(2). However, under 1986 Tax Act, in 1987, the entire amount attributable to pre-1974 participation is treated as long-term capital gain taxable at 20% rate; 1988, 95% of pre-1974 amount is taxable at 20%; 1989, 75% taxable at 20%; 1990, 50% taxable at 20%; and 1991, 25% taxable at 20%. Sect. 1122(a).

(ii) The portion attributable to participation after 1973 is taxable as ordinary income but at a special rate which allows for 10 year averaging. Sect. 402(e)(1). The tax used in this computation is at the single individual income tax rates in effect in 1986.

(iii) The portion of the distribution eligible for capital gains treatment is found by multiplying the total taxable amount by a fraction whose numerator is the number calendar years of active participation in the plan before 1974 and whose denominator is the total number of years of active participation.

(iv) The recipient may elect to forego capital gains treatment on pre-1974 amounts and subject the entire amount to the 10 year averaging method instead.

(v) Under the new transition rule of the TRA of 1986, the recipient may elect to use the new 5 year forward averaging under the current tax rates in effect at time of election rather than the 10 year averaging under the tax rate in effect in 1986.

2. Computation for employees who had not attained age 50 by January 1, 1986, is limited only to a 5 year forward averaging under the current tax rates at date of election.

II. PLANNING FOR SOCIAL SECURITY BENEFITS:

The Social Security Act (the Act) provides a broad range of cash and health benefits, including old age (retirement) survivor and disability insurance benefits (OASDI).

A. Old Age Benefits - Worker and Spouse - When and to Whom Paid

1. Workers retiring at age 65 are paid full benefits or if retiring at age 62, he will receive 80% of benefits to be received at age 65. Wage earner's benefits are increased by 5/9 of 1% for each month of early retirement that is postponed between ages 62 and 65.

2. Spouse is entitled to benefits if married to worker for one year or is natural parent of worker's child and is age 62 or cares for child entitled to benefits.

   (a) Spouse receives 1/2 the amount paid to the retired worker, or

   (b) A person already entitled to old age or disability benefits which are larger than the proposed spousal benefits will continue or may elect to receive those larger benefits.

3. Unmarried Divorced Spouse - A divorced spouse whose marriage to the worker lasted 10 years and who is currently unmarried, becomes eligible for benefits on the worker's record at age 62, regardless of whether the worker is remarried or how long ago their marriage ended. But the divorced spouse loses these benefits if he or she remarries.

4. Worker's children are entitled to benefits if dependent on worker, unmarried and under 18, or over 19 and disabled. Child may be natural, illegitimate and acknowledged, step-child or adopted.

   (a) Child benefits end with the month before the month in which one of the following events first occurs:

      (i) The child becomes 18 years old and is not disabled nor a full-time student;

(ii) The child dies or remarries. However, the benefits of a disabled child who is age 18 or older do not terminate if the child marries a person independently entitled to social security benefits.

(iii) The insured's entitlement to old age or retirement benefits ends for a reason other than death or attainment of age 65.

(iv) Children over 18 were formerly eligible for child benefits until age 22 if they were full-time students. This provision was phased out completely by August 1985, and no new benefits are payable to students who are over 18. 42 USC Sect. 402 (d)(1)(B); 20 CFR Sect. 404.369.

5. Survivor Benefits - A surviving spouse of a worker who was fully insured when he or she died, is entitled to benefits under the following conditions:

(a) The spouse is the insured's widow or widower according to the criteria set forth for a spouse:

(i) The spousal relationship to the insured lasted for at least 9 months immediately before the worker died.

(ii) The spouse and the worker were natural parents of a child.

(iii) The spouse was already entitled or could have been entitled to social security or railroad retirement benefits in the month before the spouse married the insured.

(iv) The surviving spouse is at least 60 years old or is at least 50 years old and disabled.

B. Payments of Benefits

1. Lump Sum Death Benefit:

(a) $255 is payable to surviving spouse living with worker at death; or

(b) The person who was entitled to widow's or widower's benefits or mother's or father's benefits on the worker's record for the month of the worker's death.

(c) Application for this payment must be filed within 2 years of worker's death.

2. Disability Benefits:

(a) A worker is entitled to disability benefits under the following conditions:

(i) The worker must be under 65;

(ii) The worker has insured status for disability;

(iii) The worker currently has a disability or had one that ended less than 12 months before the month in which the application was filed;

(iv) The worker has established a period of disability of 5 consecutive months, beginning with a month in which the worker was both insured for disability and disabled.

(b) There is a waiting period of 5 consecutive months before the person can begin to receive disability payments.

(c) The period cannot begin more than 17 months prior to applying for benefits.

3. Decreases in Benefits:

(a) Early Retirement - wage earner's benefit is reduced by 5/9 of 1% for each month of early retirement between 62 and 65.

(b) Benefits prior to age 70:

(i) A worker under 65 might earn in 1987 up to a maximum of $6,000 ($500 per month) without affecting his or her own benefits.

(ii) A worker over 65 but under 70 might earn $8,160 ($680 per month) without affecting his or her benefits.

(iii) If earnings exceed the above, then the benefits will be reduced by $1 for every $2 earned over the annual amount until 1990. In 1990, only $1 in $3 will be deducted from the benefit.

C. **Income Taxation of Social Security Benefits**

1. A portion of social security benefits may be subject to income taxation. The benefits will be included in the gross income of the person who has the legal right to receive the benefits. The amount includable in a payable year will be the lesser of:

   (a) 1/2 of the amount of social security benefits (SSB) received; or

   (b) 1/2 of the difference between the sum of the taxpayer's modified adjusted gross income (MGI) plus 1/2 of the amount of the SSB received minus the base amount (BA). Expressed as a formula, this alternative reads 1/2 (MGI + 1/2 SSB) - BA = amount includable in gross income.

      (i) SSB will include medicare Part B premiums withheld from SSB.

      (ii) Modified adjusted gross income (MGI) is the taxpayer's adjusted gross income plus any deduction taken for foreign income and tax exempt interest.

      (iii) The base amount is $32,000 for married individuals filing a joint return or $25,000 for single individuals and married persons who live apart from their spouses for the entire year and who file separate returns and zero for married individual who does not live apart from the spouse for the entire year and who does not file a joint return.

Tax timing, as well as practical cash and reinvestment needs and goals of the retired client, have to all be taken into consideration when determining when and in what form payments of qualified plan benefits and social security should be made.

ESTATE PLANNING TECHNIQUES
FOR
GENERATION SKIPPING TRANSFERS

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Section E

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ESTATE PLANNING TECHNIQUES FOR GENERATION SKIPPING TRANSFERS

I. BACKGROUND.

A. UNDERLYING PURPOSE OF THE GENERATION-SKIPPING TRANSFER TAX.

1. When property passes outright from one generation to a younger generation the transfer is generally subject to either the federal gift or estate tax. This continues as each generation transfers the property outright to the next generation.

> Example (1): An individual (G1) dies leaving certain property outright to his daughter (G2). Upon G2's death, G2 leaves such property outright to her son (G3). The property is subject to the federal estate tax at G1's death, when the property passes outright to G2, and the property is again subject to the federal estate tax at G2's death, when the property passes outright to G3.

2. Prior to enactment of the generation-skipping transfer tax under the Tax Reform Act of 1976 it was possible to set up certain generation-skipping trusts (and similar nontrust arrangements, such as life estates, referred to as generation-skipping trust equivalents) that passed beneficial enjoyment of property to a person in a generation younger than the initial transferor without subjecting the property to another transfer tax when it was subsequently passed to a person in an even younger generation.

> Example (2): Upon his death the initial transferor (G1) transfers property to a trust, such that his daughter (G2) receives an income interest from the property in trust for her lifetime. The remainder, upon G2's death, passes to G2's son (G3). Neither the federal estate tax nor the federal gift tax would apply to the passing of the property upon G2's death, since G2 holds only a life interest in the trust. Thus, prior to enactment of the generation-skipping transfer tax, the only transfer tax applicable to such property as it passed among three generations was that imposed upon the death of G1.

3. The purpose of the generation-skipping transfer tax was to "back-up" the federal estate and gift tax by imposing a transfer tax relative to each generation

receiving beneficial enjoyment of property, regardless of the ability of tax planners to otherwise keep the transferred property from being a taxable transfer by intervening generations (e.g., G2 in Example (2)) for federal estate or gift tax purposes.

4. Transfers permitting an intervening generation younger than the initial transferor (e.g., G2 in Example (2)) to receive beneficial enjoyment of property without subjecting the transferred property to the federal estate or gift tax when it passed from that intervening generation to an even younger generation (i.e., G3 in Example (2)) were referred to as "generation-skipping transfers" in that such transfers skipped imposition of the the federal estate and gift taxes relative to the intervening generation.

B. **THE GENERATION-SKIPPING TRANSFER TAX UNDER THE TAX REFORM ACT OF 1976.**

1. The generation-skipping transfer tax, initially imposed by the Tax Reform Act of 1976, attempted to close the generation-skipping transfer loophole by exposing such generation-sharing arrangements to this new federal transfer tax in cases where the passing of beneficial enjoyment of such property from one generation to the next would, by its nature, escape the imposition of federal estate and gift taxes.

2. The generation-skipping transfer tax under the Tax Reform Act of 1976 did not subject "direct skips" to the transfer tax. A "direct skip" is one where the initial transferor transfers property to a recipient at least two generations below his generation and there is no intervening economic enjoyment in the property by a generation younger than the transferor but older than the recipient.

> Example (3): If the initial transferor (G1) died leaving a life estate in certain real property to his daughter (G2), with the remainder interest therein passing to G2's son (G3) upon G2's death, then under the generation-skipping transfer tax enacted under the Tax Reform Act of 1976, the property subject to that generation-sharing arrangement would be subject to two federal transfer taxes. The property would first be subject to the federal estate tax as a result of its passing on G1's death. The property would again be subject to a transfer tax (i.e., the generation-skipping transfer tax) upon G2's death. However, if G1 had not created a generation-sharing arrangement with respect to such property by giving a life estate to G2, with the remainder interest to

G3, but instead had transferred the property directly to G3, the arrangement would be subject to only one transfer tax; that being the federal estate tax imposed upon the transfer at G1's death.

3. The tax on taxable generation-sharing arrangements was imposed when property subject to such arrangement was distributed to a beneficiary that was at least one generation younger than the holder of an intervening interest and at least two generations younger than the initial transferor (i.e., a "taxable distribution") or upon the termination of an intervening interest holder's interest in the generation-sharing arrangement (i.e., a "taxable termination"). However, only distributions of corpus or principal were deemed to be taxable distributions. Distributions of income from generation-sharing arrangements were not taxable distributions for purposes of the tax.

Example (4): Upon G1's death, a trust was created to provide discretionary distributions of principal and income to G1's daughter (G2) and grandson (G3) during G2's lifetime. The trust also provided that upon G2's death, the remaining principal of the trust would be distributed outright to G3. If the trustee were to make any distributions to G3 during G2's lifetime, then to the extent such distributions were from principal they would be taxable distributions, but to the extent that they were from income they would not be treated as taxable distributions. This prevented the distributed income from being subjected to both the federal income tax and the federal generation-skipping transfer tax. Upon G2's death a taxable termination would occur.

4. In order to subject taxable generation-sharing arrangements to a transfer tax substantially equivalent to the federal estate or gift tax that would have been imposed on an outright transfer by gift or inheritance to each successive generation, the tax was based upon the estate or gift tax rates applicable to the "deemed transferor" at the time of the generation-skipping transfer, after increasing the deemed transferor's tax base by the amount of the generation-skipping transfer tax.

5. The identity of the "deemed transferor" depended upon the identity of the transferee of the generation-skipping transfer.

(a) The transferee was the person who received the distribution in a taxable dis-

tribution. In the case of a taxable termination, the person who had a present beneficial interest in the property after the taxable termination had occurred was the transferee.

(b) The "deemed transferor" was generally the parent of the transferee most closely related to the initial transferor, if the parent had a beneficial interest in the generation-sharing arrangement.

(c) If the parent had no beneficial interest in the generation-sharing arrangement, then the youngest ancestor of the transferee who was related to the initial transferor and who had an interest in the generation-sharing arrangement was generally deemed the "deemed transferor."

(d) Where the generation-sharing arrangement was created for the benefit of a person not a member of the initial transferor's family, the deemed transferor was generally the parent of the transferee most closely related to the initial transferor.

6. The amount subject to the generation-skipping transfer tax was the fair market value of the property made the subject of the generation-skipping transfer at the time the taxable termination or taxable distribution was deemed to have occurred.

7. A $250,000.00 exemption (per child of the initial transferor) was available for generation-skipping transfers to grandchildren to the extent that the property vested in the grandchildren at the time of the taxable distribution or taxable termination otherwise triggering the tax. Vesting occurred when the interest of the grandchild in the property was such that the interest would be taxable in the grandchild's estate.

Example (5): If the initial transferor had two children, up to $500,000.00 could be transferred from a generation-sharing arrangement to the children of those two children ($250,000.00 to the children of each) without imposition of the generation-skipping transfer tax on the termination of interests of the initial transferor's children in the generation-sharing arrangement.

8. To the extent any transfer was subject to the federal estate or gift tax it was not considered to be a

taxable distribution or taxable termination for purposes of the generation-skipping transfer tax.

> Example (6): The initial transferor (G1) transferred property into a trust for the benefit of his daughter (G2) giving her a present income interest in such trust for life, plus a general power of appointment with respect to the property held in the trust. Upon G2's death the property was to pass outright to G2's son (G3) if the general power of appointment was not exercised by G2. Upon G2's death, the trust property would be included in her estate for federal estate tax purposes because of the general power of appointment. Since the federal estate tax was applicable at that time, the transfer to G3 would not be subject to the generation-skipping transfer tax.

9. The "deemed transferor" concept made the generation-skipping transfer tax, imposed by the Tax Reform Act of 1976, unduly complicated and, as previously mentioned, the tax did not apply to direct skips. Based on these and other complexities and loopholes found in the old generation-skipping transfer tax provisions of the Tax Reform Act of 1976, Congress enacted a new generation-skipping transfer tax under the Tax Reform Act of 1986.

II. THE NEW GENERATION-SKIPPING TRANSFER TAX.

A. REPEAL OF THE OLD GENERATION-SKIPPING TRANSFER TAX.

1. The unduly complicated generation-skipping transfer tax imposed by the Tax Reform Act of 1976 has been repealed retroactively to its original effective date of June 11, 1976. Pub.L. No. 99-514, §1433(c)(1).

2. Individuals who paid the old generation-skipping transfer tax may obtain a credit or refund (with interest) for any tax so paid. Pub.L. No. 99-514, §1443(c)(1).

3. To help accomplish this the statute of limitations for filing a refund claim has been extended to October 22, 1987. Pub.L. No. 99-514, §1443(c)(2).

B. TRANSFERS SUBJECT TO THE TAX.

1. Transfers subject to the new generation-skipping transfer tax are: (1) taxable terminations, (2) taxable distributions, and (3) direct skips. I.R.C. §2611(a).

2. **Taxable Terminations.** A taxable termination is deemed to occur upon the termination of an interest in a trust or trust equivalent if, after such termination, all interests in the trust or trust equivalent are held by "skip persons." I.R.C. §2612(a)(1). If, when an interest is terminated, any portion of the assets of the trust are distributed to "skip persons" who are lineal descendants of the holder of the terminated interest, such termination is a "taxable termination" with respect to the trust property so distributed even if, after such termination, not all interests in the trust or trust equivalent are held by skip persons. I.R.C. §2612(a)(2).

(a) A "skip person" is generally a person two or more generations below that of the transferor or a trust for the benefit of any such person or persons. I.R.C. §2613(a).

(b) A person is deemed to have an "interest" in a trust or trust equivalent where he has a current right to receive income or corpus from such trust or trust equivalent. This is true whether he is a mandatory or merely a permissible recipient of the income or corpus from the trust. I.R.C. §2652(c)(1). For example, a person having an income interest for life or holding a general power of appointment is treated as having an interest in property.

Example (7): The initial transferor (G1) creates a trust which provides for income to his children for life, and when the last of such children die, the remainder of the corpus of the trust will then be distributed outright to G1's grandchildren. The current interests of G1's children are "interests" in the trust. Generally, no taxable termination will have occurred until the last child of G1 dies. However, if the trustee is instructed to distribute a portion of property in the trust to G1's grandchildren upon the death of any such child, such would constitute a taxable termination to the extent of the property distributed to such deceased child's children, even though all interests in the trust are not held by the grandchildren.

3. **Taxable Distributions.** A "taxable distribution" occurs where there is a distribution from a trust or trust equivalent to a skip person, as defined above, which does not constitute a taxable termination or a direct skip. I.R.C. §2612(b).

(a) The distribution of income, as well as corpus, is deemed a taxable distribution subject to the generation-skipping transfer tax. This was not the case under the old generation-skipping transfer tax where only distributions of corpus were deemed taxable distributions. H.R. Rep. No. 426, 99th Cong., 1st Sess. 825.

(b) The imposition of the generation-skipping transfer tax upon a taxable distribution of income is mitigated to some degree in that the recipient of the taxable income distribution may take an income tax deduction for the generation-skipping transfer tax so imposed upon the distribution. I.R.C. §164(a)(6).

Example (8): The initial transferor (G1) sets up a trust for the benefit of his child (G2) and his grandchild (G3). The trustee may make distributions of income or principal to either G2 or G3. If the trustee makes distributions of either income or principal to G3 while G2 still has an interest in the trust such will constitute taxable distributions.

4. **Direct Skips.** A "direct skip" is any transfer of property by a transferor directly to a "skip person" if the initial transferor is subject to estate or gift tax on the transfer. I.R.C. §2612(c)(1). Direct skips are different from taxable distributions or taxable terminations because no one in generations between the initial transferor and the "skip person" enjoys an economic benefit from the arrangement.

Example (9): The initial transferor (G1) transfers property outright to his grandchild (G3). There is no intervening economic benefit to G1's child (G2). To the extent that such transfer is subject to the federal estate or gift tax it will be a "direct skip" for purposes of the generation-skipping transfer tax. The same is true if G1 were to transfer the property to a trust for G3.

C. **DETERMINING THE AMOUNT OF TAX.**

1. **Applicable Rates.** While there is a formula for determining the "applicable rate", transfers are essentially taxed at a flat rate equal to the then maximum unified estate and gift tax rate (i.e., 55% in 1987 and 50% in 1988 and thereafter). I.R.C. §2641. Because of the $1 million exemption available to each taxpayer (discussed below), the actual mechanical computation of the rate is as follows:

Maximum Federal Estate Tax Rate at the Time of the Taxable Event	x	[1-(Amount of Transferor's $1 Million Exemption Allocated to the Taxable Event ÷ The Value of the Property so Transferred)]

For purposes of determining the "applicable rate", the value of the property so transferred is reduced by the sum of any estate or death taxes actually recovered from the property transferred and any charitable deduction allocable to the property transferred. I.R.C. §2642(a)(2)(B). As you can see from the formula, unless some portion of the $1 million exemption is allocated to a generation-skipping transfer, the tax rate would generally be the then maximum estate tax rate.

2. **Amount Subject to Tax.** The amount actually subject to the tax depends upon the type of taxable event triggering the generation-skipping transfer tax.

(a) **Taxable Terminations.** The amount subject to tax where a taxable termination occurs is the value of the property with respect to which the prior intervening interest terminates, reduced by a deduction for certain expenses, indebtedness and taxes attributed to the property (to the extent such expenses would be allowed by I.R.C. §2053). I.R.C. §2622. The generation-skipping transfer tax due on a taxable termination is to be paid by the trustee of the trust or trust equivalent. I.R.C. §2603(a)(2). The "trustee", in the context of a trust equivalent, is the person in actual or constructive possession of the property subject to the arrangement. I.R.C. §2652(b)(2).

Example (10): The initial transferor (G1) transfers property into a trust in the amount of $200,000.00 for the benefit of his son (G2), for life, with any

remaining corpus going outright to G1's grandson (G3) upon G2's death. Upon G2's death in 1987, a taxable termination has occurred. The resulting tax is paid by the trustee out of the property passing to G3. Assuming the trust corpus stayed intact, without the aid of any exemptions the tax would be $110,000.00 and the grandson would receive $90,000.00.

(b) **Taxable Distributions**. Where a taxable distribution has occurred, the amount subject to the generation-skipping transfer tax is the amount received by the distributee, reduced by expenses incurred in connection with the determination, collection or refund of the generation-skipping transfer tax. I.R.C. §2621(a). The person liable for paying the tax upon a taxable distribution is the distributee of the property. I.R.C. §2603(a)(1). If the trustee, rather than the distributee, actually pays the tax, the payment is an additional distribution to the distributee, which distribution would also be subject to the generation-skipping transfer tax. I.R.C. §2621(b).

Example (11): G1 sets up a trust for the benefit of his child (G2) and grandchild (G3). During 1987, the trustee distributes $100,000.00 of trust income to G3 while G2 is still a beneficiary of the trust. The tax will be $55,000.00, to be paid by G3, and G3 will net $45,000.00. If the trustee had paid the tax on the taxable distribution, the amount of taxable distribution for purposes of the tax would be $155,000.00 instead of $100,000.00, and the tax would have been $85,250.00.

(c) **Direct Skips**. Where a direct skip occurs, the amount subject to tax is the value of the property received by the transferee. I.R.C. §2623. The person liable for paying the tax upon a direct skip is the transferor of the property. I.R.C. §2603(a)(3).

Example (12): The transferor (G1) gives $2 million to a grandchild (G3) in 1987 and no exemptions (described below) have been claimed with respect to same. G1 must pay a generation-skipping transfer tax on such transaction of $1.1 million, out of other assets of G1, and G3 receives $2 million.

The amount of any taxable gift which constitutes a direct skip is increased, for gift tax purposes, by the amount of the generation-skipping transfer tax imposed upon the transferor with respect to such gift. I.R.C. §2515. For this reason, the transfer taxes paid by a transferor in a direct skip situation may actually exceed the value of the property transferred. The confiscatory nature of this situation makes it particularly important to review transactions which might be direct skips for purposes of the generation-skipping transfer tax.

Example (13): G1 is in the 50% federal gift tax rate bracket and makes a direct gift of $1 million to his grandchild (G3) in 1988, which is subject to the federal gift tax and the generation-skipping transfer tax. G1 would have to pay $500,000.00 in generation-skipping transfer taxes and $750,000.00 in federal gift taxes as a result of the transaction. Thus, the tax cost to G1 of the transfer is 125% of the value of the property transferred.

3. **Property to be Charged with the Tax.** Unless otherwise directed by a trust instrument specifically referring to the generation-skipping transfer tax, the tax imposed upon a generation-skipping transfer is to be charged to the property so transferred. I.R.C. §2603(b). Thus, the Internal Revenue Code appears to provide two "pockets" from which the generation-skipping transfer tax may be collected. The first is from the person liable for the tax, the second is that the tax can be collected from the property involved in the generation-skipping transfer.

4. **Valuation of Property.**

(a) Property subject to the generation-skipping transfer tax is to be valued at the

time the taxable event occurs. I.R.C. §2624(a).

(b) The value of property transferred will be reduced by any consideration furnished by the transferee. I.R.C. §2624(d).

(c) Where property is transferred by way of a direct skip, as the result of the death of the transferor, and the property is included in the transferor's estate, the value of such property for generation-skipping transfer tax purposes is the same as its value for estate tax purposes. I.R.C. §2624(b). In such event, valuation on the alternate valuation date and special use valuations would be available in determining value for generation-skipping transfer tax purposes.

(d) Where a taxable termination occurs upon the death of an individual, an election may be made to value all the property as of the alternate valuation date for such individual's estate, for purposes of determining the generation-skipping transfer tax. I.R.C. §2624(c).

D. **GENERATION DETERMINATION.**

1. Generation determination is dependent on whether or not the beneficiary is a member of the transferor's family. I.R.C. §2651.

2. If the transferee is within the family line of the transferor, generations are assigned beginning with the grandparent of the transferor. I.R.C. §2651(b)(1).

(a) The transferor, his spouse, his brothers, sisters and their spouses, as well as his spouse's brothers, sisters and their spouses are members of the same generation, regardless of age. Thus, a spouse becomes a member of the same generation as the relative of the transferor to whom he or she is married. I.R.C. §2651(c).

(b) The next succeeding generation consists of the transferor's and his spouse's children, nephews, nieces and their spouses.

(c) The third succeeding generation constitutes the transferor's and his spouse's grandchildren, grandnephews, grandnieces and

spouses of same. This continues on for succeeding family levels.

(d) Adopted children are treated as children related by blood for these purposes and family members by the half-blood are treated as relations by the full-blood. I.R.C. §2651(b)(3).

3. Where the beneficiaries are not within the family line of the transferor they are determined by the respective ages of the transferor and the transferee. I.R.C. §2651(d).

(a) Any transferee born within the 12 1/2 year period following the date of the transferor's birth is of the same generation as the transferor. I.R.C. §2651(d)(1).

(b) Beneficiaries born more than 12 1/2 years but within 37 1/2 years of the transferor's date of birth is a member of the first generation below the transferor. I.R.C. §2651(d)(2). Each succeeding generation is measured by equivalent 25-year periods. I.R.C. §2651(d)(3).

4. Where a trust, estate, corporation, partnership or other entity has an interest in the property being transferred (other than certain types of charitable organizations), each individual who has a beneficial interest in such entity is treated as having an equivalent interest in such property and will be assigned to a generation under the rules described above. I.R.C. §2651(e)(2).

E. EXEMPTIONS FROM THE TAX.

1. **Certain Transfers Subject to the Federal Estate or Gift Tax.** Exempted from the generation-skipping transfer tax is any transfer (other than a direct skip) to the extent that the transfer is subject to an estate or gift tax with respect to a person in the first generation below that of the initial transferor. I.R.C. §2611(b)(1). See Example (6).

2. **Exemption for Direct Skips to Grandchildren.**

(a) A transferor may exempt up to $2 million of property transferred to each grandchild by direct skip. However, this only applies to direct skips made prior to January 1, 1990. P.L. 99-514, §1433(b)(3).

(b) While not clear, if the direct skip is in the context of a trust for the benefit of

a grandchild it may only qualify for this grandchild exemption if the interest vests in the grandchild at the time of the transfer. To vest, the property would need to be subject to taxation as a part of the grandchild's estate if the grandchild died. For instance, consider a testamentary general power of appointment for the grandchild or distribution of the property to his estate upon death. Sprinkling trusts would not result in the necessary vesting.

(c) Married persons may elect to treat each such transfer as if made one-half by each spouse in a manner similar to the gift-splitting rules under the federal gift tax. I.R.C. §2652(a)(2).

3. **Exemption for Direct Skips to "Orphaned" Grandchildren.** If a direct skip is made to a grandchild of the transferor at a time when the transferor's child, who is the parent of such grandchild, is deceased, the grandchild and all succeeding lineal descendants of such grandchild move up one generation. In such case, the transfer by the grandparent to such grandchild which would otherwise constitute a direct skip is not subject to the generation-skipping transfer tax. I.R.C. §2612(c)(2).

> Example (14): G1 transfers $3 million to his grandchild (G3), under a transaction otherwise constituting a direct skip, at a time when G2 (G1's son and G3's father) is dead. The direct skip would not be subject to the generation-skipping tax.

4. **Exemption for Non-taxable Gifts.** The generation-skipping transfer tax is inapplicable with respect to lifetime transfers exempt under the annual exclusion rules of the federal gift tax and also with respect to the transfers qualifying for the exclusion for tuition and medical expenses under the federal gift tax. I.R.C. §§2611(b)(2) and 2642(c).

5. **The One Million Dollar Exemption per Transferor.**

(a) Transferors are entitled to a $1 million exemption that they can allocate to any generation-skipping transfers they make. I.R.C. §2631(a).

(b) In general, the transferor (or his executor) may make allocations as he sees fit

among his generation-skipping transfers. However, the exemption must be allocated prior to the date that the individual's estate tax return is due (including extensions). I.R.C. §2632(a)(1).

(c) Any allocation, once made, is irrevocable. I.R.C. §2631(b).

(d) Once an allocation is made to property any subsequent appreciation in the value of the property exempted under the $1 million exemption is also exempt from the generation-skipping transfer tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 826.

> Example (15): The initial transferor (G1) transfers property to a trust for the benefit of his child (G2) for life, with the remainder interest therein passing to his grandchild (G3). The amount of property transferred is $500,000.00. If G1 allocates $500,000.00 of his $1 million exemption to the trust, then no part of such trust will ever be subject to the generation-skipping transfer tax. Thus, if subsequently a taxable termination occurs and the trust is worth $2 million no portion of the $2 million of property will be subject to the generation-skipping tax on that taxable termination.

(e) It is obviously very important to make the allocation at the earliest possible time so that any appreciation in the property thereafter will not be subject to tax.

(f) It is obviously advantageous to allocate the $1 million exemption among property which is more likely to appreciate than to property which is not likely to appreciate.

(g) Since appreciation of any property allocated to the $1 million exemption is free from the generation-skipping transfer tax it is advisable to isolate that property at the time the allocation is made so that there will be no dispute as to what appreciation may be covered by the exemption.

(h) If a generation-skipping transfer is made by a married individual, the spouses may elect to treat the transfer as made one-half by each spouse. I.R.C. §2652(a)(2).

(i) If an individual makes a lifetime direct skip, then any unused portion of his $1 million exemption is applied to such transfer unless the individual elects not to have this provision apply. I.R.C. §2632(b). If the $1 million exemption has not been fully allocated at the time of transferor's death, it will be deemed allocated first to direct skips which occur as a result of his death and next to trusts with respect to which the individual is the transferor and from which a taxable termination or taxable distribution might occur upon death. I.R.C. §2632(c)(1).

(j) Where property is transferred to a QTIP arrangement upon death, the estate of the decedent may, for purposes of the generation-skipping transfer tax only, elect to treat such property as if the QTIP election had not been made. I.R.C. §2652(a)(3). This permits the property to be treated as that of the decedent whose estate can then allocate his $1 million exemption (or what remains of it) to the property constituting QTIP property and the recipient spouse may then have his or her $1 million exemption (or what remains of it) available for other property. This election will normally be utilized where the decedent spouse's $1 million exemption would otherwise be wasted.

F. **INCOME TAX EFFECTS.**

1. The basis of property transferred in a generation-skipping transfer is increased, by the portion of the generation-skipping transfer tax imposed which is attributable to the appreciation in the property over the transferor's basis (but not in excess of its fair market value). I.R.C. §2654(a)(1).

2. Where a taxable termination has occurred as a result of a person's death the basis of such property may be stepped up in a manner similar to that provided under I.R.C. §1014(a), with certain very limited exceptions. I.R.C. §2654(a)(2).

G. **DISCLAIMERS.** If a disclaimer is made by a younger generation beneficiary which results in property being passed to a person at least two generations below that of the original

transferor, such will result in the imposition of a generation-skipping transfer tax. I.R.C. §§2654(c) and 2518.

H. **STATE TAX CREDIT**. There is a credit, not to exceed 5% of the generation-skipping transfer tax, for any generation-skipping transfer tax imposed by a state on a generation-skipping transfer occurring as a result of an individual's death. I.R.C. §2604.

I. **OTHER MISCELLANEOUS RULES**.

1. If a single trust provides for transfers to more than one generation of generation-skipping beneficiaries, then the property is subject to a generation-skipping tax when it is transferred to each succeeding generation more than one generation below that of the original transferor. I.R.C. §2653(a).

2. If trusts have substantially separate and independent shares for various beneficiaries, each such share will be treated as a separate trust for purposes of the generation-skipping transfer tax. I.R.C. §2654(b).

3. The new generation-skipping transfer tax, applies generally to transfers made after October 22, 1986. Interestingly, however, inter vivos transfers made after September 25, 1985 and on or before October 22, 1986 are treated, for purposes of the generation-skipping transfer tax as if made on October 23, 1986. Pub.L. No. 99-514, §1433(c)(3).

III. **PLANNING TIPS**.

A. Examine existing documents to make sure the client's will and other dispositive instruments properly utilize exemptions and do not provide for substantial taxable direct skips (which were not taxable under the old generation-skipping transfer tax).

B. Give the executor of the client's estate broad powers to allocate the $1 million exemption, to the extent still available upon the client's death.

C. Give the executor or trustee the authority to divide any trusts established into separate trusts; one which takes into account any allocable portion of the $1 million exemption and the other which does not.

D. Take full advantage of the gift tax annual exclusion exemption to the generation-skipping transfer tax.

E. Try to leverage the $1 million exemption by using it in conjunction with the gift tax annual exclusion.

F. Always try to allocate the $1 million exemption to assets with high appreciation potential.

G. Allocate the $1 million exemption to generation-skipping arrangements involving multiple future skips since it exempts the property with respect to each such skip which would otherwise be taxable.

H. With respect to the $1 million exemption, consider giving the "poorer" spouse assets sufficient to use his or her exemption so that the opportunity to exclude a total of $2 million (i.e., the $1 million exemption of each spouse) will not be lost if he or she predeceases the "richer" spouse.

I. Where exemptions are not available or have been used up, consider passing property outright to the intervening generation, who can then utilize available estate and gift tax exclusions and credits of their own to eliminate taxation on transfers to the next succeeding generation.

J. Consider leveraging exempt transfers to skip persons by utilizing the property so transferred to purchase life insurance on the life of the initial transferor.

K. Take full advantage of the $2 million grandchild exemption before it expires on December 31, 1989.

CHARITABLE GIVING IN ESTATE PLANNING

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Section F

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CHARITABLE GIVING AND ESTATE PLANNING

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I. Outright Charitable Gifts to Public Charities.

A. Public Charities include supporting foundations and operating foundations, philanthropic and endowment funds of Public Charities, §170(b)(1)(A)(i)-(viii).

B. Limitations on deductibility depend on type of gift:

1. Cash Gifts deductible up to 50 percent of contribution base and excess deductions are carried forward for up to 5 years, §170(b)(1)(A).

   The contribution base is adjusted gross income without adjustment for NOL carryback under §172.

2. Appreciated Long-Term Capital Gain Property is deductible up to 30 percent of base and excess deductions are carried forward for up to 5 years, §170(b)(1)(C):

   a. If donor is in AMT, he loses benefit of appreciated portion of gift;

   b. Special election available for 50 percent limitation where taxpayer reduces the deduction by the appreciation.

3. Ordinary Income Property gifts are deductible to extent of cost basis and subject to 50 percent limitation, §170(e).

4. Tangible Personalty such as art is deductible at full fair market value only if use of gift by donee is related to its tax-exempt purpose. Example, a gift of a painting to an art museum for display, §170(e)(1). Deduction must be substantiated by appraisal if in excess of $5,000.

5. Scientific Equipment manufactured by a corporate donor and gifted within 2 years of manufacture to University for research on the physical or biological services is entitled to an augmented deduction equal to basis plus half the

appreciation but not more than twice the donor's basis (§170(e)(4)).

Planning Suggestion: Where appropriate, donor should make charitable gifts in appreciated capital gain property. We must be alert to opportunities brought on by LBO's and acquisitions. The following example compares sale followed by gift with gift of stock.

	1987	1988
Sale of Stock	$100,000	$100,000
Cost Basis	1,000	1,000
Gain	99,000	99,000
Cash Gift	100,000	100,000
Tax on Gain	27,720	27,720
Tax Savings on Gift	38,500	28,000
Net Tax Savings	10,780	280
Gift of Stock	100,000	100,000
Tax on Gain	-0-	-0-
Tax Savings on Gift	38,500	28,000
Net Tax Savings	38,500	28,000

The appreciation, $99,000, constitutes a tax preference under §57(a)(6). To the extent donor is in the AMT, he will be taxed at 21 percent on the appreciation which will equal the value of the deduction for the appreciation. The minimum tax credit under §53 now available to offset regular tax in later years is not available if AMT was attributable to charitable deductions.

6. Defer gifts of appreciated property to end of year or until taxpayer has reliable estimate of all income and expenses;

7. Rate reduction from 38.5% to 28% allows more room for gifting appreciated property while avoiding AMT in 1987 than in 1988;

8. Contribution of stock in a closely-held corporation to a Public Charity can:

   a. Increase cash available to donor since he deducts fair market value of stock.

   b. If stock is redeemed by Corporation, it increases percentage of ownership of other stockholders.

   c. Be sure of valuation and that redemption by Corporation is optional by Charity.

C. Corporate Contributions, §170(b)(2).

1. Limited to 10 percent of contribution base.

2. Excess contributions may be carried forward for up to 5 years.

3. Excess contributions qualify as a deduction for computing tax on accumulated earnings.

II. Private Non-Operating Foundation.

A. 1984 TRA increased the limitation on contributions from 20 percent to 30 percent on gifts of cash and ordinary income property.

B. The limitation often is less than 30 percent since such contributions are allowable only to the extent of the lesser of (1) 30 percent of the donor's contribution base, or (2) the excess of 50 percent of contribution base over the amount of contributions allowable under §170(b)(1)(A) determined without regard to §170(b)(a)(C) (the special 30 percent limitation on capital gain property).

Example: Mr. Donor with a contribution base of $500,000 gifts $300,000 of capital gain property to his university and $100,000 cash to his private foundation. The $300,000 gift to the university is subject to the 30 percent limitation under 170(b)(1)(C), $150,000 being deductible in the current year and the remaining $150,000 to be carried forward for up to 5 years. Since the $500,000 gift to the university exceeded 50 percent of Mr. Donor's contribution base, he receives no current benefit from the gift to the private foundation but may carry it forward as well.

C. The 20 percent limitation still applies to contribution of capital gain property.

D. Contribution of capital gain property to private non-operating foundations is generally limited to donor's basis.

1. A special exception for gift of appreciated qualified stock to a private foundation where:

a. such stock is publicly traded;
b. not more than 10 percent of the outstanding stock was gifted by taxpayer and his family during his lifetime.

2. In some cases it may be better for a donor to sell appreciated stock, pay tax on the gain at 28 percent and receive a full deduction for the gift:

   a. if donor expects to be in AMT in later years;
   b. if donor's gifts in later years are expected to exceed 50 percent base.

E. Burdens of Monitoring Private Foundation.

1. Minimum Distribution Requirements.

2. Excise tax of 2 percent investment income, §4940. Reduced to 1 percent if foundation meets certain payout requirements, §4940(e).

3. Prohibitions against jeopardy investments, improper distributions, self-dealing.

4. Administrative burdens:

   a. annual reporting/public inspection
   b. investment fees
   c. trustees fees

5. More stringent limitations on deduction for charitable gifts.

III. <u>Gifts of Partial Interests</u>.

A. <u>Bargain Sales</u> - Where taxpayer sells property to a charity at less than fair market value, the sale is treated as:

1. A sale of an undivided interest and gift of the balance with taxpayer's basis being allocated between the sale and gift.

2. Gift of encumbered property is treated as a bargain sale with amount of indebtedness treated as sale proceeds.

B. <u>Gift of Remainder Interest in Personal Residence or Farm</u>.

1. Charitable deduction calculated based on 10 percent unisex actuarial tables.

2. Deduction allowable for gift of undivided interest in remainder or in case of farm for gift of a remainder in specific acreage.

3. Partial gift could be useful where gift is likely to exceed amount deductible in current and next five years.

4. Particularly advantageous where donor knows property will be left to charity.

5. Life interest can be retained by donor, spouse or other individuals.

C. <u>Qualified Conservation Contribution</u> - A perpetual conservation restriction or easement granted to a governmental unit or conservancy, §170(f)(3)(B)(iii).

1. Conservation includes preservation of land:

   a. for education or recreational purposes;
   b. protect environmental system;
   c. open space for scenic enjoyment;
   d. historically important land areas.

D. <u>Charitable Gift Annuities</u> - Where donor transfers property to a charity in return for the charity's promise to pay an annuity to donor and/or some other beneficiary. No statutory provisions. Rev. Rul. 73-1, 1973-1 C.B 117.

1. Combination of bargain sale and private annuity rules apply:

   a. Charitable deduction for fair market value in excess of value of annuity;

   b. Basis is allocated between annuity portion and charitable gift portion;

   c. Annuity portion is taxable in part and return of capital in part;

   d. If appreciated property is transferred then 30 percent limitation instead of 50 percent limitation applicable.

2. Committee of gift annuities. A voluntary committee recommends uniform gift annuity rates designed to produce a charitable deduction equal to 50 percent of the value of the property transferred.

3. Some charities reinsure their gift annuities shifting the investment risk to insurance

companies, freeing up the surplus funds for current use.

4. Gift annuities may create debt financed income for charity.

E. Deferred Gift Annuities - An extension of the gift annuity by deferring the annuity starting date for a specified period.

F. Pooled Income Funds - A common trust maintained by a public charity received gifts from donors who retain the income for life with remainder to the charity (§642(c)(5)):

1. Income may be reserved for living individuals.

2. Funds may not invest in tax-exempt securities.

3. The rate of return of all income beneficiaries of a fund is determined by the rate of return of the fund for the year.

4. The donor may retain the power exercisable only by will to accelerate the charitable remainder.

5. All property transferred to the PIF must be co-mingled.

6. No donor may be a trustee of the fund. What if the donor is an officer or director of charity?

7. Statutory requirements must be met otherwise PIF will fail to qualify and Service will disallow estate, gift and income tax deductions.

8. Donor recognizes no gain on transfer of appreciated property to a PIF, unless property is encumbered.

9. If gift is of a future interest in tangible personal property, deduction must be deferred until intervening interests expire.

10. While a PIF is not an exempt trust, it receives a set aside deduction for capital gains and is required to distribute its net income so there is no tax at trust level.

11. Gift to a pooled income fund is an excellent alternative to donor desiring to make a relatively small remainder gift.

a. Donor avoids costly administrative expenses incurred by charitable remainder trusts.

b. Donor gains the flexibility of pooled investments, i.e., diversification.

c. Not restricted to a fixed income or fixed percentage as in charitable remainder trusts. Income should rise with inflation.

d. Avoid capital gains tax on sale of appreciated securities.

G. Charitable Remainder Trusts - Strict statutory provisions govern the qualification of split interest trusts, §664.

1. Charitable Remainder Trust must:

a. be a written trust instrument;

b. in the case of a unitrust, pay a fixed percentage (at least 5 percent) of the net fair market value of the corpus determined annually, and in the case of an annuity trust, pay a sum certain;

c. payments must be made at specified intervals at least annually;

d. payments must be made to one or more individuals who were living on date of creation of the trust;

e. the trust must be for either the lives of the specified beneficiaries or a term not to exceed 20 years;

f. upon expiration of the income term, the corpus must be held or distributed for the use or benefit of charitable organizations described in §170(c), §2522 and §2055(a).

Example 1. Donor transfers $500,000 worth of stock with a cost basis of $5,000 and a current yield of 20 percent to a 6 percent charitable remainder unitrust for the benefit of his son, age 25, for life with remainder to his community foundation. The donor serves as trustee with the son as successor. The son has the power to designate alternate charities as beneficiaries. The appreciated stocks are sold and

then invested in securities paying dividends of 6 percent with capital growth of 4 percent. The donor is entitled to a current deduction of $40,540 producing an income tax savings of $15,608 in 1987. Donor has made a taxable gift of $459,460 for the benefit of his son. Donor will save $138,600 tax on the capital gain generated from the sale of the securities transferred. Assuming donor and his spouse have not used any of their unified credit, there will be no gift tax paid on the transfer. Donor's son will receive $30,000 the first year and may anticipate increases in later years. The $30,000 is likely to be taxed at a 28 percent or higher rate leaving $21,600 to spend or reinvest. Donor's son invests $3,000 a year to acquire $1,000,000 of life insurance. Donor's son has a life expectancy of 58 years. The unitrust amount is likely to grow from $30,000 in the first year to $280,557 in year 58. The remainder to be received by the charity at the son's death in 58 years would be $4,862.993. Assuming the life insurance remained in force, the company's dividend schedule remains at 9 1/4 percent and all dividends are used to pay premiums or buy paid up additions, the son will have over $13,000,000 of life insurance for his beneficiary.

Example 2. Assume the same facts except the donor creates a $30,000 per year annuity trust. The son's income remains the same, $30,000 per year. The accumulations for charity would total more than $50,000,000 for charity.

2. Qualified Charitable Remainder Trusts are exempt from Federal income tax except on unrelated business income.

    a. No tax on capital gains or on surplus income earned in trust.

    b. Income retains its character for tax when distributed and distributions are deemed to be first out of:

        i. ordinary income
        ii. capital gain
        iii. tax-exempt income
        iv. principal

3. Grantor or beneficiary may serve as trustee, or retain the power to remove the trustee, but must avoid retaining certain powers that would treat grantor as owner under grantor trust rules.

4. Additions may be made at any time to a charitable remainder unitrust.

   a. Special valuation adjustment is made to determine increase in unitrust amount.

   b. Adjustments may be made where error is made resulting in an overpayment or underpayment.

5. Charitable Remainder Unitrust may provide for distribution of lesser of unitrust amount or net earnings from trust, and in such case, CRUT may provide for catch up out of subsequent years earnings in excess of unitrust amount.

6. Grantor and/or Beneficiary may retain the power to change charitable remaindermen, but such power would subject deduction to private foundation limitations.

7. If Grantor Trust Rules under §671-678 result in taxing the grantor as owner, charitable remainder trust <u>will not qualify</u>:

   a. power to alter amount paid to a non-charitable beneficiary;

   b. power to invade for benefit of a non-charitable beneficiary;

   c. power to revoke, except power to revoke or terminate interest of non-charitable beneficiary by will;

   d. power to remove or appoint a trustee who has any of the prohibited powers.

8. Donor is entitled to a gift tax or estate tax deduction for fair market value of charitable remainder.

   a. Calculation is based on 10 percent interest assumptions and 1969-71 mortality figures.

      i. Annuity Trust - Charitable remainder is calculated by deducting from the total fair market value, the value of the annuity under the tables provided by Reg. §25.2522.

ii. Unitrust - Charitable remainder is calculated under tables provided by Reg. §1.664.

b. Five Percent Rule - IRS would disallow gift or estate tax deduction if probability that charity will not receive anything exceeds 5 percent, Rev. Rul. 77-324, 1972-2C.B.329:

i. Should not apply to unitrust since principal theoretically cannot be exhausted. But see PLR7915038.

ii. Ten percent interest assumption makes it less likely that 5 percent rule will apply.

iii. Courts may not follow the 5 percent rule, Moor v. Commissioner, TC Memo 1982¶299.

9. Safe Course is to seek private ruling as to qualification of charitable remainder trust.

10. A qualified Charitable Remainder Income Interest in favor of a spouse will, if it is the only terminable interest in advance of the charitable remainder, qualify for the marital deduction, §2056(b)(8).

11. Planning Considerations for CRT.

a. Determine grantor's objectives and where possible, prioritize them:

i. Avoid tax on capital gain;
ii. Diversify portfolio;
iii. Increase spendable income;
iv. Assure charity of capital on termination of trust;
v. Provide growth in future income to beneficiary;
vi. Provide growth in future income to beneficiary.
vii. Benefit from current income tax deduction.
viii. Take advantage of annual gift tax exclusions.

b. Choice of unitrust v. annuity trust will depend on priorities:

i. Where grantor desires a high level of income, fixed income investments and minimum administration, the annuity trust will serve his purpose.

ii. Where donor seeks a diversified portfolio, an increasing income, and expects to make periodic additions to the trust, the unitrust is preferred.

G. Charitable Lead Trusts (CLT) - A split interest trust where an income interest benefits charity followed by a non-charitable remainder.

1. Four general types of CLT:

   a. qualified non-grantor
   b. qualified grantor
   c. non-qualified non-grantor
   d. non-qualified grantor

2. "Qualified" means to be entitled to a Federal income, gift or estate tax charitable deduction, the trust must be either an annuity type or unitrust type CLT.

3. "Grantor or Non-grantor" refers to the applicability of the grantor trust rules under IRC §671-678.

4. Qualified Non-grantor CLT:

   a. Subject to Federal gift or estate tax as the case may be;

   b. No income tax charitable deduction available to grantor, but the income of the trust is not included in his gross income;

   c. Subject to private foundation rules;

   d. Trust is taxable entity but receives a deduction for amounts paid to charity, §661 et seq.;

   e. Avoids donor charitable deduction limitations;

   f. Allows donor to pass substantial wealth to remainderman with little or relatively low transfer tax cost.

g. Valuations based on government's 10 percent actuarial tables. May apply even if donor is terminally ill as long as he does not know it. Bank of California v. U.S., 672 F.2d 758 (9th Cir. 1982).

5. Qualified Grantor CLT:

   a. Donor takes a current deduction for actuarial value of charitable interest subject to limitations and carrybacks.

   b. Donor will be taxed on all income earned each year by the trust.

   c. Donor will be taxed on the actuarial value of the gift to non-charitable beneficiaries and will not be entitled to an annual exclusion.

   d. Normally, results in the inclusion of the trust in donor's gross estate for Federal estate tax purposes, because of retained reversionary interest, power to designate remainderman, or power to designate charities.

   e. It may be possible for a CLT to be a grantor trust for income tax purposes without resulting in the inclusion of the trust in the grantor's estate for Federal estate tax purposes. For example, permitting surplus income to be used to pay life insurance premiums on donor's life, §677; or power to substitute principal of equal value, §675, may not result in the trust being included in the gross estate.

6. Non-qualified Non-grantor Trust is where the split interest trust is neither an annuity trust or unitrust, nevertheless, a completed gift under local law.

   a. The trust will not qualify for a current gift tax deduction or income tax deduction.

   b. The trust income will, however, not be taxed to the grantor, thus allowing the donor in effect an unlimited income tax deduction.

   c. The non-qualified trust is not subject to the private foundation rules.

d. Sometimes used by corporations creating charitable trust with a reversionary intent in order to avoid deduction limitations.

7. <u>Non-qualified Grantor Trust</u> - Entitles grantor to no benefits from income, gift or estate taxes. Grantor will be taxed on income and receive a charitable contribution when funds are paid to the charity.

8. <u>Planning Considerations</u>:

   a. Many donors created qualified grantor CLTs in 1986 to take advantage of 50 percent charitable deduction, while reporting income in future years at hopefully lower rates.

   b. Beneficial in 1987 when rates are at 38.5 percent if you believe rates will be lower on the average for the balance of the charitable term.

   c. May desire to use qualified non-grantor CLT with intent of reducing the transfer tax on the remainder by locking in high yields to fund a high charitable annuity.

<u>Example 1</u>. Donor, age 60, transfers high-yield securities having a value of $500,000 and cost basis of $500,000 producing a 10 percent return into trust to pay a $50,000 annuity for his life to a specific charity, with remainder to his child. Donor receives a gift tax charitable deduction of $372,455 and reports as a taxable gift the remainder of $127,545.

<u>Example 2</u>. Donor is in good health and at age 60 he has a life expectancy under the 1986 actuarial tables of 21 years. Instead of providing a $50,000 per year annuity for his lifetime under Example 1, he provides a $50,000 per year annuity for 21 years. He takes a gift tax charitable deduction of $345,948 and reports as a taxable gift $154,052. Assuming he lives his life expectancy, invests surplus tax free at 7 percent interest, his son will receive in 21 years $853,448.

<u>Example 3</u>. Donor follows Example 2 but authorizes trustee to use surplus income to pay life insurance premiums on a policy on donor's life to be purchased by the trust. The trust can purchase $150,000 of life insurance on donor for $2,122 per year. Assuming donor dies in 21 years, the son would receive $1,003,448. The donor would claim a tax deduction in 1987 of

$345,948 saving Federal tax of $133,190. Donor would report each year and pay tax on the trust income. The following computer printout illustrates that at donor's death at the end of the 21st year, his son would receive $1,004,212 plus $150,000 of life insurance. Donor's estate would have decreased by $123,813.

QUALIFIED GRANTOR CHARITABLE LEAD ANNUITY TRUST

DONOR TRANSFERS $500,000 INTO TRUST PROVIDING $40,000 PER YEAR TO HIS COLLEGE FOR 21 YEARS WITH THE REMAINDER GOING TO HIS SON UPON TERMINATION OF THE TERM. THE TRUST EARNS 10% ON ITS INVESTMENTS AND PER AUTHORIZATION IN THE AGREEMENT PAYS $2122 PER YEAR OF INSURANCE PREMIUMS ON A $150,000 LIFE INSURANCE POLICY ON THE DONOR'S LIFE. DONOR RECEIVES AN INCOME TAX SAVINGS IN YEAR 1 OF 38.5% OF $345948 OR $133,190 AND INVESTS THE SAME AT 8.5% TAX FREE

YEAR	BEGINNING PRINCIPAL BALANCE	EARNINGS FOR THE YEAR	ANNUAL PAYMENT CHARITY	ANNUAL PAYMENT INSURANCE	SURPLUS INCOME TO REINVEST	DONOR'S FUNDS INVESTED	EARNINGS ON DONOR FUNDS	TRUST INCOME TAXED	DONOR'S TAX FOR YEAR	DECREASE IN DONOR FUNDS/YR	INCREASE IN FAMILY FUNDS/YR
1	500000	50000	40000	2122	7878	133190	10655	50000	14000	3345	4533
2	507878	50788	40000	2122	8666	129845	10388	50788	14221	3833	4833
3	516544	51654	40000	2122	9532	126012	10081	51654	14463	4382	5150
4	526076	52608	40000	2122	10486	121630	9730	52608	14730	5000	5486
5	536562	53656	40000	2122	11534	116630	9330	53656	15024	5693	5841
6	548096	54810	40000	2122	12688	110937	8875	54810	15347	6472	6216
7	560784	56078	40000	2122	13956	104465	8357	56078	15702	7345	6612
8	574740	57474	40000	2122	15352	97120	7770	57474	16093	8323	7029
9	590092	59009	40000	2122	16887	88797	7104	59009	16523	9419	7468
10	606979	60698	40000	2122	18576	79379	6350	60698	16995	10645	7931
11	625555	62556	40000	2122	20434	68733	5499	62556	17516	12017	8417
12	645989	64599	40000	2122	22477	56717	4537	64599	18088	13550	8927
13	668465	66847	40000	2122	24725	43166	3453	66847	18717	15264	9461
14	693190	69319	40000	2122	27197	27903	2232	69319	19409	17177	10020
15	720387	72039	40000	2122	29917	10725	858	72039	20171	19313	10604
16	750304	75030	40000	2122	32908	-8587	0	75030	21009	21009	11900
17	783212	78321	40000	2122	36199	-29596	0	78321	21930	21930	14269
18	819411	81941	40000	2122	39819	-51526	0	81941	22944	22944	16876
19	859230	85923	40000	2122	43801	-74469	0	85923	24058	24058	19743
20	903031	90303	40000	2122	48181	-98528	0	90303	25285	25285	22896
21	951212	95121	40000	2122	52999	-123813	0	95121	26634	26634	26365
22	1004212										

Example 4. Donor transfers $500,000 to the trust and invests the trust funds in utility stocks paying an 8 percent dividend with 2 percent annual appreciation. The other assumptions remain the same as in Example 2. The donor's funds generated sufficient funds to pay the tax on the trusts income.

IV. Testamentary Dispositions.

A. Use income in respect of decedent items to satisfy charitable bequests.

1. Retirement Plan Benefits - Avoid Federal estate tax and federal income tax, but lose benefit of deduction under §691(d). Probably will not avoid 15 percent excise tax on excess distributions, §4981A.

2. Accrued salary, accrued interest, ex-dividends all can be designated to specific charities.

3. Bequest of such items to a charitable remainder trust avoids income tax at trust level.

4. Bequest of such items to a private foundation will generate the same tax benefits as to a public charity.

POST MORTEM ESTATE PLANNING UNDER THE 1986 INTERNAL REVENUE CODE

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Section G

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POST MORTEM ESTATE PLANNING UNDER THE 1986 INTERNAL REVENUE CODE

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July 17, 1987

A. Reassessment of Traditional Post Mortem Planning Techniques:

1. Allocation of income between estate and beneficiaries (both individuals and trusts)

(a) Significantly affected by reduction in individual rates and compression of rate brackets for estates and trusts.

(1) Where the beneficiary is in a 28% bracket, since the estate's 15% bracket covers only its first $5000 of taxable income, the maximum potential saving by retention of income in the estate is $650 (13% of $5000)

(2) If the beneficiary's marginal income is subject to the 5% surtax applied to eliminate the benefit the 15% bracket, the potential savings through taxation of income to the estate is somewhat greater.

(3) The benefit of "trapping" distributions of principal by an estate to a beneficiary trust is similarly reduced ($650 on the first $5000, slightly more if the estate's taxable income is between $13,000 to $26,000).

(b) Choice of a fiscal year by the estate is still permitted, which can push taxation of distributed income to a beneficiary forward to the calendar year in which the estate's fiscal year ends, when both income and/or tax rates may be lower. Double deferral of estate income through a trust to a beneficiary is no longer possible.

2. Choice of fiscal year by estate

(a) Effect of estimated tax provisions:

(1) Estates must now pay estimated tax for tax years <u>ending</u> more than two years after the decedent's death. The optimum first fiscal year for an estate from an estimated tax standpoint would be one ending eleven plus months after the date of death. This would provide almost two full years in which the estate would not have to pay estimated tax.

(2) As a practical matter, if the estate makes significant distributions during its third fiscal year, the estate probably will not have to pay any estimated tax for that year.

(b) Utilization of administration expenses as fiduciary income tax deductions:

(1) With the credit equivalent now $600,000, there will be an increasing number of estates with a significant amount of administration expenses to be used, if at all, as fiduciary income tax deductions.

(2) An estate will be entitled to deduct from gross income expenses incurred in connection with the administration of the estate which would not have been incurred if the property were not held in an estate. While delineation of such expenses may be somewhat unclear, they will probably include administration expenses traditionally charged against principal, such as those relating to payment of claims, preparation and examination of death tax returns and distribution of assets.

(3) The maximum benefit will be obtained through the deduction of such expenses by an estate in a tax year in which it has significant income. If these expenses are passed through to the estate's beneficiaries in the year of final distribution as "excess deductions", they will become

miscellaneous itemized deductions subject to the 2% floor on deductibility.

(4) In estates with significant administration expenses but little or no estate tax, the executor may want to select a relatively short first fiscal year in which to accumulate a moderate amount of income taxable to the estate at favorable rates without utilization of significant administration expense deductions, followed by a full fiscal year in which the estate has substantial income offset by deductions for administration expenses and a final tax year in which few if any deductions are taken for administration expenses and whatever income the estate receives is passed through to its beneficiaries.

3. Utilization of medical expense deductions. Under § 213(c), the executor may elect to deduct medical expenses paid within one year after death on the decedent's final return. If no estate tax will be due, the executor obviously will want to make this election. If some estate tax will be paid, the executor should consider

   (a) The respective marginal tax rates; that is, the estate tax rate versus the income tax rate on the decedent's final return (after 1987, the estate tax rate should be higher);

   (b) The respective tax return due dates; and

   (c) The extent to which such expenses will be absorbed by the deductibility floor for medical expenses (5% for 1986, 7 1/2% for 1987 and afterwards). § 213(a).

4. Election to deduct administration expenses on estate or fiduciary income tax return

   (a) For fiscal years beginning after 1987, the top fiduciary income tax rate will be 28%, plus a 5% surtax on taxable income between $13,000 and $26,000. Any estate tax will be at least as much as the highest marginal fiduciary income tax rate.

(b) The effective date for an estate tax deduction is nine months after death. The effective date for a fiduciary income tax deduction is probably the due date for the return (three months and fifteen days after the end of the fiscal year).

(c) Some portion of the administration expenses may be subject to the 2% floor.

5. Election to recognize gain or loss on distribution of property in kind

(a) Under §643(d), added by TRA of 1984, an estate can elect to recognize gain or loss on the distribution of property in kind in circumstances where gain or loss would not otherwise be recognized, such as a residuary distribution. The amount of the gain or loss is determined as though the property had been sold to the distributee at its fair market value. The distributee's basis is the estate's basis adjusted for the gain or loss recognized.

(b) The 1986 Act redesignated this provision as §643(e) and "clarified" the previous language to require that such an election apply to <u>all</u> distributions made by an estate or trust during the entire fiscal year. § 643(e)(3)(B). This change probably significantly reduces the instances in which such an election will be made.

6. Special considerations for decedents dying prior to 1987

(a) An estate's fiscal year beginning in 1986 is subject to the prior law provisions regarding such matters as taxation of capital gains and the deductibility of administration expenses and interest. Note that the top rate on the estate's ordinary income will still be 50%, so the executor should consider distributing income otherwise taxable to the estate at higher brackets to beneficiaries in lower brackets.

(b) The beneficiary of an estate might be a trust, either inter vivos or testamentary, having a tax year beginning <u>after</u> January 1, 1987. The

taxable income of such a trust will be subject to lower maximum tax rates than the estate with a fiscal year beginning prior to January 1, 1987. The trust might also pass income on to its individual beneficiaries, possibly with even lower tax brackets. Where the trust is required to convert to a fiscal year ending December 31, 1987 (§ 645), the trust beneficiary receiving distributable net income during such "short" year is permitted to include one-fourth of such income in the beneficiary's calendar year 1987 income and an additional one-fourth in 1988, 1989 and 1990. 1986 Act § 1403(c)(2). Since the individual tax rates are destined to decline in 1988 and thereafter, forward spreading of income distributed by the trust is likely to reduce the tax impact. This might make it worth while to maximize distributions of taxable income to trust beneficiaries during "short" December 31, 1987, years.

B. Post Mortem Tax Planning Introduced by 1986 Code

1. Deductibility of interest. Subject to application of certain transitional rules, many types of interest paid by an estate which would have been deductible under the prior tax law will not be deductible on an estate's fiduciary income tax returns for taxable years beginning after January 1, 1987.

   (a) Interest on unpaid income tax, gift tax or ad valorem property tax will apparently be nondeductible. This circumstance should be taken into account by an executor in deciding whether to get an extension of time to pay such tax or whether to contest the purported tax deficiencies. The executor might conclude to pay the disputed tax and file a claim for refund, assuming that interest will be paid on any refund that is forthcoming.

   (b) Interest on unpaid estate tax will in most instances be deductible for federal estate tax purposes when paid as an administration expense under § 2053. See CCH Federal Estate and Gift Tax Reporter ¶ 7285.53. Since the marginal estate tax rate is generally higher than the marginal income tax rate of either an estate or its beneficiaries, there will probably be relatively few instances where an executor will

want to deduct interest on unpaid estate tax on the estate's income tax returns. An executor should nevertheless take notice of new limitations on the income tax deductibility of such interest:

(1) Under §163(h)(2)(E), any interest paid on estate tax the time for payment of which has been extended under §6163 (estate tax on a reversionary or remainder interest) or §6166 (estate tax attributable to an interest in a closely held business) is still deductible.

(2) Otherwise, interest on unpaid estate tax, including estate tax the payment of which has been extended under §6161 (reasonable cause) will no longer be deductible for income tax purposes.

(3) The executor may be thus compelled to generate refunds of estate tax in order to claim estate tax deductions for subsequently paid interest on estate tax which would not be deductible for fiduciary income tax purposes.

(c) Interest payable under KRS 394.520 on a specific pecuniary legacy which is not paid within one year after probate appears to be "personal interest" and, therefore, not deductible for fiduciary income tax purposes.

(d) Under §163(h)(3), interest on certain secured indebtedness with respect to a "qualified residence" is deductible for income tax purposes. It is not clear if or when property can be regarded as a qualified residence by an estate or trust. The best procedure would appear to be to regard title to the real estate as having passed directly to the beneficiary, subject to any outstanding indebtedness. From a tax standpoint, the executor should include any interest accrued to date of death as part of the outstanding mortgage or lien against the property on the estate and inheritance tax returns and have the devisee or surviving joint owner pay the accrued interest, so as to be able to take an income tax deduction, if the

property would constitute a qualified residence under § 163(h)(5)(A).

(e) Under §163(h)(2)(B), investment interest is deductible for income tax purposes, subject to the limitation of §163(d). Interest on indebtedness incurred or continued by an estate to carry or purchase specific investment property should qualify as investment interest, as for any taxpayer. It might even be argued that an executor holds the entire estate (with the possible exception of tangible personal property) "for investment", so that general indebtedness of an estate might be said to constitute "investment interest." From a tax standpoint it might be preferable for an executor to borrow money secured by investment assets to pay tax deficiencies, the interest on which would not be deductible for fiduciary income tax purposes.

2. Impact of passive activity assets

(a) Under §469, passive activity losses are deductible only against passive activity income, unless and until the passive activity assets are disposed of. When a disposition occurs, the previously undeducted losses are first deductible from income or gain from the activity which generated the losses (including any gain recognized on the dispositions), then from other passive income or gains, and finally from other income or gains.

(b) Since under §469(g)(2) death is treated as a disposition, passive losses which have been "suspended" during the decedent's life may be deducted on the decedent's final return against non-passive income (§469(g)(1)(A)), but only to the extent that such losses exceed the increase in the tax basis of the assets by reason of the decedent's death pursuant to §1014. § 469(g)(2)(A). The remainder of the suspended losses are gone forever. § 469(g)(2)(B).

(c) If significant suspended losses are likely to be allowable on the decedent's final income tax return, the executor should consider how to obtain the maximum benefit of the deductions thus generated (e.g., by electing to report

accrued interest on Series E and EE bonds on that return (see CCH Standard Federal Tax Reporter ¶965.0848) and by increasing the post-death income of a surviving spouse includible on the joint final return).

(d) Losses generated by passive activity assets owned by the estate will generally be subject to the limitations on losses set out in § 469, subject to a couple of special provisions:

(1) Under §469(i)(4), an estate will be regarded as actively participating during any taxable years of the estate ending less than two years after death in all real estate activities in which the decedent actively participated before his death. Subject to the phase-out provided for in §469(i)(3), the estate will be able to apply against other income losses from such activity of up to $25,000, less the amount of such losses allowable to the decedent's surviving spouse for the taxable year ending with or within the taxable year of the estate. The availability of this provision obviously needs to be taken into consideration in choosing an estate's first fiscal year.

(2) Under 1986 Act §502(d)(2), the estate of a deceased "qualified investor" in a "qualified low-income housing project" who acquired his interest prior to December 31, 1986, is entitled to the benefit of any special relief not used by the decedent, but only during the estate's first two taxable years. Once again, the applicability of this provision should be taken into account in determining such an estate's first fiscal year.

3. Generation-Skipping Transfer Tax Elections and Considerations

(a) An executor must identify generation-skipping and potential generation-skipping transfers, both those occurring by reason of the decedent's death and those occurring during the decedent's life which became irrevocable after September 25, 1985. The executor should

ascertain the age and relationship to the decedent of all beneficiaries, in order to determine generation assignments.

(b) The executor should establish the extent to which the decedent's GST exemption had been allocated during the decedent's life and determine how the decedent's unused GST exemption should be allocated.

(1) If the decedent made lifetime direct skips, any unused portion of his GST exemption will have been allocated to such transfers unless the decedent had affirmatively elected otherwise. §2632(b).

(2) The executor may allocate the decedent's unused GST exemption to other lifetime transfers by the decedent, but must use the present value of the transferred assets rather than their value at the time the transfer occurred. See 1986 Act General Explanation, p. 1265.

(3) Allocation of the GST exemption may be made at any time on or before the date prescribed for filing the estate tax return for the decedent's estate (including extensions), whether such a return is required. §2632(a)(1).

(4) If no allocation of the decedent's unused GST exemption is made, it will be deemed to have been allocated first to direct skips occurring at the decedent's death and then to trusts with respect to which the decedent is the transferor and from which a taxable distribution or taxable termination might subsequently occur. Allocation within these categories will be made on a pro-rata basis. §2632(c).

(5) The executor should make an affirmative allocation of the decedent's unused GST exemption among any non-exempt interests, for the benefit of posterity, if for no other reason.

(c) **The executor must determine how to get the most benefit from the GST exemption allocation.**

(1) Priority should be given to allocation of the exemption to fully taxable (subject to the unified credit), long-term truly generation skipping trusts (as opposed to only potentially generation-skipping trusts).

(2) If the executor must choose between allocating to direct skips (with respect to which GST tax will otherwise currently be due) and generation-skipping trusts, the executor should take into account

(A) The GST tax on direct skips is tax-exclusive, while any GST tax on taxable distributions or taxable terminations will be tax-inclusive.

(B) The trust assets may appreciate in value prior to any distribution or termination.

(C) Depending on the trust provisions and subsequent events, few (if any) taxable distributions or taxable terminations may occur.

(3) The Executor should allocate the GST exemption last to a QTIP trust of which the executor elects to have the decedent treated as transferor, since such trust's assets may be reduced by estate tax payable upon the the death of the surviving spouse.

(d) In order for an executor to be able to allocate part of the decedent's GST exemption to a QTIP trust, the executor must elect to have the decedent treated as the transferor pursuant to §2652(a)(3).

(e) The executor may want to consider whether to suggest that a beneficiary disclaim one or more interests in order to achieve a more desirable GST tax result. Such a beneficiary should probably be separately advised with regard to the desirability of such a disclaimer.

4. S Corporation Considerations

The statutory repeal of the General Utilities doctrine by new §336, the enactment of new rules on the taxation of "built-in gains" of S corporations during the ten year period after conversion and the lower individual income tax rates have significantly increased the likelihood that an estate will contain stock in one or more S corporations. In such instances, the executor should consider

(a) Subject to the proscription against unduly prolonging the administration of an estate, there is no limit as to how long an executor may hold S corporation stock acquired from a decedent, during which the income and deductions of the corporation will pass through directly to the estate.

(b) If the stock will ultimately be distributable to an ineligible shareholder, the executor may want to consider liquidating the corporation or selling the stock to an eligible shareholder.

(c) Trusts having certain characteristics (such as a QTIP trust) will qualify as an S corporation shareholder. §1361(d)(3). The executor may want to consider whether a non-qualifying trust can be transformed into a qualifying trust by one or more qualified disclaimers.

(d) Where the decedent at death owned stock in a C corporation which could elect S corporation status, the executor should consider the desirability of doing so, especially if the corporation would still be covered by the transitional rules applicable to certain relatively small corporations through 1989. 1986 Act §633(d).

5. Qualified Sale of Stock to ESOP

New §2057 permits the deduction from a decedent's gross estate for federal estate tax purposes of one-half of the "qualified proceeds" of a "qualified sale" of "employer securities" to an ESOP or an eligible worker-owned cooperative (EWOC). As originally enacted, this provision contains a number of perceived deficiencies. Consequently, in IRS Notice 87-13, the IRS has indicated that until clarifying

legislation is enacted it will not consider this provision to have been complied with unless certain requirements are met. Further, legislation has been introduced which, if enacted, will codify the provisions of Notice 87-13 effective October 22, 1986, and will impose additional requirements. Nevertheless, an executor holding stock which might qualify for this deduction should consider taking advantage of it.

C. Conclusion

Due to the comprehensive modifications of prior tax law contained in the 1986 Code, every executor and everyone advising executors must be on the alert to identify and examine all estate assets as soon as possible and ascertain any of them that possess characteristics which call for special attention for income or estate tax purposes.

*** *** *** ***

Portions of this outline are based on an outline by Henry S. Zeigler entitled "Postmortem Estate Planning after TRA 86" for the New York University Institute on Federal Taxation, May 11, 1987, and "Tax Reform Act of 1986 Makes Sweeping Changes in Income Taxation of Estates and Trusts" by Stephen L. Seftenberg, William C. Weinsheimer and Henry S. Zeigler in 12 Probate Notes 192 (1987) (American College of Probate Counsel).

CONFLICTING INTERESTS
IN REPRESENTATION OF ESTATE PLANNING CLIENTS

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Section H

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INTRODUCTION

The attorney practicing family law has the satisfaction of feeling that he is contributing to the good of the whole family rather than working toward the detriment of anyone. The family lawyer has traditionally had the opportunity to counsel with all of the members of the same family. Hopefully, the family has developed a relationship of complete trust in the advice of their family lawyer. There is no consideration given to the need of employing another attorney to represent different family members and create additional legal fees. The family lawyer is not working in an adversary setting, and decisions are based on what is best for the family unit. This is the ideal in the practice of family law.

The problem is that family members do not always have like interests, and the legal profession is becoming more conscious of the ethical dilemma in which the family lawyer is placed because of conflicts of interest among family members. The outline discusses a select few of the more frequently occurring conflict of interest situations that occur to the family lawyer, as well as some new situations that have been created by the new tax laws. The outline does not attempt to discuss the myriad of conflict of interest situations that each lawyer can relate from his own experiences.

The situations discussed are those where the family members are acting harmoniously and are not considering the possible need of separate representation. Unlike in a hostile divorce setting when everyone is alert to their respective rights, these are situations when each member of the family is completely trusting the lawyer for advice. These are times in which the clients are susceptible to being mislead and overreached by the attorney.

I. THE LAWYER'S ETHICAL GUIDELINES:

There is no "per se" ethical prohibition against representation of closely-related family members in estate planning. This practice is sanctioned under both the American Bar Association Model Rules of Professional Responsibility and the older Disciplinary Rules so long as certain conditions are met. Wade, "When Can A Lawyer Represent Both Husband and Wife in Estate Planning?," Probate and Property magazine, March/April, 1987.

Under Disciplinary Rules 5-105(A) and (B), the basic rule is that a lawyer shall decline employment or shall not continue employment if the exercise of his independent professional judgment on behalf of a client would likely involve him in representing different interests. The exception to the basic rule is provided under DR 5-105(C), which states:

> "In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each."

Another of the Disciplinary Rules that is applicable in estate planning is DR 5-107. It prohibits a lawyer from being influenced by someone other than his own client. DR 5-107(A) states that except with the consent of his client after full disclosure, a lawyer shall not accept compensation for his legal services from other than his client. Further, under DR 5-107(B):

> "[A] lawyer shall not permit a person who recommends, employs, or pays him to render legal services for another to direct or regulate his professional judgment in rendering such services."

In the new Model Rules of Professional Responsibility pertaining to conflicts of interest is Rule 1.7. It provides that:

> "(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless: (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation.
>
> "(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation."

When representation of multiple clients in a single matter is undertaken, the consultation shall include an explanation of the implications of the common representation and the advantage and risk involved.

II. CONFLICTS OF INTEREST THAT OCCUR PRIOR TO MARRIAGE:

A. Antenuptial Agreements. Kentucky is one of the many states that honor the enforceability of antenuptial agreements. However, Kentucky court decisions show the susceptiblity of such agreements to attack. Antenuptial agreements have the best chance of withstanding such attacks by the surviving spouse if the parties have had (1) independent counsel; (2) there has been a full disclosure of properties between the parties; and (3) the antenuptial agreement is "fair."

1. Independent Counsel. Neither Kentucky law nor the Uniform Pre-Marital Agreement Act (which Kentucky has not adopted) require there to be independent counsel representing each of the parties to an antenuptial agreement. Nevertheless, this is one of the most frequent grounds for attacking the agreement. When there has not been independent counsel, the surviving spouse will invariably argue that he or she was coerced, mislead, unduly influenced, and did not understand what he or she was signing.

The lawyer is frequently confronted with the couple's unwillingness to employ separate counsel. During this time of romance, it is distasteful to be discussing antenuptial agreements much less having "his" and "her" own attorney. If the parties have not had independent counsel during the negotiations for the

antenuptial agreement, the attorney drafting the antenuptial agreement should have a clear understanding that he is representing the interest of only one of the parties and continue to insist that the party who he is not representing confer with an attorney of his or her choosing before signing the antenuptial agreement. If the party steadfastly refuses to seek the advice of independent counsel, this fact should be documented by the attorney in a letter similar to the one which is attached as Appendix "A" to this outline.

The antenuptial agreement itself should contain a provision that addresses whether or not both parties had independent counsel. A clause similar to one of the following would be applicable depending upon the circumstance:

(a) The parties have each had the opportunity to consult with their own respective legal counsel, tax advisor, and other professional persons concerning the terms of this agreement and their failures to do so shall not be a reason later to invalidate this contract, Vol. 4, Rutkin, Family Law and Practice (Matthew Bender, 1986).

(b) ________________ acknowledges that he was not represented by counsel in the negotiation and

preparation of this Agreement. He acknowledges that he has been informed of his right to separate counsel, including an explanation of the implication of not having independent counsel and the risk involved. In signing this Agreement, he waives that right to separate counsel and states that he fully understands the terms and effect of this Agreement.

2. Disclosure. Antenuptial agreements should contain a full and complete disclosure of the properties of each party to the agreement. Many times, a listing of assets will be attached as exhibits to the agreement. Anyone seeking to overturn the enforceability of an antenuptial agreement will compare the assets in the decedent's estate with the assets listed on the antenuptial agreement hoping to find that there was not a full disclosure by the decedent.

   However, there is precedent for disclosure not being an absolute requirement. In Hoffman v. Hoffman, 100 A.D.2d 704, 474 N.Y.S.2d 621 (1984), it was held that the failure to disclose all assets in an antenuptial agreement does not constitute fraud and overreaching sufficient to vitiate the antenuptial agreement, especially where full disclosure is not required as a part of the agreement.

3. Fairness. When both parties are well-off financially, and both waive their rights to each other's properties, the

"fairness" test may not be applicable. However, if there is a large disparity in the financial wealth of the parties, an antenuptial agreement that provides nothing to the nonpropertied person may be found to be an "unconscionable" contract. The Uniform Premarital Agreement Act requires that antenuptial agreements must not be unconscionable at the date of their execution. Where one of the parties is wealthy and experienced in business and the other is young, inexperienced, and nonpropertied, it is best to consider structuring the agreement to share with the nonpropertied spouse the "fruit of the tree" as the price for preserving the tree as separate property. Estate of Nelson, 224 Cal. App. 2d 138, Cal. Rptr. 352 (1964).

The Court held in In Re Marriage of Matson, 705 P.2d 817 (Wash. App. 1985), that the antenuptial agreement was void because it did not meet the fairness test. The lawyer who drafted the antenuptial agreement had represented both the future husband and wife and knew both of them socially. The Court reasoned that the parties to prenuptial agreements do not deal with each other at arm's length. Their relationship is one of mutual confidence and trust which calls for the exercise of good faith, candor, and sincerity in all matters. The

antenuptial agreement even contained a paragraph which stated: "This agreement is being signed only after having been read completely by each party, and after each has had an opportunity to seek advice and counsel of his or her own choosing." The Court found:

> "Using the foregoing concepts where courts construed fundamentally unfair agreements, we conclude this prenuptial agreement does not meet the standard of fairness test for several reasons: First, there was a reasonable expectation for Mrs. Matson to assume the attorney would protect her interests. They had known each other socially, he had represented her during her prior dissolution, and there was never any indication to her that he, in fact, was representing only Mr. Matson's interest." p. 820

B. <u>Antenuptial Agreements and the Retirement Equity Act of 1984 ("REA")</u>. A new obstacle has been created by Congress in the drafting of antenuptial agreements that will meet the wishes of your clients. It is the requirement that spousal annuity benefits be provided to the surviving spouse under qualified plans unless properly waived by the nonparticipant spouse. Because of the tax advantage, a larger percentage of our clients' wealth is being accumulated in qualified employee benefit plans. It is common for the client to want those benefits to be subject to the antenuptial agreement so that upon death, the client's children by a prior marriage are recipients of those benefits.

I.R.C. Sections 401(a)(11) and 417 require that a defined benefit or money purchase plan must provide benefits in the form of a qualified joint-and-survivor annuity, where the participant has retired and has begun to receive distributions from the plan. In the case of a participant who dies prior to retirement, the plan must provide a qualified preretirement survivor annuity for the participant's surviving spouse. The new spousal requirements apply to plan years beginning after December 31, 1984.

A qualified joint-and-survivor annuity (QJSA) is an annuity for the life of a participant with a survivor annuity for the participant's surviving spouse which is not less than fifty percent (50%) of the annuity payable during the joint lives of the participant and the participant's spouse. I.R.C. Section 417(b). An effective waiver of a joint-and-survivor annuity must be executed within ninety (90) days of the participant's annuity starting date. I.R.C. Section 417(a)(5)(A).

A qualified preretirement survivor annuity (QPSA) is the actuarial equivalent of the survivor annuity under a joint-and-survivor plan, but is payable in the event that the participant dies before retirement or before attaining the earliest retirement age, or for defined contribution plans, an annuity for the life of the surviving spouse the actuarial

equivalent of which is not less than fifty percent (50%) of the account balance of the participant as of the date of death, I.R.C. Section 417(c). An effective waiver of the preretirement annuity must be executed on or after the first day of the plan year in which the participant attains thirty-five (35) years of age. I.R.C. Section 417(a)(5)(B).

For the spousal waiver to be effective, it must meet the following requirements of I.R.C. Section 417(a)(1) and (2):

1. Spouse of participant must consent in writing.
2. Witnessed by plan administrator or notary public.
3. Spouse's consent must acknowledge the effect of the participant's election.
4. Specific waiver of both joint-and-survivor annuity and preretirement survivor annuity benefits.
5. Acknowledgement that designation of beneficiary or form of benefit cannot be changed without further consent of participant's spouse (Effective after October 22, 1986).

I.R.C. Section 401(a)(11)(B)(iii) requires profit-sharing and stock-bonus plans to provide the automatic survivor annuity benefits, unless: (1) the participant's nonforfeitable accrued benefit is payable in full to a participant's surviving spouse, or if there is no surviving spouse, or if the surviving spouse consents to a designated beneficiary; (2) under a plan

that offers a life annuity, the participant does not elect payment of benefits in the form of a life annuity; and (3) the plan is not a transferee of a plan that is subject to the qualified annuity requirements.

The exemption provided by I.R.C. Section 401(a)(11)(B) for certain profit-sharing or stock bonus plans from the REA survivor annuity provisions is illusory. The participant's entire nonforfeitable account balance must be paid to the surviving spouse, unless the spouse consents, (in the same manner as required to execute a REA spousal annuity waiver), to the designation of a non-spouse beneficiary.

Individual Retirement Accounts are not required to provide automatic survivor annuity benefits.

Query: Do the requirements of the REA survivor annuity provisions effectively preempt the parties' antenuptial agreement with respect to the parties' qualified benefit plan?

The REA survivor annuity provisions require that the participant's accrued benefit must be paid to the surviving spouse in the form of either a QJSA or a QPSA, unless the spouse has previously consented to waive his/her rights. Pursuant to the preemption provisions of ERISA, REA survivor annuity provisions would preempt any conflicting designation in an antenuptial agreement.

In order to avoid having the antenuptial agreement preempted with respect to the disposition of qualified plan

benefits, it can be argued that the antenuptial agreement itself constitutes a valid waiver for purposes of REA of a spouse's right to receive either a QJSA or a QPSA.

The problem with this argument is that the antenuptial agreement must be executed before marriage and the I.R.C. spousal waiver to plan annuity benefits seems to indicate that it must be executed after the marriage. It is assumed that the use of the word "spouse" in the context of I.R.C. §401(a)(11) and 417 requires that the "spousal consent" can be executed only after the participant becomes married. However, the word "spouse" could be viewed as strictly a relational term to identify a particular person at the time of the participant's death. As long as the "spouse" received all of the necessary information to make an informed decision regarding the waiver of their survivor annuity rights, it should not make any difference if the spouse executed the survivor annuity waiver before or after they married the plan participant.

If the law develops to require that a valid spousal waiver cannot be made until after the participant and his spouse-to-be have actually become married, an attorney can use the antenuptial agreement to obtain a spousal waiver after the marriage. The antenuptial agreement should be drafted to include language which specifically recognizes that the spouse has REA survivor annuity benefits in her spouse's qualified

plan accounts, that she waives those rights, and that she agrees to execute in the future all necessary documents, waivers, releases, etc., in order to give effect to the antenuptial agreement. Max Gutierrez, Jr., Esq., in his article entitled, "Marriage As a Business Relationship: Consequences for Trust and Estate Lawyers," presented to the American College of Probate Counsel, suggested that antenuptial agreements which intend to be a waiver of all spousal annuity rights created by REA contain language similar to the following:

> "Husband is a participant of the ______________ qualified employee benefit plan in connection with his employment with ______________________. Either or both of the parties may also become participants in other qualified employee benefit plans during their marriage. Under the Retirement Equity Act of 1984, Wife will be entitled to payment of benefits upon Husband's death whether prior to retirement or after retirement as his surviving spouse. These spousal benefits must be provided unless Wife consents to an alternative election of benefits by Husband. A consent by Wife would permit Husband to choose the form of benefit payable and to designate the beneficiary or beneficiaries of such benefit. It is the intention of the parties to give Husband complete discretion in making an election under the plan as to the payment of benefits and the person or persons who shall enjoy such benefits. It is also the intention of the parties to give one another complete discretion in election of benefits under any qualified employee benefit plan in which either shall acquire rights.
>
> "Upon the request of Husband, Wife hereby agrees to waive any rights she may have in the

____________________ qualified employee benefit plan or any other qualified employee benefit plan in which Husband may have rights or acquire rights. Wife agrees to consent to an election by Husband of a form of benefit other than a joint and survivor annuity and to his designation of beneficiary or beneficiaries. Wife also agrees to consent to an election by Husband to waive a preretirement spousal annuity which would be payable in the event Husband died prior to retirement and if Husband elects another form of preretirement benefit, Wife agrees to consent to his designation of beneficiary or beneficiaries. Wife agrees to execute the necessary documents for an effective consent if and when presented to her by Husband. Wife further agrees to consent to any subsequent elections by Husband.

"If Husband files an election subsequent to the date of this Agreement, then this Agreement shall, to the fullest extent possible under the law, constitute a consent to such election.

"If Husband files an election subsequent to the date of this Agreement waiving spousal benefits, but such election is ineffective solely due to a lack of effective consent by Wife, and the benefits are, in fact, paid over to Wife, she agrees to pay those benefits over to the beneficiary designated by Husband in the otherwise ineffective election.

"Wife also agrees to consent to any loan from the plan or any other plan or any reduction of an account balance or the present value of an accrued benefit to satisfy an obligation of Husband arising in connection with a loan from the plan.

"If Wife becomes a participant in any qualified employee benefit plan, Husband agrees to consent in a similar manner to Wife's election of form of payment of benefits and the person or persons who shall enjoy such benefits and to any loan from the plan by Wife."

Mr. Gutierrez's sample language indicates that if the antenuptial agreement is ineffective to waive the spouse's interests in the participant's qualified plan accounts due to lack of effective consent by the spouse, and those benefits are in fact paid to the spouse, that the spouse agrees to pay those benefits to the beneficiary designated by the participant in his ineffective beneficiary designation. However, would the combination of the ERISA anti-alienation provisions, the REA annuity provisions, and the ERISA preemption provisions deal a death blow to such a provision. As an alternative, the antenuptial agreement could reduce the amount of any other property going to a spouse by the amount of any REA benefits received by the spouse, because of an ineffective spousal waiver.

The effect of REA upon antenuptial agreements has not been litigated in a reported case as of June 25, 1987.

C. Antenuptial Agreements to Protect Business and Professional Interests. Frequently, clients want their closely-held business interests protected by an antenuptial agreement. The need to keep the new spouse out of the family business may have more far reaching consequences than a waiver of the spousal statutory share of any other assets in the estate.

Sometimes antenuptial agreements are ambiguous on whether the parties intended the appreciation in value of the

closely-held business after marriage to be marital property or property subject to the antenuptial agreement. For instance, the attorney representing the surviving spouse concedes the antenuptial agreement was intended to include the Five Hundred Thousand and 00/100 Dollars ($500,000.00) fair market value of the business at the date of marriage, but contends that the date of death value of the business was One Million and 00/100 Dollars ($1,000,000.00). Therefore, the attorney claims the Five Hundred Thousand and 00/100 Dollars ($500,000.00) of appreciation after marriage was not intended to be covered by the antenuptial agreement.

The attorney drafting the antenuptial agreement should discuss and understand the intention of the parties on how appreciation in value of the closely-held business after marriage is to be handled in the antenuptial agreement.

If the intent is to make the appreciation in value of the closely-held business after marriage subject to the antenuptial agreement, language similar to the following would be applicable:

> The ownership interest of ________________ in ________________, Inc., is his separate property and the parties intend that it will remain his separate property regardless of any increase in value of his interest resulting from his personal services, skill, effort, and work. All profits and appreciation of ______________________'s ownership interest in ____________________, Inc., during the marriage, whether or not resulting from his personal services, skills,

effort, and work, shall be his separate property and shall be enjoyed by him and shall be subject to his disposition as his separate property in the same manner as though the parties had never entered into the proposed marriage. Notwithstanding, except as set forth above, any payments made to ______________ from ______________, Inc., while an employee of ________________, which payments are identified and characterized by the entity as payment for services rendered (including salary, commissions, fees, and bonuses) shall constitute marital property. However, any further interests acquired by ______________, whether or not the interest acquired would have otherwise been deemed compensation for services to the party from that entity, i.e., stock received as a corporate dividend, shall be his separate property.

III. CONFLICTS OF INTEREST THAT OCCUR DURING MARRIAGE:

A. Business Buy/Sell Agreements. Frequently, an attorney is the counsel for both the closely-held corporation as well as the family attorney for one of the shareholders.

It is obvious that in this type of situation there are different interests to be protected. What is in the best interest of the corporation may not be in the best interest of the surviving widow of the deceased shareholder. For example:

1. The buy/sell agreement may result in a financial windfall to the surviving shareholders to the prejudice of the deceased shareholder's widow.
2. The valuation of the shares set forth in the buy/sell agreement may be relevant in a divorce proceeding.
3. The possibility of the spouse becoming an unwanted shareholder by reason of death or a divorce decree.

The issue that arises during a divorce is whether a shareholder's wife will be bound by the terms of the buy/sell agreement. The majority of cases have held that a buy/sell agreement will be given considerable weight, but will not be binding upon the wife of a shareholder.

In Suther v. Suther, Wash. App., 627 P.2d 110, the wife was held not to be bound by the valuation of the stock set forth in the buy/sell agreement notwithstanding that the wife had signed the buy/sell agreement. The court found that the wife never participated in the operation of the business, had no financial experience, had no real concept of corporate structure, and did not understand the legal purport of the buy/sell agreement. The trial court made a finding that the wife was not represented by counsel when the agreement was effectuated. The Washington Court looked at the law of different jurisdictions and concluded:

> "We conclude that the courts which have recently considered the question of the applicability of a buy/sell agreement to the determination of the value of the stock of a close corporation in a dissolution proceeding have held that such an agreement is a factor to be considered but is not determinative of the stock's value."

There is also the possibility that the divorce court might enter a decree directing that the shares of stock in the closely-held corporation be divided between the divorced couple.

The buy/sell agreements in Durkee v. Durkee Mower Co., 428 N.E.2d 139 (Mass. 1981) and Castonguay v. Castonguay, 306

N.W.2d 143 (Minn. 1981) were both found inadequate to prevent a former spouse from acquiring shares in a family corporation. However, the court in the Castonguay decision added that the agreement could have precluded a transfer incident to a divorce decree by covering involuntary transfers.

Based upon this knowledge, the attorney has a conflict of interest problem. After the attorney has advised the stockholders that the majority of court decisions hold that wives are not bound by the buy/sell agreement in the event of a divorce, he knows that he can suggest certain actions to be taken that will increase the probability of a court finding that the wife is bound by the buy/sell agreement. If the attorney considers himself also the attorney for the wife of the stockholder, does he make those suggestions? He has a difficult ethical decision. For example, if the attorney elects to suggest ways to make the buy/sell agreement more likely to be enforceable against the wife, the attorney can recommend:

1. Have the wife sign the buy/sell agreement because it would have a better chance of being enforceable against the wife if she had signed the agreement along with the shareholders.
2. Have the buy/sell agreement contain a clause that would require the wife to sell any shares that she was awarded by a divorce court decree. The typical buy/sell agreement will cover both voluntary and involuntary

lifetime transfers. Usually, the involuntary transfers are defined to include: (i) the filing of a shareholder's voluntary or involuntary bankruptcy; (ii) the insolvency of a shareholder; and (iii) the receipt by the shareholder of a notice of a public, private, or judicial sale of all or any portion of the shares. As an additional involuntary transfer, the buy/sell agreement could contain a clause that states (iv) the entry of a final order of a court in a divorce proceeding, from which there is no further right of appeal, directing a transfer of the shares, constitutes an involuntary transfer. Such an involuntary transfer would trigger an option in the corporation or the other shareholders to purchase the affected shares at the value determined in the buy/sell agreement. The disadvantage to the corporation is that it may force the company into acquiring shares when it is not economically feasible to do so. It also may alter the percentage of ownership among the shareholders so that the divorcing shareholder may be placed in minority shareholder status.

For additional planning techniques through the use of buy/sell agreements to protect shareholders against ex-spouses' claims, see Landsman, "Divorce Planning in the Closely-Held Business Context," (Trust & Estates, May 1984).

B. Wills for Family Members.

1. Wills for Husband and Wife. The most common occurrence in the practice of family estate planning is the husband and wife asking the lawyer to draft Wills for them. Some of the potential conflict of interest situations created are:

   (a) Qualified terminable interest trust (Q-Tip Trust) created by ERTA of 1981;

   (b) Financial management of trusts;

   (c) Gifts during lifetime between husband and wife;

   (d) Irrevocable Trust;

   (e) Powers of Appointment; and

   (f) Different testamentary desires.

2. Wills for Family Members Other Than Husband and Wife. Sometimes certain members of the family assert enormous pressure and influence on other members of the family and the lawyer in estate planning. In these circumstances, the lawyer must keep in mind who in the family is his client for whom he is drafting the Will. Otherwise, the lawyer may be guilty of malpractice or be subject to disciplinary action of the bar association. Haynes v. First National State Bank, N.J. 432 A.2d 890 (1981) and Committee on Professional Ethics v. Christian, 191 F.Supp. 87 (DC V.I. 1961).

CONCLUSION

There will continue to be a place for the family lawyer in estate planning. He provides a valuable service of being a mediator and problem-solver for members of the family unit. In most cases, the family lawyer is able to provide his legal service more efficiently and at less legal cost than when each party is represented by independent counsel. However, attorneys have an increased sensitivity to the conflicts of interest that continually arise in estate planning. The legal profession's codes of conduct are not always helpful in these conflict situations. The Code of Professional Responsibility is more applicable to the lawyer who is acting in his role as advocate. The Model Rules of Professional Conduct do not always give the family lawyer clear directions.

Although the family lawyer will continue to do estate planning for members of the same family, there are times when the lawyer should require separate legal representation for the parties, or, at a minimum, document that he has recommended and explained the reasons why there is need for independent legal counsel. Recent court decisions are using a lawyer's conflict of interest as grounds for refusal to enforce contracts, wills, trusts, and other legal documents that the lawyer prepared. It would be a grave disservice to your client for a document you drafted to be held unenforceable because of your dual representation being found to be a conflict of interest.

APPENDIX "A"

Dear _____________:

This will confirm that I have been employed by _____________ as his attorney in the negotiation and drafting of an antenuptial agreement between you and _______________. I have only represented __________________, and you have understood that I have not been representing you in this matter. I have recommended to you on several occasions that you retain independent legal counsel of your own choice. You have informed me that you do not wish to retain separate counsel and have acknowledged that you have voluntarily and with knowledge that by entering into the antenuptial agreement releasing rights which would accrue to you by reason of your marriage to ___________, decided not to obtain separate legal counsel and to execute the agreement without the advice of such counsel.

You understand that under the laws of the Commonwealth of Kentucky, you are giving up the right to certain spousal rights, including, but not limited to, the right to inherit from _____________ an amount equal to one-half (1/2) the value of his personal property, and an amount equal to one-half (1/2) the value of his real property if he dies before you without a Will. In addition, you are releasing the right to receive the surviving spouse's statutory share of $7,500.00. If he has a Will, you are giving up the right to renounce his Will and take an amount equal to one-half (1/2) the value of his personal property and an amount equal to one-third (1/3) the value of his real property owned at the time of his death.

You further confirm by your signature below that you will not claim that the antenuptial agreement between you and _________________ is void or unenforceable because you were not represented by independent counsel.

Sincerely,

____

Attorney for ______________________

I acknowledge that I have read, understand, and accept as true the above statements contained in Hon. ________________ letter to me.

____

FORMS OF HOLDING AND METHODS OF ACQUIRING TITLE

By

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Washington, D.C.

Section I

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I. TYPES OF CONCURRENT OWNERSHIP

A. Joint tenancy with right of survivorship

1. Right to entire property upon death of co-tenant.
2. Unilaterally severable.
3. Income and control are equally shared.
4. Severance usually creates tenancy in common.
5. Creditors of either owner have rights against that share.
6. Interest may not be devised or bequeathed.

B. Tenancy by the entirety

1. Between spouses only.
2. Right of survivorship.
3. Cannot be unilaterally severed. Severed by mutual consent or divorce.
4. Control and income shared equally in most states.
5. Rights of either spouse subject only to claims of creditors of both spouses--not separate creditors.
6. Interest may not be devised or bequeathed.

C. Tenancy in common

1. No right of survivorship.
2. Unilaterally severable by sale.
3. Control and income shared equally.
4. Each tenant's share is subject to claims of creditors of that tenant.
5. May be devised or bequeathed.

D. Community property

1. Exists in 8 states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

2. Formerly existed in Hawaii, Montana, Oklahoma, and Oregon.

3. Covers property acquired by either spouse during marriage (other than by gift, descent or distribution).

4. Similar to a tenancy in common, in that each spouse has a separate interest.

5. Control sometimes vested solely in husband.

6. CAVEAT: The community property laws of each state vary significantly. Check out any problems individually.

II. NONTAX CONSEQUENCES OF CONCURRENT OWNERSHIP FORMS

A. Control: Results in a loss of testamentary control, since

BUT: This can result in an overfunded marital deduction.

B. Simplicity: Eases the burden of estate administration, but the estate tax return may be more complicated.

C. Cost: May result in reduction in probate fees and inheritance taxes but the savings offset by costs of retitling.

D. Creditors: May avoid creditors' claims, at least creditors of only one owner.

III. TAX CONSEQUENCES OF CONCURRENT OWNERSHIP FORMS

A. Joint tenancies with right of survivorship (not between spouses)

1. Income tax consequences. The joint owners typically split income equally. Income taxes follow.

Dividend exclusions doubled.

2. <u>Gift tax consequences</u>. A taxable gift may occur when a joint tenancy is created or terminated.

a. <u>Creation.</u> The creation of a joint tenancy with right of survivorship is a taxable gift for gift tax purposes if:

i. the transfer is completed (i.e., the donor cannot take back the transfer), and

ii. One tenant receives a share disproportionate to his or her contribution. Regs. §25.2511-1(h)(5), and

iii. PARTIES ARE <u>NOT</u> SPOUSES.

EXAMPLE: A purchases an office building for $500,000 and takes title as joint tenants with B, his brother. Absent other circumstances, A has made a taxable gift to B of $250,000--B's interest in the tenancy. A must file a gift tax return.

a. <u>Termination</u>: The termination of a joint tenancy with right of survivorship is a taxable gift if one tenant receives a distribution disproportionately greater than his or her contribution. Regs. § 25.2511-2(d).

i. Completed transfer. If the "donor" has a right to reimbursement from the donee under state law, it may be argued that the transfer is not completed.

ii. EXAMPLE: A and B purchase a residence together for $100,000. A and B each contribute $50,000. Ten years later, when the residence is worth $200,000, the tenancy is dissolved and B receives $75,000 and A receives $125,000. B has made a taxable gift of $25,000, the difference between A's share of the proceeds and A's proportionate share of the property.

iii. PLANNING: When severing jointly-held property interests, to avoid a taxable gift, sever according to relative contributions.

b. Conversion: The conversion of a joint tenancy into a tenancy in common constitutes a potentially taxable termination of the joint tenancy. Rev. Rul. 56-437, 1956-2 C.B. 507.

c. Specific assets:

i. Bank accounts: Normally, bank accounts are of a type in which each co-owner has an unlimited withdrawal right. Either tenant can withdraw the entire amount.

AA. Taxable gift. In this type of account, the deposit is not a taxable gift because it is revocable. Regs. § 25.2511-1(h)(4). However, withdrawal of the funds from this type of account by the noncontributing co-owner constitutes a taxable gift.

ii. Securities: When securities are purchased jointly, a taxable gift of one-half of the value of the gift occurs at registration. Regs. § 25.2511-1(h)(5).

AA. NOTE: If the securities are sold and the proceeds are reinvested in the same percentage of ownership, there is no additional taxable gift.

BB. Distinguish this from joint brokerage accounts containing street name shares, which are trreated like a joint bank account. Rev. Rul. 69-148, 1969-1 C.B. 226.

iii. Savings bonds: Series E bonds are issued at a discount and interest is received upon redemption. Series H

bonds are issued at face amount and interest is paid twice a year.

AA. The only joint ownership of savings bonds is "A or B," which creates a joint tenancy with right of survivorship.

BB. The purchase of a bond with disproportionate contributions does not constitute a taxable gift because it is revocable. Regs. § 25.2511-1(h)(4); Rev. Rul. 68-269, 1968-1 C.B. 399.

CC. The redemption of the bonds by the noncontributing owner (or a disproportionate distribution of the proceeds) is a taxable gift, unless local law provides a right to reimbursement. Rev. Rul. 68-269, supra.

3. Estate tax consequences: Except as to married joint tenants, the full value of the jointly held property is included in the estate of the first owner to die, subject to exclusion of a ratable share shown to be attributable to contribution by a survivor. Code § 2040(a). (All references to "Code" are to the Internal Revenue Code of 1986.)

a. Consideration: The exclusion is available only if the contribution is made in money or money's worth.

i. Money or property given to the survivor by the deceased does not count. Regs. § 20.2040-1(c)(4). Therefore, if A gives B a one-half interest in property held jointly with A, not only has A made a taxable gift but the entire value of the property is included in A's gross estate. See e.g., Estate of Lyons, 35 T.C.M. 605 (1976).

ii. Services rendered by surviving owner do not count as a contribution. But see Code § 2040(c); Estate of Evert Otte, 31 T.C.M. 301 (1972); and Craig, 42 AFTR 2d 148, 265 (D.S.D. 1978).

iii. Income received by the survivor from property given by the decedent and contributed to the property is separate consideration and it counts. Regs. § 20.2040-1(c)(5).

iv. It is unclear whether realized or unrealized appreciation in the value of property given to the survivor by the decedent constitutes separate consideration. Regs. § 20.2040(a)(2); but see Estate of Goldsborough, 70 T.C. No. 96 (1978) in which D gave his two daughters realty worth $25,000. Three years later they sold it for $32,500, and invested the proceeds in securities as joint tenants with their father. 7,500/32,500 was excluded from the father's gross estate under Code § 2040(a). See also Harvey, 185 F.2d 463 (7th Cir. 1950); First National Bank of Kansas City, 223 F.Supp. 963 (W.D.Mo. 1953); and Schwartz, 182 F. Supp. 540 (D. Mass. 1960).

b. Gifts and inheritances: If the jointly held property was acquired by gift or inheritance, rather than by purchase, the contributions of the two owners are deemed to be their relative shares received. Regs. § 20.2040-1(c)(8).

B. Tenancy by the entirety.

In general, tenancies by the entirety and joint tenancies with right of survivorship between spouses are treated the same.

1. Income tax consequences. Income from the property, and the income tax liability for it, is split between the spouses. (This makes a difference only if no joint income tax return is filed.)

2. Gift tax consequences.

a. Prior to 1977, the creation or termination of any concurrent ownership estate with a survivorship right that was not

unilaterally severable (typically, a tenancy by the entirety, but not a joint tenancy), resulted in a taxable gift, unless the contribution or distribution of proceeds were made in accordance with the actuarial life expectancies of the joint owners.

EXAMPLE: H (50) and W (45) purchased a stock portfolio in 1960 to be held as tenants by the entirety, each contributing $50,000. Each has a one-half interest in the stock, but the H's interest is actuarially worth $55,716. Therefore, W has made a $5,716 gift to H.

Fifteen years later(1975), the stock has doubled in value to $200,000, and the owners (now 65 and 60, respectively) divide it in half. However, at those ages the W's interest is worth $115,642. Therefore, W has made another gift, of $15,642, to H.

b. Section 2515(c), as amended by the Tax Reform Act of 1976 and the Revenue Act of 1978, eliminates the requirements of using actuarial values on the creation or termination of tenancies by the entireties, and uses instead one-half of the value as the measure of one tenant's interest.

c. More significantly, the Economic Recovery Tax Act of 1981 provided an unlimited marital deduction against the gift and estate tax, which eliminates most concerns about whether the creation or termination of a tenancy by the entirety (by definition, only between spouses) results in a taxable gift.

3. <u>Estate Tax Consequences</u>.

a. Code Section 2040(b) provides that upon the death of one spouse, his estate will include one-half of the value of all property held by the decedent and his surviving spouse as tenants by the entirety.

b. Unless disclaimed, the decedent's interest passes to the spouse, and will qualify for

the unlimited marital deduction under Code Section 2056.

c. Upon the surviving spouse's death, the entire value of the property will be included in his/her estate.

C. Tenancies in Common

1. Income tax consequences: In whatever proportions the tenancy is shared, the income and income tax consequences are shared.

2. Gift tax consequences:

a. Creation: The creation of a tenancy in common is a taxable gift if the interests received a disproportionate to the contributions, and if it is a completed gift.

b. Termination: The termination of a tenancy in common is a taxable gift if the interests received are disproporationate to the interests of the owners.

3. Estate tax consequences: Each owner's one-half (or other proportionate) interest is included in his or her gross estate; not under Code § 2040 but under 2033.

a. Passes by will, not operation of law.

D. Community property: Generally, community property is much like a tenancy in common, but it is important to review the applicable state laws because they vary substantially.

1. Income tax consequences: the income derived from property held as community is divided equally.

2. Gift tax consequences:

a. Creation: The acquisition of property as community property is not treated as a taxable gift because it occurs by operation of law, not donative transfer.

i. NOTE: If separate property is converted into community property by

express agreement of the spouses, this is a taxable gift.

b. Termination: When community property is converted into separate property by agreement of the spouses, it is a taxable gift.

i. NOTE: Conversion of community property into jointly held property is probably not a taxable gift since the interests have not changed.

3. Estate tax consequences: Generally, the estate of the deceased spouse includes only one-half interest held by that spouse in the property.

IV. Consecutive Ownership.

A. Clifford or Spousal Reversion Trusts

1. Prior Law: Prior to the Tax Reform Act of 1976, *Clifford* trusts and spousal remainder trusts (*Clifford* trusts with a gift of the remainder to the grantor's spouse) were used to shift income from a specified period from a high-bracket taxpayer to a lower-bracket one (typically a child or parent). At the termination of the specified period, the property reverted back to the grantor or his spouse. This form of "consecutive" ownership lost many of its tax benefits under the 1986 Act, which now taxes all income from such trusts to the grantor if his reversionary interest (or that of his spouse) is worth more than 5% of the value of the property.

2. Grandfather Rules: Clifford or Spousal Reversion Trusts created and funded before March 1, 1986 are grandfathered (i.e., not treated as grantor trusts. However, any property subsequently transferred to such a trust is not grandfathered.

3. Continuing Alternative: One alternative remaining is to create an income trust for the benefit of a parent, with the reversion to a child or other non-spouse beneficiary. This would not be considered a grantor trust under the 1986 Act.

B. Joint Purchase.

1. Design: Another method of planning for consecutive ownership is a joint or "split" purchase. It usually is accomplished by having an older-generation family member purchase a life estate in property with a simultaneous purchase of the remainder interest by a younger-generation family member. Upon the death of the life tenant, the property passes to the remainderman.

2. Gift Tax Consequences: There should be no gift tax consequences if each owner is paying the fair market value of his respective interest to the seller. Generally, these can be determined using the tables provided at Treas. Reg. § 25.2512-5 for valuing a life interest, and using the balance of the fair market value of the remainder.

   a. Note that the tables are not to be used when the death of either tenant is "clearly imminent"; Rev. Rul. 80-80, 1980-1 C.B. 194.

   b. The IRS might also challenge the use of the tables if the property purchased is not income-producing.

   c. Any improvements to the property, and the principal of debt incurred with respect to it, should be paid by the tenants in proportion of their respective interests at the time the improvement is made; otherwise a gift may result. Grant v. Commissioner, 202 F.Supp. 608 (W.D. Va. 1962); Penn v. Commissioner, 16 T.C. 1497 (1951), aff'd 199 F.2d 210 (8th Cir. 1952), cert. denied, 344 U.S. 927 (1953).

   d. Interest on any debt incurred should be paid entirely by the life tenant.

3. Income Tax Consequences: The income tax consequences are more complex than one might assume. Generally, the life tenant will be entitled to all of the income and charged with all of the interest under state law, and will be taxed on it.

a. If the property is sold, both of the owners will recognize gain or loss (probably capital), notwithstanding that capital gain is ordinarily allocated to principal under state principal and income allocation statutes; Rev. Rul. 71-122, 1971-1 C.B. 224. Each owner will have his own basis in his interest against which to measure gain or loss.

b. Since the life tenant has purchased a wasting asset, he should be entitled to an amortization deduction if the property is held for the production of income; <u>Bell v. Harrison</u>, 212 F.2d 253 (7th Cir. 1954), <u>Acq.</u>, Rev. Rul. 62-132, 1962-2 C.B. 73. The annual deduction would be the purchase price of the life tenancy divided over the number of years of the life tenant's life expectancy at the time of the purchase, and is allowable even if the underlying asset is not depreciable (e.g., unimproved real estate, or securities).

c. NOTE: In <u>Gordon v. Commissioner</u>, 85 T.C. No. 18 (1985) the Tax Court disallowed an amortization deduction as to a split purchase, but the result is based on poor execution of the formalities, which allowed the Court to consider the transaction as a purchase of the whole, followed by a transfer of the remainder interest, by the life tenant.

d. If the underlying asset is itself depreciable, the life tenant should be entitled to a depreciation deduction.

   i. Section 167(h) provides that the depreciation deduction is to be "computed as if the life tenant were the absolute owner of the property...".

   ii. Regs. § 1.167(h)-1(a) provides that a life tenant "will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman."

iii. It is not clear whether the life tenant will be entitled to both a depreciation deduction as to the asset and an amortization deduction as to his life interest. Theoretically, two distinct property interests exist, and the double deduction should be allowed. Even if this is not so, the life tenant should get an amortization deduction as to his interest in any otherwise nondepreciable portion of the underlying asset. For example, the life tenant of a commercial office building should be entitled to the depreciation deduction as to the building, and an amortization deduction as to his interest in the underlying ground (although it is not depreciable).

4. Appropriate Circumstances:

a. A joint purchase may be more or less appropriate, depending on the age of the life tenant, the expected rate of appreciation of the asset, and the comparative tax brackets of the tenants. Note that the parties forego any basis step-up at death.

b. The key advantage is that the IRS tables used in determining the purchase prices of the interests assume that all assets yield a 10% after tax return, and do not appreciate in value. Therefore, if the objective of the parties is to maximize the current income tax benefits to the life tenant, and to maximize the transfer of wealth (at no estate tax cost) to the remainderman, the asset selected should be one that will appreciate in value over time, such as real estate or securities. If the real estate is income producing, the depreciation deduction is an extra bonus. If the securities are tax-exempt bonds, the life tenant will have an amortization deduction, and no taxable income.

5. Implementation:

a. If the asset is real estate, the documentation required is a recorded deed

reflecting the life tenancy and the remainder interest. These are not unusual.

b. Securities are not typically owned this way, so more care is required.

i. The certificate may be jointly titled to reflect the interests of the parties, as in a real estate deed, or

ii. if securities are held in a brokerage account, a written agreement between the parties would be helpful (see the "Joint Purchase Agreement" in the Gordon case, supra).

c. The remainderman should, in any case, provide his own funds. If they are received by gift from the life tenant, the IRS may collapse the transaction, as in the Gordon case, and the entire value of the property would be included in the life tenant's estate under Code § 2036.

C. Sale of a Remainder Interest

Another possibility is for an owner of property to sell a remainder interest in the property to others.

1. Gift Tax Consequences: If the sale is at the fair market value of the remainder interest, there is no gift.

2. Gift Tax Consequences: If the sale is at the fair market value of the remainder interest, the asset is not included in the life tenant's estate at death. Code § 2036(a).

a. If the value of the remainder interest is even slightly higher than the sales price, the entire value of the property is included in the life tenant's estate.

b. If the value of the remainder interest is deliberately set too high, the remainderman has made a gift to the life tenant of the excess.

3. Income Tax Consequences:

a. The life tenant will have gain or loss on the sale (after allocating his basis in the

asset between the interest sold and that retained.)

b. The remainderman-purchaser will have a basis in the remainder interest acquired, which is a nondepreciable, non-income producing asset.

c. The life tenant will not be entitled to amortize his life estate, even if the asset is income-producing; Lomas Santa Fe, Inc. v. Comm'r, 693 F.2d 71 (9th Cir. 1982).

D. Nontax Consequences of Consecutive Ownership

1. Control: Consecutive ownership normally means loss of control by either party, since a life or remainder interest, though severable, will not be readily salable.

2. Simplicity: Techniques for creating consecutive ownership are almost as simple or straight forward as the more typical ownership formats, but are more unusual and hence require more care.

3. Cost: May result in lower probate and estate taxes, and hence are beneficial. Costs incurred in evaluating and creating the interests may mitigate benefits.

4. Creditors: Although consecutive interests are severable and may be subject to liens, they are inconvenient for creditors to attach (especially remainder interests).

INSURANCE PRODUCTS UNDER TAX REFORM

By

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Section J

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Daniel B. Santos

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I. LIFE INSURANCE: TAX-FAVORED BENEFITS

A. Two key advantages enhance the attractiveness and marketability of life insurance in light of current tax law climate:

1. Death benefit continues to be income tax-free. (Exception - transfer-for-value)
2. Cash values continue to grow on a tax-deferred basis.

II. ANNUITIES

A. Tax deferred growth of cash values for individuals.

B. No withdrawal penalties after 59-1/2.

C. Ten percent withdrawal penalty before age 59-1/2.

III. CONSUMER INTEREST (PERSONAL INTEREST)

A. Under pre-'86 law consumer interest generally deductible (life insurance must meet the "4 out of 7" rule, however)

B. New Law - Consumer interest not deductible - law provides 4 year transition period - can deduct.

65% in 1987
40% in 1988
20% in 1989
10% in 1990
0% in 1991

C. No grandfathering of pre-1987 transactions.

C. Continued

1. New Law applies to:

   a. Personal loans

   b. Credit and debt

   c. Finance charges for purchases of durable items (autos, furniture, household appliances, etc.)

   d. Minimum deposit policy loans

   e. Interest on tax under payments (except deferred payments of estate taxes)

2. New Law does not apply to:

   a. Interest on debt incurred in connection with the conduct of a trade or business.

   b. Investment interest.

   c. Interest taken into account in computing taxpayers income or loss from a passive activity.

   d. Qualified residence interest (taxpayer's principal residence and second home used as a family second residence or vacation home.

   e. Interest on estate tax payments deferred under Sec. 6166 or Sec. 6163.

3. Investment Interest

   a. Prior law - could deduct net investment interest equal to $10,000 plus net investment income.

4. New Law

   a. Investment interest can be deducted up to extent of "net investment income".

   b. Excess interest can be carried forward indefinitely.

   c. $10,000 floor of prior law phased out over a 4 year period, 1987-1990.

<u>Comment</u> - Can life insurance interest be treated as investment interest? Perhaps, <u>if</u> taxpayer can show funds borrowed from policy and invested -- a minimum deposit plan does not seem to qualify.

IV. <u>LOANS ON CORPORATE-OWNED POLICIES</u>

A. Old Law; meeting the "4 out of 7" minimum deposit rule was the only requirement to be met in order to deduct any and all policy loan interest on the corporate tax return.

B. New Law; The minimum deposit rule must still be satisfied; but even then, there is a limitation on loan interest deductibility for policies <u>owned by</u> the corporate taxpayer.

   1. Policies purchased June 21, 1986, or earlier - they are all "grandfathered" and the old, liberal law applies to them.

   2. Policies purchased June 21, 1986, or later -

      a. Interest is deductible only on <u>loan amounts</u> which do not exceed $50,000.

B. New Law - Continued

2. b. If loans exceed $50,000, only the interest on the first $50,000 may be deducted.

   c. Policies involved in new rules:

      (1) those on life of an officer or employee;

      (2) those on life of any person who is financially interested in the trade or business of the taxpayer;

      (3) in the case of an unincorporated business, those on the life of the sole proprietor or any partner - the limitation applies also to a business other than a corporation.

   d. $50,000 loan cap applies on an aggregate basis for each insured, i.e., the insured is an officer in several businesses of the taxpayer; affiliated corporations are deemed to be a single taxpayer. This means that all such policies must be added together to determine if the $50,000 cap on loans has been exceeded.

   e. Apparently, it matters not what the business purpose might be for use of the borrowed amounts. This directly reflects on policies used for purposes of salary continuation/deferred compensation, stock redemptions, etc.

B. New Law - Continued

f. Definitions of the words "purchase" and "purchased":

1. The exhange of a pre-6/20/86 life policy for a new policy from a different insurance company post 6/20/86 is the purchase of a new policy.

2. Substitution of insureds, i.e., Insurance Exchange Rider: a Senate coloquy said that this event would not be considered a new purchase of the policy; but Ways and Means Chairman Rostenkowski disagreed. Thus, the law here is unclear.

3. If an application for insurance was submitted on or before 6/20/86, it was purchased by that date, even if issued post 6/20/86.

4. Query? Some commentators theorize that old issued personally-owned policies transferred by individuals to corporations they own would be grandfathered. Is this a way for personal policies with "fat loans" to continue through corporation ownership on a limited mini-dip basis? This theory stretches item (3) and is unsubstantiated. The taxpayer's own counsel would need to render an opinion on this point.

B. New Law - Continued

g. Can an over-$50,000 policy loan for true and normal business indebtedness allow interest deductions for the loan excess over $50,000? A senate coloquoy said yes. Majority leader Dole gave the example of a farmer who borrowed to plant crops and who pledged his life insurance as security. Senate Finance Chairman Packwood said, "The new provision would not disallow interest on indebtedness incurred under the circumstances described."
However, Rep. Rostenkowski did not issue any compliance, so the point is unclear. Taxpayer must seek private counsel.

V. B. U. R. P. - BOOK INCOME (Business Untaxed Reported Profits

A. These are income items which increase a corporation's net worth on its annual financial statement, but which are not subjected to regular corporate income tax - what is reported to shareholders for non-tax purposes.

B. This new Code Section 56 provision is effective for the three taxable years beginning in 1987, 1988, and 1989. Treasury Secretary is to make recommendations to Congress for 1990, and beyond.

C. Book income provisions provide that the AMT income will include 50% of the amount by which adjusted net book income exceeds the AMT (alternative minimum tax) income before other calculations are made.

V. B. U. R. P. - BOOK INCOME - Continued

C. (Cont.) Stated simply, these are items the corporation shows on its "books"; and- which would not otherwise be taxed (but for these new provisions). These items are the business untaxed reported profits or B.U.R.P.

D. Relevance to life insurance:

1. Tax-free inside buildup of cash values is now a corporate book income preference item;
2. Any death benefit in excess of cash value is now a corporate book income preference item;
3. This could mean a tax of 10% on the cash value growth or death proceeds - effectively, only half of the usual 20% AMT rate.

E. Cash value included in book income is only that amount which exceeds <u>net</u> premiums paid.

1. Effect uncertain on new sales, but let us presume that the provision will end in 1989.
2. Already-issued policies with high cash value will become affected this year.

F. Death benefits where insured dies prior to 1990 will be affected.

1. Total proceeds exceeding cash value must be included in book income. This means amount at risk could be subject to a 10% levy (half of 20% AMT).

F. 2. Example, excluding additions, etc:

$250,000	Face Amount Policy
50,000	Cash Value
$200,000	Amount at Risk

$200,000 x 10% = #20,000 tax payable

G. On the brighter side, that portion of the premium attributable to the amount at risk, and policy loan interest paid, will be deductible in determining net book income.

1. This would partially cancel out cash value increases or death proceeds received that must be included to determine net book income during these three years.

H. <u>Suggestion</u>

1. May need to Split Dollar a policy now held as Key Person Insurance. The insured's personal beneficiary will received the amount at risk. Result - No BURP on amount paid to personal beneficiary.
2. May need to sell more insurance to increase the coverage, so that any prospective AMT on the death proceeds amount at risk will not dissipate the amount needed by the corporation, i.e., corporation needs $500,000 for a stock redemption immediately after death of shareholder.
   Formula to calculate precise total face amount needed: present face amount, divided by one minus effective AMT rate of 10%.

H. Suggestion - Continued

2. (Cont.) $500,000 ÷ (1 - .10) =

$500,000 ÷ (.90 = $555,555 new total face amount.

(Within a few years, the valuation of this insured's corporate share interest will increase this much at least, assuming we are at 1990, or beyond.)

3. Remember, depending on the regular tax payable, there might not be any AMT!

I. Buy-Sell Agreements in the Corporation

1. Stock Redemption vis-a-vis Cross Purchase Prologue: Before you can attempt to convince a client what type of an agreement is best, you must first convince the client that an agreement is necessary. The client must come to the realization of the personal and family benefits to be obtained through such an agreement. This applies whether the client dies first or one of the co-shareholders dies first. The purpose for a buy-sell agreement might be summarized as follows:

   a. It permits a survivor to carry on the business without the possible problems of having a hostile co-shareholder (e.g., the widow, widower, executor of a former shareholder or a third party purchaser from the estate).

I. Buy-Sell Agreements - Continued

1. Stock Redemption (Cont.)

b. It permits decedent to provide for an equitable market for stock after death, provided the agreement is properly drafted.

c. Stock Redemption (sometimes called "Retirement" means that the corporate entity purchases back the stock of the deceased shareholder. Corporation owns life insurance policy on each shareholder, and is beneficiary thereof.

d. Cross Purchase (sometimes called "Criss-Cross") means that each shareholder owns a policy on every other shareholder, and is beneficiary thereof. Each surviving shareholder makes a direct purchase of stock from deceased's estate. Big advantage: the actual <u>purchase</u> gives the survivor(s) a higher basis for income tax purposes in event of a later sale of stock during lifetime.

J. Tax Reform Implications in Redemption Agreements

1. Book Inoome problem might cause cash values or death proceeds to become a BURP (Business Untaxed Reported Profits) item. This could be true of old or new life policies.

J. Tax Reform Implications - Continued

2. "Transfer for Value" and death proceeds: One <u>cannot</u> transfer ownership of policies on the life of one shareholder from the corporation to a co-shareholder without creating potential income tax problems at the instant of death.

   a. There is an exception to the transfer for value rule: a policy on an officer or shareholder can be transferred to the corporation, but <u>not</u> vice-versa. Neither does a two-step process work using the insured as a "straw party" for the first step in the transfer process from corporation to co-shareholder.

   b. The key person policies in the corporation for stock redemption should be left there for that purpose.

3. New buy-sell agreements should be written on the cross purchase method, so as to avoid the book income problem. This is true, even if there are three or four shareholders, unless they insist on limited minimum depositing in the corporation. Assuming phase-out of the book income provisions, the cross-purchased policies could be transferred to corporate ownership later.

K. Salary Continuation - Deferred Compensation

1. Salary Continuation (sometimes called a SERP - supplemental executive retirement plan) is a "Golden handcuffs" corporate fringe benefit provided to key employees over and above what they will receive from a pension and/or profit sharing plan. A written agreement is used to state the benefits and the obligations.

2. Deferred Compensation (sometimes used as a generic term to encompass salary continuation) is an agreement (in its true form) between employee and corporation whereby the employee decided, for income tax purposes, to forego a year-end bonus or a merit increase. "Don't pay it to me now; but pay it to me later.

3. In either scenario, the corporation "agrees" to pay out the benefits at some later time, usually starting at normal retirement age. If the agreement is properly drafted, benefits should be taxable only when received by the employee. These plans can be discrimatory.

4. The former, Salary Continuation (SERP) is the more popular.

5. Funding for an "unfunded" SERP.

a. Annuities, as changed by tax reform implications, primarily aimed at corporation ownership -

K. Salary Continuation - Continued

5. Funding (Cont.) a. Annuities

(1) Generally, non-individual owners will be currently taxed on any increase in the cash surrender value attributable to "premiums" or "purchase payments" made after February 28, 1986, regardness of when the policy was issued. Prior "premiums" or "purchase payments" retain their tax-deferred status. Generally, this will mean that earnings under annuities owned by corporations or certain trusts will be treated as current, ordinary income and are subject to federal income tax, unlike annuities owned by or for the benefit of individuals.

(2) In addition, this change, which applies to policies owned by other than "natural persons" has exceptions. It does not apply to policies acquired for purposes of estate administration, purchased and held by an employer upon termination of a qualified pension or profit-sharing plan, held by a tax-qualified plan, an IRA or TSA, an immediate annuity (where the first payment is deferred no longer than one year after purchase), or a trust established for the benefit of an individual.

K. Salary Continuation - Continued

5. Funding (Cont. a. Annuities

(3) Generally, annuities are used in Salary Continuation plans only when there is an uninsurable person to be benefited.

b. Life Insurance - the preferred funding method. The corporation is the applicant, owner, premium payer, and beneficiary of a life insurance policy on the employee. It is a key employee policy which sits on the shelf for future use.

(1) Book Income/BURP could be a problem in the short term, but let's assume that those provisions fade out of existence several years hence.

(2) Life Insurance is still the best way to build, and informally fund for, pre-retirement death benefits disability retirement benefits, and the ultimate post-retirement benefits - all through one policy.

(3) Key employees will be looking for more ways for their corporations to supplement their pre-retirement and post-retirement income because of now-limited qualified plan funding and distribution rules about to take effect. Life Insurance is the natural way to do this funding on a selective basis through a Salary Continuation/SERP agreement.

K. Salary Continuation - Continued

5. Funding (Cont.) b. Life Insurance

(4) Better yet, the corporation can give more "benefit for the buck" in the future. Corporate tax rates are coming down, so it will take less after-tax income to fund a specific SERP amount. -Tax deduction is allowable only when benefits are actually paid out to the employee.

(a) The top corporate tax bracket will soon be only 34%. It will take $15,152 before taxes to have $10,000 left for a premium.

(b) Formerly, to set aside that $10,000, it took $18,519, in a top 46% bracket pre-tax.

(c) Have the corporation still set aside $18,519 pre-tax = bigger premium for bigger policy for key employee!!

(5) Will corporate tax rates go back up in 1989 when a new President takes office? Probably..

(a) Let the corporation use inexpensive dollars in these early years, then take its payout deduction later when dollars will probably be more expensive.

(b) If the corporation is in the top 34% tax bracket, it must earn barely more than $1.50 to pay $1.00 in premiums after taxes.

(c) Assume the top tax rate later goes to 46% again, i.e., when the benefit payout time arrives.

K. Salary Continuation - Continued

5. Funding (Cont) b. Life Insurance

(5) (c) Then, it will cost the corporation only 54 cents in taxes when it pays out each dollar to the retired employee.

VI. EXECUTIVE BONUS INSURANCE (sometimes called a Plus Employee or IRC Sec. 162 Plan)

1. Let's keep assuming that the corporation stays in the top 34% Federal tax bracket.
2. Selling life insurance through an Executive Bonus arrangement is an attractive way to satisfy traditional needs for personal life insurance.
3. There are two advantages of the Executive Bonus method.
   a. The employer buys a life insurance policy on the life of an employee - usually an executive or other valued employee - pays the premiums, and receives a tax deduction for each premium paid. The employee owns the policy and obtains the insurance protection for the cost of the taxes on the premium.
   b. In effect, a valuable fringe benefit is provided to the employee without the employer becoming entangled in nondiscrimination requirements or tedious and burdensome paperwork and record-keeping.
4. The Executive Bonus arrangement is usually most impressive when the combined tax brackets of employer and employee operate to reduce the total combined outlays to less than 100% of the premium.

4. (Continued)

If, for example, an employer is in the 34% tax bracket the premium really costs the employer 66 cents per dollar. If the employee's marginal income tax bracket, after the increase in income is 28%, the tax paid by the employee is 28 cents per dollar. Obviously, the higher the employer's tax rate, and the lower the employee's rate, the better the tax leveraging.

5. The employee owns the policy, and can reduce later outlays by electing to receive the dividends in cash. If the employee uses premium offset, the employer's outlays can be limited to premiums due before the offset year.

6. The corporation can double-bonus the amount of premium to the insured and deduct it (assuming it is considered reasonable compensation).

7. No book income/BURP problem. The corporation pays the premiums, and has no interest in the policy.

VII. SPLIT DOLLAR LIFE INSURANCE FOR KEY EMPLOYEES

1. Let us now assume that a closely held corporation's marginal tax bracket is only 15% -- pre-tax profits have been used for salary, qualified plan and other fringe benefit funding, so that only $50,000 or less will be taxable. Since the shareholder-employee(s) take out so much as salary, they personally will be in a 28% or 33% marginal tax bracket.

VII. SPLIT DOLLAR LIFE - Continued

2. Split Dollar Life insurance is a method of joining the life insurance needs of selected employees, including shareholder-employees, with the premium paying ability of the corporation. When the employee dies, the proceeds are split. Generally an amount equal to the premiums paid by the business is paid to the employer. The employee's beneficiary receives the balance of the proceeds.

3. The employer might pay the entire premium for the life insurance, or the employee might contribute part of the premium. If the employee contributes a part of the annual premium, the approach is called a contributory arrangement. This is the usual method today. If the employee's contribution is less than the current value of the life insurance protection, the difference must be reported as taxable compensation.

4. The advantages of split dollar life insurance to the business.

    a. Split dollar life insurance can be used as a selective extra benefit to attract and hold key employees to the business. The business dollar is used to help the employee acquire and maintain additional life insurance protection that would normally be paid for with personal after-tax dollars.

VII. Split Dollar Life - Continued

4. b. The employer is "owner" of its cash values. Thus, the business has a growing and readily available reserve fund to call upon for business needs and opportunities.

   c. At the employee's death, the business recovers all premiums it has paid over the years.

   d. The arrangement may be installed with a minimum of procedural detail and need not be submitted to the Internal Revenue Service for approval.

5. Advantages to the employee

   a. Insurance protection at a favorable overall cost.

   b. Increased protection that the employee may not be able to afford otherwise.

   c. Insurance which may be kept free from the federal estate tax, in certain circumstances.

   d. A particularly attractive benefit for shareholder-employees.

6. Back to the income tax aspects, and Leveraging

   a. Lower tax brackets now make it less costly for the corporation to pay its nondeductable portion of the premium (no deduction because the corporation can now borrow against the cash values and receive part of the death proceeds).

VII. Split Dollar Life - Continued

6. b. The "economic benefit" included in the gross income of the insured employee will be taxed at lower individual rates now; or, it will be less costly if the economic benefit is contributed by the insured as part of the annual program.

c. Book Income/BURP will hardly be a problem.

(1) Corporation has rights to cash values only to extent of gross premiums paid (in the usual collateral assignment method). Cash value included in book income is only that amount which exceeds net premiums paid, so the difference would be slight.

(2) Corporation receives death proceeds only to extent of gross premiums paid. BURP should not encompass the death proceeds, because the amount would not exceed cash value; and, the cash value was taken into account in AMT (alternative minimum tax) calculations for all years prior to death.

7. Some practical uses of corporate Split Dollar would be:

- To fund cross-purchase buy/sell agreements.
- For deferred compensation; and
- To purchase personal life insurance

VII. Split Dollar Life - Continued

7. (Cont.) Let's take a look at how this last item could work with a whole life contract. In the illustration in Appendix A, the employer makes premium contributions for 17 years. The employer, at all times, is entitled to a return of his money through borrowing, surrender, or death proceeds. The difference between the employer's premiums and the total cash value increase in the contract then goes to the employee. The employee is paying premiums based on our IPT rates.

   For instance, in the 10th year, if the employees pays a $370 premium, the employees' cash value account would increase by $2,349, totalling $7,102.

   At age 65, the total premiums paid by the employee equals $6,941, and the employee's cash value totals $51,870. (In the past, illustrations have been "product driven" in that they showed the numerical results of premium impact over a period of time).

   We, (New York Life) are making rapid advances toward "market driven" illustrations such as the one used here where the prospects' objectives are outlined and the premium will be determined to meet these objectives.

APPENDIX A

SPLIT DOLLAR SALES OPPORTUNITY! (see page 21)

MR. PROSPECT
WHOLE LIFE ILLUSTRATION
Face Amount $100,000 Sex M Age 45
New York Life Insurance Co. Premiums Paid Annually
Rated STANDARD NON-SMOKER
WHOLE LIFE ILLUSTRATION

POLICY DIVIDEND OPTION Paid-Up Additions
DIVIDEND SURRENDER Surrender table
SPLIT DOLLAR TYPE Contributory
ECONOMIC BENEFIT RATES IPT

Yr	Age	Employer Premium Contribution B.O.Y.	Employees Premium Contribution B.O.Y.	Employers Cash Value B.O.Y.	Employees Cash Value B.O.Y.	Employers Net Death Benefit B.O.Y.	Employees Net Death Benefit B.O.Y.
1	45	2,024	221	0	0	2,024	97,976
2	46	2,014	231	1,150	0	4,038	96,661
3	47	2,003	242	3,466	0	6,041	95,760
4	48	1,991	254	5,968	0	8,032	95,288
5	49	1,978	267	8,784	0	10,010	95,276
6	50	1,960	285	11,809	0	11,970	95,671
7	51	1,942	303	13,912	1,155	13,912	96,492
8	52	1,922	323	15,834	2,749	15,834	97,760
9	53	1,900	345	17,734	4,753	17,734	99,503
10	54	1,875	370	19,609	7,102	19,609	101,753
11	55	1,847	398	21,456	9,835	21,456	104,539
12	56	1,814	431	23,270	13,491	23,270	107,894
13	57	1,765	480	25,035	17,273	25,035	112,361
14	58	1,700	545	26,735	21,637	26,735	117,038
15	59	1,614	631	28,349	26,651	28,349	122,482
16	60	1,506	739	29,855	32,485	29,855	128,861
17	61	1,369	876	31,224	38,970	31,224	136,140
18	62	-31,224	0	0	41,917	0	107,379
19	63	0	0	0	45,058	0	108,391
20	64	0	0	0	48,416	0	109,697
Age							
65	65	0	0	0	51,870	0	111,314
70	70	0	0	0	74,329	0	125,631

Policy Prem. of $2,245.00 with WP of $0.00 ADB of $0.00 PPO of $0.00

AVERAGE		NET	
Net Death Benefit . . . 20th yr.	$117,734	Net Death Benefit . . . 20th yr.	$109,697
Cost of a Dollar . . . . . 20th yr.	$ 0.324	Cost of a Dollar . . . . . 20th yr.	$ 0.348

VIII. FAMILY - ESTATE TAX

A. Top rate in 1987 - 55%, drops to 50% in 1988. Estate rate highest Federal tax rate!

B. Emphasis now on reducing impact on federal estate tax.

C. How do you reduce estate tax?

1. Spend your estate
2. Give away estate
3. Freeze estate
4. Provide for non-estate taxable liquidity

D. Spend your estate - means -

1. Have a good time
2. Don't plan for your future
3. Don't plan for your family
4. Finish up on Medicaid
5. For practical purposes, enjoy your estate but don't "blow" it

E. Give your estate away -

1. Make use of your annual exclusions
2. Utilize gift tax marital deduction to equalize estates so that both spouses claim unified credit
3. Use taxable gifts to transfer property you believe will appreciate in future.
4. Keep enough of your estate so that you can live comfortably.

VIII. FAMILY - ESTATE TAX - Continued

F. Freeze your estate (give away future appreciation)

1. Recapitalization

a. Exchange your voting common shares for preferred shares and common shares

b. Preferred shares will equal present value of business.

c. If interest rates stay down, preferred share dividends are manageable.

d. Common stock has little value, can be given away and remove appreciation from estate

e. Keyman policy for redemption of preferred shares or third party ownership to provide estate liquidity

2. Personal Holding Company

a. Transfer stock to PHC common and preferred shares

b. The present value of old shares equal value of preferred shares - give away common shares at no gift tax cost.

c. See (1.) above for similar details.

3. Family Limited Partnership

a. Family partnership has general partner and other limited partners

b. Business owner transfers assets to partnership capital is frozen, business owner will retain fixed income preference, nominal appreciaton rights and management control

VIII. Family - Estate Tax - Continued

3. c. appreciation to limited partners

   d. some advisors believe that the family partnership to be more flexible than corporate form

   e. Life insurance in partnership to liquidate general partner's interest

4. Private Annuity

   a. Sales of family business for an annuity for life of seller

   b. Value of annuity equals value of business

   c. at death of seller, payments stop - nothing included in estate.

   d. Insurance sale on life of buyer - buyer's estate carries out contract. Insurance proceeds offset by debt

5. Charitable Lead Trust

   a. transfer property to irrevocable trust

   b. income to a charity for period of years

   c. at end of trust, property reverts to remainder beneficiaries (next generation)

   d. it doesn't claim income tax deduction - income not taxed to donor

   e. gift of remainder interest is a gift of present value of property to be received sometime in future - greatly reduced gift

   f. when trust ends - property passes to beneficiaries if donor dies before trust ends

5. g. Insurance on donor's life to provide income to trust beneficiaries if donor dies before trust ends

6. a. transfer property to irrevocable trust

   b. donor has current income tax deductions for present value of remainder interest that will pass to charity

   c. income to donor and, perhaps donor's estate

   d. after life estate(s), property passes to charity - not taxable in donor's estate

   e. use some income from trust to acquire life insurance to replace property gifted to charity - some form of third party ownership

   f. donor has income from trust and an income tax deduction in year trust is funded. Property not taxable in donor's estate

G. Non-estate includable liquidity

1. Outright Third Party Ownership of life insurance

   a. estate owner gifts premium dollars

   b. outlive 3 year period of Sec. 2035 - donor "home free"

   c. if premium gift exceed annual exclusion - keep appreciation out of estate

VIII. FAMILY - ESTATE TAX - Continued

G. 2. Trust Owner of policy

a. donor gifts premiums

b. Crummey clause avoids gift tax

c. donor has to live 3 years to be "home free"

d. trust allows donor to avoid problem of outright gift of proceeds to individuals - can have splits in income and principal and can have payment discretion in hands of trustee

The Tax Reform Act has left the individual life product line stronger than ever. Life insurance still provides the best way to protect income, and may be one of the few remaining income tax deferment alternatives available.
Cash value buildup not currently taxed and policy loans not taxed. If surrendered, gain taxed. If insured dies, life insurance proceeds are received by beneficiary income tax free.

The following illustrations show a premium payment method based on present dividend scales or current interest rates. These dividends and interest rates are not guaranteed.

Whole Life Using Optional Premium Payment Rider (OPP)

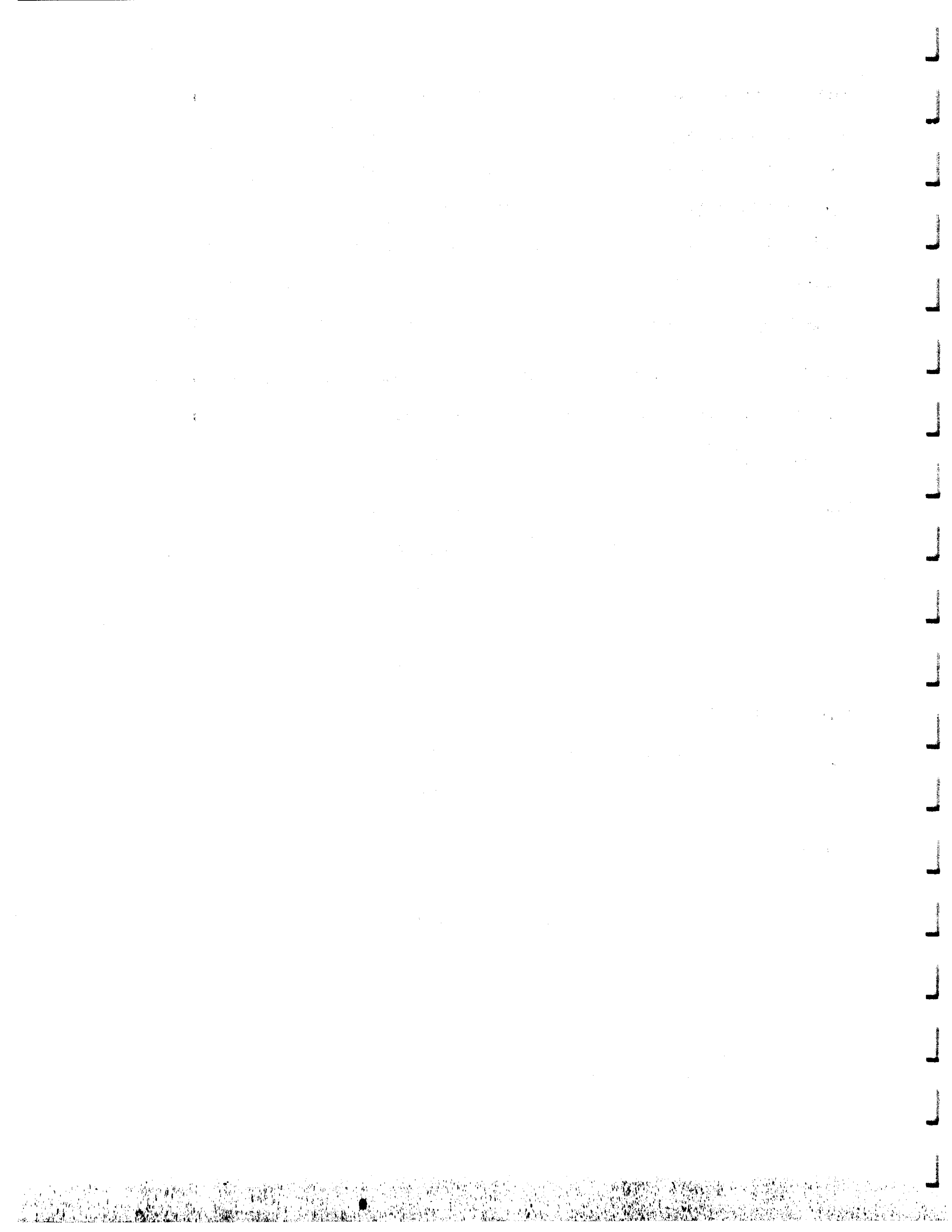
Illustration 1 - Male Age 1
2 - Male Age 1
3 - Male Age 35
4 - Male Age 35

Universal Life

Illustration 5 - Male Age 1
6 - Male Age 35

Single Premium Life

Illustration 7 - Male Age 1
8 - Male Age 35



JOHN DOE
WHOLE LIFE ILLUSTRATION
Face Amount $ 100,000 Sex M Age 1
New York Life Insurance Co. Premiums Paid Annually
Rated Standard
CUSTOM DESIGNED ILLUSTRATION

ILLUSTRATION 2

POLICY DIVIDEND OPTION Paid-Up Additions
DIVIDEND SURRENDER Premium only at age 66

YR	NET PREMIUM	POLICY CASH VALUE	CASH VALUE OF ADDS	NET CASH VALUE	FACE AMOUNT OF ADDS	NET DEATH BENEFIT
1	1064	0	548	548	9812	109812
2	1064	0	1328	1328	19331	119331
3	1064	0	2225	2225	32218	132218
4	1064	0	3236	3236	46209	146209
5	1064	0	4392	4392	61036	161036
6	1064	0	5696	5696	76983	176983
7	1064	0	7163	7163	93884	193884
8	1064	200	8813	9013	111693	211693
9	1064	500	10668	11168	130497	230497
10	1064	800	12746	13546	150353	250353
11	1064	1300	15052	16352	171286	271286
12	1064	1800	17605	19405	193182	293182
13	1064	2300	20429	22729	216176	316176
14	1064	2800	23549	26349	240457	340457
15	1064	3300	26996	30296	266203	366203
16	1064	3800	30822	34622	293668	393668
17	1064	4300	35068	39368	323140	423140
18	1064	4800	39775	44575	354798	454798
19	1064	5300	44988	50288	388651	488651
20	1064	5900	50761	56911	424667	524667
**** AGE ******						
65	1064	52900	5219042	5272467	8823491	8924016
70	0	61000	8147852	8209377	12120860	12221390
75	0	68700	12545250	12614480	16690600	16791120
80	0	75600	19081100	19157220	23229460	23329990
84	0	80500	26423770	26504790	30309110	30409640

Policy Prem. of $ 532.00 w/ WP of $ 0.00 ADB of $ 0.00 PPO of $ 0.00

*************** AVERAGE *************** ***************** NET *****************

Net Death Benefit 20th yr $ 280,212 Net Death Benefit 20th yr $ 524,667
Cost of a Dollar 20th yr $ .076 Cost of a Dollar 20th yr. $ .041

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JOHN DOE
WHOLE LIFE ILLUSTRATION

ILLUSTRATION 3

Face Amount $ 100,000 Sex M Age 35
New York Life Insurance Co. Premiums Paid Annually
Rated Non-Smoker
CUSTOM DESIGNED ILLUSTRATION

POLICY DIVIDEND OPTION Paid-Up Additions
DIVIDEND SURRENDER Premium only at age 66

YR	NET PREMIUM	POLICY CASH VALUE	CASH VALUE OF ADDS	NET CASH VALUE	FACE AMOUNT OF ADDS	NET DEATH BENEFIT
1	1130	0	0	0	0	100000
2	1130	0	180	180	0	100000
3	1130	300	421	721	884	100884
4	1130	1200	731	1931	1987	101987
5	1130	2100	1125	3225	3316	103316
6	1130	3100	1608	4708	4907	104907
7	1130	4000	2194	6194	6747	106747
8	1130	5100	2893	7993	8856	108856
9	1130	6100	3721	9821	11242	111242
10	1130	7200	4693	11893	13920	113920
11	1130	8400	5841	14241	16909	116909
12	1130	10100	7187	17287	20276	120276
13	1130	11800	8751	20551	24044	124044
14	1130	13600	10555	24155	28224	128224
15	1130	15400	12626	28026	32828	132828
16	1130	17300	14991	32691	37881	137881
17	1130	19100	17685	37260	43401	143801
18	1130	21100	20743	42393	49427	149902
19	1130	23000	24204	47829	55987	156537
20	1130	25000	28115	53815	63123	163748
**** AGE **********						
65	1130	44700	119713	165663	197114	298364
70	0	54200	200372	255822	292548	393798
75	0	63200	325945	390395	427679	528929
80	0	71300	517399	589949	623700	724950
99	0	100000	2686889	2788139	2548664	2649914

Policy Prem. of $ 1,130.00 w/ WP of $ 0.00 ADB of $ 0.00 PPO of $ 0.00

*************** AVERAGE *************** ***************** NET *****************

Net Death Benefit 20th yr $ 121,301 Net Death Benefit 20th yr $ 163,748
Cost of a Dollar 20th yr $ .186 Cost of a Dollar 20th yr. $ .138

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JOHN DOE
WHOLE LIFE ILLUSTRATION
Face Amount $ 100,000 Sex M Age 35 ILLUSTRATION 4
New York Life Insurance Co. Premiums Paid Annually
Rated Non-Smoker
CUSTOM DESIGNED ILLUSTRATION

POLICY DIVIDEND OPTION Paid-Up Additions
DIVIDEND SURRENDER Premium only at age 66

YR	NET PREMIUM	POLICY CASH VALUE	CASH VALUE OF ADDS	NET CASH VALUE	FACE AMOUNT OF ADDS	NET DEATH BENEFIT
1	2260	0	1176	1176	6007	106007
2	2260	0	2716	2716	11779	111779
3	2260	300	4454	4754	18881	118881
4	2260	1200	6409	7609	26344	126344
5	2260	2100	8650	10750	34195	134195
6	2260	3100	11173	14273	42655	142655
7	2260	4000	14009	18009	51611	151611
8	2260	5100	17193	22293	61112	161112
9	2260	6100	20759	26859	71189	171189
10	2260	7200	24752	31952	81884	181884
11	2260	8400	29228	37628	93249	193249
12	2260	10100	34242	44342	105380	205380
13	2260	11800	39847	51647	118337	218337
14	2260	13600	46098	59698	132158	232158
15	2260	15400	53062	68462	146886	246886
16	2260	17300	60807	78507	162587	262587
17	2260	19100	69414	88989	179313	279713
18	2260	21100	78968	100618	197153	297628
19	2260	23000	89562	113187	216189	316739
20	2260	25000	101304	127004	236521	337146
**** AGE ****						
65	1130	44700	345019	390969	578284	679534
70	0	54200	551262	606712	814798	916048
75	0	63200	865214	929664	1145413	1246663
80	0	71300	1336465	1409015	1621114	1722364
99	0	100000	6592060	6693310	6263805	6365055

Policy Prem. of $ 1,130.00 w/ WP of $ 0.00 ADB of $ 0.00 PPO of $ 0.00

************** AVERAGE ************** **************** NET ****************

Net Death Benefit 20th yr $ 199,774 Net Death Benefit 20th yr $ 337,146
Cost of a Dollar 20th yr $ .226 Cost of a Dollar 20th yr. $ .134

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PREPARED FOR: 2
MALE AGE 1 STANDARD

INITIAL SPECIFIED FACE: 100,000

ILLUSTRATION 5

DEATH BENEFIT EQUALS SPECIFIED FACE AMOUNT

			CURRENT MORTALITY CHARGES				GUARANTEED MORTALITY	
			CURRENT INTEREST OF 9.600%		ILLUSTRATED INTEREST OF 8.000%		GUARANTEED INTEREST OF 4.500%	
AGE	YR	ANNUALIZED PREMIUM	ACCUMULATION VALUE	DEATH BENEFIT	ACCUMULATION VALUE	DEATH BENEFIT	ACCUMULATION VALUE	DEATH BENEFIT
1	1	408	249	100,000	244	100,000	205	100,000
2	2	366	491	100,000	477	100,000		
3	3	366	756	100,000	730	100,000		
4	4	366	1,047	100,000	1,002	100,000		
5	5	366	1,367	100,000	1,297	100,000		
6	6	366	1,730	100,000	1,628	100,000		
7	7	366	2,127	100,000	1,985	100,000		
8	8	366	2,576	100,000	2,384	100,000		
9	9	366	3,068	100,000	2,815	100,000		
10	10	366	3,608	100,000	3,281	100,000		
11	11	366	4,200	100,000	3,784	100,000		
12	12	366	4,838	100,000	4,316	100,000		
13	13	366	5,525	100,000	4,880	100,000		
14	14	366	6,255	100,000	5,465	100,000		
15	15	366	7,045	100,000	6,086	100,000		
16	16	366	7,888	100,000	6,735	100,000		
17	17	366	8,802	100,000	7,424	100,000		
18	18	366	9,795	100,000	8,159	100,000		
19	19	366	10,873	100,000	8,943	100,000		
20	20	366	12,057	100,000	9,791	100,000		
61	61	366	532,935	682,157	252,121	322,714		
62	62	366	581,504	732,695	271,245	341,769		
63	63	366	634,422	786,683	291,775	361,801		
64	64	366	692,108	844,372	313,826	382,868		
65	65	366	755,016	906,020	337,523	405,028		
66	66	-50,000	768,513	914,530	308,790	367,460		
67	67	-50,000	783,090	924,046	277,874	327,892		
68	68	-50,000	798,848	934,652	244,628	286,215		
69	69	-50,000	815,901	946,445	208,893	242,316		
70	70	-50,000	834,365	959,520	170,499	196,074		
71	71	-50,000	854,732	965,847	129,317	146,128		
72	72	-50,000	877,262	973,761	85,123	94,486		
73	73	-50,000	902,280	983,485	37,663	41,053		
74	74	-50,000	930,194	995,308				
75	75	-50,000	961,493	1,009,568				
76	76	-50,000	995,370	1,045,138				
77	77	-50,000	1,032,020	1,083,621				
78	78	-50,000	1,071,666	1,125,250				
79	79	-50,000	1,114,534	1,170,261				

ADDITIONAL BENEFITS AND INFORMATION

MODAL PREMIUM: ANNUAL
MINIMUM FIRST YEAR ANNUAL PREMIUM = 408
GUIDELINE SINGLE PREMIUM = 5,331 GUIDELINE ANNUAL PREMIUM = 418

TARGET LIFE II - FLEXIBLE PREMIUM ADJUSTABLE LIFE INSURANCE

PREPARED FOR: JOHN DOE — INITIAL SPECIFIED FACE: 100,000

MALE AGE 35 NON-SMOKER

ILLUSTRATION

DEATH BENEFIT EQUALS SPECIFIED FACE AMOUNT

			CURRENT MORTALITY CHARGES				GUARANTEED MORTALITY	
			CURRENT INTEREST OF 9.600%		ILLUSTRATED INTEREST OF 8.000%		GUARANTEED INTEREST OF 4.500%	
AGE	YR	ANNUAL-IZED PREMIUM	ACCUMU-LATION VALUE	DEATH BENEFIT	ACCUMU-LATION VALUE	DEATH BENEFIT	ACCUMU-LATION VALUE	DEATH BENEFIT
35	1	1,286	1,065	100,000	1,047	100,000	959	100,000
36	2	1,286	2,222	100,000	2,169	100,000	1,952	100,000
37	3	1,286	3,480	100,000	3,370	100,000	2,979	100,000
38	4	1,286	4,839	100,000	4,647	100,000	4,032	100,000
39	5	1,286	6,320	100,000	6,017	100,000	5,124	100,000
40	6	1,286	7,924	100,000	7,479	100,000	6,245	100,000
41	7	1,286	9,676	100,000	9,050	100,000	7,397	100,000
42	8	1,286	11,569	100,000	10,718	100,000	8,572	100,000
43	9	1,286	13,650	100,000	12,526	100,000	9,781	100,000
44	10	1,286	15,938	100,000	14,485	100,000	11,017	100,000
45	11	1,286	18,455	100,000	16,608	100,000	12,282	100,000
46	12	1,286	21,203	100,000	18,888	100,000	13,578	100,000
47	13	1,286	24,215	100,000	21,350	100,000	14,908	100,000
48	14	1,286	27,520	100,000	24,009	100,000	16,263	100,000
49	15	1,286	31,147	100,000	26,882	100,000	17,648	100,000
50	16	1,286	35,138	100,000	29,997	100,000	19,064	100,000
51	17	1,286	39,506	100,000	33,350	100,000	20,504	100,000
52	18	1,286	44,293	100,000	36,963	100,000	21,973	100,000
53	19	1,286	49,537	100,000	40,852	100,000	23,454	100,000
54	20	1,286	55,290	100,000	45,047	100,000	24,951	100,000
65	31	-20,000	146,227	175,472	98,358	118,029	19,630	80,000
66	32	-20,000	137,819	164,005	84,271	100,283		
67	33	-20,000	128,622	151,774	69,099	81,537		
68	34	-20,000	118,562	138,717	52,760	61,730		
69	35	-20,000	107,565	124,775	35,171	40,798		
70	36	-20,000	95,488	109,811	16,228	18,663		
71	37	-20,000	82,323	93,025				
72	38	-20,000	67,969	75,445				
73	39	-20,000	52,311	57,019				
74	40	-20,000	35,223	37,688				
75	41	-20,000	16,557	17,385				

ADDITIONAL BENEFITS AND INFORMATION

MODAL PREMIUM: ANNUAL

MINIMUM FIRST YEAR ANNUAL PREMIUM = 828

GUIDELINE SINGLE PREMIUM = 16,481 GUIDELINE ANNUAL PREMIUM = 1,338

SINGLE PREMIUM LIFE POLICY WITH ENDOWMENT BENEFIT

PREPARED FOR: JOHN DOE — INITIAL DEATH BENEFIT: 297,973
MALE AGE 1 — SINGLE PREMIUM 10,000

ILLUSTRATIVE VALUES REFLECT CURRENT INTEREST OF 7.200% ILLUSTRATION 7

A CURRENT INTEREST RATE OF 7.200% IS GUARANTEED FOR 1 YEAR
THE GUARANTEED INTEREST RATE THEREAFTER IS 4.000%

		ILLUSTRATIVE VALUES			GUARANTEED VALUES		
AGE	YR	GROSS CASH VALUE	GROSS CASH SURRENDER VALUE	GROSS DEATH BENEFIT	GROSS CASH VALUE	GROSS CASH SURRENDER VALUE	GROSS DEATH BENEFIT
1	1	10,720	9,970	297,973	10,720	9,970	297,973
2	2	11,492	10,802	297,973	11,149	10,480	297,973
3	3	12,319	11,703	297,973	11,595	11,015	297,973
4	4	13,206	12,678	297,973	12,059	11,576	297,973
5	5	14,157	13,732	297,973	12,541	12,165	297,973
6	6	15,176	14,873	297,973	13,043	12,782	297,973
7	7	16,269	16,106	297,973	13,564	13,429	297,973
8	8	17,440	17,440	297,973	14,107	14,107	297,973
9	9	18,696	18,696	297,973	14,671	14,671	297,973
10	10	20,042	20,042	297,973	15,258	15,258	297,973
11	11	21,485	21,485	297,973	15,868	15,868	297,973
12	12	23,032	23,032	297,973	16,503	16,503	297,973
13	13	24,691	24,691	297,973	17,163	17,163	297,973
14	14	26,468	26,468	297,973	17,850	17,850	297,973
15	15	28,374	28,374	[illegible]	[illegible]	[illegible]	[illegible]
41	41	172,976	172,976	408,224	51,467	51,467	297,973
42	42	185,430	185,430	424,636	53,526	53,526	297,973
43	43	198,781	198,781	441,295	55,667	55,667	297,973
44	44	213,094	213,094	458,151	57,893	57,893	297,973
45	45	228,436	228,436	477,432	60,209	60,209	297,973
46	46	244,884	244,884	497,114	62,617	62,617	297,973
47	47	262,515	262,515	517,155	65,122	65,122	297,973
48	48	281,417	281,417	537,506	67,727	67,727	297,973
49	49	301,679	301,679	558,105	70,436	70,436	297,973
50	50	323,399	323,399	575,651	73,254	73,254	297,973
51	51	346,684	346,684	592,830	76,184	76,184	297,973
52	52	371,645	371,645	609,499	79,231	79,231	297,973
53	53	398,404	398,404	625,494	82,400	82,400	297,973
54	54	427,089	427,089	640,633	85,696	85,696	297,973
55	55	457,839	457,839	668,446	89,124	89,124	297,973
56	56	490,804	490,804	696,941	92,689	92,689	297,973
57	57	526,142	526,142	726,076	96,397	96,397	297,973
58	58	564,024	564,024	755,792	100,252	100,252	297,973
59	59	604,634	604,634	786,024	104,263	104,263	297,973
60	60	648,167	648,167	829,654	108,433	108,433	297,973

PRESENTED BY: DANIEL B. SANTOS, CLU

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NEW YORK LIFE INSURANCE AND ANNUITY CORPORATION
SINGLE PREMIUM LIFE POLICY WITH ENDOWMENT BENEFIT

PREPARED FOR: JOHN DOE — INITIAL DEATH BENEFIT: 75,454
MALE AGE 35 — SINGLE PREMIUM 10,000

ILLUSTRATIVE VALUES REFLECT CURRENT INTEREST OF 7.200% — ILLUSTRATION 8

A CURRENT INTEREST RATE OF 7.200% IS GUARANTEED FOR 1 YEAR
THE GUARANTEED INTEREST RATE THEREAFTER IS 4.000%

		ILLUSTRATIVE VALUES			GUARANTEED VALUES		
AGE	YR	GROSS CASH VALUE	GROSS CASH SURRENDER VALUE	GROSS DEATH BENEFIT	GROSS CASH VALUE	GROSS CASH SURRENDER VALUE	GROSS DEATH BENEFIT
35	1	10,720	9,970	75,454	10,720	9,970	75,454
36	2	11,492	10,802	75,454	11,149	10,480	75,454
37	3	12,319	11,703	75,454	11,595	11,015	75,454
38	4	13,206	12,678	75,454	12,059	11,576	75,454
39	5	14,157	13,732	75,454	12,541	12,165	75,454
40	6	15,176	14,873	75,454	13,043	12,782	75,454
41	7	16,269	16,106	75,454	13,564	13,429	75,454
42	8	17,440	17,440	75,454	14,107	14,107	75,454
43	9	18,696	18,696	75,454	14,671	14,671	75,454
44	10	20,042	20,042	75,454	15,258	15,258	75,454
45	11	21,485	21,485	75,454	15,868	15,868	75,454
46	12	23,032	23,032	75,454	16,503	16,503	75,454
47	13	24,691	24,691	75,454	17,163	17,163	75,454
48	14	26,468	26,468	75,454	17,850	17,850	75,454
49	15	28,374	28,374	75,454	18,564	18,564	75,454
50	16	30,417	30,417	75,454	19,306	19,306	75,454
51	17	32,607	32,607	75,454	20,078	20,078	75,454
52	18	34,955	34,955	75,454	20,881	20,881	75,454
53	19	37,471	37,471	75,454	21,717	21,717	75,454
54	20	40,169	40,169	75,454	22,585	22,585	75,454
55	21	43,062	43,062	75,454	23,489	23,489	75,454
56	22	46,162	46,162	75,454	24,428	24,428	75,454
57	23	49,486	49,486	75,454	25,406	25,406	75,454
58	24	53,049	53,049	75,454	26,422	26,422	75,454
59	25	56,868	56,868	75,454	27,479	27,479	75,454
60	26	60,963	60,963	78,032	28,578	28,578	75,454
61	27	65,352	65,352	82,344	29,721	29,721	75,454
62	28	70,057	70,057	86,871	30,910	30,910	75,454
63	29	75,102	75,102	91,624	32,146	32,146	75,454
64	30	80,509	80,509	96,611	33,432	33,432	75,454

PRESENTED BY: DANIEL B. SANTOS, CLU
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