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21st Annual Midwest/Midsouth Estate Planning Institute

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Legislative, Caselaw & Regulatory Update For 1993-94

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NOTABLE DEVELOPMENTS IN ESTATE PLANNING
Legislative, Caselaw & Regulatory Update For 1993-1994

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SECTION A

APPENDICES

A. Revenue Reconciliation Act of 1993

1. Income Tax.

The income tax rate brackets for trusts and estates are as follows for tax years beginning after December 31, 1993:

Up to $1,500	15 percent
$1,500 - 3,600	28 percent
$3,600 - 5,500	31 percent
$5,500 - 7,500	36 percent
Above $7,500	39.6 percent

The election to pay additional 1993 taxes attributable to the rate increases in the 1993 Act in three installments, available to many taxpayers, is not available to trusts and estates.

Rate compression creates an incentive not to accumulate income in a trust or estate. Timely distributions can eliminate the problem for estates, and for trusts. However, this presents a problem with respect to exemption equivalent trusts, generation skipping tax trusts, and trusts for disabled individuals. In those trusts, other considerations suggest that income should be accumulated.

2. Estimated Taxes.

The estimated tax payment rules have been changed. For taxable years beginning after December 31, 1993, a trust or estate with adjusted gross income ("AGI") of not more than $150,000 will avoid underpayment penalties by making estimated payments equal to the lesser of (i) 90 percent of the tax shown as due on the return for the current year or (ii) 100 percent of the tax shown on the return for the preceding year. For trusts or estates with AGI of

$150,000 or more, 110 percent of the preceding year's tax must be paid.

3. Estate and Gift Tax Rates.

The reduction in rates was eliminated, retroactively to December 31, 1992. Thus, the highest rate is 55%, plus the 5% surcharge for amounts between $10,000,000 and $21,040,000.

4. Medicaid Rules.

The rules concerning Medicaid eligibility were changed with respect to transfers of assets and the treatment of trusts. The look-back period has been changed to 36 months, which runs from the date of application or institutionalization, whichever is later. The number of months of delay in eligibility is equal to the total, cumulative uncompensated value of all assets transferred after the look-back date, divided by the average monthly cost to a private patient of nursing facilities in the state. The period of delay begins with the first month during which the assets were disposed of.

Transfers by co-owners are considered made by the applicant if the transfer reduces the applicant's interest in the asset.

The term "Medicaid qualifying trust" has been eliminated. There is a 60-month look back rule for payments from trusts, rather than 36 months. That is probably an error. There does not appear a clear reason why a different time period would be used for transfers from revocable trusts, versus property transferred directly by the grantor.

Importantly, supplemental needs trusts created by persons other than the person applying for Medicaid are not taken into account for eligibility purposes. Thus, gifts from parent to child, with child creating a trust for parent, would seem useful. Presumably, a lapse of time between the two transfers would be helpful. The child's transfer would need to be incomplete for gift tax purposes -- by the child retaining a special power of appointment, for instance. An interesting issue is the effect of powers of withdrawal for Medicaid; the creation and lapse of a power would seem to transfer grantor status to the powerholder, even if protected by the "5 x 5" power of section 2514(e). Put another way, for state law purposes does the person having a general power of appointment (i.e., a power of withdrawal, as above) become the grantor of the trust?

Revocable trust assets are considered resources available to the individual, and payments from the trust to others are considered assets disposed of by the individual.

With respect to irrevocable trusts created by the individual, the rules are stringent. The rules provide that if there are any circumstances under which payment from the trust could be made to or for the benefit of the individual, the portion of the corpus from which, or the income on the corpus from which, payment to the individual could be made shall be considered resources available to the individual, and payments from that portion of the corpus or income to someone else will be a disposition.

The provisions apply without regard to the purposes for which a trust is established, whether the trustees have or exercise any discretion under the trust, any restrictions on when or whether distributions may be made from the trust, or any restrictions on the use of distributions from the trust.

Three types of trusts containing the assets of disabled individuals are not subject to these rules. The first is a trust in which after the beneficiary dies, the state will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this title.

The second is for a trust, if the trust is comprised only of pension, Social Security, and other income to the individual (and accumulated income in the trust), if the state will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this title, and the state makes medical assistance available to individuals (with some limitations).

The third exception is for a trust established and managed by a non-profit association, where a separate account is maintained for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts, if accounts in the trust are established solely for the benefit of individuals by the parent, grandparent, or legal guardian of such individuals, by such individuals, or by a court, and to the extent that amounts remaining in the beneficiary's account upon the death of the beneficiary are not retained by the trust, the trust pays to the state from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the state plan under this title.

An important issue is the effect on effective transfers under prior law. Arguably, a trust established under prior law which, for example, provides for the donor-now-Medicaid-recipient to receive all the income, is not grandfathered.

B. Section 61 - Gross Income

Healy v. Jones, ________________ (D.C. S.D. 1994) considered the meaning of "published" rates and rates "available to all standard risks," as used in Revenue Ruling 66-110 and Revenue Ruling 67-154, 1967-1 C.B.. The issue was said by the court to be one of first impression. The controversy arose from a split-dollar insurance plan which was described by the court in this way:

> This policy was acquired pursuant to a split-dollar insurance agreement between Patrick and his employer. The split-dollar arrangement involves the employer purchasing an insurance policy, containing a substantial investment element, on the employee's life. Rev. Rul. 64-328, 1964-2 C.B. 11. The particular agreement at issue is referred to as a collateral assignment arrangement. Id. Under the agreement at issue, the employee is required to pay the annual premiums on the policy. Id. However, the employer is required to loan him the amount of the premiums. Id. The employee assigns the policy to the employer as collateral security for the annual premium loans. Id. Upon Patrick's death, the employer receives the full amount of the premiums paid by it and the beneficiary, Carolyn, receives the remainder. If Patrick's employment is terminated or the policy is terminated, the employer receives the cash surrender value of the policy.
>
> From the employee's perspective, a split-dollar arrangement converts a whole life policy into a term policy at no cost to the employee. Id. The employee receives an economic benefit in "an amount equal to the 1-year term cost of the declining life insurance protection" which the employee receives as a result of the arrangement. Id. The employee must then include this amount as gross income on his tax return.

> In their 1985 tax return, Plaintiffs reported the economic benefit using rate tables provided by the IRS for valuing split-dollar life insurance policies. Plaintiffs subsequently sought to amend their 1985 return using a substantially lower rate table provided by Great West Life Assurance Company. Plaintiffs also used this lower rate table in computing their 1986 through 1988 tax returns.
>
> The lower rate table used by Plaintiffs provides a 2% commission on the first-year premium to the agent selling the policy. Most policies provide at 50% commission on the first year premium to the agent.

(Emphasis added.)

In pertinent part, Revenue Ruling 66-110, 1966-1 C.B. 12, provides that:

> In that case where the current published premiums rates per $1,000 of insurance protection charged by an insurer for individual 1-year term life insurance available to all standard risks are lower than those set forth in Revenue Ruling 55-747, such published rates may be used in place of the rates set forth in that Revenue Ruling for determining the cost of insurance in connection with individual policies issued by the same insurer and used for "split dollar arrangements."

The IRS contended the rates were not published because they were "not made known to the public through general circulation publications such as in Best's Flitcraft Compend which reports the premium rates of various insurance companies." The court rejected the contention because a representative of the company testified that "the rate on the particular policy at issue is published in Best's Flitcraft, as well as in a rate book sent to agents and branch managers." He also testified that the rates were generally available. The IRS presented no contrary evidence.

The case is important because standard term rates are typically used today instead of the P.S. 58 rates (for single life insurance) or the P.S. 38 rates (for survivorship insurance). It remains to be seen whether this is a unique attack by the IRS, or part of a larger effort.

[With respect to the application of section 7872 to split-dollar insurance, see F(2).]

C. Sections 170 and 664 -- Charitable Transfers

1. New Substantiation Requirements.

OBRA '93 added new section 170(f)(8) to the Code which disallows a charitable deduction for any contribution of $250 or more that is not substantiated by a written acknowledgement from the charity stating the money or other property contributed and any goods or services provided to the donor by the charity in consideration for the contribution. The provision has been interpreted by the IRS in News Release 93-121 (December 21, 1993) and in proposed regulations issued on May 26, 1994. The regulations deal primarily with payroll deduction contributions; the News Release is more general. Both are attached as Appendix A.

2. Transfer of Farm and Cattle Operation to Charitable Remainder Unitrust.

In PLR 9413020, the Service issued a number of favorable rulings in the context of the transfer of cattle ranching and farming operations to a charitable remainder unitrust ("CRUT"), over a 2 year period. The trustee was the charitable beneficiary. The key elements to the ruling were representations that the CRUT would not carry on the business of ranching or farming, but would liquidate the assets (e.g., cattle would be fed to keep them alive but not the fatten them for market), and that the trustee had no obligation to sell any of the transferred assets. The first representation would be important because a CRUT which has any unrelated business income for a tax year is <u>not</u> tax-exempt for that year. The second representation would be needed to prevent the IRS from asserting that the transferred assets were, in effect, sold by the donor and then the proceeds contributed to the trust.

3. Options.

In PLR 9417005 the IRS revoked PLR 9240017 dealing with the transfer of an option to purchase real estate to a CRT. This ruling makes an already risky series of transactions more suspect.

4. Partnership as Donor and Beneficiary.

PLR 9419021 approved a term of years charitable remainder unitrust with a partnership as donor and beneficiary. This is in accordance with its previous ruling policy. The IRS has, in the past year, refused to issue a favorable ruling allowing a grantor trust to be the beneficiary of a charitable remainder trust for the lifetime of the grantor. Favorable rulings have been issued where the beneficiary is disabled.

D. Section 408 - IRAs

1. Spousal Rollover Via Trust.

PLR 9350040 considered whether a surviving spouse who received IRA distributions through a trust could roll them over to her own IRA. The IRA beneficiary was a trust, which required the distribution to be allocated to a subtrust over which the surviving spouse had an unlimited power of withdrawal. The IRS allowed the rollover.

E. <u>Sections 671-687 -- Grantor Trusts</u>

1. Section 675(4)(C) -- Power to Substitute Assets.

Whenever it is important to have the grantor treated as the owner of a trust for income tax purposes (e.g., GRITs, GRATs, PRTs) section 675(4)(C) is often used. That section of the Code provides that the grantor is the owner of a trust if the grantor retains, in a nonfiduciary capacity, the power to reacquire trust property by substituting other property of an equivalent value. The IRS is not currently happy with this approach. In several letter rulings (e.g., 9335028, 9337011, 9352004, 9352007 and 9413045), the IRS has refused to rule on the issue, stating that the issue of whether an act could be exercised in a non-fiduciary capacity was a fact and circumstance inquiry.

An example would be PLR 9335028 which states:

> Based on the information submitted and our examination of the terms of each of the proposed trust instruments, we conclude as follows:
>
> 1. The circumstances surrounding the administration of each of proposed trusts will determine whether A [the grantor] holds the power of administration in a nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved here have been examined by the office of the District Director in which the returns are filed. Upon execution of each of the proposed trusts, provided that the circumstances indicate that A has a power of administration exercisable over the corpus of each trust in a nonfiduciary capacity, A will be treated as the owner of the two trusts

> under section 675 and will be taxed on the income of X allocated to these trusts under section 671. Accordingly, A must include in computing taxable income, deductions, and credits, all items of income, deductions and credits against tax of the trusts.

On the other hand, other rulings have been issued which do not raise the issue (e.g., 9345035, 9351005, 9352017, and 9416009).

On this point, Treas. Reg. §1.675-1(b)(4) provides that:

> If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.
>
> (c) *Authority of trustee*. The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

Another aspect of the issue is, who can have the power? Must it be the grantor? The Code uses the term "reacquire" which suggests only the grantor can have the power -- others could not "reacquire." Treas. Reg. §1.675-1(b)(4) provides that the grantor is taxed on a portion of a trust as to which there is "[t]he existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity" and a power of administration includes a "power to reacquire the trust corpus by substituting other property of equivalent value." The IRS has, in previous letter rulings, not even required that the person with the power be nonadverse.

F. Section 1361 -- S Corporations

1. Continued Use.

Limited Liability Companies will often be used instead of S corporations because LLCs are more flexible entities. Legislation has been introduced in Congress which would expand the categories of shareholders of S corporations. Especially beneficial could be the use of S stock to fund charitable remainder trusts.

2. Second Class of Stock and Split-Dollar Life Insurance.

PLR 9331009 holds that split-dollar life insurance arrangements between a company and its shareholder-employees do not create more than one class of stock within the meaning of IRC Sec. 1361(b)(1)(D). However, the ruling states "no opinion is expressed or implied concerning the application of section 7872." This presents the question whether the IRS is considering revocation of Revenue Ruling 64-328, which characterizes a split-dollar arrangement as a "life insurance plan" and not a loan from the employer to an employee.

G. IRC Sec. 2013 -- Previously Taxed Property Credit

1. Value of Annuity.

Estate of Benjamin Shapiro, 67 TCM 1067, involved the valuation of a trust annuity for section 2013 purposes, but it is of more importance with respect to zeroed-out GRATs. The IRS conceded that there was a credit, but disagreed with the estate as to its amount. The trust was valued at a little more than $1 million; the estate valued the decedent's interest at about $943,000. The annuity was equal to roughly 30% of the original value of the trust clearly in excess of the trust's earning power under the IRS Tables. Treas. Reg. §20.2013-4(a) provides that a limited interest in property is valued for section 2013 purposes pursuant to Treas. Reg. §§20.2031-7 and 20.2031-10. Treas. Reg. §20.2031-7(a)(2) provides that:

> The present value of an annuity *** which is dependent on the continuation or termination of the life of one person is computed by the use of Table A in paragraph (f) of this section. *** [However], [i]f the interest to be valued is dependent upon *** a term certain concurrent with one or more lives, see paragraph (e) of this section.

The estate used Table A. The IRS disagreed for several reasons. Of interest here are the IRS arguments that (a) the decedent's interest in the trust must be valued as a term certain concurrent with one life rather than as a lifetime "annuity" because the payments would be limited by the decreasing trust assets and therefore was not solely dependent on the continuation or termination of the life of one person as required under Treas. Reg. §20.2031-7(a)(2); and (b) Table A would not apply in any event because the residuary trust was "underfunded" because the corpus was not large enough to support the annuity obligation in case decedent had lived to be age 109. These contentions are essentially the same.

The Tax Court rejected the IRS position, as follows:

> Taking respondent's argument to its theoretical conclusion, ANY TRUST created with corpus funds equivalent to the present value of a lifetime annuity obligation as computed under Table A would be deemed to be "underfunded" in that it would have insufficient funds to sustain the annual payments should the annuitant live beyond his or her average life expectancy. In this regard, respondent's argument contravenes the fundamental purposes and presumptions underlying the actuarial tables.
>
> Table A is premised on two actuarial presumptions: (1) the interest rate on the principal amount is assumed to be 10 percent, and (2) a person, at any given age, is assumed to die within a time consistent with the average mortality rate for that age. Sec. 20.2031-7(f), Estate Tax Regs. Table A does not expect or presume that a 91-year-old person will live for 18 more years; to the contrary, the table implicitly recognizes the possibility of any person reaching 109 years of age is extremely remote.
>
> * * *
>
> In essence, respondent argues that unless an annuity is "guaranteed" throughout an annuitant's extreme life expectancy, just as a commercial annuity is guaranteed, the computation of the annuity's present value must be made on a case-by-case basis using a

special actuarial factor supplied by the Internal Revenue Service; any computation of an unguaranteed, private annuity under Table A would be deemed invalid in respondent's view. Respondent's position, if it were correct, would vitiate the use of Table A as an administrative convenience and bright-line approach to valuation. Table A could not be used to determine the present values of all sorts of unguaranteed, privately funded annuities; they would all be subject to individual analysis under a facts-and-circumstances test.

As noted, one of the principal purposes of the actuarial tables is to prevent every case from becoming a question of fact as to the most likely outcome of the case. Simpson v. United States, 252 U.S. 547 (1920). Although we have ignored the actuarial tables when their use will violate reason, Estate of McLendon v. Commissioner, T.C. Memo. 1993-459, and cases cited therein, absent an unreasonable result we will use the tables as the best method of valuation. Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir. 1971), affg. 52 T.C. 601 (1969). In petitioner's case, we have found that the valuation of decedent's interest in his wife's residuary trust under Table A is not unreasonable. Moreover, respondent has failed to present any persuasive reason for ignoring the valuation result achieved under Table A. Accordingly, we reject respondent's argument that petitioner's Table A valuation is invalid because the residuary trust was incapable of sustaining the annuity payments in the event decedent lived to be 109 years old. We have evaluated respondent's other arguments and find them similarly unpersuasive.

We have found that petitioner properly characterized decedent's interest in his wife's residuary trust as a lifetime annuity under both New York law and section 20.2031-7, Estate Tax Regs. We have also found that the value of the residuary trust on the date of Mrs. Shapiro's death exceeded the present

> value of decedent's annuity as computed under Table A and that the trust was therefore sufficient to sustain the annuity obligation for decedent's life.

The IRS, essentially, argued the position adopted in Revenue Ruling 77-454. The court soundly rejected the argument, or did it? By noting that the Tables apply always unless <u>unreasonable</u>, the Tax Court left open future challenges of this type. Of course, the annuity in question was sufficiently large to provide comfort for a great many GRATs, but not all.

H. Sections 2031 and 2513 -- Valuation

Valuation continues to be a most important issue in estate planning. In large part the benefit of family limited partnerships turn out to be, primarily, a help in valuation.

1. Control Stock.

In Estate of Charles Russell Bennett, 65 TCM 1816, the decedent owned all of the outstanding stock of a real estate development company. The estate valued the stock using a lack of marketability discount, but the IRS claimed that such a discount should never be allowed in a 100 percent ownership case. The IRS relied on Estate of Jephson v. Comm'r, 87 T.C. 297 (1986), where a discount was not allowed when valuing the stock of two investment companies consisting of cash and marketable securities.

The court allowed a 15 percent discount:

> Our holding that a lack of marketability discount is warranted is based on a totality of the facts presented. Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liability of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties. Thus, the line of cases in which we have recognized that difficulties arise in holding nonliquid assets in the corporate form, even in the 100-percent ownership situation, is applicable in this case.

The court did not allow, however, a discount for costs associated with the liquidation of the company's real estate. The court noted that:

> [b]oth parties have agreed that there was no reasonable prospect of liquidation in this case. When liquidation is only speculative, the valuation of assets should not take these costs into account because it is unlikely they will ever be incurred. . . . Our goal of determining the price a willing seller could get from a willing buyer is not assisted by considering what a buyer might eventually realize from the sale of all of the corporation's assets.

The court's holding on this issue is in line with the IRS position in TAM 9150001.

TAM 9419001 disregarded the value stipulated in the company's Articles of Incorporation for certain preferred shares upon liquidation and redemption, without reference to Chapter 14 (the restrictions occurred in 1984; the death in July, 1990), because the preferred shares represented 99.86% of voting control. With voting control, the company did not need to be liquidated nor the shares redeemed in order for the owner to benefit.

2. Discounts and Penalties.

In Estate of Jung, the issue was the valuation of a 20 percent interest in a closely-held company, Jung Corp., for estate tax purposes on the decedent's death in 1984. In 1986 the company sold most of its assets to another corporation for over $59,000,000, and sold other assets worth almost $7,000,000. Thus, the decedent's estate received more than $13,000,000 ($66,000,000 x 20%). These sales were not foreseeable at the decedent death.

The court determined that when the decedent died Jung Corp. was worth between $32,000,000 and $34,000,000 meaning that the decedent's shares were worth $6,400,000 to $6,800,000 before discounts. The court allowed a 35 percent discount for lack of marketability; no discount was allowed for a minority interest, because the court accepted an appraisal which used the discounted cash flow method.

The court discussed use of the discounted cash flow ("DCF") method, as discussed in a previously decided case:

> Petitioner contends that in Northern Trust Co., Transferee v. Commissioner, 87 T.C. 349, (1986), affd. sub nom. Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249 (7th Cir. 1988), this Court approved the use of a minority discount when the DCF approach is used in valuation. Respondent tells us that the instant case provides us "with an opportunity to reconsider issues" in Northern Trust Co., Transferee.
>
> In Northern Trust Co., Transferee, stock of a closely held corporation was valued. Grabowski [the appraiser] submitted an expert witness report and testified in that case. Grabowski used the DCF approach, and he used the CAPM [capital asset pricing model] to determine the discount rate. After deciding on a value for the corporation, he applied a minority discount. 87 T.C. at 369. This court concluded that the DCF approach correctly determined the value of the stock. We also allowed both minority and marketability discounts. Id. However, in Northern Trust co., Transferee, respondent did not content that no minority discount was

> appropriate. Rather, respondent merely argued for a lower minority discount that the discount for which the taxpayer contended. Id. Because the parties in Northern Trust Co., Transferee did not present to the Court the question of whether a minority discount could be allowed in conjunction with the DCF approach, the opinion in that case did not explore whether the DCF approach that Grabowski used in the case was calculated on a control basis rather than on a minority basis. See Estate of Fusz v. Commissioner, 46 T.C. 214, 215 n.2 (1966).
>
> Thus, we do not accept respondent's invitation to reconsider our opinion in Northern Trust Co., Transferee v. Commissioner, supra, and we also conclude that that opinion does not require us to allow a minority discount in the instant case.

In general, if the discounted cash flow method is used based on factors derived from publicly traded companies, as will usually be the case, the method values a business as a minority interest, with no further discount for a minority interest being appropriate.

The court also held that the IRS abused its discretion by not waiving the addition to tax under section 6660 (old)(now section 6662). That section provided for a waiver upon a showing that (1) there was a reasonable basis for the valuation and (2) the taxpayer acted in good faith in claiming that valuation. Here, in large part, the estate was saved because the IRS asserted a value which was substantially higher than the court's finding, and the estate did have an appraisal. The court noted:

> Also, it is evident that valuing decedent's interest is a difficult task. After all, in the notice of deficiency respondent overvalued

> decedent's interest by about 89 percent. Even on brief, after having access to all the expert witness reports and other evidence of record (more than 3-1/2 linear feet of exhibits and almost 1,000 pages of transcript), respondent overvalued decedent's interest by about 82 percent. Thus, petitioner's valuation was much closer to the mark than was respondent's valuation.

Of importance also is the court's discussion of Estate of Berg, in which penalties were approved by the Tax Court, but not by the Eighth Circuit:

> In Estate of Berg v. Commissioner, T.C. Memo 1991-279, affd. in part and revd. in part 976 F.2d 1163 (8th Cir. 1992), we held that respondent's discretion had not been abused in refusing to waive the section 6660 addition to tax. The Court of Appeals reversed on that issue. The record in the instant case is far more favorable to petitioner than the record presented by the taxpayer in Estate of Berg.
>
> In Estate of Berg, the taxpayer did not commission an appraisal until more than 4 years after the decedent's death; in the instant case petitioner did commission an appraisal promptly, and the value of the timely field estate tax return was based on that appraisal. In Estate of Berg, the estate tax return did not provide support for the claimed valuation, except for a reference to another opinion of this Court; in the instant case, Robinson's appraisal was deficient in terms of evidentiary standards, but provided some substantive support for the claimed valuation. In Estate of Berg, we agreed with respondent's determination of value; in the instant case, respondent overvalued the property by more than twice as much as petitioner undervalued it. Thus, our conclusion in the instant case that respondent's discretion was abused is consistent with out conclusion in Estate of

Berg that respondent's discretion was not abused.

3. **Valuation of Interests in Jointly-Held Property.**

In TAM 9336002, the IRS ruled that the amount of the discount should be limited to the estimated cost of a partition of the property, which seems inconsistent with the results in the recently decided cases. The IRS stated:

> From the perspective of the owner of an undivided interest in property, a lack of unity of ownership is a possible disadvantage if the owner wishes to sell the interest. If the seller's co-owners decline to join in a sale of the whole property, the seller of an undivided interest may be forced either to accept a reduced price for his interest or to seek a partition. On the other hand, if all the co-owners were to join in the sale, the rationale for a discount would disappear because the owners' unity for disposition purposes would permit them to convey a 100 percent interest in the property. In such a case, the purchaser would acquire the property free of the disadvantages associated with ownership of undivided interests, and there would be no reason for him to demand, or for the sellers to accept, a discount from the property's full fair market value.
>
> The definition of fair market value contemplates that the hypothetical buyer and seller will choose to act in their own best economic interests. The courts recognize that partitioning is an alternative that results in greater economic benefit to the owner of an undivided interest. In Estate of Frank Fittl v. Commissioner, TC Memo 1986-542 [CCH Dec. 43,488(M)], the court held that the discount attributable to an undivided interest in real property should be limited to the cost of partition. See also, Kennedy v. Commissioner, 804 F.2d 1332 (7th Cir. 1986)[86-2 USTC ¶13,699].

The Fittl case involved the valuation of farmland. There the taxpayer's expert failed to take such a discount, so the court did not either. The Kennedy case is primarily concerned with a disclaimer.

In Samuel J. LeFrak, 66 TCM 1297, a father gave interests in various buildings to his children, or to trusts for their benefit. The interest transferred to each child or trust was less than 10 percent. After discussing the appraisal experts, the court discussed the applicable discounts:

> Discounts for Minority Interest and Lack of Marketability
>
> For gift tax purposes, the value of the fractional interest in the property transferred, and not the value of the property as a whole, must ultimately be decided. Propstra v. United States [82-2 USTC ¶ 13,475], 680 F.2d 1248, 1251 (9th Cir. 1982); Bank of the West v. Commissioner [Dec. 46,073], 93 T.C. 462, 468 (1989); Zable v. Commissioner [Dec. 46,360(M)], T.C. Memo. 1990-55; Filler v. Commissioner, [Dec. 44,201(M), T.C. Memo, 1987-468, affd. sub nom. Robino, Inc. Pension Trust v. Commissioner [90-1 USTC ¶ 50,059], 894 F.2d 342 (9th Cir. 1990). The fair market value of a fractional interest in real property cannot as a general rule be derived by simply applying the percentage of the interest in the whole to the value of the entire property. See Propstra v. United States, supra; Estate of Campanari v. Commissioner [Dec. 14,685, 5 T.C. 488, 492 (1945); Estate of Henry V. Commissioner [Dec. 14,259], 4 T.C. 423, 447 (1944), affd. [47-1 USTC ¶ 10,558] 161 F.2d 574 (3d Cir. 1947);

Estate of Haydel v. Commissioner [Dec. 47,678(M), T.C. Memo. 1919-507, affd. without published opinion 988 F.2d 1213 (5th Cir. 1993). Accordingly, we must consider whether the proportional net value of the interests in the buildings should be further adjusted to arrive at the taxable value of the gifts. Whether a discount should be allowed in arriving at the final value of the gift is a question of fact. Estate of Newhouse v. Commissioner [Dec. 46,411], 94 T.C. at 249.

Petitioners ask that the value of the gifts be discounted because the donees received minority interests in the buildings and because the interests transferred were not readily marketable. Petitioners offered the expert report of Mr. Gregory Vlasak to support their contention concerning the appropriate amount of discount. Respondent contends that no discount is warranted, and, in the alternative, disputes the amount of discount calculated by petitioners' expert.

Petitioners point out that each discount sought is conceptually distinct and is designed to measure a different factor reducing the value. Estate of Andrews v. Commissioner [Dec. 39,523], 79 T.C. 938, 952-953 (1982). A minority discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownership. Estate of Campanari v. Commissioner, supra at 492-493. However, a holder of a fractional interest in real property has the power to compel partition of property, which is not available with other types of shares ownership interests. Bittker & Lokken, Federal Income Taxation of Estates, Gifts, & Trusts, par. 135.3.4, at 135-41 (2d ed. 1993). Accordingly, Bittker and Lokken have suggested that the discount should reflect the cost of partition and the value of the interest secured thereby. Id. We have on several occasions considered the cost, uncertainty, and delays attendant upon partition proceedings as the basis for allowing a discount in value fractional interests in real property. Estate of Pillsbury v. Commissioner [Dec. 48,378(M)], T.C. Memo. 1992-425; Estate of Wildman v. Commissioner, [Dec. 46,218(M)] T.C. Memo 1989-667; Estate of Youle V. Commissioner, [Dec. 45,579(M)], T.C. Memo. 1989-138; Sels V. Commissioner, T.C. Memo 1986-501; see also Estate of Henry V. Commissioner, supra at 477. The marketability discount, by contrast, measures the diminution in value attributable to the lack of a ready market for the property. Ward v. Commissioner, [Dec. 43, 178], 87 T.C. 78, 106-107 (1986). Accordingly, we will consider each discount separately.

* * *

Mr. Vlasak estimated that a 40-percent discount for minority interest should be allowed in valuing the donated interests. Respondent criticizes Mr. Vlasak's analysis, and contends that no more than 15 percent should be allowed, if any. Respondent points out that, on their gift tax return, petitioners claimed only a 15-percent discount in valuing the gift for tax purposes, and that this Court in other cases generally has not allowed discounts of greater magnitude in valuing donative transfers of real estate interests. Estate of Campanari v. Commissioner [Dec. 14,685], 5 T.C. 488, 492 (1945); Estate of Wildman v. Commissioner [Dec. 46, 218(M)], T.C. Memo 1989-667.

Petitioners counter that this Court has allowed minority interest discounts of the magnitude advanced by Mr. Vlasak, citing Harwood v. Commissioner [Dec. 40,985], 82 T.C. 239, 269 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986), in which a 50-percent discount was allowed. We do not agree. The discount allowed in Harwood represents a combined reduction for both lack of marketability and minority interest and so does not furnish a basis for comparison solely as to minority interest. Id. at 268. Petitioners also cite Estate of Watts v.

> Commissioner, [Dec. 42,521(M)], T.C. Memo. 1985-595, affd. [87-2 USTC ¶ 13,726] 823 F.2d 483 (11th Cir. 1987), in which a 35-percent discount was allowed, but such discount also represents a combined figure for lack of marketability and minority interest. Accordingly, such cases seem to suggest that the discount urged by petitioners is excessive, but, as the question is one of fact, we must remind the parties that the amount of discount must be decided on the basis of the record in the instant case, and not on what a court found reasonable in another case involving different evidence.

The court allowed a 20 percent minority interest discount and a 10 percent lack of marketability discount. The result is contrary to TAM 9336002. Also of importance is the court's implication that greater discounts would have been allowed had the real estate interests been subsumed within a partnership and the partnership interests transferred, assuming the holders of those interests could not liquidate the partnership. That point could be different under section 2704.

What is the value of jointly-held property included in a decedent's estate under section 2040? Only half the property is included. Does section 2040 mean that with two joint tenants one-half of the entire value is included, or does section 2040 provide only for inclusion, with valuation being determined separately, and at a discounted value?

4. Use of Actuarial Tables.

Estate of Gordon B. McLendon, 66 TCM 946, involved the application of Revenue Ruling 80-80, 1980-1 C.B. 194, relating to the use of the actuarial tables to value partial interests in property that depend upon the life expectancy of an individual who does not have a normal expectancy.

The Tax Court held that the decedent's actual life expectancy was sufficiently predictable as of March 5, 1986, the date of the private annuity, to require departure from the actuarial tables in computing the value of the remainder interest. Thus, the transaction resulted in a large taxable gift. The facts in McClendon were very disadvantageous to the taxpayer and are worth reading to review circumstances in which a private annuity should not be attempted. The court described him as "an increasingly sick man suffering from a virtually incurable disease" and found his life expectancy to be one year. The court's statement of the law is of interest:

> Use of Actuarial Tables
>
> The common theme of these cases is that the actuarial tables generally are to be respected unless the established facts show that the result under the tables is unrealistic or unreasonable. Consistent with the Estate of Jennings [10 T.C. 323 (1948)] line of cases, the proper inquiry in this case is whether the life tenant's actual life expectancy is so exceptional that a departure from the actuarial tables is justified. While the term "exceptional" is difficult to define, Estate of Jennings and its progeny require proof that death is either imminent or predictable to a reasonable certainty within 1 year of the valuation date.

In private annuity cases it matters whether the transaction is ultimately characterized as a gift, or as a transfer with a retained interest. Often the second argument -- that the assets should be included in the estate because the annuity was essentially the income of the property -- is a "throwaway" for the IRS. But, if the case is settled, settlement on that basis produces an increase in basis.

5. New IRS Valuation Handbook.

On January 28, 1994 the IRS issued a new Valuation Guide for use in training appeals officers. The Table of Contents is attached as Appendix B. The text is worth review because (a) it is a good discussion of important valuation principles and techniques, (b) it contains good, albeit selective, references to other sources (e.g., SEC studies), (c) the cases cited are not representative, and thus provide insight into particular IRS bias, and (d) the examining agent, and appeals officer, will have read it.

In general, the text supports settlement rather than litigation.

6. Flower Bonds.

Weld v. U.S., ________________ (U.S. Ct. Fed. Cl. 1994) involved the valuation of flower bonds. The court held that the value is par plus accrued interest as of the decedent's date of death. The court rejected, as creative but wrong, the taxpayer's argument:

[p]laintiffs argue that a discount analysis is necessary to determine the value of flower bonds on the date of death because the estate will not receive the full value of the bonds until nine months after the date of death. Under such a discount analysis, each monetary benefit that the estate will receive during these nine months must be discounted from the date of its receipt back to the date of death, using as the discount rate the pertinent Treasury bill interest rates in effect on the date of death. When this methodology is applied to the instant facts, on the respective dates of death the Bright and Weld flower fonds have a value that is less than par value plus accrued interest because the discount rate employed on the dates of death (i.e., the applicable Treasury bill interest rate) was significantly higher than the rate at which the flower bonds accrued interest during the nine-month period.

* * *

In sum, the tax laws, in effect, left plaintiffs with a choice. They could redeem the bonds in the payment of estate taxes for par value plus accrued interest on the dates of death or they could take advantage of the grace period and wait up to nine months and redeem the bonds for par value plus a slightly higher accrued interest. Plaintiffs selected the economically optimal choice and waited the full nine months before redeeming the flower bonds and thereby secured the extra interest. But when valuing all assets for estate tax purposes, the regulations focus on the fair market value on date of death, not on the amount of income that a bond owner potentially could receive during the nine months after death. Herein, on the respective dates of death, the government stood willing to redeem the bonds for par value plus accrued interest in the payment of estate taxes. That was the highest value plaintiffs could secure on those dates. It would be inconsistent with the controlling standards to ignore the existence of such a willing buyer and to designate the

> fair market value on the date of death at an amount that is less than the amount that a willing buyer was prepared to pay. Thus, while the premise that plaintiffs would be unwilling to turn the bonds over to the government on the dates of death in the payment of taxes owed is an appropriate premise for predicting the timing of plaintiffs' actions, it is not determinative when assessing the fair market value of the bonds on the dates of death.

7. Underwriting Fees.

Gillespie v. U.S., ________________ (2d Cir. 1994) dealt with the valuation of a large block of publicly held stock. The estate involved was that of Eugene Meyer of the Washington Post. Because a large block of stock was in the estate, most of the shares were valued, and in fact sold, in an underwritten secondary offering. The court stated these facts:

> The proceeds received by the Estate from its underwriter, Salomon Brothers, Inc. ("Salomon"), totaled $14,365,000, or $34 per share. In connection with this offering the Estate incurred expenses of $213,142, which included, *inter alia*, accounting fees, legal fees, printing fees, and registration fees, but did not include underwriting fees. Plaintiffs and Salomon agreed that, as an underwriting fee for the transaction, Salomon would be allowed to retain possession of the proceeds of the sale of the 422,500 shares until the 90th day following the sale and would make no payment to the Estate for the use of those funds during the 90-day period.
>
> In seeking to place a value on the Estate's original 743,500 WPC shares for tax purposes, plaintiffs sought the opinion of Salomon as to the price, expense, and yield that could have been realized in a second offering immediately after Meyer's death (the "hypothetical

> offering"). In an opinion dated November 22, 1982, Salomon concluded that the hypothetical offering would have yielded $25.3725 per share to the Estate.

In its valuation, Salomon deducted presumed underwriting fees.

The primary issue before the Second Circuit was the deductibility of the "estimated" underwriting fee, given that no actual underwriting fee was paid, and the fees. The court found the relevant authority to be Revenue Ruling 83-30:

> Although there is no dispositive Treasury regulation, in 1983 the IRS issued a pertinent revenue ruling. In Revenue Ruling 83-30 (the "1983 Ruling"), the IRS ruled that, in determining the value of a block of stock too large to be sold on the open market without depressing the price, "the relevant figure is the price that the public would pay to the underwriter for the stock, and not the price that the underwriter would pay to the estate. Accordingly, underwriting fees should not be considered in determining the blockage discount." Rev. Rul. 83-30, 1983-1 C.B. 224, 225 (1983). The 1983 Ruling went on to hold that "[u]nderwriting fees, necessarily incurred in marketing a large block of stock are deductible as an administration expense under section 2053(a)(2) of the Code, and are not considered in determining the blockage discount to be accorded in valuing the stock under section 2013." Rev. Rul. 83-30, 1983-1 C.B. at 225.

The court's conclusion was that:

> . . . Revenue Ruling 83-30, which held that underwriting fees incurred in a secondary offering of a large block of stock should be excluded from the calculation of the fair market value of the stock for the purposes of computing the value of the gross estate, is neither unreasonable nor contrary to any statutory or regulatory provision.

> The district court found, and no one disputes, that buyers would have been willing and able to pay for the Estate's WPC shares $27.125 per share, that is, the market price less the blockage discount. The court properly declined to allow a further deduction for hypothetical underwriting fees and other sale-related expenses in arriving at the fair market value of the stock.

8. Lack of Marketability -- S Corporation; Preferred Shares.

A unique ranch, the largest single tract of land in Arizona, was valued by the Tax Court in Estate of Star Simpson, 67 TCM 1994-207. The ranch was owned by an S corporation. The issue arose in the context of a gift. The court allowed a 30% discount for lack of marketability (there was no true minority interest -- the family acted in concert at the father's direction).

On another issue, the court valued preferred shares (in a different company) which lacked any "equity kicker" such as a convertibility feature, by using the dividend rate and calculating a price for the shares which would make the dividend a market rate.

A 10% discount for lack of marketability was allowed, but not a minority interest discount because the dividend rate had been derived from publicly traded comparables which already included a discount.

9. Valuation of Art; Risks of Litigation.

Estate of Robert C. Scull, 67 TCM 1994-211, provides an overview of art valuation in a complex case. Some works of art were sold at auction, others were so offered but not sold, and others were merely appraised. In general, the court used the auction prices (without reduction for commissions paid) for those auctioned, and the appraised values for the others. Litigation was involved, having to do with a property settlement, which resulted in the decedent receiving a 65% interest in the collection; the court allowed, reluctantly, a 5% discount for risks of litigation.

10. Residential Valuation.

The Tax Court opinion in Estate of Calista B. Dowlin, TCM 1994-183, may be reviewed for a discussion of expert opinion in residential valuation. The opinion does not deal with valuing one-half of a residence owned by a husband whose wife owns the other half. That issue is of importance when creating personal residence trusts.

11. General Discounts.

Estate of Ray A. Ford, TCM 1993-580, involved the valuation of three real estate holding companies, one equipment holding company, and one operating company. The court allowed a 10% lack of marketability discount for each corporation, and a 20% minority discount for those in which the decedent was a minority shareholder. The net asset method was used to value the holding companies.

I. <u>Section 2032A -- Special Use Valuation</u>

1. Fixed Cash Rental.

Children of a decedent whose farm was valued under section 2032A must continue to farm (i.e., use in a qualified use) the property for 10 years after the decedent's death. In general, when the children enter into a fixed cash rental arrangement with another party who assumes the "financial risks of farming," they cease to be in the farming business and became landlords. This triggers recapture of the estate tax savings. In <u>Minter v. U.S.</u>, ________________ (8th Cir. 1994), the decedent's children entered into a fixed cash rental to a family farming corporation owned, after parent's death, by (directly or indirectly) the children. The court held:

> When we apply the test of substantial dependence on production to the undisputed facts in this case, we conclude the trustee's leases of the farmland to the family's farming corporation continued the use that qualified Mrs. Fisher's estate for preferential treatment when the estate tax return was filed. As the owners of the farmland and the family farming corporation, the sisters and their brother necessarily retained the financial risks of farming when their farmland was farmed by their corporation. The sisters' rent income, like their mother's rent income before them, depended on the farmland's productivity and the variable risks of weather, disease, and fluctuating prices. Unlike landowners entering into leases with another farmer who takes on the risks and agrees to pay fixed rent whether the farming operation is profitable or not, the sisters assumed substantially the same risks under the trustee's leases as they would have incurred

> by farming the land themselves. If the corporation's farming operation flourished, the sisters received their rent income; otherwise not. Indeed, the undisputed facts refute the Government's argument that the leases insulated the sisters from the risks of farming. During the period covered by the trustee's leases, the sisters each lost over $25,000 from the corporation's farming activities.

2. **General Points.**

PLR 9407015 breaks no new ground, but does illustrate two points.

First, section 2032A, when properly elected, determines the value, for estate tax purposes, of the property for which the election is made. Rev. Rul. 83-81, 1983-1 C.B. 230. Thus, the section 2032A value is used in making the allocations required by a marital deduction formula clause.

When the drafter anticipates use of section 2032A, the formula clause should use a pecuniary marital with a credit shelter residual disposition. Assume a decedent who owns a $1,000,000 farm, but which has a value for section 2032A purposes of $400,000. The decedent has $150,000 of other assets. If a pecuniary credit shelter is used, requiring distribution based on date of distribution values, not all of the farm will be "needed" and thus some will pass to the marital share. But, if a pecuniary marital is used, the entire farm, and other assets, will pass to the residue because no pecuniary amount need be set aside.

Second, where a decedent creates a life estate for the family with remainder to charity, section 2032A cannot be used because the charity is not a qualified heir under Section 2032A(e)(1). Rev. Rul. 81-220, 1981-2 C.B. 175.

J. Section 2033 - Gross Estate

1. Corporate Stock.

The taxpayer decedent lost in Estate of Ruth E. DuBois, 67 TCM 1994-210: The facts confronted by the Tax Court involved ownership of a certain corporation:

> Bell Estates (Corporation) is a California corporation, formed on January 7, 1957. the three incorporators were Edwin W. Lehmer, Jane Wood, and William D. Markee who were also named as the initial directors.
>
> On January 8, 1957, decedent transferred property which she valued at $338,670 to the Corporation. In the estate tax return, the Corporation was valued, based upon 1,000 "fictional shares," at $2,658.10 per share, a value which respondent has not disputed. The Corporation never issued any shares of stock. The record does not disclose any minutes in respect of the issuance of stock or the election of directors and/or officers.
>
> Decedent's last will and testament provided that her property be divided equally between her two sons, Edwin W. Lehmer and George H. Lehmer.
>
> The Corporation's tax return for its fiscal year ending August 31, 1964, was signed by decedent as secretary.
>
> The Corporation's tax return for its fiscal year ending August 31, 1965, was signed by Edwin W. Lehmer, as president.
>
> On the Corporation's tax returns for the fiscal years ending on August 31, 1969, 1973, 1979, and 1983 through 1988, the question whether any corporation, individual, partnership, trust, estate or association owned 50 percent or more of its voting stock was answered, "No."

> On the Corporation's tax returns for the years ending on August 31, 1979, and 1983 through 1987, the decedent and her two sons were reported as officers of the Corporation, each owning 33.33 percent of its stock.
>
> All returns other than those for the years ending August 31, 1964 and 1965, were signed by a tax return preparer, but the name or signature of the signing officer of the Corporation does not appear on the stipulated copies of the returns. Those returns contain no further relevant information.

The issue was whether the decedent owned only one-third of the company, or all of it. The court rejected the estate's argument that it should be one-third only:

> Petitioner relies heavily on the statement of ownership of the Corporation on several of the Corporation's tax returns. However, tax returns do not establish facts. Roberts v. Commissioner [Dec. 32, 789], 62 TC. 834, 837 (1974). Nor does the fact that decedent's will divided her property between her two sons constitute persuasive evidence that she gifted them an interest in the Corporation prior to her death. A will speaks only as of the date of death and, in any event, the provisions equally dividing the "property" does not answer the question of what property was being divided. Beyond the foregoing, we think it significant that decedent never filed any gift tax return covering the claimed gifts to her two sons. With respect to the financial activities reflected on the Corporation's tax returns and the actions of Edwin W. Lehmer, as president of the Corporation, neither of these elements provides any persuasive evidence as to the ownership of the Corporation.
>
> The record herein is totally devoid of any other actions on the part of decedent, such as the issuance and transfer of certificates of shares of stock or transfers of stock on the books and records of the corporation, actions

> which standing alone might not have been sufficient but in the totality of the picture herein might have buttressed petitioner's position.

The clear point is the importance of proper, and consistent, records.

2. Plan Benefits.

The issue in Stack, Admin v. U.S., 94-1 USTC _________, decided by the Eighth Circuit earlier this year was the construction of the following retirement plan beneficiary designation:

> In the event of my death, I [J. Fred McCarthy] hereby designate Milan E. McCarthy (address inserted), son, Mrs. Mary Francis Quinn (address inserted), daughter, or their issue per stirpes as the beneficiary or beneficiaries of whatever benefits are due me from the trust funds at the time of my death, and in the event the aforementioned beneficiary or beneficiaries shall predecease me, I hereby designate to my estate as a contingent beneficiary or beneficiaries.

Fred McCarthy died in 1981; Mrs. Quinn died in 1982. The plan proceeds were being distributed in 10 equal annual installments. Mrs. Quinn's estate contended, essentially, that the beneficiary designation created a life estate and that the unpaid balance of Mrs. Quinn's portion should not be included in her estate. Applying Minnesota law, the court disagreed and held the language was unambiguous.

K. Sections 2035-2038 -- Retained Interests

1. Revenue Ruling 79-353 and the Power to Replace Trustee.

In Estate of Wall v. Comm'r, 101 T.C. 21, the Tax Court rejected the holding of Revenue Ruling 79-353, 1979-2 C.B. 325. That ruling had held that the grantor's unrestricted power to replace a corporate trustee causes the powers of that trustee to be attributed to the grantor for estate tax purposes.

The court summarized the IRS position as follows:

> The underlying assumption of Rev. Rul. 79-353 and respondent's argument is that even a corporate trustee will be compelled to follow the bidding of a settlor who has the power to remove the trustee; otherwise the settlor will be able to find another corporate trustee which will act as the settlor wishes. In other words, says respondent, under these circumstances the settlor has the de facto power to exercise the powers vested in the trustee. But the Supreme Court has said in Byrum, [1972)] that the section 2036(a)(2) right connotes an ascertainable and legally enforceable power, as exemplified by the facts in United States v. O'Malley, 383 U.S. 627 (1966). As the Supreme Court states in Byrum, "O'Malley was covered precisely by the statute [section 2036(a)(2)] for two reasons: (1) there the settlor had reserved a legal right, set forth in the instrument; and (2) this right expressly authorized the settlor, 'in conjunction' with others, to accumulate income and thereby 'to designate' the persons to enjoy it." United States v. Byrum, 408 U.S. at 136.
>
> * * *
>
> In irrevocable trusts such as those under scrutiny, the trustee is accountable only to the beneficiaries, not to the settlor, and any right of action for breach of fiduciary duty

> lies in the beneficiaries, not in the settlor. Bogert, supra, sec. 42, at 431-433. It also seems incontrovertible that the trustee's duty of sole fidelity to the beneficiary remains the same regardless of whether or not distributions are discretionary and whether or not limited by a standard such as one related to health, education, support in reasonable comfort, and the like.
>
> In the absence of some compelling reason to do so, which respondent has not shown, we are not inclined to infer any kind of fraudulent side agreement between Mrs. Wall and First Wisconsin as to how the administration of these trusts would be manipulated by Mrs. Wall. Instead, since the language of the trust indentures provides maximum flexibility as to distributions of income and principal, the trustee would be expected to look to the circumstances of the beneficiaries to whom sole allegiance is owed, and not to Mrs. Wall, in order to determine the timing and amount of discretionary distributions.

The IRS is very unhappy with this result. The now widely-publicized "IRS Wish List," see Section W, contains a proposal that a new Code section be created to compel the Revenue Ruling 79-353 position. The case is also significant for purposes of section 2041.

2. Limited Partnerships.

PLR 9415007 confirms that limited partnership interests may be effectively given away with the transferor continuing to exercise control as general partner. The facts and rulings requested were these:

> The Transferor and his wife created the limited partnership (Partnership) in 1993. The Transferor initially contributed cash to

the Partnership in exchange for a 9.259 percent general partnership interest and a 90.278 percent limited partnership interest. The Transferor's wife initially contributed cash in exchange for a 0.463 percent limited partnership interest. Subsequently, the trustees of certain trusts for the benefit of the Transferor's family and a custodian under a uniform gifts to minors act account invested additional funds in the Partnership in exchange for limited partnership interests.

The Transferor as general partner has exclusive management control of the Partnership, including full discretion to determine the amount and timing the distributions to the partners; provided, however, that if the general partner directs the distribution of partnership funds to the partners, distributions must be made to all partners at the same time in accordance with each partner's percentage interest in the Partnership (based on each partner's capital account).

Under the terms of the partnership agreement and applicable state law, the Transferor as general partner has a fiduciary duty to the limited partners to manage and operate the Partnership in the best interests of the Partnership and its partners. In exercising the powers granted in the partnership agreement, the general partner is bound to act in accordance with this fiduciary duty.

The partnership agreement provides that all items of income and deductions are to be allocated in accordance with the principles of §704(b) and the regulations thereunder.

During the term of the Partnership, no partner is entitled to demand a distribution or a return of his capital account. however, the partners have the right to sell their interests to third parties, subject to the right of first refusal granted to the other partners.

> When the partnership is dissolved, its assets will be distributed to the partners on a pro rata basis in accordance with their respective partnership interests.
>
> The transferor proposes to make gifts of limited partnership interests. If the transferor desires to have a particular gift qualify for the $10,000 annual exclusion under §2053(b), he will make the transfer either outright or to a trustee of a trust that meets the requirements of §2503(c).
>
> You request that we rule as follows:
>
> 1. The Transferor's proposed transfers (outright or to trusts qualifying under § 2503(c)) of limited partnership interests will constitute gifts of present interests for purposes of §2053(b).
>
> 2. The value of the limited partnership interests gratuitously transferred will not be subject to the special valuation rules under §2701.
>
> 3. Upon the death of the Transferor, the value of the transferred partnership interests will not be includible in the Transferor's gross estate under §§ 2036 and 2038 as a result of the Transferor's retained powers as general partner.

All of the requested rulings were given.

3. Gifts Within Three Years of Death.

The U.S. District Court for the Eastern District of Michigan rendered an incredible opinion in Estate of Collins v. U.S., 94-1 USTC ____. After first finding that the decedent's attorney in fact was not authorized to make gifts under Michigan law, because the power of attorney did not specifically authorize such, the court considered whether gifts made from a revocable trust within three years of death should be included in the decedent's estate under section 2035. The IRS position is that such gifts will be if the grantor is not the sole beneficiary of the trust, based on the Jalkut decision, discussed as follows:

> The seminal case on this issue is Estate of Jalkut v. Commissioner, 96 T.C. 675 (1991), acq., 1991-2 C.B. 1. Pursuant to Jalkut, inclusion in the gross estate under §2038 is dependent on the terms of the trust instrument. If the decedent-settlor is the sole beneficiary of the trust, then transfers to donees are viewed as withdrawal of trust funds by the grantor and then direct gifts from the grantor to the donees. If the donees are potential beneficiaries of the trust, transfers to them are seen as direct transfers to them from the trust. In the first instance, the transferred amounts are not included in the gross estate under §2038, while in the latter instance they are. Jalkut, 96 T.C. at 685-686.

The trust provision was as follows:

> Section 3. During Grantor's lifetime, the Trust shall be administered for the sole and exclusive benefit of Grantor pursuant to the following terms hereof, to wit:
>
> (a) Trustee shall distribute all net income of the Trust Estate *either to or for the benefit of Grantor* at least quarter annually, or at such other or more frequent intervals as maybe convenient; (emphasis added).

The court concluded that because distributions of income could be made for the grantor's benefit the "plain meaning" of the provision is that others were proper beneficiaries. In general, the court's interpretation would seem to be wrong.

L. Sections 2041 and 2514 -- General Power of Appointment

1. Ascertainable Standards.

The Tenth Circuit has reversed the Tax Court in Estate of Vissering v. Comm'r, 96 T.C. 749 (1991). The income beneficiary was a co-trustee and would receive principal "as may, in the discretion of the Trustees, be required for the continued comfort, support, maintenance, or education of said beneficiary."

The Tenth Circuit, construing Florida law, stated that "comfort" standing alone may create a general power of appointment, but did not in this instance:

> However, there is modifying language in the trust before us that we believe would lead the Florida courts to hold that "comfort," in context, does not permit an unlimited power of invasion. The instant language states that invasion of principal is permitted to the extent "required for the continued comfort" of the decedent, and is part of a clause referencing the support, maintenance and education of the beneficiary. Invasion of the corpus is not permitted to the extent "determined" or "desired" for the beneficiary's comfort but only to the extent that it is "required." Furthermore, the invasion must be for the beneficiary's "continued" comfort, implying, we believe, more than the minimum necessary for survival, but nevertheless reasonably necessary to maintain the beneficiary in his accustomed manner of living. These words in context state a standard essentially no different from the examples in the Treasury Regulation, in which phrases such as "support in reasonable comfort," maintenance in health and reasonable comfort" and "support in his accustomed manner of living" are deemed to be limited by an ascertainable standard. Treas. Reg. §20.2041-1(c)(2). See, e.g., United States v. Powell,

> 307 F.2d 821, 828 (10th Cir. 1962)(under Kansas law, invasion of the corpus if "it is necessary or advisable . . . for the maintenance, welfare, comfort or happiness" of beneficiaries, and only if the need justifies the reduction in principal, is subject to ascertainable standard); <u>Hunter v. United States</u>, 597 F.Supp. 1293, 1295 (W.D. Pa. 1984) (power to invade for "comfortable support and maintenance" of beneficiaries is subject to ascertainable standard).
>
> We believe that had decedent, during his life, sought to use the assets of the trust to increase significantly his standard of living beyond that which he had previously enjoyed, his co-trustee would have been obligated to refuse to consent, and the remainder beneficiaries of the trust could have successfully petitioned the court to disallow such expenditures as inconsistent with the intent of the trust instrument. The Tax court erred in ruling that this power was a general power of appointment includible in decedent's estate.

The opinion renders unnecessary, in part, the new Florida statute on point.

2. Life Estate.

In <u>Estate of Jane H. Duvall</u>, 66 TCM 164, the Tax Court addressed the issue of whether, under Kentucky law, a life tenant has a general power of appointment. The Will creating the life estate had been construed by the federal district court for the Eastern District of Kentucky in 1965, as not creating a general power (thus denying a marital deduction). The IRS argument was described by the court as follows:

> Respondent does not dispute the general rationale and appeal of the intervenors'

argument. Respondent, however, argues: (1) That in 1974 a decision was rendered by the Kentucky Court of Appeals in Melton v. Wyatt, 517 S.W. 2d 242 (Ky. 1974), that effectively overruled the District Court's holding in Duvall v. United States, supra; (2) that Melton v. Wyatt, supra, would be applied by Kentucky courts retroactively; (3) that therefore Duvall v. United States, supra, must now be regarded by us as wrongly decided and that we should ignore or refuse to follow Duvall v. United States, supra, in interpreting the language of Mr. Duvall's will and in reaching our conclusion as to the nature of decedent's life estate in the remainder of Mr. Duvall's property; (4) that primarily because of the alleged change in Kentucky case law collateral estoppel does not apply; and (5) that Mr. Duvall's will established in favor of decedent a life estate in the remainder of Mr. Duvall's property that constituted a general power of appointment not limited by an ascertainable standard.

We agree with the intervenors as to the proper interpretation of Mr. Duvall's will. In our opinion, respondent significantly misreads Duvall v. United States, supra, and Melton v. Wyatt, supra. The former decision was not overruled by the latter decision, and the decision of the District Court in Duvall v. United States, supra, provided significant guidance to us as to how Kentucky courts would interpret the language of Mr. Duvall's will.

Prior to 1974, where the language of a will created a life estate in favor of a surviving spouse with a gift over, but where the language of the will was not clear as to the extent of the power to invade corpus that was given to the holder of the life estate, Kentucky State courts, in analyzing the nature of the life estate, would reach differing and not always consistent results. As explained in Melton v. Wyatt, supra at 243:

The cases decided by this court in construing language in a will which would by the application of ordinarily understood definitions import unlimited power of use and disposition with a gift over have evolved from denying the power to encroach upon the principal, to successive recognition of the power to encroach on the principal to the extent of providing for necessaries, to encroach on the principal to the extent deemed necessary, to unlimited power to encroach upon the principal for the personal use and benefit of the devisee and the unlimited power of use and disposition without the power to waste or give away the property.

The court in Melton v. Wyatt, supra at 244, went on to hold that - language of unlimited power in a devise of life estate with a gift over should mean what it says and that such power to use AND DISPOSE of during the lifetime of the devisee of the life estate should be unlimited. *** [Emphasis added.]

Thus, where the language of a will implied a testamentary intent to give the surviving spouse unlimited power over property subject to a life estate, the Kentucky Court of Appeals in Melton v. Wyatt, supra, at 244, held that the implied language of unlimited power should mean "what it says" and that "such power to use and dispose of during the lifetime of the devisee of the life estate should be unlimited." Id.

Melton v. Wyatt, supra, however, in our opinion did not in any way change Kentucky law to the effect that where language of a will and the testator's intent are clear, where that language does not contain language of unlimited power, and where the language establishes only a limited power to invade corpus, that language will be recognized. Clarke v. Kirk, 795 S.W.2d 936, 938 (Ky. 1990); Molloy v. Molloy, 727 S.W.2d 870, 872 (Ky. Ct. App. 1987). Where a will contains language that confers broad discretion merely to use and manage the life estate but does not contain language of disposition, the power of appointment will, under Kentucky law, be

> regarded as a limited power of appointment. Molloy v. Molloy, supra, at 872.
>
> That is the case here, and that is exactly what the District Court held in Duvall v. United States, 246 F. Sup. 378 (E.D. Ky. 1965). After commenting on a number of cases involving unclear testamentary language, some of which were also commented on and reversed by Melton v. Wyatt, 517 S.W.2d 242 (Ky. 1974), the District Court in Duvall v. United States, supra, distinguished those cases (and thereby the issue involved in and the holding of Melton v. Wyatt, supra) by concluding that Mr. Duvall's will was not unclear, that it was "explicit," that the will gave to decedent a power to invade corpus only to the extent necessary for decedent's "health, education, support, and maintenance." Duvall v. United States, supra.
>
> In further support of our reading of Duvall v. United States, supra, and of our conclusion that Melton v. Wyatt, supra, did not overrule Duvall v. United States, supra, we note that the opinion in Melton v. Wyatt, supra, does not even refer to Duvall v. United States, supra.

Footnote 3 of the opinion quotes KRS 391.160 enacted in 1974 which limits, absent direction in the instrument to the contrary, a life tenant's invasion to health, education (including college and professional education), and support in accustomed manner of living).

The court discusses the statutes as follows:

> Further, it would appear that if language similar to the language of Mr. Duvall's will is to be regarded as ambiguous and unclear as to the extent of the beneficiary's power of appointment, under this statute (at least with respect to Kentucky wills whose effective date is after enactment of the statute) the

> beneficiary would be regarded as having a power of appointment over the remainder of the property that is limited by the demands of the decedent's health, education, support, and maintenance - an interpretation consistent with that of the District Court in Duvall v. United States, 236 F.Supp. 378 (E.D. Ky. 1965), and with our interpretation herein.

3. Distributions From Marital Trust.

TAM 9337001 involved facts similar to those presented in Estate of Hartzell v. Comm'r, Tax Court Docket No. 27300-92. The trustees were authorized to distribute from the marital trust amounts of principal to the surviving spouse "as my trustees shall, after consultation with her, deem necessary or advisable in addition to the net income, for her care, support, maintenance, and comfort." In 1989, 1990 and 1991 the trustees made distributions as annual exclusion gifts to the spouse's grandchildren and great-grandchildren. Those distributions were approved by the spouse. The IRS ruled that distributions to descendants for estate planning purposes were not for the benefit of the spouse, and so were not authorized.

A way to solve this difficulty would be to allow the spouse to withdraw 5% of the martial trust annually. Such a withdrawal right could be problematic with a spendthrift spouse or a second marriage. Conditioning the withdrawal right on the spouse using the funds to make gifts would probably be challenged by the IRS as tantamount to the spouse having an inter vivos special power. Such are not allowed in QTIP trusts. What if the spouse could withdraw the lesser of 5% of the trust property or the amount the spouse gave away in the previous year through annual exclusion gifts? There would be no condition on the exercise, rather the amount subject to the spouse's withdrawal right would be limited.

M. <u>Section 2042 - Life Insurance</u>

1. Corporation Owns Policy on Shareholder's Life.

TAM 9349002 dealt with the inclusion of life insurance proceeds on the life of a shareholder where the corporation owned the policy. The decedent owned 49.5 percent of the stock of a closely-held company, with the other shares owned mostly by B. A few employees owned the rest. The ruling discussed the buy-sell and related arrangements:

> After the Third amendment, the buy-sell agreement provided that, if either Decedent or B survived the other by thirty days, the Company stock held by the first to die of Decedent or B would be acquired by the surviving shareholders to the extent insurance proceeds were available. To the extent such proceeds were not available, or if neither survived the other by thirty days, the Company was to redeem the stock. The amount to be paid on the purchase of redemption of the stock was the greater of (1) the amount of insurance proceeds available, or (2) the amount otherwise calculated under the agreement. Any amount in excess of the insurance proceeds was to be paid by the Company over a period of four years pursuant to a promissory note containing the terms set forth in the agreement.
>
> * * *
>
> The amended buy-sell agreement named a corporate trustee to be the applicant, owner, and beneficiary of policies of insurance on the lives of each of Decedent and B except that the company was to be the owner to the extent of each policy's cash surrender value. The trustee was precluded from exercising any powers of ownership by canceling a policy, assigning ownership, changing the name of the beneficiary, borrowing against a policy, or otherwise changing the nature or value of any policy.
>
> The amended buy-sell agreement provided that, upon termination of the trust, any unmatured policy was to be transferred to the Company subject to the right of the

insured to purchase the policy for the then interpolated terminal reserve (cash surrender value).

In 1989, when Decedent was age 54, the trust acquired an increasing premium term policy on Decedent's life ($500,000 face value) and the company paid the premium. Under the terms of the policy there would be "no cash values until after insured's age 71."

Subsequently in 1989, Decedent, and three of the small shareholders entered into "STOCK PURCHASE AND REDEMPTION AGREEMENT" (the "redemption agreement") wherein it was agreed that the Company would purchase Decedent's shares by delivery of a promissory note having a face value of $300,000 payable over a thirty month period. The agreement also provided that Decedent would receive a cash payment of $150,000 at closing in exchange for her covenant not to compete for a period of two years. The agreement, signed by B as President, was contingent on the execution by B of a repurchase agreement with respect to B's shares in another jointly owned company engaged in a similar line of business. No insurance policies were involved with respect to the repurchase of B's shares in the other company.

On December 15, 1989, Decedent surrendered her shares to Company in exchange for a promissory note in the amount of $300,000. The note provided for 30 equal monthly payments of principal and interest with the final payment due on June 15, 1992.

Decedent died on September 27, 1991, at age 55 (age 56 as of her nearest birthday) when the balance due under the promissory note was about $96,000 Upon the death of Decedent the trustee distributed a portion of the insurance proceeds to the estate (in an amount equal to the balance due on the promissory note) and the balance to B and the other shareholders.

In effect, the insurance was security for the payment of the purchase price. The IRS concluded:

> The policy was structured so that its cash surrender value would be zero until several years after the trust terminated. Thus, the Decedent would have been able to acquire the policy by paying the then unexpired (pro-rata) portion of the annual premium regardless of the actual value of the policy at the completion of the redemption.

> Treas. Reg. §20.2042-1(c)(4) states in part:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS found that the decedent did possess an incident of ownership:

> When the insured cannot initiate the acts associated with the incidents of ownership but can only consent to or veto the exercise of the incidents of ownership by another, the courts have held that the veto power itself constitutes an incident of ownership over the

> policy. The Second Circuit held that where the insured must consent before the actions of others effectively alter a revocable trust, the insured holds incidents of ownership in a life insurance policy held by the trust. Estate of Karagheusian v. Commissioner, 233 F.2d 197 (2d Cir. 1956). Similarly, the Court of Claims held that where the beneficiary/owner of an insurance policy had the power to change the beneficiary, but the power could be exercised only with the consent of the insured, the insured held incidents of ownership in the policy for federal estate tax purposes. Estate of Goldstein v. United States, 122 F.Supp 677 (Ct. Cl. 1954). It is immaterial whether the decedent may initiate changes, or whether he must merely consent to them. It is the power and not the substantiality of the power that we must look to. Schwager v. Commissioner, 64 T.C. 781 (1975).
>
> * * *
>
> Analysis of the terms of the amended buy-sell agreement indicates that the duties of the "trustee" thereunder are limited to acquiring the policies of insurance on the lives of B and the Decedent; receiving premium payments from the Company and forwarding those payments to the insurer, and distributing any proceeds paid under the policies to the actual beneficiaries thereof. In as much as the "trustee" was precluded from exercising any of the "powers of ownership" of the policy, it is apparent that the "trustee" acted more as an agent for the shareholders rather than as an independent trustee.

The IRS also ruled that the proceeds would be included in the gross estate because the decedent had a reversionary interest in the policy:

> Taxpayer argues that the Decedent did not have a reversionary interest in the policy immediately prior to

death. Taxpayer contends that a reversion cannot exist in property that was never held by the Decedent and, even if it could, no reversion exists in this case because the policy would not have automatically returned to the Decedent.

Taxpayer relies on Estate of Leder v. Commissioner, 893 F.2d 237 (10th Cir. 1989), Estate of Headrick v. Commissioner, 918 F.2d 1263 (6th Cir. 1990), and Estate of Perry v. Commissioner, 927 F.2d 209 (5th Cir. 1991), for the proposition that Decedent did not "transfer" a policy of insurance on Decedent's life. We believe taxpayer's reliance is misplaced. While those cases did reject a "constructive" (or "beamed") transfer doctrine in the application of section 2035(d)(2), they did not deny the validity of that doctrine.

In Leder for example, the court recognized the existence of a transfer, stating, in part:

> This typical example of a constructive transfer is where the decedent purchases a life insurance policy on himself or herself, pays all the premiums, and designates his or her children or spouse as the owners and beneficiaries. In these situations courts construing section 2035(a) view the decedent's actions as acts of transfer, because the decedent's "beamed" the policy proceeds to the children or spouse by paying the policy premiums and creating in the children or spouse all of the contractual rights to the insurance benefits. [Bel, 452 F.2d 683 (5th Cir. 1971), cert. denied, 406 U.S. 919 (1972)].

It is clear that in Leder, as in the other cases cited by the taxpayer, the decision did not hinge on whether the insured had transferred a policy of insurance but on the technical issue of whether the insured had transferred an interest in the policy that would have caused inclusion of the proceeds under section 2042 of the Code if the interest had not been transferred. In addition, in those cases the trustee or other third party transferee who purchased the policy ostensibly had a much greater degree of independence in the selection and acquisition of trust assets.

In this case the Decedent, along with the other shareholders, caused the Company to transfer assets to the trustee who was directed to acquire a policy of insurance on the life of each of the two major shareholders. Whether the arrangement is viewed as a transfer of the assets or as an interest free loan, the result is a constructive transfer of an insurance policy.

Similarly, we disagree with the taxpayer's analysis of the Decedent's potential right to re-acquire the policy.

Taxpayer, citing Estate of Smith, 73 T.C. 307 (1979), in result only, 1981-1 C.B. 2, suggests that no reversion exists if return of the policy is contingent on events over which the insured has no control. We believe the absence of control is relevant only with respect to the value of the insured's right (the probability of reverter) and has no relevance with respect to the existence of that right (the possibility of reverter).

2. When Is a Policy Transferred.

In Estate of O'Daniel v. United States, 6 F.3d 321 (5th Cir. 1993), the taxpayer won a strange one. The facts are worth quoting in detail.

> Pioneer began negotiations for a merger with the Pillsbury Company that would result in Pillsbury's owning the insurance policies. During the negotiations, there were discussions about Pillsbury's selling the life insurance policies to O'Daniel. The general counsel for Pioneer, Norvell Plowman, testified that he met with Jerry Levin, an officer of Pillsbury, during a lunch meeting in Minneapolis, at which they agreed that Pillsbury would sell the life insurance policies to O'Daniel at the closing date of the merger. Levin testified by deposition that there was such an agreement, although he did not state whether the agreement was struck at the lunch meeting in Minneapolis, or on a different day. No written agreement regarding the sale of life insurance policies from Pillsbury to O'Daniel was ever executed either before or after the merger.
>
> On June 29, 1979, Pioneer merged with Pillsbury. On the morning of the merger, O'Daniel and Levin reconfirmed

> that O'Daniel would own the insurance policies at the time of the closing. One week after the Pillsbury-Pioneer merger, on July 8, 1979, O'Daniel and his wife signed a trust agreement (the "life insurance trust"), which provided that O'Daniel transferred the life insurance policies to his wife as trustee.
>
> On May 29, 1980, change of ownership forms were signed that switched ownership of the NORTHWESTERN policy from Pioneer to O'Daniel. One day later, O'Daniel signed a change of beneficiary form on the NORTHWESTERN policy, requesting that the beneficiary be changed to his wife as trustee of the life insurance trust. On July 24, 1980, NORTHWESTERN loaned $48,996.78 to O'Daniel on the NORTHWESTERN policy. On September 24, 1980, O'Daniel signed an insurance form requesting that ownership of the NORTHWESTERN policy be transferred from him to his wife as trustee. Between May and September 1980, the insurance company records for all twelve policies were changed to reflect a change in ownership from Pioneer to O'Daniel, a change in beneficiary from Pioneer to the life insurance trust, and finally a change in ownership from O'Daniel to the life insurance trust.

O'Daniel died on September 18, 1982.

The issue was whether O'Daniel transferred all incidents of ownership in the policies more than three years before his death. The court first determined that under applicable state law (Arkansas) the oral agreement of Pillsbury to sell the policies to O'Daniel was unenforceable. Even so, the Fifth Circuit went on as follows:

> Even though the oral agreement was unenforceable, it still was valid for the purpose of the incidents-of-ownership test. In Camp v. Commissioner, 21 B.T.A. 962 (1930) the Board of Tax Appeals held that when land is sold pursuant to an agreement violating the statute of frauds, any subsequent income arising form the land is taxable to the buyer, not to the seller. By analogy, an oral agreement although unenforceable under the statute of frauds, can transfer all incidents of legal ownership from Pillsbury to O'Daniel within the meaning of §2035.

The I.R.S. is a third party and cannot assert the statute of frauds to void the contract.

The district court may have erred technically in characterizing the oral agreement as "enforceable." Nonetheless, the agreement was valid for the purpose of determining the value of Estate.

The Fifth Circuit dismissed the contentions of the IRS:

> The government makes two arguments why O'Daniel still retained incidents of ownership in the policies despite the signing of the trust agreement on July 8, 1979. First, the government argues that O'Daniel failed to pay a gift tax on his gift of the insurance policies to the trust on that date. Despite the fact that the policies had a cash value of over $100,000, O'Daniel did not report any such gift on his gift tax return for the appropriate quarter (the quarter ending September 30, 1979). Although O'Daniel's failure to pay a gift tax may help prove a gift was never made, it does not establish that the gift was made later rather than sooner.
>
> Second, the government argues that O'Daniel withdrew the cash surrender values on all policies in 1980. This withdrawal, the government argues, was an exercise of O'Daniel's incidents of ownership over the policies. The Estate replies that the withdrawal took place in O'Daniel's capacity as the agent for his trust, rather than for his own personal benefit.
>
> * * *
>
> Even if O'Daniel acted illegally in withdrawing money from the insurance policy, however, he did not exercise incidents of ownership within the meaning of §2042. Incidents of ownership connote the legal power to exercise ownership, not the decedent's practical ability to do so. As the Tax Court stated in <u>Estate of Bartlett</u>, 54 T.C. 1590, 1598, 1970 WL 2411 (1970),
>
>> While the insured could possibly have cashed in some of the policies or could have exercised a second assignment with notice thereof to the insurers, any such action on his part would have constituted a breach of the trust agreement and would have amounted to fraud against the bank, as assignee and

> trustee. "Incidents of ownership" are to be measured by a "general, legal power to exercise ownership without regard to the owner's ability to exercise it at a particular moment." Commissioner v. Estate of Noel, 380 U.S. 678, 684 [85 S.Ct. 1238, 1241, 14 L.Ed.2d 159] (1965).
>
> Even though O'Daniel possessed and exercised the practical ability to withdraw the cash value of the insurance policies, he did not see a legal incident of ownership over the policies during the three years before his death. Therefore, the proceeds of the twelve key man life insurance policies should have been excluded from his estate.

To summarize, the court held that O'Daniel's statement that ownership was transferred, in the trust agreement, was sufficient. Should practitioners follow O'Daniel by treating insurance transfers as occurring on the date an insurance trust -- with appropriate recitations -- is executed, rather than waiting for the formal transfer (which may take a few days, or many months)?

3. Defective Insurance Trust; Bail-Out.

How can you bail-out of a bad life insurance trust. That issue was dealt with in PLR 9413045. The facts were as follows:

> [I]n 1985, the taxpayer and his spouse each created a life insurance trust. The A trust was created by the taxpayer as grantor, and designated his spouse as Trustee. The B trust was created by this spouse as grantor, and designated the taxpayer as trustee. Both trusts were irrevocable. Life insurance policies insuring the life of the taxpayer were transferred to the A trust and policies insuring the life of the spouse were transferred to the B trust.
>
> In 1989, the spouse, as trustee of the A trust, purchased a second-to-die life

> insurance policy insuring the lives of both the taxpayer and herself, the spouse. On the same date, the taxpayer, as trustee of the B trust, purchased a second-to-die life insurance policy on the lives of the taxpayer and his spouse.
>
> The taxpayer and his spouse, as trustees of the A and B trusts, have the right to change the beneficiaries on the policies in their respective trusts and to pledge or assign the policies or their proceeds as collateral. In addition, the trustees have various powers over the trusts including the power to distribute trust income and principal, to sell trust assets, and to merge the trusts with other trusts. Thus, the taxpayer/trustee has incidents of ownership over the second-to-die policy held in the B trust of which the taxpayer is the trustee. Similarly, the spouse, as trustee of the A trust, holds incidents of ownership over the second-to-die policy in the A trust.

Thus, there are reciprocal trusts, each with polices included in the spouses' estates. To solve the problem, a new trust was proposed, with a third-party as trustee. The taxpayers and spouse would have no rights in the new trust except a section 675(4) power, and the right to be reimbursed for income taxes if the trust were a grantor trust. (The trust was, of course, designed to be a grantor trust.) The new trust would then purchase the policies, for fair market value (interpolated terminal reserve plus unexpired premiums), from the "bad" trusts.

The IRS first concluded that, after the purchase, there would be no inclusion of the policies in the taxpayers' or the spouse's estates, under section 2035, even if death occurred within 3 years of the purchase. And, the IRS concluded that the section 675(4) power (without the approval or consent of any person in a fiduciary capacity, to reacquire all or any part of the trust corpus by substituting other property of an equivalent value in place of such reacquired trust corpus, in this instance) would not cause the policies to be included in the taxpayer's or spouse's estate, citing Estate of Jordahl, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1. Interestingly, Jordahl itself dealt with the power to substitute assets in a fiduciary capacity; the distinction is not relevant, according the IRS. The right to receive reimbursement for income taxes if the trust were a grantor trust was not section 2036 retained right.

Ominously the IRS refused to rule on whether the new trust would be a grantor trust because, it stated, the area is "under extensive study." Thus, it could not rule on whether the sale constituted a transfer for value under section 101(a)(2).

Traditionally these sort of defective insurance trusts have been handled by the insured purchasing the policy, and then transferring it to a proper life insurance trust. That, of course, requires the insured to make a gift to the new trust, and to survive three years. Many commentators have suggested that an alternative would be a sale to a grantor trust, claiming that Swanson, ___________, stands for the proposition that a sale to a grantor trust is the equivalent of a sale to the grantor (insured) and is outside the transfer for value rules. However, in Swanson the grantor trust status of the trust was clear. Unless the insured is very likely to die within three years, the potential income tax risk would seem to outweigh the transfer tax savings.

4. Indirect Incidents of Ownership.

PLR 9421037 finds no incidents of ownership over an insurance policy on an employee's life in an employer who can, by firing the employee, terminate (indirectly) the employee's interest in the trust which owns the policy.

N. Section 2053 - Debts and Administration Expenses

1. Expenses in Selling Residence.

TAM 9342002 involved the deductibility of the expenses of sale of the decedent's residence. The decedent's child was the only beneficiary of the estate. The IRS auditing agent argued that the sale was unnecessary because there was sufficient cash in bank accounts which were joint with the decedent's child.

The National Office found otherwise:

> Although the decedent had created the joint accounts and had contributed all of the property held in the accounts, the jointly held property passed to A [the child] outside of the decedent's will and was beyond the jurisdiction of the probate court. Therefore, A, in his capacity as executor, had no authority to apply the cash in the bank accounts for the payment of the expenses allocable to the probate estate.
>
> Because there were no cash assets in the probate estate, a sale of some probate assets was necessary to obtain the proceeds to pay the decedent's debts, the expenses of administration of the estate, and those taxes payable from the probate estate. Consequently, to the extent that the sale of the residence was necessary for the settlement and the distribution of the estate, the costs incurred thereon are allowable deductions as administration expenses within the meaning of section 2053(a) of the Code.

2. Interest.

In Axtell v. United States, ________________ (D.C. Wy. 1994), the court considered the deductibility of interest paid to a third-party lender on a loan used by the estate to pay the federal estate tax. The court recited these facts:

> The plaintiff in this case is the representative and beneficiary of the estate of Paul W. Axtell. Paul Axtell died on March 19, 1979. His estate originally elected to defer payment of estate taxes pursuant to Internal Revenue Code ("IRC") §6166. Section 6166 allows for a deferral of estate taxes when the estate consists largely of interest in a closely held business. See 26 U.S.C. §6166 (1986).
>
> In 1985, in order to avoid the high interest expense on the outstanding estate tax, the Axtell estate obtained a third party loan from the Wyoming Farm Loan Board to pay down the estate tax liability. As a result of the Internal Revenue Service's ("IRS") allowance of interest deductions as credits against the estate tax and interest still owing, the estate tax and interest was fully paid as of December 16, 1988. In the years 1986 through 1989, the estate made, and the IRS allowed, refund claims based on IRC §2053 administrative expense deductions for loan interest paid during those years. When the Axtell estate made a refund claim based on the same interest payments in 1990, however, the IRS disallowed the claim as untimely under IRC §6511.

Section 6511(a) requires an estate to file a claim for refund within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever is later. Here that period had expired. The court stated the estate's problem very well:

> When an estate borrows funds from a private lender to satisfy its estate taxes, the interest on the loan remains deductible as an administrative expense deduction under IRC §2053(a)(2). Hipp v. United States, 72-1 U.S.T.C. 84,678, 84,680 (D.S.C. 1971); Estate

of Sturgis, 56 T.C.M. (P-H) ¶ 87,415 at 2155 (1987). As with interest on deferred estate tax payments, interest on a private loan for the purpose of paying federal estate tax generally does not meet the Treasury Regulation 20.2053-1(b)(3) test for the allowance of estimated administrative expenses, and therefore the interest may only be claimed once the interest has actually been paid.[1]

However, unlike an estate which "borrows" money from the IRS by deferring payment for the estate tax, and which, as a result, does not fully pay the estate tax until the last installment is paid, an estate which borrows money from a private lender to pay its federal estate tax pays its tax liability in full. Consequently, where an estate borrows funds from a private lender, the section 6511(a) limitations period may expire before the estate has made all of the interest payments which might otherwise be allowed as administrative expense deductions. In other words, by operation of the section 6511(a) limitations period, the treatment of an estate which defers payment of the estate tax and an estate which borrows money from a private lender may be quite different even though both estates are paying interest on their tax payment. An estate that makes deferred payments to the IRS will be able to submit an

[1]The question remains open, however, whether an estate can avoid this rule in a particular case by demonstrating that the possibility of the interest not being paid is remote. Compare Spillar, 54 T.C.M. (P-H) at 2381 (even the remote possibility of nonpayment of interest prevents claiming a deduction as estimated future administrative expense); with Estate of Graegin, 57 T.C.M. (P-H) ¶88,477 at 2447 (1988)(allowing estate's deduction of estimated future administrative expense for interest to be paid because amount of interest is certain and co-executor intends to pay the interest). Regardless of whether an estate may be able to meet the 20.2053-1(b)(3) requirements with respect to a claim for estimated future interest on a private loan used to pay the estate tax, such a claim was not made in this case and need to be addressed by this Court.

> administrative refund claim for all interest paid because it will not fully pay the estate tax until the last payment is made. In contrast, an estate that borrows money and pays the estate tax liability in full will be unable to file a claim for administrative refund once the section 6511(a) limitations period expires, even though it may continue to pay interest on the loan after that time.

The estate advanced two arguments. First, that the amended Forms 706 constituted protective claims. The court disagreed because the forms, as filed, did not contain sufficient information to allow the IRS to commence an examination of the claim. In a footnote the court noted that amended Forms 706 could, in certain instances, constitute protective claims:

> That is not to say, however, that a Form 706 could never constitute a valid protective claim. In order to do so the taxpayer must apprise the IRS of its intention to take future interest expense deductions and must detail the factual basis for the claim, including as estimation of anticipated future interest payments and the years in which those payments will be made.

Second, the estate argued that section 6511(a) was unconstitutional. Although recognizing the unfairness involved, the court held as follows:

> The Court recognizes that the limitations period at issue in this case, IRC §6511(a), prevents estates that elect to take loans from private lenders to pay off their estate tax liabilities from claiming the administrative expense deduction for interest paid on their loan more than two years after the payment of the estate tax in full and more than three years after the filing of the estate tax return. The Court also recognizes that this

> result is inconsistent with the treatment of those estates that elect to defer payment of the estate tax to the IRS, because those estate are able to deduct all interest paid to the IRS.
>
> The Court concludes, however, that this uneven treatment is not unconstitutional. Section 6511(a) serves the rational purpose of establishing a time limit by which taxpayers must bring an administrative claim for refund against the IRS. Tying the limitations period for an administrative claim to the tie when the tax is paid in full or when the tax return is filed is certainly a rational manner in which to accomplish the legitimate purpose of finality and closure. Moreover, taxpayers in the same situation as the estate in this case unilaterally elect to take private loans to pay their estate tax fully, knowing that the section 6511(a) may prevent them from deducting all interest paid on their loans as administrative expenses. Finally, as mentioned above, a taxpayer would easily avoid this result by making a protective claim for the deduction of future interest payments.

The planning point is to note that interest is deductible <u>even in</u> the non-6166 situation, if properly claimed.

3. City Inheritance Taxes.

TAM 9422002 determined that city inheritance taxes are not deductible as administration expenses based on section 2053(c)(1)(B), which specifically precludes the deduction, and the legislative history from 1924.

O. Sections 2055 and 2522 - Charitable Deduction

1. Qualified Reformation.

Wells Fargo Bank v. United States, 1 F.3d 830 (9th Cir.), involved a special rule under section 2055(e)(3), which permits a charitable deduction for a qualified reformation, for wills executed before January 1, 1979. The decedent's will was executed in 1971; a third codicil was executed in 1982 which changed an annuity payable, and then stated "I confirm and republish" the 1971 will. The issue was whether the Codicil republished the Will, so that the Will became executed after January 1, 1979. The court relied upon a 1974 amendment of the special rule which deleted certain language regarding "republishing" and held that the decedent's will was executed before January 1, 1979.

The opinion is also interesting because the court held that the decedent's will could be reformed, because the charitable remainder was ascertainable. In pertinent part the will provided as follows:

> 1. My said Trustee shall pay from the income or from the principal, if necessary, of said trust to my trusted employee, JAMES M. FULLER, the sum of Two Hundred Fifty Dollars ($250.00) per month for the term of his natural life.
>
> 2. I direct that my house located at 1144 Crestline Drive, Las Positas Estates, Santa Barbara, California, be held and maintained by my said Trustee during the lifetime of said JAMES M. FULLER. There shall be paid from my Trust all taxes, all expenses of maintenance, repairs <u>or improvements</u> on said house. The use of said house as to maintained shall be

> provided for my said employee, JAMES M. FULLER, for the term of his natural life.
>
> 3. Further I direct my said Trustee to pay from the income or, if necessary, from the principal of said Trust all unusual and exceptional expenses of said JAMES M. FULLER, such as hospital, medical, dental bills and <u>to pay all income taxes due from said JAMES M. FULLER to the United States of America and to the State of California during the period of his life.</u>
>
> The primary purpose and intent in creating this Trust is to provide for said JAMES M. FULLER, and the rights and interests of remainderman are subordinate and incidental to that purpose. The provisions of this Trust shall be liberally construed in the interest and for the benefit of said JAMES M. FULLER, however, the Trustees shall consider JAMES M. FULLER's independent income and other resources outside the Trust Estate in reaching such decisions covered by this paragraph.

The language did not grant unlimited power to the trustee, according to the court because:

> A house may sometimes need improvements in order to remain in substantially the same condition of usefulness, as when a drain must be installed to prevent flooding, yet such an expense is no less ascertainable than that which will be necessary to maintain the life tenant in "comfort," cf. <u>Thaca</u>, and is about the same as "upkeep." Cf. <u>Bowers v. South Carolina Nat'l Bank v. Greenville</u>, 228 F.2d 4 (4th Cir. 1955). For example, Mr. Fuller needed a handrail to move about the house. The handrail was probably an improvement rather than maintenance, but it was no more than necessary to maintain the house for his use, and no less ascertainable than his comfort. Nothing about the phrase "improvement" suggests unlimited subjective power in Mr. Fuller to improve the house beyond what would be necessary to so maintain

it. Cf. Salisbury v. United States, 377 F.2d 700, 704-05 (2nd Cir. 1967). The Government argues that discretion to invade the corpus for "improvements" destroys ascertainability, under In re McCord's Estate, 516 F.2d 832, 836 (6th Cir. 1075), cert. denied sub. nom. U. S. Braton v. United States, 423 U.S. 995 (19785), but there the testatrix's "primary objective" was the "betterment of the condition under which my daughter is living," id. at 833, suggesting change, while here, the phrase "as so maintained" suggests stability.

As for the trustee's power to invade principal to pay Mr. Fuller's federal and state income taxes, this bequest is no more unascertainable in amount than invasion of principal for the beneficiary's future "comfort," or to cover those "reasonably necessary" expenses occasioned by accident or illness. The amount of Mr. Fuller's income taxes would have nothing to do with such untrammeled standards as his "happiness," "desire," or "pleasure." Cf. Ithaca, Comm's of Internal Revenue, Merchants, Henslee. We agree with the Second Circuit that a power to invade principal for income taxes does not give the life beneficiary "significant volitional power" over the charitable remainderman, and, so doesn't lack the objectivity necessary of present ascertainability. Schildkraut's Estate v. Comm'r of Internal Revenue, 368 F.2d 40, 47 (2nd Cir. 1966), cert. denied, 386 U.S. 959 (1967). The instrument at issue in the Revenue Ruling cited by the government, Rev. Rul. 71-221, unlike Mrs. Wand's will, involved a power to invade for any kinds of taxes, and numerous and indeterminate life beneficiaries.

2. **Disclaimer to Private Foundations.**

Rulings continued to be issued involving disclaimers to private foundations. See, e.g., PLRs 9350032 and 9350033.

The issue involved is how much, if any, control the disclaiming party may have over the distribution of the funds from the private foundation. In general, the rulings will allow the disclaiming party to be involved in the foundation so long as someone else makes distribution decisions. If a grandchild's private foundation is the intended beneficiary, the grandchild's parent can be the disclaiming party.

3. Section 2055(a) versus Section 170(c).

TAM 9404002 is important as an illustration of the differences between organizations described in section 170(c) and those described in section 2055(a). Section 170(c) provides as follows:

> (c) CHARITABLE CONTRIBUTION DEFINED. - For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of --
>
> > (1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.
> >
> > (2) A corporation, trust, or community chest, fund, or foundation --
> >
> > > (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
> > >
> > > (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 510(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), or political campaign on behalf of (or in opposition to) any candidate for public office.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B). Rules similar to the rules of section 501(j) shall apply for purposes of this paragraph.

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization --

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that

purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

For purposes of this section, the term "charitable contribution" also means an amount treated under subsection (g) as paid for the use of an organization described in paragraph (2), (3), or (4).

Section 2055(a) reads differently:

(a) IN GENERAL. - For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers --

(1) to or for the use of the United States, any State, any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office;

(3) to a trustee or trustees, or a fraternal society, order, or association operating under

> the lodge system, but only if such contributions or gifts are to be used by such trustee or trustees, or by such fraternal society, order, or association, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, such trust, fraternal society, order, or association would not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and such trustee or trustees, or such fraternal society, order, or association, does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office; or
>
> (4) to or for the use of any veterans' organization incorporated by Act of Congress, or of its departments or local chapters or posts, no part of the net earnings of which inures to the benefit of any private shareholder or individual.
>
> For purposes of this subsection, the complete termination before the date prescribed for the filing of the estate tax return of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised by reason of the death of such individual or for any other reason shall be considered and deemed to be a qualified disclaimer with the same full force and effect as though he had filed such qualified disclaimer. Rules similar to the rules of section 501(j) shall apply for purposes of paragraph (2).

In the TAM, a transfer to a foundation was involved. The foundation's governing instrument provided:

> At all times, and from time to time, Trustee and the Administrative Committee shall use and apply all of the principal and income of Foundation exclusively for religious, charitable, literary, scientific, or educational purposes, or for the prevention of cruelty to children or animals.

* * *

> No gift may be made by Trustee to any organization, or directed by the Administrative Committee to be made to an organization, other than to the type of organization to which a charitable contribution as defined in Section 170(c), Internal Revenue Code of 1954, or any amended statute of similar import, may be made.

The IRS concluded that the Foundation's purposes were limited to those described in section 2055(a), thus a charitable estate tax deduction would be allowed. Rev. Rul. 76-307, 1976-2 CB 56, cited by the Service, requires a governing instrument to limit the charitable beneficiaries to organizations to those described in section 170(c) <u>and</u> 2055(a) (or 2522, gift tax, or 2106, tax on nonresident noncitizens). In general, charitable transfers should be made to organizations described in section 170(c), 2055(a), and 2522(a); if the transfer is to be limited to public charities, excluding thereby private foundations, then reference should be made to section 170(b)(1)(A) as well.

4. Calculation of Charitable Deduction; Tax Apportionment.

The IRS national office disagreed with the district office in TAM 9419006. The decedent died with a marital trust included in her estate under section 2044; the trust became a charitable remainder unitrust. The facts as relate to tax apportionment were these:

> Under §2207A and the terms of the decedent's will, the marital trust was burdened with the estate taxes generated by the inclusion of the

> trust in the decedent's gross estate. The trust instrument contains no provision regarding the apportionment of federal estate taxes to be paid by the trust. The applicable State X apportionment statute provides as follows with respect to the apportionment of transfer taxes in the case of successive interests passing in trust:
>
> If both a present interest and a future interest in property are involved, a tax shall be apportioned entirely to the principal. This shall be the case even if the future interest qualifies for an estate tax charitable deduction, even if the holder of the present interest also has rights in the principal, and even if the principal is otherwise exempt from apportionment.

The estate calculated the charitable deduction by determining the net amount passing to the unitrust, before payment of estate taxes, subtracting the share of taxes attributable to the unitrust, and using the unitrust remainder factor. The district office advocated another approach:

> Upon audit of the return, the district office took the position that pursuant to the estate's methodology, because the estate tax liability was paid "off the top" of the trust corpus, the lifetime beneficiary's unitrust interest (which is the lesser of trust income or percentage of the value of the trust) was necessarily reduced proportionately. Thus, the estate's method for apportioning the estate tax effectively placed the burden of a portion the estate tax liability generated by the unitrust on the interest of the lifetime unitrust beneficiary.
>
> The district argues that this approach conflicts with the State X statute which specifically provides that any estate tax is to be apportioned "entirely to the principal." The district contends that, under the statute,

> the unitrust/income beneficiary is exonerated from paying any tax, and the entire tax burden is borne by beneficiary of the trust principal - the charitable remainderman. This result could be obtained, even though the taxes are paid currently, if for example, the lifetime beneficiary received an additional payment each month to compensate for the reduced unitrust/income payment resulting from the tax payment. The charitable deduction would be computed by subtracting the value of the unitrust interest from the value of the trust corpus and from the amount so obtained, subtract the estate taxes allocable to the trust. The balance is the amount of the charitable deduction.

The IRS agreed with the estate, upon review of court decisions (not in State X) which appeared to say that tax created by the life interest is charged to the trust corpus.

5. Value of Property Passing to Charity.

The Tax Court confronted several difficult issues in Estate of Foy Proctor, 67 TCM 1994-208:

> (1) the fair market value of the Channing Ranch to be included in decedent's gross estate for purposes of section 2031(a); (2) whether an option to lease the surface rights of the Channing Ranch for grazing purposes, granted to Mrs. Hays for the duration of her life, diminishes the fair market value of the Channing Ranch, and, if so, the amount of such diminution; and (3) whether such option causes the devise of the Channing Ranch to Texas Tech University (Texas Tech) to lapse under the terms of decedent's will.

In pertinent part, the decedent's estate plan gave his Channing Reach to charity (Texas Tech University), but subject to an option in certain persons to lease the Ranch for grazing purposes. The option was designed to be at fair market value:

> The special devise contained in Section 5.1 hereof shall be subject to a continuing option in favor of J.D. (Junior) Hays and wife, Beth Hays, or the survivor of them to lease said Channing Ranch for grazing purposes, for a term or terms not to exceed the duration of the life of the survivor of them, plus six months. Such lease shall be negotiated and renegotiated from time to time between J.D. (Junior) Hays and wife, Beth Hays, or the survivor of them, and Texas Tech University to provide for lease terms conforming to the fair market value of the use of said land for grazing purposes, and for such terms and restrictions as are appropriate to the maintenance and preservation of the market value of said land for grazing purposes.
>
> * * *
>
> It is the intent hereof that Texas Tech University shall receive, upon my death, the full fee title to said premises, and that the terms of the optional lease available to J.D. (Junior) Hays and wife, Beth Hays, or the survivor of them, shall be such as conform to the market value of the grazing use of the premises, and shall not operate to reduce the commercial value of the premises as a ranch property.

In addition, the decedent provided that the devise would lapse if no charitable deduction were allowed:

> The special devise in favor of Texas Tech University contained in Section 5.1 hereof is made in the good faith, belief and expectation that the value of the subject matter thereof will be deductible from my gross estate for the determination of the United States estate tax liability of my estate, as provided in section 2055(a)(1), Internal Revenue Code. Should it be finally determined by competent

> authority that the expected deduction is not allowed, whether under Section 2055(a)(1), or other provision of applicable law, the special devise made in this Section 5 hereof to Texas Tech University shall lapse. In such event, I give and devise the surface interest in and to my said Channing Reach, exclusive of my record interest in and to the oil, gas and other minerals in and under and that may be produced therefrom, to J.D. (Junior) Hays and wife, Beth Hays, or the survivor of them, subject, however, to payment by the devisees of so much of the death taxes assessed upon my estate as may exceed the amount of death taxes which would have been assessed upon my estate had I not owned such surface interest in said Channing Ranch. This contingent devise of the surface interest in such Channing Ranch to J.D. (Junior) Hays and wife, Beth Hays, or the survivor of them, shall not entail personal liability of the devisees for such taxes, but shall constitute a lien upon the subject matter. Should the devise to Texas Tech University given in this Section 5 hereof be defeated by the contingency contemplated in this Subsection 5.3 hereof, my record interest in and to the oil, gas and other minerals in and under and that may be produced from said land shall be a part of the residue of my estate to pass as provided in Subsection 6.1 hereof.

The reason the devise of the Ranch was handled in this way was described by the drafting attorney in a letter to a trust officer, quoted by the court:

> Though Section 5.2 of the will gives to Beth Hays a continuing option to lease the Channing Ranch for grazing purposes for a term or terms not to exceed the duration of her life plus six months, it contains restrictions intended to insure that the option will not be construed as repugnant to the fee given to Texas Tech University in Section 5.1, *in either a legal or economic sense.* ***

* * *

Section 5.3 of the will subjects the gift to Texas Tech University appearing in Section 5.1 thereof to a condition subsequent which will defeat such gift, "should it be finally determined by competent authority that the expected deduction is not allowed, whether under Section 2055(a)(1) or other provision of applicable law; that is, should it be so determined that the value of the gift to the University is not deductible from the value of Foy Proctor's gross estate for determination of federal estate tax liability of the estate. To insure that such adverse authoritative determination will not be made, the gift to the University is recited several times to be of the fee simple title vesting upon the death of the testator as provided by Section 37, Texas Probate Code, and the option to lease given to Beth Hays is so restricted as to provide for a rental conforming to the fair market value of the premises for grazing purposes, and for a rental and other terms not impairing the market value of the premises for grazing purposes. In order to effectuate the intent of the testator, it is essential that the option not be construed as a gift of a life interest in land, and that, the gift to the University not be construed as a remainder interest in land.

* * *

The structure of the will and its dominant intent is to avoid the creation of a charitable remainder trust. An additional argument that his result has been achieved may be made with reference to the exclusion of family farms in the statutory restriction upon the deductibility of remainder interests in charitable trusts. *The emphasis of the will is upon avoiding the creation of a trust which is a charitable remainder trust in either an economic or a legal sense regardless of the application of the family farm provision.* [Emphasis added.]

Texas Tech sought to intervene in the case, to protect its interest, as did the residuary takers, Mrs. Hays and Ms. Baker, which the court allowed:

> In the instant case, Texas Tech, Mrs. Hays, and Ms. Baker contend that intervention should be permitted for the following reasons: (1) Because, according to the terms of decedent's will, our decision regarding the deductibilty and fair market value of the Channing Reach subject to Mrs. Hays' lifetime lease affects whether the devise of the Channing Ranch to Texas Tech lapses, all three of the moving parties have a direct and immediate interest in the subject matter of his proceeding; (2) because petitioner has a fiduciary duty to deal impartially with all beneficiaries of decedent's estate, petitioner is not able to adequately protect the interests of Texas Tech, Mrs. Hays, and Ms. Baker due to the fact that their respective interests in the subject matter of the instant case are adverse; (3) permitting intervention will not result in new issues of law or fact to be decided by the Court, and therefore, intervention will not unduly delay the adjudication; (4) permitting intervention will allow a more complete presentation of issues to be resolved in the instant case; and (5) petitioner has not objected to the parties' motions to intervene, but rather, has invited the parties to intervene.
>
> We granted the motions to intervene of Texas Tech and Mrs. Hays and Ms. Baker. In so doing, we limited the scope of intervention to (1) the issue of the fair market value of the Channing Ranch to be included in decedent's gross estate for purposes of section 2031(a), and (2) respondent's adjustment to the value of the charitable contribution deduction for the Channing Ranch claimed by petitioner on its Federal estate tax return.

The court first determined that the option was not relevant in determining estate tax value. The Tax Court pointed out that neither the decedent's death nor his Will affected what the <u>decedent owned</u>. Thus the full fair market value of the Ranch ($6,000,000), without the option, was included in the decedent's gross estate.

Next, the court determined the value with the option for purposes of deciding the amount of the charitable deduction. The experts of the various parties were not far from one another and the court settled on a value of $4,836,320.

The court finally confronted the IRS and the residuary takers which argued that the charitable bequest lapsed. The issue turned on the meaning of the sentence, "[s]hould it be finally determined by competent authority that the expected deduction is not allowed, whether under Section 2055(a)(1), or other provision of applicable law, this special devise . . . shall lapse." What did the decedent mean by the expected deduction?

The residuary takers and the IRS argued that it meant a deduction equal to the value of the Ranch in the decedent's gross estate. Texas Tech argued that it meant only substantially equal; the residuary takers and the IRS responded that the deduction -- $4,836,320 --was not substantially equal to the gross estate value ($6,000,000).

The court found the phrase to be ambiguous and looked to extrinsic evidence, particularly testimony from, and client letters written by, the drafter of the Will. In particular, the court focused on the following discussion of the effect of the grazing option on the value of the charitable deduction:

> You may well ask why provide that J.D. (Junior) Hays and wife, Beth Hayes, must pay rent to Texas Tech University for a grazing lease on the Channing Ranch. I have two reasons; namely,
>
> (1) It enables me to pass the fee simple title to the Ranch to the University immediately upon your death, thus distinguishing it from a remainder interest, which is a title postponed to a title having prior enjoyment; and
>
> (2) It should make the value of the interest passing to the University *substantially* the full value of the Ranch at date of death. A remainder interest must be valued by subtracting the value of the preceding life estate from the date of death value. The value of the life estate is determined by applying a factor found in life tables published in the Internal Revenue Regulations to the full value, as of the inception of the life interest. Valuation of the interest passing to charity in that manner would result in an increased burden on the liquid assets of the estate to pay death taxes. If the University is to receive immediate title, subject only to an option to J. D. (Junior) Hays and wife, Beth Hays, to lease the premises for the only purpose for which it is definitely suited at the market value of such a lease, it can hardly be supposed that the value to the University is *substantially* less than it would be in the absence of the option. [Emphasis added.]

The court held that the tests were whether the deduction was "substantially equal" to the gross estate value. The court stated as follows on the issue of substantially equal:

> In light of the foregoing, we hold that decedent's primary intent was to devise his interest in the Channing Ranch to charity in a manner that would allow his estate to claim a *substantial* charitable deduction under section 2055(a) while allowing Mrs. Hays to remain on the Ranch. Accordingly, we hold that decedent "expected" that his estate would be entitled to claim a substantial charitable deduction for the devise of the Channing Ranch to Texas Tech. We concluded, *supra* p. 53, that petitioner would be entitled to a charitable deduction under section 2055(a) in the amount of $4,836,320, if the devise of the Channing Ranch to Texas Tech did not lapse under section 5.3 of decedent's will. A $4,836,320 deduction is slightly more than 80 percent of the value of the Channing Ranch on the date of decedent's death ($6,000,000). We believe that a deduction equal to approximately 80 percent of the fair market value of the Channing Ranch on the date of decedent's death is "substantial." Consequently, the special devise of the Channing Ranch to Texas Tech does not lapse under section 5.3 of decedent's will.

The court did not discuss the tax apportionment ramifications of its decision. From portions of the Will reproduced in the opinion it would appear that the intestate takers would pay the increase in estate taxes.

An interesting issue would have been the effect of putting the option on the property prior to the decedent's death. Presumably that could have been done by sale to Mrs. Hays and Ms. Baker, for even a de minimis sum.

P. Sections 2056 and 2056A - Marital Deduction

1. Post-Death Interest.

In Richardson, 89 T.C. 1193 (1987), Street, 974 F.2d 723 (6th Cir. 1992), and Whittle, 994 F.2d 379 (7th Cir.), various courts determined that post-death interest on deferred federal estate taxes payable from transferred property should not reduce the value of this property. The issue is important for valuing the charitable deduction, but is more important (because more frequent) with respect to the marital deduction.

Revenue Ruling 93-48, IRB 1993-25 at 9, reflects IRS acknowledgement of the cases. The ruling states as follows:

> Rev. Rul. 82-6 [1982-1 C.B. 137] holds that, if deferred federal estate taxes and post-death interest thereon are payable out of a residuary estate, the value of a residuary charitable bequest for purposes of section 2055 of the Internal Revenue Code must be reduced by an estimate of the maximum amount of the interest that is expected to be paid out of the residuary estate. In light of the cases cited above, Rev. Rul. 82-6 is revoked.
>
> Rev. Rul. 66-233, 1966-2 C.B. 428, holds that, for purposes of section 2013 of the Code, the value of a residuary bequest transferred by a prior decedent is to be reduced by the amount of all administrative expenses payable from the residuary bequest. Rev. Rul. 66-233 is modified to apply to administration expenses other than interest accruing on obligations payable from the residuary bequest.
>
> Rev. Rul. 73-98, 1973-1 C.B. 407, holds that, for purposes of section 2055 of the Code, the value of a residuary charitable bequest is reduced by the amount of administrative expenses payable from the income of the

residuary property. Rev. Rul. 73-98 is modified to apply to administrative expenses other than interest accruing on obligations payable from the residuary principal or income.

Rev. Rul. 80-159, 1980-1 C.B. 206, holds that, for purposes of section 2056 of the Code, the value of a residuary marital request is not reduced by any interest paid on deferred federal estate taxes where state law requires both estate tax and interest on the tax to be paid from portions of the estate other than the residuary marital bequest. Rev. Rul. 80-159 is clarified to hold that the value of the marital bequest for purposes of section 2056(b)(4) is not reduced by post-death interest expense accruing on taxes even if state law requires payment from the marital bequest of estate tax and interest on the tax.

2. **QTIP Regulations.**

The IRS has issued final and temporary regulations taking into consideration the following tax acts: ERTA, DRA '84, TRA '86, TAMRA, OBRA, and EPA '92. The drafter's Explanation is attached as Appendix B. The following are a few of the more important points:

a. **Lifetime QTIP.**

The regulations allow a donor spouse to create a lifetime QTIP trust for the donee spouse, which will be included in the donee spouse's estate under section 2044(b), <u>even if</u> the donor spouse retains an income interest if the donee spouse predeceases. Generally, absent a gift tax return showing a gift, section 2044 inclusion will be presumed. Treas. Reg. § 25.2523(f)-1(d), and Treas. Reg. § 25.2523(f)-1(f), Examples 10 and 11. Those Examples are as follows:

Example 10. Retention by donor spouse of income interest in property. On October 1, 1994, D transfers property to an irrevocable trust under the terms of which trust income is to be paid to S for life, then to D for life and, on D's death, the trust corpus is to be paid to D's children. D elects under section 2523(f) to treat the property as qualified terminable interest property. D dies in 1996, survived by S. S subsequently dies in 1998. Under §2523(f)-1(d)(1), because D elected to treat the transfer as qualified terminable interest property, no part of the trust corpus is includible in D's gross estate because of D's retained interest in the trust corpus. On S's subsequent death in 1998, the trust corpus is includible in S's gross estate under section 2044.

Example 11. Retention by donor spouse of income interest in property. The facts are the same as in *Example 10*, except that S dies in 1996 survived by D, who subsequently dies in 1998. Because D made an election under section 2523(f) with respect to the trust, on S's death the trust corpus is includible in S's gross estate under section 2044. Accordingly, under section 2044(c), S is treated as the transferor of the property for estate and gift tax purposes. Upon D's subsequent death in 1998, because the property was subject to inclusion in S's gross estate under section 2044, the exclusion rule in §25.2523(f)-1(d)(1) does not apply under §25.2523(f)-1(d)(2). However, because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038. If the executor of S's estate made a section 2056(b)(7) election with respect to the trust, the trust is includible in D's gross estate under section 2044 upon D's later death.

Presumably, the donor spouse may also receive principal distributions, and may have a special power of appointment, without causing inclusion in the donor spouse's estate.

On the other hand, the donor spouse may not have an income interest which precedes the donee spouse's (Example 9).

b. Specific Portion.

The term has been redefined to allow a marital deduction if a spouse receives an income interest over a specific portion of property. The issue about receiving an annuity is answered "yes" for transfers before October 25, 1992, but left unanswered thereafter. The answer should be the same, but may not be. Treas. Reg. §§ 20.2056(b)-5(c)(2) and 25.2523(e)-1(c).

c. Protective Elections.

Are allowed. Treas. Reg. §20.2056(b)-7(c).

d. Trust Division.

A trust division will be allowed which meets three criteria: (1) it is allowed by the trust instrument or applicable state law; (2) it is done before estate administration ends, and is noted on the estate tax return; and (3) it is made on a fractional or percentage basis, but may be non-pro rata (contrary to the GST regulations). A faulty division simply means that the division is invalid for income tax and estate tax purposes. A partial QTIP can be made, and all distributions to the spouse charged to the QTIPed portion, without dividing the trust. Treas. Reg. §§ 20.2056(b)-7(b)(2)(ii) and 20.2044-1(d)(3).

e. Distributions to Spouse to Make Gifts.

This will be a problem if the spouse is legally bound to make gifts. Treas. Reg. § 20.2056(b)-7(d)(6) provides as follows:

> (6) *Power to distribute principal to spouse.* An income interest in a trust will not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the surviving spouse. The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

[See the discussion in Section L-3 of these materials.]

f. Charitable Remainder Trusts and Pooled Income Funds.

Treas. Reg. § 20.2056-b(8) and Treas. Reg. § 20.2056(b)-7(d)(5) allow the marital deduction only if the spouse has the only non-charitable interest (with some grandfathered exceptions).

g. Right of Recovery -- Section 2207.

Failure to exercise a right of recovery is a gift, unless the beneficiaries cannot compel the executor to exercise it. Treas. Reg. § 20.2207A-1(a)(3).

3. Partial QTIP Election.

This is a different result from Prop. Reg. §26.2654-1(c)(2), which for GST purposes, that the trusts be "funded with a fractional share of each and every substantial interest or right held by the single trust." Private Letter Ruling 9335025 indicates that the IRS may not require pro rata funding when dividing a QTIP trust. The ruling states:

> A trust may be divided into separate trusts to reflect a partial election that has been made or is to be made if authorized under the governing instrument or otherwise permissible under local law. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. The separate trusts formed after the division do not have to be funded with a pro rata portion of each asset held by the undivided trust. However, the value of the assets used to fund each trust must be equal respectively to the value of the fractional portion of the residuary trust as of the date of funding represented by each trust.

The ruling is in accordance with the QTIP regulations discussed above.

4. Contingent QTIP.

The Eighth Circuit, in Robertson Estate v. Commissioner, 15 F.3d 779 (1994) has followed the Fifth Circuit's decision in Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992) and reversed the Tax Court on the issue of the QTIP election where the executor's failure to make the election would change the disposition of the property. A case is before the Sixth Circuit on this issue. Treas. Reg. § 20.2056(b)-7(d)(3) follows the IRS position.

5. Marital Deduction and Guarantees.

PLR 9113009 set forth an IRS position that no marital deduction would be allowed for <u>any</u> assets which <u>could be</u> used to satisfy loans guaranteed by the decedent. The Service has now changed its position. The facts recited by the IRS were:

> To facilitate a lender's approval of loans to corporations and other business entities owned by the taxpayer's children, the taxpayer gratuitously provided the lender with the taxpayer's personal guarantee that the loans will be repaid. The taxpayer has not pledged or otherwise conveyed any interest in specific property to secure any of these guarantees. If the taxpayer dies before all of these loans are repaid, the taxpayer's estate will become liable for each outstanding guarantee. As a result, property that passes to a marital discretionary income trust described in §20.2056(e)-2(b) of the Estate Tax Regulations (Estate Trust) and a marital income trust described in §2056(b)(7) of the Internal Revenue Code (Marital Trust) may become subject to the payment of the guaranteed loans. The will provides that property equal to two times the "Net Value Cost" of making payments on guarantees given by the taxpayer that are outstanding as of the date of the taxpayer's death is to be allocated to the Estate Trust. The Estate Trust defines "Net Value Cost" in terms of twice an estimate of the present value of satisfying the loan guarantees. The residue of the estate is to be allocated to the Marital Trust.
>
> Under applicable local law, if the borrower defaults on a guaranteed loan and the guarantor or his estate pays the defaulted amount to the lender, the guarantor or his estate is subrogated to the lender's

collection rights on the loan for the amount the guarantor or his estate paid.

The new conclusions are:

Under §2056(b)(4), if property passing to the surviving spouse is encumbered in any manner, the encumbrance is taken into account in the same manner as if the amount of a gift to the spouse were being determined. Under the terms of the taxpayer's will, assets will pass to the Estate Trust for the benefit of the surviving spouse only if there are any loan guarantees outstanding at the taxpayer's death. The marital deduction for the bequest of such assets would not be reduced by the entire unpaid balance of the guaranteed loans unless at the time of the taxpayer's death it appears that a default after the Estate Tax Return is filed is likely, that assets of the Estate Trust will be used to pay the entire unpaid balance of such loans, and that the subrogation rights appear to be worthless.

It is well settled that, notwithstanding the restrictions of §2056(b), an asset in the form of a promissory note that passes from a decedent to or for the benefit of the surviving spouse is ordinarily eligible for the marital deduction, whether the note passes outright to the spouse or to an estate trust described in §20.2056(e)-2(b) or to a marital trust described in §2056(b)(5) or (b)(7). After a decedent's death, the spouse (or the trustee of the trust for the benefit of the spouse) holds the note as a creditor of the borrower and is subject to a risk of loss if the borrower were to default and be incapable of repaying the note. It follows that the mere presence of a promissory note among assets passing to a trust for the benefit of the surviving spouse would not ordinarily cause the disallowance of the marital deduction.

If one or more assets (not necessarily promissory notes) pass from a decedent to or for the benefit of the spouse subject to a

> loan guarantee encumbrance, the spouse (or the trustee of the trust for the benefit of the spouse) is subject to a risk of loss if the borrower were to default and be incapable of repaying the guaranteed loan. In the event of default, the spouse (or the trustee) would pay the lender pursuant to the guarantee, as a result of which the spouse (or the trustee) would be immediately subrogated to the lender and would consequently become a creditor of the borrower for the amount paid pursuant to the guarantee.
>
> Thus, for purposes of §2056(b), the position of a spouse (or trustee) as a note holder is indistinguishable from the position of a spouse (or trustee) as holder of assets subject to a loan guarantee. In the case of the note asset and in the case of the guarantee-encumbered asset, the risk of the borrower's default presents the same issue for purposes of determining whether a surviving spouse's interest in the asset is considered a nondeductible terminable interest. In either case, neither the borrower nor the lender possesses an "interest in" or a "power to appoint" property, as those terms are used in §2056(b).

The importance of the changes is clear: there is no risk of a complete disallowance of the marital deduction. However, a number of issues remain. The IRS analogized to the risk that a promissory note might be unpaid. In such instances, the value of the note depends on, among other factors, the likelihood of repayment. Presumably, if marital deduction assets were likely to be used for the payment of a guarantee, there would be a reduction in the value of the marital deduction.

The 1990 ruling had also dealt with gift guarantees. The new ruling does not.

6. Loans From a QTIP.

The IRS addressed loans from a QTIP trust in PLR 9418013. In pertinent part, the transaction was as follows:

> The Marital Trust contains substantial liquid assets. The trustee proposes to make loans of up to $Y to each of the three sons from the assets of the Marital Trust. These loans in the aggregate will not exceed 8% of the current fair market value of the Martial Trust. In exchange for the loan, each son will execute a promissory note to the Marital Trust, payable on the spouse's death bearing a rate of interest sufficient to satisfy the provisions of §7872, although the interest will accrue instead of being paid on a current basis.
>
> Under the proposed loan arrangements, the trustee will make principal distributions to the spouse each year in an amount equal to the accrued interest on the promissory notes.

The IRS held that there was no disposition of the spouse's interest:

> In the present case, the trustee proposes to make loans of up to $Y to each of decedent's three sons from the corpus of the Marital Trust. The interest on the loans will be a rate of interest that meets the requirements of §7872. The interest however, will accrue instead of being paid on a current basis. Under the proposed loan arrangement, the trustee will make principal distributions to spouse each year in an amount equal to the accrued interest. This distribution will offset the loss of "real income" to spouse. Under these circumstances, the spouse will not be deprived of the income that she would receive from the Marital Trust if the loans were not made. Therefore, the quality of the spouse's qualifying income interest for life will remain substantially unchanged as a result of the proposed transaction. In

addition, the promissory notes that will be given in exchange for the loans will accrue interest over the life of the spouse and upon her death, the promissory notes and the accrued interest thereon, will be includible in spouse's estate under section 2044.

7. **Apportionment of Taxes to QTIP.**

The Ohio tax apportionment statute was involved in Estate of Hans W. Vahlteich, 67 TCM 1994-168. The statute provides as follows, in relevant part:

> (A) Unless a will or other governing instrument otherwise provides, and *except as otherwise provided in this section*, a tax shall be apportioned equitably in accordance with the provisions of this section among all persons interested in an estate in proportion to the value of the interest of each person as determined for estate tax purposes.
>
> * * *
>
> (I) If any part of an estate consists of property, the value of which is included in the gross estate of the decedent by reason of section 2044 of the "Internal Revenue Code of 1986," 100 Sta. 2085, 26 U.S.C.A. 2044, as amended, or of section 5731.131 * * * of the Revised Code, the estate is entitled to recover from the persons holding or receiving the property any amount by which the estate tax payable exceeds the estate tax that would have been payable if the value of the property had not been included in the gross estate of the decedent. *This division does not apply if a decedent provides otherwise in his will or another governing instrument and the will or instrument refers to either section mentioned in this division or to qualified terminable interest marital deduction property.* [Emphasis added.]

The decedent's will provided for the residue of the estate to be distributed to charity. An asset of the decedent's estate was a QTIP trust; if the taxes generated to the estate by the QTIP trust were paid from the residue, the resulting charitable deduction would be reduced creating a "tax on tax" situation. On the other hand, if the taxes were to come from the QTIP trust itself, the residue would remain intact.

The decedent's tax clause said this:

> I direct that all my just debts, funeral and administration expenses be paid as soon as practicable after my decease and that *all transfer, estate or inheritance taxes*, including any interest and penalties thereon, *imposed* by any taxing authority *upon or in relation to any property owned by me at the time of my death* which is disposed of by this Will or any Codicil to it, *or upon or in relation to any trust*, gift, insurance, annuity, joint property or transfer, *included* as part of my taxable estate, *shall be paid as an expense out of my residuary estate (as hereinafter defined) without apportionment* against the legatees, beneficiaries, donees, or transferees thereof. [Emphasis added.]

The court determined the nub of the issue to be: does the Ohio statute require a specific reference to either section 2044 of the Internal Revenue Code or qualified terminable interest property in order for apportionment to be waived? The court said no. First the court noted that the Ohio Legislature could have required a specific reference, but that the statute does not. Second, the decedent's tax clause provided that all taxes imposed on account of trust being included in the decedent's taxable estate would be paid from the residue without apportionment. The QTIP trust was the only such trust.

KRS 140.190(2) provides that:

> (2) The heir, devisee or other donee shall be personally liable for the tax on real property, as well as the personal representative or trustee, and if the personal representative or trustee pays the tax he may, unless the tax is made an expense of administration by the will or other instrument, recover the tax from the heir, devisee or other donee of the real property.

Also of interest is University of Louisville v. Liberty National Bank & Trust Company, Ky., 499 S.W.2d 288 (1973) construing a clause to pay taxes from the estate to be a direction that the residue generally should be charged, without allocation, with the result that a charitable interest was burdened with tax, and Union Bank and Trust Company v. Barrett, Ky., 253 S.W.2d 632 (1952) dealing with allocation to power of appointment property.

Q. Sections 2501 to 2524 - Gifts

1. Check to Individual.

In recent years several cases have dealt with when a gift by check is effective for gift tax purposes, the most recent being Estate of Metzger v. Comm'r, 100 T.C 204, which discusses the prior cases. The issue was whether payment of checks to individuals in 1986 related back to the delivery and deposit of the checks in 1985. The court answered this question in the affirmative. The opinion states:

> We see no reason for refusing to apply the relating back doctrine to noncharitable gifts where the taxpayer is able to establish: (1) The donor's intent to make a gift, (2) unconditional delivery of the check, and (3) presentment of the check within the year for which favorable tax treatment is sought and within a reasonable time of issuance. Assuming these elements are present, the practical realities of everyday commerce recognized in Estate of Spiegel v. Commissioner, 12 T.C. 524, 529 (1949), require a limited extension of the relation-back rule.

A contrary interpretation was reached by the Virginia Supreme Court in Woo v. Smart, 442 S.E.2d 690 (1994) which held that checks given to donee prior to the donor's death that were cashed after the donor's death were not gifts. The court held that a check was neither an inter vivos gift nor a gift causa mortis because there were no transfers of funds and thus no delivery.

2. Gifts by Power of Attorney.

Technical Advice Memorandum 9342002 holds that a power of attorney which gives the attorneys-in-fact broad powers but does not expressly authorize them to make gifts cannot be effectively exercised, under Oregon law, to make gifts or to create a trust on behalf of the decedent which authorizes the trustee to make transfers to other persons during the decedent's life.

Technical Advice Memorandum 9347003 reaches the same result under Texas law.

> Although the Texas Supreme Court has not addressed the authority of an attorney-in-fact under a durable power of attorney to make gifts if not specifically authorized, other Texas courts have addressed the extent of the authority of an agent under a power of attorney. In Gouldy v. Metcalf, 12 S.W. 830 (Tex. 1889), the court set forth the established rule that, where the authority is conferred in a formal instrument, the general words are restricted to the context of the instrument and construed as to exclude the exercise of any unwarranted power. (Citations omitted.)
>
> The durable power of attorney gave A the power to sell, convey, mortgage, and exchange any real property and, generally, to do anything that D could do. However, it did not specifically give A the power to make gifts of the property or to transfer the property without adequate consideration. under Texas law, the instrument must be strictly construed and we do not believe that the Texas Supreme Court would construe this instrument as giving a the power to transfer D's property without full and adequate consideration.

PLR 9410028 expresses the IRS view that, under Colorado law, attorneys in fact may not make gifts without specific authority to do so. No Colorado case or statute was cited.

3. Section 483 - Interest Rates.

In Schusterman v. U.S., ______________ (D.C. N. Okla. 1994) the court followed Krabbenhoft v. Commissioner, 939 F. 29 529 (8th Cir. 1991) and rejected Ballard v. Commissioner, 854 F.2d 184 (7th Cir. 1988), in holding that the interest rates of section 483 are irrelevant to gift tax. The facts involved interest-free leans prior to Dickman v. Commissioner, 465 U.S. 330 (1984).

4. Dominion and Control.

The case of Claude J. Autin v. Commissioner, 102 T.C. No. 35, involved unusual facts. On August 14, 1974, father and son incorporated Louisiana International Marine, Inc. ("LIM"); father received 51 shares and son received 49 shares. Father filed no gift tax return, even though son furnished no capital. On the same day, father and son executed a "counter letter" which the court discussed as follows:

> On August 14, 1974, petitioner and his son executed the counter letter, which states that petitioner signed the following documents before Mr. Pitre, as notary public:
>
> > Articles of Incorporation for Louisiana International Marine, Inc., an Initial Report, Minutes of a Meeting of Incorporation, Minutes of the First Meeting of the Board of Directors, By-Laws, two (2) stock certificates and a receipt for Stock Certificate No. 1 for fifty-one (51) shares of Capital Stock of Louisiana International Marine, Inc. for the

> purpose of forming said Corporation so that he and his son Bobby C. Autin, could begin working together in the Marine Industry; that in accordance with all of the documents above mentioned, Claude J. Autin, appeals herein, received and is the registered owner of Certificate No. 1 representing 51 shares of the Capital Stock of Louisiana International Marine, Inc.;

The counter letter further states:

> That in truth and in fact appearer has no ownership interest in said stock certificate of said capital stock of said corporation; that the same was acquired by him for the account of his son, Bobby C. Autin, and that he will execute in favor of said Bobby C. Autin, or his nominee, at such time as appearer is called upon so to do, any and all instruments and documents necessary to transfer to the said Bobby C. Autin all right, title and interest that appearer has or may have in and to Louisiana International Marine, Inc. and/or Certificate No. 1 representing 51 shares of the capital stock of said corporation.

The counter letter also states the following as the reason why the 51 shares were issued in petitioner's name:

> although the corporation in truth and in fact belongs to Bobby C. Autin, and appearer will be employed as president of the corporation, it will be to the best interest of the corporation, and his son that the clients and customers of said corporation believe appearer to be the principal stock holder of Louisiana International Marine, Inc. because of appearer's reputation in the Marine industry and because of the personal contacts and relationships established over the years between appearer and these customers.

Father held himself out as in charge of LIM, although son also worked in the business. In 1988, father retired from LIM and the

51 shares were recorded in son's name. Upon gift tax audit, father argued there was no 1988 gift because he never owned the shares, or had transferred them by the counter letter. The IRS claimed that father never relinquished dominion and control over the shares and that the counter letter was not effective against people who had no notice of it.

The court concluded as follows:

> Respondent contends that the following factors indicate petitioner's dominion and control over, and substantive ownership of, the 51 shares: (1) Petitioner held himself out as a 51-percent shareholder on LIM's Federal and State corporate income tax returns; (2) petitioner signed corporate tax returns under penalties of perjury, (3) petitioner reported 51 percent of all of LIM's undistributed taxable income on his Form 1040 for taxable year 1974 when LIM was an S corporation; (4) during 1974, LIM reported to the Internal Revenue Service that petitioner was a 51-percent shareholder in LIM; (5) to break the subchapter S election, the 49 shares held by petitioner's son were reduced to 48, rather then reducing petitioner's shares from 51 to 50; (6) once LIM became a C corporation, LIM's corporate minutes reflect that petitioner attended the shareholders meetings and exercised his voting rights as to the 51 shares; (7) petitioner was in charge of LIM from the time of LIM's incorporation until June 1988 when he resigned as president (in favor of his son's become president) and became vice president; (8) petitioner traveled 2 to 4 days per week to meet with potential customers to sell LIM's services; (9) petitioner was the guiding force who set up LIM's business and successfully managed it until his son gained the experience necessary to successfully run LIM; (10) petitioner personally guaranteed several of LIM's loans during early days; (11) petitioner had the

authority to invest LIM's capital; (12) as part of their community property settlement, petitioner paid Cherie Autin to waive her rights and claims to petitioner's interest in LIM; and (13) throughout the years, petitioner's auditors and attorneys who knew of the counter letter apparently treated the counter letter as a secret document that had an effect only between petitioner and his son.

We agree with respondent that petitioner's actions indicate his extensive assertion of dominion and control over LIM and petitioner's substantive ownership of the 51 shares. Significantly, petitioner held himself out as the majority shareholder to all of LIM's customers and business associates and acted as the true owner of the 51 shares. He held himself out to the Internal Revenue Service as well as the Louisiana taxing authorities as a 51-percent owner. Petitioner reported 51 percent of LIM's undistributed taxable income on his Form 1040 for taxable year 1974. He attended shareholders meetings and exercised his voting rights with respect to the 51 shares. Petitioner controlled LIM as president from August 1974 through June 1988. At the same time that petitioner relinquished the presidency of LIM, he transferred the 51 shares into his son's name. Indeed, petitioner transferred the shares to his son during 1988, not because his son demanded them, but because petitioner decided that he wanted to retire from LIM.

There is nothing in the record indicating that petitioner's son, who purportedly owned 100 percent of LIM pursuant to the counter letter, had acted as the sole shareholder. There were no voting trust agreements or shareholder agreements to document that petitioner was required to vote the 51 shares as a fiduciary on behalf of his son or in the same manner that his son voted his shares. Moreover, petitioner's son did not testify as to his control over the 51 shares or his understanding with petitioner as to the ownership of the 51 shares. The rule is well

> settled that failure of a party to introduce evidence within his possession and which, if true, would be favorable to him, gives rise to the presumption that if produced it would be unfavorable." Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947).

5. Exercise of Special Power of Appointment.

In TAM 9419007 the IRS found that a gift occurred upon the exercise of an inter vivos power of appointment. The facts, which are very important, were these:

> Under the facts as presented, in 1959, the Grantor purportedly created eleven separate trusts for the benefit of the members of the family of M. Each trust had an initial term of 20 years. During the first 15 years of the trust term, income was accumulated. During the next 5 years of the trust term, income was paid for the support of a designated older generation family member.
>
> At the end of the 20-year term, each trust was to be held for the benefit of a designated grandchild of N. The principal and accumulated income of each separate trust was distributable to a designated grandchild when he or she reached age 30. If a grandchild died before reaching age 30, the trust property otherwise distributable to him or her was to be distributed instead to his or her issue, or if none, to (or for the benefit of) the other younger generation family members. Between the end of the 20-year trust term and the date that a respective grandchild reached age 30, the income of the separate trust held for that grandchild was payable to him or her. The provision creating this interest states:
>
> As to any persons designated to receive distributions . . . who shall be under 30 years of age at the end of the 60 month period, instead of making distribution to such person, Trustee shall distribute to such

> person the net income from his trust until he attains the age of 30, at which time Trustee shall distribute to him all the accumulated income fund, current income and any principal then remaining in his trust. [Emphasis added.]

> Under the provisions of each separate trust, each grandchild had a power of appointment, labeled a "Limited Power of Appointment." The power was exercisable at any time during the grandchild's lifetime by written instrument or at death by testamentary instrument. Under the "Limited Power of Appointment," each grandchild could appoint "his interest in the trust estate" to, or in trust for, certain family members. The trust instrument states:

> No power of appointment . . . shall be exercised to any extent in favor of the Donee of such power, his estate or for the benefit of his creditor or the creditors of his estate.

In 1980, when the Donor's grandchild was of majority age, but not yet 30, the Donor exercised the power of appointment in favor of new trusts for other beneficiaries. The IRS described the Donor's property interests at that time, and the issue:

> At the time that the powers of appointment were exercised, the Donor (and each grandchild) possessed: 1) a contingent remainder interest in a trust (which would ripen into absolute ownership of the property upon that grandchild's reaching age 30); and 2) the right to receive current trust income until reaching age 30. The issue presented is whether the Donor made a taxable gift when she exercised the "Limited Power of Appointment," thus relinquishing these interests in favor of the other family members.

The IRS position was that by exercising the power the Donor relinquished valuable property rights, namely the right to income, and the contingent remainder. The IRS refused to follow Self v. United States, 142 F.Supp. 939 (Ct. Cl. 1956), as stated in Rev. Rul. 79-327, 1979-2 C.B. 342. Self involved the appointment of principal which terminated an income interest.

The IRS relied on the U.S. Supreme Court opinion in Jewett v. Commissioner, 455 U.S. 302 (1982) where the Court said:

> [P]etitioner argues that the disclaimer of a contingent remainder is not a taxable event by analogizing it to an exercise of a special power of appointment, which generally is not considered a taxable transfer. 26 U.S.C. §2514. As the Commissioner notes in response, however, a disclaimant's control over property more closely resembles a general power of appointment, the exercise of which is a taxable transfer . . . Unlike the holder of a special power -- but like the holder of a general power -- a disclaimant may decide to retain the interest himself.

The donor argued that this passage was dictum, because, in fact, Jewett was decided primarily on other grounds.

If correct, the IRS position would transform the exercise of many inter vivos special powers into gifts. For example, where someone can receive income and principal for ascertainable standards there could be a gift. Is there a different result if the trust provides for the beneficiary to receive income and principal only if beneficiary does not exercise the special power of appointment; in that event the "standard" has anticipated an exercise? What if distributions are purely discretionary?

6. **Gift By Not Redeeming Stock.**

The IRS answered the following question in the affirmative in TAM 9420001:

> For purposes of §2511 of the Internal Revenue Code, did the taxpayer, as the sole voting common shareholder, make taxable gifts to the nonvoting preferred shareholders by failing to have the corporation redeem the preferred stock, if, as a result of the failure to redeem the preferred stock, the preferred stock became convertible into voting common stock with a value in excess of the preferred stock?

From 1964 until 1984 the preferred stock could have been redeemed to prevent its conversion. The IRS relied on Snyder v. Commissioner, 93 T.C. 529 (1989), Rev. Rul. 89-3, 1989-1 C.B. 278, and Rev. Rul. 84-105, 984-2 C.B. 197, to conclude, in general, that "the taxpayer's failure to protect her economic interest resulted in an indirect transfer to the other shareholders. Consequently, for purposes of the gift tax, the taxpayer is regarded as making an indirect gift to the preferred shareholders."

7. **Value of Gift.**

The Eighth Circuit, in O'Reilly v. Commissioner, 973 F.2d 1403 (8th Cir. 1992), determined that the valuation tables of section 2512 should not apply in valuing an income interest in closely-held shares which, historically, had paid a miniscule dividend. The Tax Court has now determined the proper value to be less than 10% of the fair market value of the shares. Charles H. O'Reilly, Sr., 67 TCM 1994-61.

8. **Promise To Make a Gift.**

Roberta Schreiber Ulmer, et. al. v. Commissioner, 67 TCM 1994-234, was a taxpayer victory in Tax Court. The facts were complex and involved IRS claims that gifts were made by means of certain family agreements and bargain sales. Of interest is the court's discussion of the gift tax implications of promises to make gifts:

> The rule with regard to a promise to make a gift has been well stated by the Court of Appeals for the Second Circuit, in Rosenthal v. Commissioner [53-2 USTC ¶10,908], 205 F.2d 505, 509 (1953), revg. and remanding [Dec. 18, 681] 17 T.C. 1047 (1951): "a binding promise to make a gift becomes subject to gift taxation in the year the obligation is undertaken and not when the discharging payments are made." That was the view of the Tax Court in Rosenthal v. Commissioner [Dec. 18,681], 17 T.C. 1047 (1951), which was revd. and remanded by the Court of Appeals for the Second Circuit [53-2 USTC ¶10,908], 205 F.2d 505 (2d Cir. 1953), to determine whether the binding promise in question was made in consideration of the release of the taxpayer from an earlier binding promise. See also Estate of Coply v. Commissioner, 15 T.C. 17, 20 (1950)(payments made in 1946 and 1944, pursuant to a binding contract (an antenuptial agreement) entered into in 1931, were not taxable as gifts in 1936 and 1944), affd. 194 F.2d 364 (7th Cir. 1952).

9. **Timing of Gift.**

The Tax Court, in Estate of Larch M. Cummins, TCM 1993-518, determined that funds transferred after the decedent's death by the decedent's stock broker to individuals named in a letter of instruction were not completed gifts under applicable state law (Oregon). The Irrevocable Letter of Instruction was signed by the decedent at 3:46 p.m., delivered to the broker at 4:00 p.m., accepted by 4:30 p.m. by the broker, and the decedent died at 4:40 p.m. The instructions were carried out the next day. The court rejected arguments that the letter created a trust relationship because the broker was not a designated trustee and the letter did not transfer legal title to the broker. And, the broker was not the donees' agent because the letter created no obligation to the donees directly.

R. <u>Section 2518 - Disclaimer</u>

1. Effective Date.

The U.S. Supreme Court has held that the disclaimer of a remainder interest in a trust is subject to federal gift tax even if the trust created before the enactment of the tax. <u>U.S. v. Irvine</u>, ______________ (U.S. 1994). Justice Souter stated the issue to be:

> In <u>Jewett v. Commissioner</u>, 455 U.S. 305 (1982), we construed the 1958 version of Treasury Regulation §25.2511-1(c) to provide that the disclaimer of a remainder interest in a trust effects a taxable gift unless the disclaimant acts within a reasonable time after learning of the transfer that created the interest. This case presents the question whether the rule is the same, under current Treasury Regulation §25.2511-1(c)(2)(Regulation), when the creation of the interest (but not the disclaimer) occurred before enactment of the federal gift tax provisions of the Revenue Act of 1932. We hold that it is.

In 1917 Mr. Ordway established a trust, which terminated in 1979 in favor of Mr. Ordway's living grandchildren (and the descendants of a deceased grandchild). Two months after termination a grandchild disclaimed; the disclaimer was valid under applicable state law (Minnesota) because it was within 6 months of the grandchild becoming indefeasibly vested in the interest. The IRS argued that the disclaimer was not within a reasonable time after the grandchild learned of the interest. With respect to reasonableness, the Court said:

> The opportunity to disclaim, and thereby to avoid gift as well as estate taxation, should not be so long as to provide a virtually unlimited opportunity to consider estate planning consequences. While a decision to disclaim even at the earliest opportunity may be made with appreciation of potential estate tax consequences, the passage of time puts the prospective disclaimant in a correspondingly superior position to determine whether her need to enjoy the property (and incur a tax for a subsequent gift of it or an increased estate tax if she retains it) outweighs the favorable estate and gift tax consequences of a disclaimer. Although there is no bright line rule for timeliness in the absence of a statute or regulation providing one, Mrs. Irvine's delay for at least 47 years after the clock began running, until she reached age 68, could not possibly be thought reasonable. By the date of her disclaimer, Mrs. Irvine was in a position to make a fairly precise determination of the advantage to be gained by a transfer diminishing her estate and its eventual taxation. If her decision were treated as timely, the requirement for a timely election would have no bite at all.

The Court rejected the taxpayer's arguments:

> Even assuming the soundness of one or both of these arguments that the Regulation is inapposite, however, the disclaimer would not escape federal gift taxation by reference to state law rules giving effect to the disclaimer as causing a transfer to the beneficiary next in line. Any such reasoning would run counter to our holding in Jewett.

2. **Devolution of Disclaimed Property.**

TAM 9417002 reviewed Mississippi disclaimer law and discussed the consequences in light of no statutory provisions. The result was unfortunate for the taxpayer. The facts were simple:

> The decedent died testate in 1989, a resident of Mississippi. under the decedent's Will, her daughter, A, was named as the sole beneficiary of the residue after the payment of debts and expenses. The Will further provides that if A does not survive the decedent, a specified percentage of the decedent's stock in a close corporation will pass to each of A's three children named in the will and to A's spouse; the remaining property will pass to A's children named in the Will. The Will contains no provision concerning any beneficiary's disclaimer of an interest or the lapse of an interest. A survived the decedent and was appointed executor of the estate.
>
> Within nine months after the decedent's death, A executed a disclaimer of part of her interest as sole residuary beneficiary in the closely held shares. The disclaimer recited that, under the decedent's will, A is the beneficiary of 48,162 shares of the stock and that she was disclaiming any interest in 23,085 of the shares in that gift. On the same date, A's spouse executed a disclaimer, reciting his belief that, due to A's disclaimer, an interest in the disclaimed shares would pass to him under the decedent's will and that he disclaimed that interest. Both disclaimers were silent concerning any possible intestate interests of either person in the disclaimed property.
>
> A, as executor, distributed all of the disclaimed shares to her children named in the will.

The IRS determined that at common law disclaimed property passed to intestate takers. The decedent's child, A, was the intestate taker. Thus, there was a gift when A distributed the assets to her children.

The intended result could have been achieved if A had disclaimed the intestate share too.

S. Sections 2601-2654 - Generation-Skipping Transfer Tax

1. Grandfather Protection.

PLR 9335005 held that a judicial modification of two trusts would not affect their grandfathered status for GST purposes. Among the trust assets were closely-held stock. One of the two trust remaindermen was actively involved with the closely-held company. The judicial modification would permit the trustee to make a non-pro rata distribution of the trust assets at termination so that the stock of the closely-held company would be distributed to the remainderman who was active in the company. The other remainderman would receive other assets of equal value. The ruling notes this additional limitation on the trustee's power:

> The trust as judicially modified will provide that the power to make a non-pro rata distribution must not allow the trustee to affect the timing or fair market value of any distribution. Under the proposed modification, in selecting assets to be distributed to E and F, the trustee would not be restricted by the liquidity, or the income tax basis, of the assets being distributed, or the acceptance or approval of the non-pro rata distribution by the trust beneficiaries.

T. <u>Sections 2701-2704 - Special Valuation Rules</u>

1. Section 2701.

In T.D. 8536 (May 4, 1994) a short final regulation relating to the mitigation of double taxation was issued.

2. Section 2702.

A. T.D. 8536 also eliminated the need to prorate the first year's payment for GRATs and GRUTs, thereby simplifying the valuation.

B. As interest rates increase, personal residence trusts become more attractive and GRATs less attractive.

U. <u>Sections 4940 - 4947 -- Private Foundation Restriction</u>.

1. Stock Options.

PLR 9411018 allowed the contribution of stock options to a private foundation by a disqualified person. The facts presented, and rulings given, were as follows:

> M is an individual who owns approximately 81% of the outstanding common stock of X and 100% of the Series A preferred stock of X. Foundation is a nonprofit trust recognized by the Internal Revenue Service as exempt from tax under section 501(c)(3) of the Internal Revenue Code. Foundation is also a private foundation as defined in section 509(a) of the Code. Both M and X are disqualified persons with respect to Foundation.
>
> M wishes to pledge stock options to Foundation which provides Foundation with an option to purchase X's common stock at an option price equal to M's mean per share cost basis in the stock. The pledge option is exercisable by Foundation commencing on December 31, 1993 until twenty years from the date of the pledge.
>
> Prior to the expiration of the stock options, Foundation will transfer the stock options to one or more unrelated charitable organizations described in section 501(c)(3) of the Code. It is expected that the unrelated charitable organizations will pay to Foundation a price for the option equal to the difference between the fair market value of the stock subject to the option on the date of the transfer and the exercise price of the option, less an agreed-upon discount. The unrelated charitable organization will thereafter exercise the option prior to its expiration date.
>
> * * *
>
> Based on the information submitted, we rule as follows:

> 1. The pledge of the stock options by M to Foundation does not constitute an act of self-dealing between Foundation and a disqualified person under section 4941 of the Code.
>
> 2. The exercise of the pledged stock options by unrelated charitable organizations to whom the options are transferred will not constitute acts of self-dealing between Foundation and a disqualified person under section 4941 of the Code.
>
> 4. The pledged options will be excluded from the assets taken into account in computing the amount of the minimum investment return or Foundation for purposes of determining the tax on failure to distribute income under section 4942 of the Code.
>
> 5. Gains form the sales of the options by Foundation to unrelated charitable organizations will not be treated as net investment income of Foundation under section 4940 of the Code.
>
> 6. Gains from Foundation's sale of options to unrelated charitable organizations will be excluded from unrelated business taxable income under section 512(b)(5).

2. **Charitable Lead Trusts and Private Foundations.**

The Ninth Circuit has upheld the Tax Court in The Ann Jackson Family Foundation v. Commissioner, ______________ (1994). The issue, as the court presented it, was whether Treas. Reg. §53.4942(1)-2(b)(2) was invalid because inconsistent with section 4942(e) of the Internal Revenue Code. The court's analysis was straightforward:

> By placing the amended statute [amended in 1981] alongside the unrevised regulation, the difference between the two becomes obvious:

> Under the statute, "distributable amount" is effectively limited to a maximum of 5% of the fair market value of a foundation's own assets, while the regulation defines "distributable amount" as beginning with that same 5%, then adding thereto the income portion of trusts (which the IRS seeks to have here defined as included the Trust's entire corpus). In short, the regulation seeks to include all of the Trusts's assets in those of the Foundation. (Footnote omitted.)

Thus, charitable lead trusts become very helpful as ways to fund a family foundation.

V. Tax Administration

1. Section 6501 - Six Year Gift Tax Statute of Limitations.

Section 6501(e)(2) provides that if a gift tax return omits from total gifts an item or items in excess of 25 percent of the amount of total gifts, gift tax may be assessed within 6 years after the filing of the return. In Estate of Robinson v. Comm'r, 101 T.C. 33, the court rejected the IRS position that the section applied to a return in which the donor claimed excessive annual exclusions:

> The 6-year period of limitations found in section 6501(e)(2) does not apply in the instant gift tax case because decedent reported the correct values of all gifts she made during 1983 on her 1983 Federal gift tax return. There was no omission from total gifts of an item or items in excess of 25 percent of the amount of total gifts reported by decedent on her 1983 gift tax return. Assuming, without deciding, for the purpose of the instant case, that claiming more annual exclusions that allowable under section 2503(b) would lead to our holding that an omission from the total amount of gifts occurred for purposes of section 6501(e)(2), the gift tax returns filed by decedent made no such omission. As stated above, section 6501(e)(2) provides that items which are adequately disclosed are not taken into account in determining the amount omitted from total gifts. The Federal gift tax returns filed by decedent stated the number of annual exclusions being claimed and, therefore, adequately apprised the Commissioner of the specific number of annual exclusions claimed by decedent. Indeed, respondent does not argue that decedent did not adequately disclose the annual exclusions being claimed. Consequently, the exclusions are not to be taken into account for purposes of determining

> the amount omitted from total gifts for purposes of section 6501(e)(2), and the 6-year period of limitations found in section 6501(e)(2) is not applicable to the 1983 gift tax year.

2. **Section 6324(b) - Gift Tax Lien.**

In Ripley v. Commissioner, 102 T.C. No. 26 (1994), the court held that the gift tax lien of section 6324(b) was not subject to usual deficiency procedures (e.g 90 day letter, etc.). The court described the operation of section 6324 as follows:

> In sum, section 6324(b) provides that where a donor fails to pay Federal gift tax for particular period for which a gift tax return was filed, a special 10-year lien attached to all gifts made by the donor during that period and the donees of such gifts are personally liable for the tax. Further, should the donee transfer the gifted property to a purchaser or security interest holder, the lien does not remain on the transferred property but a like lien attaches to the donee's other property, including after-acquired property.

The court relied on the regulations issued under section 6324:

> (d) *Application of lien imposed by section 6321*. The general lien under section 6321 and the special lien under subsection (a) or (b) of section 6234 for the estate or gift tax are not exclusive of each other, but are cumulative. Each lien will arise when the conditions precedent to the creation of such lien are met and will continue in accordance with the provisions applicable to the particular lien. Thus, the special lien may exist without the general lien being in force, or the general lien may exist without the special lien being in force, or the general lien and the special lien may exist simultaneously, depending upon the facts and pertinent statutory provisions applicable to the respective liens.

three year gift tax statute of limitations expired, under section 6501(a), without an audit by the IRS. On April 13, 1992, the IRS sent to the grandchildren notices of transferee liability for a deficiency in the O'Neals' gift tax liability. The gift tax issue was picked up by the IRS because Mrs. O'Neal died in 1988, and the gift tax returns were reviewed as part of the estate tax audit.

The Tax Court stated the issues as follows:

> The issues for decision are: (1) whether a donee/transferee can be held liable at law as a donee/transferee for gift tax and generation-skipping transfer tax when respondent failed to assert the deficiency against the donor prior to the running of the statute of limitations against the donor; (2) whether, in accordance with section 6910, notice of liability was properly sent to petitioners; and (3) whether section 2504(c) precludes respondent from challenging the value used by the donors in reporting the gifts when the period of limitations for assessment against the donors has expired.

The court analyzed the first issue in this way:

> Section 2501 imposes a tax on the transfer of property by gift. An additional tax on a generation-skipping transfer is imposed by section 2601. A generation-skipping transfer is defined to include transfers of property from a grandparent to a grandchild. Secs. 2611, 2612 and 2613.
>
> The second sentence of section 6324(b) provides that if the gift tax or generation-skipping transfer tax is not paid when due, the donee is personally liable for the gift tax or the generation skipping transfer tax to the extent of the value of the gift. Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186, 187-188 (8th Cir. 1945), affg. a Memorandum Opinion of this Court. In Fletcher

Trust Co. V. Commissioner, 141 F.2d 36, 40 (7th Cir. 1944), affg. 1 T.C. 798 (1943), the Court of Appeals for the Seventh Circuit, in affirming our decision, held that the predecessor to section 6324(b) imposed liability at law upon a donee. See also Bauer v. Commissioner, 145 F.2d 338 (3d Cir. 1944) affg. 2 T.C. 1916 (1943). There are no requirements that respondent first assert a deficiency against a donor or that other steps be taken to collect from the donor. Mississippi Valley Trust Co. v. Commissioner, supra at 188; Moore v. Commissioner, 1 T.C. 14, 15 (1942), affd. 146 F.2d 824 (2d Cir. 1945). Likewise, there is not requirement under section 6324(b) that the period of limitations on assessment of tax against the donor has not expired. If the tax "is not paid when due," the donee is personally liable for the tax to the extent of the gift under section 6324(b).

The fact of the personal liability of the donee "at law" distinguishes this case and similar cases from those cases such as Commissioner v. Stern, 257 U.S. 39 (1958), whether respondent was required to show liability of the transferee in equity under State law. cases such as Stern have no applicability to the instant case.

No matter what the reason for the donor's failure to pay the tax when due, the donee is liable for the tax to the extent of the value of the Gift. Mississippi Valley Trust Co. v. Commissioner, supra at 187-188. That the reason for the donor's not paying the tax when due was that no deficiency had been determined against the donor before the period of limitations for assessment against the donor expired is immaterial. The only requirement is that there be tax due with respect to the gift which remains unpaid.

With respect to the second issue, the court noted that section 6901(c) gives the IRS one year after the limitations period against the donor runs to assess the donees. Thus, the time periods were met. The court also rejected the application of section 2504(c) saying:

> Section 2504(c) does not limit how respondent values a gift of the current year. It limits the valuation for a prior year where the time within which "a tax may be assessed under this chapter" for the year has expired. Here, we have held that the time to assess the gift tax for the year would have not expired as to the transferee. Section 2504(c) limits how a gift from a preceding calendar year is valued for assessment of the gift tax for a subsequent calendar year. In the present case, the asserted deficiency is for the 1987 calendar year, and the gifts took place during 1987. Since the gifts are not gifts from a calendar period preceding the year in issue, the valuation of the gifts is not restricted by section 2504(c).

4. Renunciation; Effect on Section 6321.

In U.S. v. Comparato, ____________ F.3d __________ (2d Cir. 1994), the court held that once liens attach to property interests to be received by taxpayers from an estate, under section 6321, a subsequent renunciation of the property interests by the taxpayers will not defeat the liens even if the renunciation is retroactive under applicable state law to before the date of the IRS assessments against the taxpayers.

5. Retroactivity of Tax Changes.

In United States v. Carlton, ______ U.S. _____ (1994), Justice Blackmun delivered the unanimous judgment of the Court that the 1987 repeal of a 1986 estate tax provision giving special tax treatment to sales to ESOPs, which harmed a taxpayer who made use of the provision before repeal, did not violate the Fifth Amendment of the Constitution.

W. Potential Forthcoming Developments

1. **Fiduciary Income Tax Rates**. Reportedly, efforts are being made to have the income tax rates on trusts and estates lowered to the rates that apply to married individuals filing separately. The Daily Tax Reporter (May 23, 1994) notes efforts by the AICPA Tax Division, the American Bankers Association Taxation Committee, and the ABA Taxation and Real Property, Probate and Trust Law, Sections, and ACTEC. If successful, the top tax rate for a trust or estate would begin above $125,000.

2. **Regulations.** Comments of Richard Grosebauer (Branch Chief, Office of Assistant Chief Counsel, Passthroughs and Special Industries) before ABA Tax Section on May 13.

A. Section 7520 - final regulations expected soon (in fact, issued on June 10, 1994; see Appendix C for copy and comments).

B. Section 2056A -- proposed regulations expected by October (QDOTs).

C. Section 2518 - proposed regulation relating to timing in light of the U.S. Supreme Court's decision in J. Irvine, and clarifying rules about disclaimers of joint property.

D. Section 2056 - proposed regulations relating to the marital deduction "specific portion" requirements and annuities expected, maybe, in early 1995.

E. Generally working on some section 2032A issues and Chapter 14 issues.

3. IRS Wish List.

This Wish List has now been widely circulated (e.g., 1994 Heckerling Estate Planning Institute; Practical Drafting).

IRS "Wish List" of Transfer Tax Changes

The following list of suggested transfer tax changes prepared by personnel in the IRS National Office as distributed at a June 1993 IRS meeting in Austin, Texas:

a. Amend section 2053(a)(2) to disallow a deduction for any interest expense accruing to the estate after the decedent's death.

b. Amend section 2503(b) to provide that an annual exclusion is not allowable for a gift to a donee unless it is certain that the donee will eventually receive the gift property.

c. Amend section 2519 of the Code to provide that, to the extent that there is an underfunding of a disposition establishing a QTIP interest for a surviving spouse, the underfunded portion will be deemed a gift made by the surviving spouse. The statute of limitations would not begin to run on this gift until the later of the date it is reported in full or the date that the estate tax return of the surviving spouse is filed.

d. Amend section 2519 of the Code to provide that the purchase by the surviving spouse (or donee spouse) of the remainder interest in property subject to a QTIP election is deemed to be a gift of the amount of the purchase price. The statute of limitations would not begin to run on this gift until the later of the date it is reported in full or the date that the estate tax return of the surviving spouse is filed.

e. Amend section 2652(a)(3) to permit the estate of the decedent to elect to treat all or a portion of the property in a QTIP trust as if the election to be treated as QTIP had not been made.

f. Add new section 2047 to provide that if an individual [who could be the grantor or beneficiary] has a power to remove and replace a trustee, then that individual shall be deemed to possess the powers of the trustee.

g. HR 11 section 4702 would amend section 2035 of the Code by clarifying the present language.

h. Amend the present section 2035(d)(2) to provide that a life insurance policy issued within three years of the decedent's death is includible in the gross estate even if the decedent did not technically own the incidents of ownership in the policy prior to death.

i. Amend section 2039(a) to provide that survivor benefits payable pursuant to an employer's nonqualified benefit plan are treated as payable under the same contract or agreement as the benefits payable under the employer's qualified pension plan.

j. Amend the estate, gift and generation-skipping transfer tax provisions of the Code to limit the application or minority discounts when valuing transfers of minority interests in closely held corporations among family members.

k. Amend sections 2056(d)(2)(B), 2056(d)(4)(A) and 2056(d)(5)(i) to clarify that the acts required by these relief provisions must be completed before the estate tax return is filed and no later than one year after the due date for the return.

l. Amend section 2056(d)(3) to provide specific rules for allowance of the section 2013 credit for prior transfers for the estate of the surviving alien spouse.

m. Amend section 2056 to provide that, to the extent that property passing to the surviving spouse exceeds $3,000,000, the marital deduction is limited to one-half of the value so passing.

n. Amend section 2604 of the Code to repeal the credit for certain state generation-skipping transfer taxes (GSTT).

o. Amend section 2612 to clarify that any generation-skipping transfer that meets the definition of a direct skip and the definition of a taxable termination shall be defined as a direct skip.

p. Amend section 6163 to provide for the deferral of estate tax that is attributable to the inclusion of an annuity in a decedent's gross estate.

q. Add a new section 7872 A to provide for the valuation of loan guarantees for purposes of chapters 11 and 12.

X. **Miscellaneous State Cases of Interest**

1. In Matter of Estate of Laschkewitsch, 507 N.W.2d 65 (N.D. 1993), the court denied a claim filed in the state of ancillary probate, even though the claim related to repairs made on property in the ancillary state, because the claimant had actual knowledge of the domiciliary probate.

2. In Lansburgh v. Lansburgh, 632 A.2d 221 (Md. App. 1993), a trust terminated at the death of husband, with the remaining assets to be divided with husband's widow receiving the amount she would have received had the trust been part of husband's estate at his death. Husband was a domiciliary of Texas at his death; the trust was created and administered in Maryland. The court concluded Maryland law would control.

3. Burch v. George, 866 P.2d 92 (Cal. 1994), dealt with the application of community property claims, and ERISA preemption, to in terrorem clauses. The surviving spouse wanted to be free to litigate certain community property claims, and ERISA claims, without being subject to the clause; the court said no.

Y. Kentucky Developments.

1. **New Health Care Surrogate and Living Will Statute**. Copy attached as Appendix D.

The new Act is a clear improvement over the prior legislative efforts. There are a number of potential issues however.

a. **What is its effect on non-Kentucky documents?** The term "advance directive" applies to "any other document that provides direction relative to health care to be provided to the person executing the document." Yet, section 3(2) provides that an "advance directive" must be executed in a particular manner. What about those executed in other states that do not meet this requirement?

b. **Precedence**. Assume that in the Living Will Directive the grantor has authorized the withholding or withdrawal of artificially provided food, water, or other artificially provided nourishment or fluids. Does that take precedence over, or is it subservient to, the provisions of section 5(3) setting forth specific circumstances under which a health care surrogate may authorize a withdrawal or withholding of artificially provided nutrition and hydration? Section 2 provides that a directive must be honored even if there is no health care surrogate. This should not mean that you are better off in certain circumstances not to have a health care surrogate.

c. **Effectiveness**. The Living Will Directive provides that it sets forth the grantor's wishes regarding "life-prolonging treatment and artificially provided nutrition and hydration to be provided to me if I no longer have decisional capacity, have a terminal condition, or become permanently unconscious. . . " Is the lack of decisional capacity alone a triggering event? Or, is it tied to having a terminal condition or becoming permanently unconscious? Presumably the latter was intended, but the exact wording of the statute is confusing.

d. **Terminal Condition**. The definition of "terminal condition" is a condition which "to a reasonable degree of medical probability," as certified in certain ways, is incurable and irreversible and will result in death within a relatively short time, and where the application of life-prolonging treatment would serve only to artificially prolong the dying process. What about conditions which would otherwise be terminal -- that is they are incurable, irreversible and will result in death within a relatively short time, but which are not affected by the application of life-prolonging treatment but only by the application of artificial nutrition and hydration?

e. **Life-prolonging treatment**. The definition of "life-prolonging treatment" is any medical action which uses mechanical or other artificial means to sustain, prolong, restore, or supplant a spontaneous vital function and when administered to a patient would serve only to prolong the dying process. Is there an accepted meaning to "prolong the dying process?"

f. **<u>Determination of permanently unconscious or terminal condition</u>**. Both the definition of "permanently unconscious" and "terminal condition" require a determination to a reasonable degree of medical probability, and provide that such will be determined <u>solely</u> by the patient's attending physician and one other physician. Presumably, to determine a terminal condition, it is not necessary to have the other physician clinically examine the individual, because the phrase "on clinical examination" is present in the definition of permanently unconscious, but not terminal condition. Is that intentional?

Can a person's attending physician be changed? By whom? Generally, that would be part of a health care decision-making process so that a health care surrogate could change the attending physician. The phrase "attending physician" is defined as "the physician who has primary responsibility for the treatment and care of the patient."

Is it intended that the determination of whether someone is in a permanently unconscious state or has a terminal condition is not to be subject to review by (1) the health care provider, or (2) the courts. Section 7(2) provides that a physician or health care facility which refuses to comply with an advance directive may not impede the transfer of the patient to another physician or health care facility which will comply. This could create a paradox. An attending physician has no duty to comply with a health care surrogate directed, for example, to withdraw life prolonging treatment if there is no terminal condition (because the attending physician has decided that there is not a terminal condition). But, if another physician would decide that there is a terminal condition, then presumably the statute intends the second attending physician to take over.

g. **Execution**. The Advance Directive must be witnessed by two or more adults in the presence of the Grantor and in the presence of each other, or acknowledged before a Notary Public, and the statute sets forth a number of people who cannot be witnesses. That would appear to mean that the Notary replaces the witnesses, not that the witnesses have either to be in the presence of the Grantor and the presence of each other, or the witnesses have to be acknowledged by the Notary. If so, can the Notary be a blood relative, etc.? Ordinarily you would think "yes" because of the literal language of the statute. However, the statute specifically provides that an employee of a health care facility in which the grantor is a patient cannot be a witness, but can be a Notary Public. The safest path would appear to be to have two witnesses and a Notary, like a Will.

h. **Withdrawal of nutrition and hydration**. A health care surrogate may authorize the withdrawal or withholding of artificially provided nutrition and hydration in certain circumstances, some of which are interesting. The first is "when inevitable death is imminent." For that purpose, the statute says the phrase means when death is expected within a few days, and that the determination is to be made "by reasonable medical judgment." There is none of the attending physician/second physician language that the statute provides elsewhere. The second is "when a patient is in a permanently unconscious state if the grantor has executed an advance directive" authorizing the withholding or withdrawal. Presumably that means that the health care surrogate can authorize a withdrawal or withholding of artificially provided nutrition and hydration at any time when inevitable death is imminent, regardless of what the Grantor has said, assuming that the Grantor has not said anything contrary, but only if the Grantor is in a permanently unconscious state if the Grantor has executed an Advance Directive. In the so called "Karen Ann Quinlan situation," the person would be in a permanently unconscious state, but would not have executed an Advance Directive. The same would be true in a DeGrella or similar circumstance. Of course, the statute says that "may authorize" in the following circumstances and does not rule out authorizing in other circumstances. Is that important?

i. **Pregnancy**. The pregnancy provision is of interest. The statute returns to the reasonable degree of medical certainty standard but with subtle differences. The reasonable degree of medical certainty must be certified on the woman's medical chart by the intending physician and one other physician who has examined the woman. Is the change intentional? The statute goes on to provide that nutrition and hydration will be provided to a pregnant woman unless, in accordance with that reasonable degree of medical certainty, the procedures will not maintain the woman in a way to permit the continuing development live birth of the unborn child, or will be physically harmful to the woman, or will prolong severe pain which cannot be alleviated by medication. When would the provision of artificial nutrition and hydration be physically harmful to the woman? Further, the statute already suggests that artificial nutrition and hydration cannot be withdrawn if it is needed for the comfort or relief of pain (section 4(3)(d)).

j. **Applicability**. This Act only applies to adults. Section 2 provides that an adult with decisional capacity may make a written living will directive. Section 6 provides what happens to an adult patient who does not have decisional capacity but who has not executed an advance directive or who has not executed one which is directed if a decision must be made. A potential problem with section 6 would be for a person who has multiple children, and no spouse, and no guardian, because the decisions are made by a majority of the adult children who are reasonably available for consultation. What does reasonably available for consultation mean? If a person has no guardian, spouse, adult child or parent, the person falls into a catchall which is the nearest living relative of the patient, or, if more than one relative of the same relation, a majority of the nearest living relatives, again using the reasonably available consultation standard.

The statute provides that more than one health care surrogate may be designated, and that the health care surrogate(s) will act by unanimous decision unless a designation provides otherwise. Yet the statute earlier provided for a majority of children to serve. Thus, the statute does not choose a clear policy when the provisions of section 6(1) have in line the parents of the patient, does it require the parents to act unanimously or not? By the way, it also does not say the parents who are reasonably available, or if one declines to act, can the other act?

k. <u>Presumptions</u>. Section 9 contains interesting provisions. Section 4 provides that the Act will not create a presumption concerning the intention of an adult who has revoked or has not executed an Advance Directive with respect to the use, withholding, withdrawal of a life-prolonging treatment if a terminal condition exists. Does that mean there is a presumption if the person is permanently unconscious? Surely that is not what the Legislature intended. Also, should there be an inference from the fact that a person has revoked an Advance Directive?

2. Real Estate Transfer Tax Statute. Copy attached as Appendix E. In general, transfers for estate planning purposes (e.g., to a revocable trust agreement or personal residence trust) are protected.

3. Lilly v. Citizens Fidelity Bank and Trust Company, Ky. App., 859 S.W. 2d 666 (1993). The court held, on complicated facts, that the law in effect when a testator died controlled whether a power of appointment was exercised, not the law at the time the power was created. Further, a power of appointment may be exercised in favor of a trust, absent a limitation in the power, as long as the trust beneficiaries are objects of the power.

4. Everly v. Wright, Ky. App., 872 S.W.2d 95 (1993). A widow who had never been appointed personal representative could not bring a wrongful death action.

APPENDIX A

IRS NEWS RELEASE 93-121 (12/21/93) AND PROPOSED REGULATIONS (5/26/94)

REQUIREMENT FOR CHARITABLE CONTRIBUTIONS TO BE SUBSTANTIATED BY WRITTEN ACKNOWLEDGEMENT FROM CHARITY

[¶ 7222] Internal Revenue News Release 93-121, December 21, 1993.

[*Code Secs. 170 and 6115*]

Charitable contributions: Revenue Reconciliation Act of 1993.—The IRS has provided guidance to charities and individuals for compliance with the new requirements for donations over $250 and quid pro quo contributions imposed by the Revenue Reconciliation Act of 1993 in New Publication 1771, Charitable Contributions-Substantiation and Disclosure Requirements. Back references: ¶ 1882.05 and 5084A.05.

Charities have a new substantiation requirement for certain contributions they receive on or after January 1, 1994, due to the Omnibus Budget Reconciliation Act of 1993.

To assist charities in complying with these new rules the IRS has developed new Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements. The IRS said it is mailing this publication to over 500,000 charities in December 1993.

Beginning January 1, charities receiving payments described as "quid pro quo contributions," in excess of $75, must provide a written statement to the donor. A quid pro quo contribution is one in which part of the payment is for goods or services received and part is a contribution.

This statement must give a good faith estimate of the value of the goods and services plus inform the donor that the charitable deduction is limited to the amount of the payment in excess of the value of the goods and services provided. For example, if a person gives a charity $100 and receives in exchange a $40 dinner, the charity must inform the donor in writing that the dinner was valued at $40 and only the portion of the payment exceeding the value of the dinner, $60, qualifies as a charitable contribution.

A written statement is not required if the goods or services provided by the organization are de minimis, token goods or services, or an intangible religious benefit.

The responsibility for providing disclosure statements for quid pro quo contributions over $75 rests with the charity. The charity must pro-

[2] If section 1002(d) of the Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103d Cong., 1st Sess., is enacted, Section 7 of Rev. Proc. 92-102 (unmodified) would be applicable for tax years beginning in 1993.

vide the statement in connection with either the solicitation or the receipt of the contribution. A penalty of $10 per contribution can be imposed on the charity for each failure to provide the required statement.

Charities also need to be aware of a new change affecting contributors. For charitable contributions of $250 or more made after Dec. 31, 1993, the donor is not allowed a deduction unless the gift is acknowledged by the charity in writing. Also, the donor must obtain the acknowledgement by the earlier of the date the return is filed or the due date of the return, including any extensions.

The acknowledgement must contain the amount of the cash or check and a description of any noncash property contributed. It must state whether the charity provided any goods or services in return for the contribution. If so, it must also include a description and good faith estimate of the value of the goods or services or, if the goods and services consist solely of intangible religious benefits, a statement to that effect.

A copy of Publication 1771 is attached.

Publication 1771

Charitable Contributions—Substantiation and Disclosure Requirements

UNDER THE NEW LAW, CHARITIES WILL NEED TO PROVIDE NEW KINDS OF INFORMATION TO DONORS. Failure to do so may result in denial of deductions to donors and the imposition of penalties on charities.

Legislation signed into law by the President on August 10, 1993, contains a number of significant provisions affecting tax-exempt charitable organizations described in section 501(c)(3) of the Internal Revenue Code. These provisions include: (1) new substantiation requirements for donors, and (2) new public disclosure requirements for charities (with potential penalties for failing to comply). Additionally, charities should note that donors could be penalized by loss of the deduction if they fail to substantiate. **THE SUBSTANTIATION AND DISCLOSURE PROVISIONS APPLY TO CONTRIBUTIONS MADE AFTER DECEMBER 31, 1993.**

Charities need to familiarize themselves with these tax law changes in order to bring themselves into compliance. This Publication alerts you to the new provisions affecting tax-exempt charitable organizations. Set forth below are brief descriptions of the new law's key provisions. The Internal Revenue Service plans to provide further guidance in the near future.

Donor's Substantiation Requirements

Documenting Certain Charitable Contributions.—Beginning January 1, 1994, no deduction will be allowed under section 170 of the Internal Revenue Code for any charitable contribution of $250 or more unless the donor has contemporaneous written substantiation from the charity. In cases where the charity has provided goods or services to the donor in exchange for making the contribution, this contemporaneous written acknowledgement must include a good faith estimate of the value of such goods or services. Thus, taxpayers may no longer rely solely on a cancelled check to substantiate a cash contribution of $250 or more.

The substantiation must be "contemporaneous." That is, it must be obtained by the donor no later than the date the donor actually files a return for the tax year in which the contribution was made. If the return is filed after the due date or extended due date, then the substantiation must have been obtained by the due date or extended due date.

The responsibility for obtaining this substantiation lies with the donor, who must request it from the charity. The charity is not required to record or report this information to the IRS on behalf of donors.

The legislation provides that substantiation will *not* be required if, in accordance with regulations prescribed by the Secretary, the charity reports directly to the IRS the information required to be provided in the written substantiation. At present, there are no regulations establishing procedures for direct reporting by charities to the IRS of charitable contributions made in 1994. Consequently, charities and donors should be prepared to provide/obtain the described substantiation for 1994 contributions of $250 or more.

There is no prescribed format for the written acknowledgement. For example, letters, postcards or computer-generated forms may be acceptable. The acknowledgement does not have to include the donor's social security or tax identification number. It must, however, provide sufficient information to substantiate the amount of the deductible contribution. The acknowledgement should note the amount of any cash contribution. However, if the donation is in the form of property, then the acknowledgement must describe, but need not value, such property. Valuation of the donated property is the responsibility of the donor.

The written substantiation should also note whether the donee organization provided any goods or services in consideration, in whole or in part, for the contribution and, if so, must provide a description and good-faith estimate of the value of the goods or services. In the new law these are referred to as "quid pro quo contributions."

Please note that there is a new law requiring charities to furnish disclosure statements to donors for such quid pro quo donations in excess of $75. This is addressed in the next section regarding Disclosure by Charity.

If the goods or services consist entirely of intangible religious benefits, the statement should indicate this, but the statement need not describe or provide an estimate of the value of these benefits. "Intangible religious benefits" are also discussed in the following section on Disclosure by Charity. If, on the other hand, the donor received nothing in return for the contribution, the written substantiation must so state.

The present law remains in effect that, generally, if the value of an item or group of like items exceeds $5,000, the donor must obtain a qualified appraisal and submit an appraisal summary with the return claiming the deduction.

The organization may either provide separate statements for each contribution of $250 or more from a taxpayer, or furnish periodic statements substantiating contributions of $250 or more.

Separate payments are regarded as independent contributions and are not aggregated for purposes of measuring the $250 threshold. However, the Service is authorized to establish anti-abuse rules to prevent avoidance of the substantiation requirement by taxpayers writing separate smaller checks on the same date.

If donations are made through payroll deductions, the deduction from each paycheck is regarded as a separate payment.

A charity that knowingly provides false written substantiation to a donor may be subject to the penalties for aiding and abetting an understatement of tax liability under section 6701 of the Code.

Disclosure by Charity of Receipt of Quid Pro Quo Contribution

Beginning January 1, 1994, under new section 6115 of the Internal Revenue Code, a charitable organization must provide a written disclosure statement to donors who make a payment, described as a "quid pro quo contribution," in excess of $75. This requirement is separate from the written substantiation required for deductibility purposes as discussed above. While, in certain circumstances, an organization may be able to meet both requirements with the same written document, an organization must be careful to satisfy the section 6115 written disclosure statement requirement in a timely manner because of the penalties involved.

A quid pro quo contribution is a payment made partly as a contribution and partly for goods or services provided to the donor by the charity. An example of a quid pro quo contribution is where the donor gives a charity $100 in consideration for a concert ticket valued at $40. In this example, $60 would be deductible. Because the donor's payment (quid pro quo contribution) exceeds $75, the disclosure statement must be furnished, even though the deductible amount does not exceed $75.

Separate payments of $75 or less made at different times of the year for separate fundraising events will not be aggregated for purposes of the $75 threshold. However, the Service is authorized to develop anti-abuse rules to prevent avoidance of this disclosure requirement in situations such as the writing of multiple checks for the same transaction.

The required written disclosure statement must:

(1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the value of goods or services provided by the charity, and

(2) provide the donor with a good-faith estimate of the value of the goods or services that the donor received.

The charity must furnish the statement in connection with either the solicitation or the receipt of the quid pro quo contribution. If the disclosure statement is furnished in connection with a particular solicitation, it is not necessary for the organization to provide another statement when the associated contribution is actually received.

The disclosure must be in writing and must be made in a manner that is reasonably likely to come to the attention of the donor. For example, a disclosure in small print within a larger document might not meet this requirement.

In the following three circumstances, the disclosure statement is not required.

(1) Where the only goods or services given to a donor meet the standards for "insubstantial value" set out in section 3.01, paragraph 2 of Rev. Proc. 90-12, 1990-1 C.B. 471, as amplified by section 2.01 of Rev. Proc. 92-49, 1992-1 C.B. 987 (or any updates or revisions thereof);

(2) Where there is no donative element involved in a particular transaction with a charity, such as in a typical museum gift shop sale.

(3) Where there is only an intangible religious benefit provided to the donor. The intangible re-

ligious benefit must be provided to the donor by an organization organized exclusively for religious purposes, and must be of a type that generally is not sold in a commercial transaction outside the donative context. An example of an intangible religious benefit would be admission to a religious ceremony. The exception also generally applies to de minimis tangible benefits, such as wine, provided in connection with a religious ceremony. The intangible religious benefit exception, however, does not apply to such items as payments for tuition for education leading to a recognized degree, or for travel services, or consumer goods.

A penalty is imposed on charities that do not meet the disclosure requirements. For failure to make the required disclosure in connection with a quid pro quo contribution of more than $75, there is a penalty of $10 per contribution, not to exceed $5,000 per fundraising event or mailing. The charity may avoid the penalty if it can show that the failure was due to reasonable cause.

Please note that the prevailing basic rule allowing donor deductions only to the extent that the payment exceeds the fair market value of the goods or services received in return still applies generally to all quid pro quo contributions. The $75 threshold pertains only to the obligation to disclose and the imposition of the $10 per contribution penalty, not the rule on deductibility of the payment.

INTERNAL REVENUE SERVICE TEMPORARY REGULATIONS (TD 8544) AND NOTICE OF PROPOSED RULEMAKING (IA-74-93) BY CROSS-REFERENCE TO TEMPORARY REGULATIONS REGARDING SUBSTANTIATION REQUIREMENTS FOR CERTAIN CONTRIBUTIONS, ISSUED MAY 26, 1994
(TEXT)

(Note: The temporary regulations and notice of proposed rulemaking are scheduled to appear in the *Federal Register* dated May 27, 1994.)

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 1 and 602
[TD 8544]

RIN 1545-AS28
Substantiation Requirement for Certain Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: These temporary regulations are being issued to provide guidance to the public with respect to the substantiation requirement contained in section 170(f)(8) of the Internal Revenue Code. Section 170(f)(8) was added to the Code by section 13172 of the Omnibus Budget Reconciliation Act of 1993. The guidance contained in these regulations affects donors of charitable contributions of $250 or more.

EFFECTIVE DATE: January 1, 1994.

FOR FURTHER INFORMATION CONTACT: Joel S. Rutstein, 202-622-4930 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1431.

For further information concerning this collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble in the cross-reference notice of proposed rulemaking published in the Proposed Rules section of this issue of the Federal Register.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to the substantiation requirement for the deduction of certain charitable contributions under section 170(f)(8) of the Internal Revenue Code (Code). Section 170(f)(8) was added by section 13172 of the Omnibus Budget Reconciliation Act of 1993.

Need for Temporary Regulations

The provisions contained in this Treasury decision are needed immediately to provide guidance to the public with respect to the application of the substantiation requirement of section 170(f)(8). Therefore, it is found impracticable and contrary to the public interest to issue this Treasury decision with prior notice under section 553(b) of title 5 of the United States Code.

Explanation of Provisions

Section 170 allows a deduction for contributions to or for the use of certain specified organizations, including those organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

To be deductible under section 170 of the Code, a payment to or for the use of a qualified organization must be a gift—that is, a payment of money or transfer of property without adequate consideration. Rev. Rul. 67-246, 1967-2 C.B. 104. Thus, if a taxpayer receives goods or services from the organization in consideration for a payment, the taxpayer may not deduct as a charitable contribution more than the excess of the amount paid over the value of the consideration received therefor. Id. The Service has determined, however, that if a taxpayer receives only certain inconsequential or insubstantial benefits in consideration for a payment to a qualified organization, the taxpayer may deduct the entire payment as a charitable contribution. Rev. Proc. 90-12, 1990-1 C.B. 471. See also Rev. Proc. 92-49, 1992-1 C.B. 987 (amplifying Rev. Proc. 90-12 by providing that certain free, unordered, low-cost items that accompany charitable solicitations are considered to have insubstantial value). (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.)

Section 170(f)(8) disallows a deduction for any contribution of $250 or more that is not substantiated by a written acknowledgment from the donee organization. The acknowledgment must provide information regarding (a) the money or other property contributed, and (b) any goods or services provided by the donee organization in whole or partial consideration for the contributed money or other property.

Section 170(f)(8) is a compliance provision, intended to facilitate the enforcement of the substantive requirements for a deduction under section 170. The compliance purpose of section 170(f)(8) does not require that an acknowledgment refer to goods or services provided by a donee organization to a donor if the provision of goods or services does not affect the amount that the donor is entitled to deduct as a charitable contribution. Therefore, the temporary regulations provide that goods or services given in return for a contribution need not be taken into account for purposes of section 170(f)(8), if the goods or services have insubstantial value under the guidelines provided in Rev. Procs. 90-12 and 92-49 (and any successor documents). (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.)

The legislative history of the 1993 Act states that Congress intended a similar exception to apply in connection with the disclosure requirement of section 6115. See H. Rep. No. 213, 103d Cong., 1st Sess. 566 (1993). Although the legislative history does not discuss application of such an exception to the substantiation requirement of section 170(f)(8), the Service has determined that such an exception is equally appropriate.

Some donee organizations receive contributions through arrangements in which employers withhold amounts from the wages of their employees in accordance with pledges made by the employees, and pay the withheld amounts to the donee organizations. Donee organizations that use these arrangements may not know the identity of the contributing employees or the amounts contributed by each employee. Therefore, these donee organizations may face difficulty in preparing the acknowledgments contemplated by section 170(f)(8).

The statutory language and legislative history of section 170(f)(8) suggest that Congress appreciated the difficulties of applying the substantiation requirement to contributions made by payroll deduction and intended that these difficulties be addressed by regulations. Section 170(f)(8)(E) directs the Secretary to "provide such regulations as may be necessary or appropriate" to carry out the purposes of section 170(f)(8), "including regulations that may provide that some or all of the requirements of [that section] do not apply in appropriate cases." The Conference Report on the 1993 Act expresses the conferees' intent that the Secretary exercise his regulatory authority "to clarify the treatment of contributions made through payroll deductions." H. Rep. No. 213, supra, at 567.

Accordingly, the temporary regulations also provide special rules for contributions made by payroll deduction. The special rules allow taxpayers to substantiate contributions made by payroll deduction by a combination of two documents: (a) a document furnished by the taxpayer's employer that evidences the amount withheld from the taxpayer's wages, and (b) a document prepared by the donee organization that states that the organization does not provide goods or services as whole or partial consideration for any contributions made by payroll deduction.

The special rules for contributions made by payroll deduction, like the underlying statutory provisions, do not require that the document prepared by the donee organization take any particular form. Similarly, although donors must obtain the document in time to meet the "contemporaneous" requirement of the statute (generally, by the time they file the relevant tax return), the rules do not require the donee organization to prepare the document at any particular time. Therefore, if a donee organization includes the statement contemplated by the rules on a pledge card prepared to solicit contributions in 1995, a donor who receives the card before timely filing the donor's 1994 tax return could use the card to substantiate contributions made in 1994. Contributions made by payroll deduction during 1994 can thus be substantiated under these rules even if the donee organization has used pledge cards for 1994 contributions that do not include the statement contemplated by the rules. As a result, the Service understands that donee organizations will be able to comply with the "contemporaneous" requirement for 1994 contributions. The Service invites comments, however, on whether transitional relief from the "contemporaneous" requirement is needed for 1994 contributions.

The temporary regulations also provide that, for purposes of applying the $250 threshold provided in section 170(f)(8)(A) to contributions made by payroll deduction, the amount withheld from each paycheck is treated as a separate contribution. Thus, the substantiation requirement of section 170(f)(8) will not apply to contributions made by payroll deduction unless the employer deducts $250 or more from a single paycheck for the purpose of payment to a donee organization. This rule is consistent with the legislative history of section 170(f)(8). See H. Rep. No. 213, supra, at 565 n.29 ("In cases of contributions paid by withholding from wages, the deduction from each paycheck will be treated as a separate payment.").

Some charitable organizations solicit contributions in the form of payroll deductions or lump-sum payments for the purpose of distributing the amounts received to other charitable organizations. The temporary regulations provide that, in such cases, the distributing organization is treated as a donee organization for purposes of the substantiation requirement of section 170(f)(8). This rule applies regardless of whether the distributing organization distributes the contributed funds pursuant to the donor's instructions. The rule does not apply, however, if a distributee organization provides goods or services to the donor as part of a transaction structured with a view to avoid taking the goods or services into account in determining the amount of the deduction to which the donor is entitled under section 170.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Joel S. Rutstein, Office of the Assistant Chief counsel (Income Tax & Accounting), Internal Revenue Service. However, other personnel from the Service and Treasury Department participated in their development.

List of Subjects
26 CFR part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602, are amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * §1.170A-13T also issued under 26 U.S.C 170(f)(8)(E).

Par. 2. Section 1.170A-13T is added to read as follows:

§1.170A-13T Substantiation requirement for certain contributions.

(a) *Certain goods or services that have insubstantial value not taken into account.* Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90-12, 1990-1 C.B. 471, and 92-49, 1992-1 C.B. 987, (and any successor documents) need not be taken into account for purposes of section 170(f)(8). (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.)

(b) *Contributions made by payroll deduction* — (1) *Form of substantiation.* A contribution made by means of withholding from a taxpayer's wages and payment by the taxpayer's employer to a donee organization may be substantiated, for purposes of section 170(f)(8), by —

(i) A pay stub, Form W-2, or other document furnished by the employer that evidences the amount withheld by the employer for the purpose of payment to a donee organization, and

(ii) A pledge card or other document prepared by the donee organization that includes a statement that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

(2) *Application of $250 threshold.* For the purpose of applying the $250 threshold provided in section 170(f)(8)(A) to contributions made by the means described in paragraph (b)(1) of this section, the amount withheld from each payment of wages to a taxpayer is treated as a separate contribution.

(c) *Distributing organizations as donees.* An organization described in section 170(c), or an organization described in 5 CFR 950.105 (a Principal Combined Fund Organization for purposes of the Combined Federal Campaign) and acting in that capacity, that receives a payment made as a contribution is treated as a donee organization solely for purposes of section 170(f)(8), even if the organization (pursuant to the donor's instructions or otherwise) distributes the amount received to one or more organizations described in section 170(c). This paragraph (c) does not apply, however, to a case in which the distributee organization provides goods or services as part of a transaction structured with a view to avoid taking the goods or services into account in determining the amount of the deduction to which the donor is entitled under section 170.

(d) *Effective date.* The rules of this section apply to contributions made on or after January 1, 1994.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority for part 602 continues to read:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by adding the entry "1.170A-13T ... 1545-1431" in numerical order to the table.

/s/ Margaret Milner Richardson
Commissioner of Internal Revenue

Approved: May 6, 1994

/s/ Leslie Samuels
Assistant Secretary of the Treasury

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 1 and 602

IA-74-93
RIN 1545-AS27

Substantiation Requirement for Certain Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of this issue of the Federal Register, the Internal Revenue Service is issuing temporary regulations relating to the substantiation requirement for certain charitable contributions under section 170(f)(8) of the Internal Revenue Code. The guidance contained in those temporary regulations affects donors of charitable contributions of $250 or more. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking. Comments will be considered not only on the temporary rules promulgated, but also on other issues arising under section 170(f)(8). These issues include, but are not limited to, (a) what constitutes a good faith estimate of the value of goods and services, (b) what is an intangible religious benefit, and (c) what is a contemporaneous acknowledgment.

DATES: Comments and requests for a public hearing must be delivered or mailed by July 26, 1994.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station,

Attn: CC:DOM:CORP:T:R (IA-74-93), Room 5228, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Joel S. Rutstein, 202-622-4930 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been submitted to the Office of Management and Budget for review n accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer PC:FP, Washington, DC 20224.

The collection of information in this notice of proposed rulemaking is in section 1.170A-13T. This information is required by the Internal Revenue Service to substantiate certain charitable contributions. The likely recordkeepers are individuals, business or other for-profit institutions, and small businesses.

Estimated total annual recordkeeping burden: 51,500 hours. The estimated annual burden per recordkeeper varies from 15 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 30 minutes. Estimated number of recordkeepers: 16,000.

Background

For the text of the temporary regulations adding §1.170A-13T to 26 CFR part 1, see TD 8544, published in the Rules and Regulations section of this issue of the Federal Register. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are timely submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who timely submits written comments on the proposed rules. Notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Joel S. Rutstein, Office of the Assistant Chief Counsel (Income Tax & Accounting), Internal Revenue Service. However, other personnel from the Service and Treasury Department participated in their development.

List of Subjects in 26 CFR part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * §1.170A-13A also issued under 26 U.S.C. 170(f)(8)(E).

Par. 2. Section 1.170A-13A is added to read as follows:

§1.170A-13A Substantiation requirement for certain contributions.

[The text of this proposed section is the same as the text of §1.170A-13T published elsewhere in this issue of the Federal Register].

/s/ Margaret Milner Richardson
Commissioner of Internal Revenue

End of Text

IRS VALUATION GUIDEBOOK FOR TRAINING OF APPEALS OFFICERS (1/28/94)
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INTERNAL REVENUE SERVICE NOTICE OF PROPOSED RULEMAKING (PS-26-93), PROPOSED AMENDMENTS TO INCOME, ESTATE, AND GIFT TAX REGULATIONS UNDER INTERNAL REVENUE CODE RELATING TO EXCEPTIONS TO USE OF STANDARD VALUATION TABLES FOR VALUING ANNUITIES, INTERESTS OF LIFE OR A TERM OF YEARS, AND REMAINDER OR REVERSIONARY INTERESTS, ISSUED JUNE 9, 1994 (TEXT)

(Note: The notice of proposed rulemaking is scheduled to appear in the *Federal Register* dated June 10, 1994.)

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 1, 20, and 25

[PS-26-93]

RIN 1545-AR56

Actuarial Tables Exceptions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the income, estate, and gift tax regulations under the Internal Revenue Code relating to exceptions to the use of standard valuation tables for valuing annuities, interests for life or a term of years, and remainder or reversionary interests. These amendments are necessary in order to provide guidance consistent with court decisions that call for deviation from the use of standard valuation tables in valuing those interests. The proposed regulations would apply in valuing all interests that would, but for the exceptions, be valued under section 7520 of the Code.

DATES: Written comments and requests for a public hearing must be received by August 9, 1994.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R ([PS-26-93]), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:DOM: CORP:T:R ([PS-26-93]), room 5228, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: William L. Blodgett, telephone (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations (26 CFR 1.7520-3(b), 20.7520-3(b), and 25.7520-3(b)) for the valuation of certain partial interests in property under section 7520 of the Internal Revenue Code (Code), as added by section 5031 of the Technical and Miscellaneous Revenue Act of 1988, when the use of standard actuarial tables would produce unreasonable results. The regulations are proposed to be effective for valuation dates occurring after the date the regulations are published as final regulations in the Federal Register.

Explanation of Provisions

Section 7520(a), which is effective after April 30, 1989, provides that the value of annuities, interests for life or a term of years, and remainder or reversionary interests is to be determined under tables published by the IRS based on an interest rate equal to 120 percent of the applicable Federal mid-term rate (rounded to the nearest two-tenths of one percent) in effect under section 1274(d)(1) for the month in which the valuation date falls. Section 7520(b) provides that section 7520 shall not apply for purposes of any provision specified in regulations. The Conference Report to the Technical and Miscellaneous Revenue Act of 1988, H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 113 (1988), 1988-3 C.B. 603, explains that section 7520 does not apply to "situations specified in Treasury regulations."

The IRS has never attempted to include in the regulations all of the different actuarial factors that could apply to the many different kinds of vested and contingent annuity, income, and remainder interests that can arise in tax administration. The actuarial tables that have been set forth in the regulations from time to time have listed only those factors that are most frequently needed by taxpayers. Generally, these actuarial tables have included the one-life annuity, income, and remainder factors for ages 0 through 109 and the term-certain annuity, income, and remainder factors for periods of 1 through 60 years. These one-life and term-certain factors are often referred to in this notice of proposed rulemaking as "standard actuarial factors" or "standard section 7520 actuarial factors."

Other standard actuarial factors that are less frequently needed by taxpayers are included in tables that have been separately published by the IRS from time to time and that may be purchased from the Government Printing Office. The tables in these books include two-life actuarial factors, as well as many one-life factors and term-certain factors not found in the regulations tables. These publications also include a number of examples that illustrate how to compute special section 7520 actuarial factors such as the annuity, income, or remainder factor for a period limited to the lesser of a term certain or a lifetime. Special actuarial factors have for many years been referred to as such in the regulations. See, for example, §20.2055-2(f)(5).

Other special section 7520 actuarial factors that may apply to more unusual situations may be computed by the taxpayer or, upon request, by the Internal Revenue Service for the taxpayer, by using actuarial methods consistent with those used to compute the standard section 7520 actuarial factors that appear in the tables in the regulations and in the Service's publications. Examples of these more unusual situations include an annuity payable for more than two lives, a right to income for a term certain or until the prior death of the first to die of two individuals, and the right to receive a remainder after a term certain if an individual survives the term.

In calculating a standard section 7520 actuarial factor, certain assumptions are made. For all standard section 7520 actuarial factors in the single-life and term-certain tables in §20.2031-7(d), the interest rate for enjoyment or the postponement of enjoyment is the applicable section 7520 rate. In the case of a life annuity, income, or remainder factor, the basis for mortality rates for measuring lives is the data in Table 80 CNSMT. However, in unusual situations, where special section 7520 actuarial factors must be computed, one or more alternative assumptions may be appropriate. For example, if the actual income is known to be below applicable standards, the section 7520 interest rate may not be used to project the trust income yield. Similarly, if a measuring life is classified as terminally ill, the standard mortality data from Table 80 CNSMT may not be used as the mortality basis. But, even though one or both of these exceptions is applicable in a case, the section 7520 interest rate will ordinarily be used to discount the value of the right to any postponed enjoyment.

In cases requiring the valuation of ordinary annuities, income interests, and remainder and reversionary interests, the courts have consistently recognized the need to use the standard actuarial factors prescribed by the regulations. See *Ithaca Trust v. United States*, 279 U.S. 151 (1929).

However, the courts have recognized that the use of the standard actuarial factors is inappropriate in certain cases. *Robinette v. Helvering*, 318 U.S. 184 (1943) (reversionary interest with several interdependent contingencies); *Stark v. United States*, 477 F.2d 131 (8th Cir. 1973), *cert. denied*, 414 U.S. 975 (1973) (closely held stock that was not publicly traded and paid no dividends); *O'Reilly v. Commissioner*, 973 F.2d 1403 (8th Cir. 1992), *rem'd*, T.C.M. 1994-61 (disparity between .2 percent yield and 10 percent tables produced unrealistic and unreasonable result); and *Commissioner v. Estate of Sternberger*, 348 U.S. 187 (1955) (charitable bequest that would occur only if decedent's unmarried daughter died without issue surviving her and her mother). In addition, the courts have held that the standard actuarial factors cannot be used if the measuring life is terminally ill. *Estate of McLendon v. Commissioner*, T.C.M. 1993-459; *Estate of Jennings v. Commissioner*, 10 T.C. 323 (1948); and *Estate of Denbigh v. Commissioner*, 7 T.C. 387 (1946). See Rev. Rul. 80-80, 1980-1 C.B. 194, which provides that, in cases where the individual's death is imminent, the taxpayer may not use standard actuarial factors prescribed by the regulations. See also, *Carter v. United States*, 921 F.2d 63 (5th Cir. 1991), where the court refused to ascribe value to an income interest for purposes of the section 2013 credit where death of the measuring life was simultaneous with that of the decedent.

In *Shapiro v. Commissioner*, T.C. Memo 1993-483 (1993), the Tax Court allowed the taxpayer to improperly value an annuity with a standard one-life annuity actuarial factor from Table A in §20.2031-7(f) in a situation in which the annuity could have exhausted the fund from which the annuity was to be paid before the death of the annuitant. The Internal Revenue Service believes that the annuity factor that should have been used in this case is a special annuity factor for the right to receive annual payments for 4 years or until the prior death of the annuitant. See Rev. Rul. 77-454, 1977-2 C.B. 351. See also *Moffett v. Commissioner*, 269 F.2d 738 (4th Cir. 1959), and *United States v. Dean*, 224 f.2d 26 (1st Cir. 1955). Therefore, the Service will not follow the result in *Shapiro*.

Sections 1.7520-3(a), 20.7520-3(a), and 25.7520-3(a) set forth specific Code sections that are exempt from the valuation rules of section 7520. The proposed regulations contained in this notice describe other areas in which the valuation methodology applicable to standard and special section 7520 actuarial factors is not to be used. Generally, if the interest in property that is to be valued is not an ordinary annuity, income interest, or remainder interest, the standard annuity, income, and remainder factors in the tables of factors set forth in the regulations and IRS publications cannot be used. In some cases in which the standard factors from the regulations and publications tables cannot be used, a special factor may be computed by the taxpayer or by the Service upon the request of the taxpayer. In other cases where standard or special factors may not be used, the property interest may be valued using other valuation techniques. Depending upon the facts and circumstances, a property interest that cannot be valued using the standard or special section 7520 factors may have no ascertainable value.

The proposed regulations establish two primary tests to determine whether the fair market value of the interest is computed by use of the standard section 7520 actuarial factors found in the regulations and IRS publications. The first test is whether the instrument of transfer provides the beneficiary with the degree of beneficial enjoyment that is consistent with the type of property interest that the standard valuation tables are designed to measure. In this regard, the rights of an annuity beneficiary must be adequately defined and, if the annuity is payable from a group of assets, the value of the assets must be sufficient to support all of the annuity payments. Similarly, the rights of an income beneficiary must be consistent with the rights of an outright owner of the property interest for the same period of time, and the rights of a remainder or reversionary beneficiary must be protected against invasion or erosion of the corpus.

The second test in the proposed regulations addresses the mortality component of the transferred interest. The Internal Revenue Service previously addressed this issue in Rev. Rul. 66- 307, 1966-2 C.B. 429, and Rev. Rul 80-80. Rev. Rul. 66-307 set forth the rule that the value of a life or remainder interest would be determined by taking into account the health of the life tenant if it was known on the valuation date that the life tenant was afflicted with a fatal and incurable disease in its advanced stages and that the life tenant could not survive for more than a brief period of time. Rev. Rul. 80-80 clarified the "brief period" test in Rev. Rul. 66-307, and stated that the standard life actuarial factors are to be applied to value the interest unless death is clearly imminent. In the view of the Service, because the test for determining whether death is imminent set forth in Rev. Rul. 66-307 and Rev. Rul. 80-80 does not satisfactorily quantify the probability of death occurring within 1 year from the valuation date, this test may permit the use of standard actuarial factors in inappropriate situations. These regulations propose to explicitly quantify the applicable standard for purposes of applying this test.

Under the proposed regulations, if an individual who is a measuring life of the interest being transferred is known to be terminally ill, the mortality test of the proposed regulations is not satisfied and a special section 7502 actuarial factor, rather than a standard actuarial factor must be used in valuing the interest. Terminal illness is defined in the proposed regulations as an incurable illness or other deteriorating physical condition that would substantially reduce a person's life expectancy to the extent that there is at least a 50 percent probability that the individual will not survive for more than 1 year from the valuation date. Exceptions are made in the regulations for special situations under sections 2013, 2037, and 2042.

In the case of the simultaneous death of the transferor and an individual who is the measuring life of a property interest, the proposed regulations specifically preclude use of the standard factors in the tables to value that interest. This is pertinent in determining the previously taxed property credit under section 2013 and reaffirms the position of the Fifth Circuit in the *Carter* case.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the Internal Revenue Service. In particular, the Service invites comments on whether the proposed definition of terminal illness adequately deals with certain illnesses that are known to cause death in a short period of time but are often diagnosed more than 1 year before death. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is William L. Blodgett, Office of Assistant Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 20 and 25 are proposed to be amended as follows:

Part 1——INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.7520-3 is amended by adding the text of paragraph (b) to read as follows:

§1.7520-3 Limitation on the application of section 7520.

* * * * *

(b) *Other limitations on the application of section 7520*—— (1) *In general*——(i) *Ordinary beneficial interests*. For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from, or the use of, property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the income from $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or for some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests*. A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See *Example* 2 in §1.7520-3(b)(4), which illustrates a situation where a special section 7520 actuarial factor is needed to take into account the shorter life expectancy of the terminally ill measuring life. See §1.7520-1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests*. If, under the provisions of §1.7520-3(b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment*——(i) *Annuities*. A standard section 7520 annuity factor is not to be used to determine the present value of an annuity for a specified

term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110, because every standard section 7520 life annuity factor is calculated on the basis of that assumption. If it is determined that the trust or other fund from which an annuity is to be paid may exhaust before the end of the defined period of the annuity, it will be necessary to calculate a special section 7520 annuity factor that takes into account the facts and circumstances that may exhaust the trust or fund.

(ii) *Income and similar interests*——(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest is not to be used to determine the present value of an income or similar interest in trust for a term of years or for the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or other specified period of time, the interest rate component prescribed under section 7520 and §1.7520-1 is not to be used unless, during the specified period, the beneficiary is entitled to that degree of use, possession, and enjoyment of the property that an outright owner would be entitled to exercise during a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest is not to be used to value an income interest or similar interest in property for a term of years or for one or more measuring lives if——

(*1*) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(*2*) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit during the income beneficiary's term of enjoyment without the consent of and accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests.* A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest is not to be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected from erosion, invasion, depletion, or damage until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred.

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in §1.642(c)-6.

(3) *Mortality component.* The mortality component prescribed under section 7520 is not to be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life for the interest dies or is terminally ill at the time of the transaction. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year.

(4) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. Annuity funded with unproductive property. The taxpayer transfers corporation stock worth $1,000,000 to a trust. The trust provides for a 6 percent ($60,000 per year) annuity in cash or other property to be paid to a charitable organization for 25 years and for the remainder to be distributed to the donor's child. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The section 7520 interest rate for the month of the transfer is 8.2 percent. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment for a trust with diversified investments because the corporation's practice of retaining its earnings has caused the value of the corporation stock to grow commensurately each year. Considering the 6 percent annuity payout rate and the 8.2 percent section 7520 interest rate, the trust corpus is considered sufficient to pay this annuity for the entire 25-year term of the trust, or even indefinitely. Thus, though the trust assets not likely to earn dividend income during the term of the trust, the assets would be assumed to appreciate at the rate of 8.2 percent per year if there were no income. Therefore, the trust's sole investment in this corporation is not expected to adversely affect the interest of either the annuitant or the remainder beneficiary. Although it appears that neither beneficiary would be able to compel the trustee to make the trust corpus produce investment income, the annuity interest in this case is considered to be an ordinary annuity interest, and the standard section 7520 annuity factor may be used to determine the present value of the annuity. In this case, the section 7520 annuity factor would represent the right to receive $1.00 per year for a term of 25 years.

Example 2. Terminal illness. The taxpayer transfers property worth $1,000,000, to a charitable remainder unitrust described in section 664(d)(2) and §1.664-3. The trust provides for a fixed-percentage 7 percent unitrust benefit (each annual payment is equal to 7 percent of the trust assets as valued at the beginning of each year) to be paid quarterly to an individual beneficiary for life and for the remainder to be distributed to a charitable organization. At the time the trust is created, the individual beneficiary is age 60 and has been diagnosed with an incurable illness and there is at least a 50 percent probability of the individual dying within 1 year. Because there is at least a 50 percent probability that this beneficiary will die within 1 year, the standard section 7520 unitrust remainder factor for a person age 60 from the valuation tables may not be used to determine the present value of the charitable remainder interest. Instead, a special unitrust remainder factor must be computed that is based on the section 7520 interest rate and that takes into account the projection of the individual beneficiary's actual life expectancy.

(5) *Additional limitations.* Section 7520 does not apply to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures.

(6) *Effective date.* The provisions of paragraph (b) of this section are effective with respect to transactions after the date these regulations are published as final regulations in the Federal Register.

PART 20--ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 3. The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 4. Section 20.7520-3 is amended by adding the text of paragraph (b) to read as follows:

§20.7520-3 Limitation on the application of section 7520.

* * * * *

(b) *Other limitations on the application of section 7520*—— (1) *In general*——(i) *Ordinary beneficial interests.* For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from or the use of property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the income from $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or for some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See *Example 4* in §20.7520-3(b)(2)(iv) and *Example 2* in §20.7520- 3(b)(4), which illustrate situations where special section 7520 actuarial factors are needed to take into account limitations on beneficial interests. See §20.7520-1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of §20.7520-3(b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment*——(i) *Annuities.* A standard section 7520 annuity factor is not to be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110, because every standard section 7520 annuity factor is calculated on the basis of that assumption. If it is determined that the trust or other fund from which an annuity is to be paid may exhaust before the end of the defined period of the annuity, it will be necessary to calculate a special section 7520 annuity factor that takes into account the facts and circumstances that may exhaust the trust or fund.

(ii) *Income and Similar Interests*——(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest is not to be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or other specified period of time, the interest rate component prescribed under section 7520 and §20.7520-1 is not to be used unless, during the specified period, the beneficiary is entitled to that degree of use, possession, and enjoyment of the property that an outright owner would be entitled to exercise during a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest is not to be used to value an income interest or similar interest in property for a term of years, or for one or more measuring lives, if——

(*1*) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(*2*) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit without the consent of the income beneficiary during the income beneficiary's term of enjoyment and without accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests.* A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest is not to be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected from erosion, invasion, depletion, or damage until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred.

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in §42(c)-6 of this chapter (Income Tax Regulations).

(v) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. Unproductive property. The decedent's will provides for a bequest of corporation stock to a trust under the terms of which all of the trust income is payable to the decedent's child for life. After the death of the life income beneficiary, the trust is to terminate and the trust property is to be distributed to the decedent's grandchild. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be an adequately sound growth investment for a trust with diversified investments because the corporation's practice of retaining its earnings has caused the value of the corporation stock to increase commensurately each year. The facts and circumstances, including applicable state law, indicate that the life income beneficiary would not be able to compel the trustee to make the trust corpus productive in conformity with the requirements for a lifetime trust income interest under applicable local law. Therefore, the life income interest in this case is considered nonproductive. Consequently, the income interest may not be valued actuarially under this section.

Example 2. Beneficiary's right to make trust productive. The facts are the same as in *Example 1*, except that the trustee is not specifically authorized to retain the shares of stock. Further, the terms of the trust specifically provide that the life income beneficiary may require the trustee to make the trust corpus productive consistent with income yield standards for trusts under applicable state law. Under that law, the minimum rate of income that a productive trust may produce is substantially below the section 7520 interest rate for the month of the decedent's death. In this case, because the income beneficiary has the right to compel the trustee to make the trust productive for purposes of applicable local law during the beneficiary's lifetime, the income interest is considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 life income interest factor may be used to determine the present value of the income interest.

Example 3. Discretionary invasion of corpus. The decedent transfers property to a trust under the terms of which all of the trust income is to be paid to the decedent's child for life and the remainder of the trust is to be distributed to a grandchild. The trust authorizes the trustee without restriction to distribute corpus to the decedent's surviving spouse for the spouse's comfort and happiness. In this case, because the trustee's power to invade trust corpus is unrestricted, the exercise of the power could result in the termination of the income interest at any time. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and may not be valued actuarially under this section.

Example 4. Limited invasion of corpus. The decedent bequeaths property to a trust under the terms of which all of the trust income is to be paid to the decedent's child for life and the remainder is to be distributed to the decedent's grandchild. The trust authorizes the child to withdraw up to $5,000 per year from the trust corpus. In this case, the child's power to invade trust corpus is limited to an ascertainable amount each year. Annual invasions of any amount would be expected to progressively diminish the property from which the child's income is paid. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 income interest factor may not be used to determine the present value of the income interest. Nevertheless, the present value of the child's income interest is ascertainable by making a special actuarial calculation that would take into account not only the initial value of the trust corpus, the section 7520 interest rate for the month of the transfer, and the mortality component for the child's age, but also the assumption that the trust corpus will decline at the rate of $5,000 each year during the child's lifetime. The child's right to receive an amount not in excess of $5,000 per year may be separately valued in this instance and, assuming the trust corpus would not exhaust before the child would attain age 110, would be considered an ordinary annuity interest.

Example 5. Power to consume. The decedent devises a life estate in 3 parcels of real estate to the surviving spouse with the remainder to a child. The decedent also confers upon the spouse an unrestricted power to consume the property, which includes the right to sell part or all of the property and to use the proceeds for the spouse's support, comfort, happiness, and other purposes. Any portion of the property or its sale proceeds remaining at the death of the surviving spouse is to vest by operation of law in the child at that time. In this case, the surviving spouse's power to consume the corpus is unrestricted, and the exercise of the power could entirely exhaust the remainder interest during the life of the spouse. Consequently, the remainder interest is not considered an ordinary remainder interest for purposes of this paragraph and may not be valued actuarially under this section.

(3) *Mortality component.* (i) *Terminal illness cases.* Except as provided in paragraph (b)(3)(ii) of this section, the mortality component prescribed under section 7520 is not to be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time of the decedent's death. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year.

(ii) *Exceptions.* If, in the case of the allowance of the credit for tax on a prior transfer under section 2013, the tax in the transferor's estate was finally determined without regard to the fact that one or more measuring lives were terminally ill at the time of the transferor's death, the value of any transferred interest dependent on any of those lives shall be determined for purposes of section 2013 without regard to the fact that those measuring lives were terminally ill. In addition, the value of a decedent's reversionary interest under section 2037(b) or 2042(2) shall be determined without regard to the physical condition of the decedent immediately before death.

(4) *Examples.* The provisions of paragraph (b)(3) of this section are illustrated by the following examples:

Example 1. Simultaneous deaths. The decedent's will establishes a trust to pay income to the decedent's surviving spouse for life. The will provides that, upon the spouse's death, or if the spouse fails to survive the decedent, the trust property is to pass to the decedent's children. The decedent and the decedent's spouse die simultaneously in an accident under circumstances in which it was impossible to determine who survived the other. Applicable state law presumes that the decedent died first with the result that the property interest is considered to have passed in trust for the benefit of the spouse for life, after which the remainder is to be distributed to the decedent's children. Therefore, the spouse's life income interest may not be valued under this section.

Example 2. Terminal illness. The decedent bequeaths $1,000,000 to a trust under the terms of which the trustee is to pay $103,000 per year to a charitable organization during the life of the decedent's child. Upon the death of the child, the remainder in the trust is to be distributed to the decedent's grandchild. The child, who is age 60, has been diagnosed with an incurable illness, and there is at least a 50 percent probability of the child dying within 1 year. The section 7520 interest rate for the month of the decedent's death is 10.6 percent. The standard life annuity factor for a person age 60 (7.4230) may not be used to determine the present value of the charitable organization's annuity interest because there is at least a 50 percent probability that the measuring life will die within 1 year. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the child's actual life expectancy.

(5) *Additional Limitations* Section 7520 does not apply to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures.

(6) *Effective date.* The provisions of this paragraph (b) are effective with respect to estates of decedents dying after the date these regulations are published as final regulations in the Federal Register.

PART 25--GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority citation for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 6. Section 25.7520-3 is amended by adding the text of paragraph (b) to read as follows:

§25.7520-3 Limitation on the application of section 7520.

* * * * *

(b) *Other limitations on the application of section 7520*——(1) *In general*——(i) *Ordinary beneficial interests.* For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from or the use of property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the income from $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. However, in the case of certain gifts made after October 8, 1990, if the donor does not retain a qualified annuity, unitrust, or reversionary interest, the value of any interest retained by the donor is considered to be zero if the remainder beneficiary is a member of the donor's family. See §25.2702-2.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or for some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See *Examples 3, 4,* and *5* in §25.7520-3(b)(2)(iv) and the *Example* in §25.7520-3(b)(4), which illustrate situations in which special section 7520 actuarial factors are needed to take into account limitations on beneficial interests. See §25.7520-1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of §25.7520-3(b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment*—(i) *Annuities.* A standard section 7520 annuity factor is not to be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110, because every standard section 7520 annuity factor is calculated on the basis of that assumption. If it is determined that the trust or other fund from which an annuity is to be paid may exhaust before the end of the defined period of the annuity, it will be necessary to calculate a special section 7520 annuity factor that takes into account the facts and circumstances that may exhaust the trust or fund.

(ii) *Income and similar interests*—(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest is not to be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or other specified period of time, the interest rate component prescribed under section 7520 and §25.7520-1 is not to be used unless, during the specified period, the beneficiary is entitled to that degree of use, possession, and enjoyment of the property that an outright owner would be entitled to exercise during a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest is not to be used to value an income interest or similar interest in property for a term of years, or for one or more measuring lives, if—

(*1*) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(*2*) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit without the consent of the income beneficiary during the income beneficiary's term of enjoyment and without accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests.* A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest is not to be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected from erosion, invasion, depletion, or damage until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred.

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in §1.642(c)-6 of this chapter (Income Tax Regulations).

(v) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. Unproductive property. The donor transfers corporation stock to a trust under the terms of which all of the trust income is payable to a child for life. After the death of the life income beneficiary, the trust is to terminate and the trust property is to be distributed to a grandchild. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be an adequately sound growth investment for a trust with diversified investments because the corporation's practice of retaining its earnings has caused the value of the corporation stock to increase commensurately each year. The facts and circumstances, including applicable state law, indicate that the income beneficiary would not have the legal right to compel the trustee to make the trust corpus productive in conformity with the requirements for a lifetime trust income interest under applicable local law. Therefore, the life income interest in this case is considered nonproductive. Consequently, the income interest may not be valued actuarially under this section.

Example 2. Beneficiary's right to make trust productive. The facts are the same as in *Example 1*, except that the trustee is not specifically authorized to retain the shares of corporation stock. Further, the terms of the trust specifically provide that the life income beneficiary may require the trustee to make the trust corpus productive consistent with income yield standards for trusts under applicable state law. Under that law, the minimum rate of income that a productive trust may produce is substantially below the section 7520 interest rate on the valuation date. In this case, because the income beneficiary has the right to compel the trustee to make the trust productive for purposes of applicable local law during the beneficiary's lifetime, the income interest is considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 life income factor may be used to determine the value of the income interest. However, in the case of gifts made after October 8, 1990, if the donor was the life income beneficiary, the value of the income interest would be considered to be zero in this situation. See §25.2702-2.

Example 3. Annuity trust funded with unproductive property. The donor, who is age 60, transfers corporation stock worth $1,000,000 to a trust. The trust will pay a 6 percent ($60,000 per year) annuity in cash or other property to the donor for 10 years or until the donor's prior death. Upon the termination of the trust, the trust property is to be distributed to the donor's child. The section 7520 rate for the month of the transfer is 8.2 percent. The corporation has paid no dividends on the stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment for a trust with diversified investments because the corporation's practice of retaining its earnings has caused the value of the corporation stock to grow commensurately each year. Considering the 6 percent annuity payout rate and the 8.2 percent section 7520 interest rate, the trust corpus is considered sufficient to pay this annuity for the entire 10-year term of the trust, or even indefinitely. Thus, though the trust assets not likely to earn dividend income during the term of the trust, the assets would be assumed to appreciate at the rate of 8.2 percent per year if there were no income. Therefore, the trust's sole investment in this corporation is not expected to adversely affect the interest of either the annuity beneficiary or the remainder beneficiary. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. Although it appears that neither beneficiary would be able to compel the trustee to make the trust corpus produce investment income, the annuity interest in this case is considered to be an ordinary annuity interest, and a section 7520 annuity factor may be used to determine the present value of the annuity. In this case, the section 7520 annuity factor would represent the right to receive $1.00 per year for a term of 10 years or the prior death of a person age 60.

Example 4. Unitrust funded with unproductive property. The facts are the same as in *Example 3*, except that the donor has retained a unitrust interest equal to 7 percent of the value of the trust property, valued as of the beginning of each year. Although the trust corpus is nonincome producing, the present value of the donor's retained unitrust interest may be determined by using the section 7520 unitrust factor for a term of years or a prior death.

Example 5. Eroding corpus in an annuity trust. The donor, who is age 60 and in normal health, transfers property worth $1,000,000 to a trust. The trust will pay a 10 percent ($100,000 per year) annuity to a charitable organization for the life of the donor, and the remainder is to be distributed to the donor's child. The section 7520 rate for the month of the transfer is 6.8 percent. Because the 10 percent annuity payout rate exceeds the 6.8 percent income and growth rate that the trust is expected to experience each year, the annuity payout must be assumed to progressively erode the corpus. Using an interest rate of 6.8 percent, an annuity payout of $100,000 per year will exhaust a $1,000,000 trust corpus in 18 years. The final payment at the end of the 18th year will consist of a partial payment of $32,712. Under section 7520, the standard life annuity factors are based on the assumption that any person may survive until age 110. This means that the standard life annuity factor for age 60 (9.8585) takes into account the separate probabilities that a person age 60 may survive to receive each of 50 different annuity payments. However, in the present case, because of the eroding corpus, the person age 60 can be assumed to receive no more than 17 $100,000 annuity payments, regardless how long that person might survive. Therefore, the standard life annuity factor for a person age 60 (9.8585) is not applicable in this case, and special section 7520 annuity factors that take into account the 18-year limitation on the annuity payout must be used. The special annuity factor for the present value of the right to receive $1.00 per year for 17 years or until the prior death of a person age 60 is $8.6121, and the special factor for the present value of the right to receive $1.00 in 18 years if a person age 60 survives is $.1836. The present value of the charitable annuity interest is $867,269 ($100,000 X 8.6121 plus $32,712 X .1836).

(3) *Mortality component.* The mortality component prescribed under section 7520 is not to be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year.

(4) *Example.* The provisions of paragraph (b)(3) of this section are illustrated by the following example:

Example. Terminal illness. The donor transfers property worth $1,000,000 to a child in exchange for the child's promise to pay the donor $103,000 per year for the donor's life. The donor is age 60 but has been diagnosed with an incurable illness and has at least a 50 percent probability of dying within 1 year. The section 7520 interest rate for the month of the transfer is 10.6 percent, and the standard annuity factor at that interest rate for a person age 60 in normal health is 7.4230. Thus, if the donor were not terminally ill, the present value of the annuity would be $764,569 ($103,000 X 7.4230). Because there is at least a 50 percent probability that the donor will not survive for 1 more year, the standard section 7520 annuity factor may not be used to determine the present value of the donor's annuity interest. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the donor's actual life expectancy.

(5) *Additional limitations.* Section 7520 does not apply to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures.

(6) *Effective date.* The provisions of this paragraph are effective with respect to gifts made after the date these regulations are published as final regulations in the Federal Register.

/s/ Margaret Milner Richardson
Commissioner of Internal Revenue

End of Text

APPENDIX D

KENTUCKY'S 1994 HEALTH CARE AND LIVING WILL STATUTE

GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

REGULAR SESSION 1994

SENATE BILL NO. 311

WEDNESDAY, MARCH 16, 1994

The following bill was reported to the House from the Senate and ordered to be printed.

AN ACT relating to health care decisions.

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

SECTION 1. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

As used in Sections 1 to 12 of this Act:

(1) "Adult" means a person eighteen (18) years of age or older and who is of sound mind.

(2) "Advance directive" means a living will directive made in accordance with Sections 1 to 12 of this Act, a living will or designation of health care surrogate executed prior to the effective date of Sections 1 to 12 of this Act, and any other document that provides directions relative to health care to be provided to the person executing the document.

(3) "Artificially provided nutrition and hydration" means sustenance or fluids that are artificially or technologically administered.

(4) "Attending physician" means the physician who has primary responsibility for the treatment and care of the patient.

(5) "Decisional capacity" means the ability to make and communicate a health care decision.

(6) "Directive" means a living will directive in writing voluntarily made by an adult in accordance with the provisions of Sections 1 to 12 of this Act.

(7) "Grantor" means an adult who has executed an advance directive in accordance with Sections 1 to 12 of this Act.

(8) "Health care decision" means consenting to, or withdrawing consent for any medical procedure, treatment or intervention.

(9) "Health care facility" means any institution, place, building, agency, or portion thereof, public or private, whether organized for profit or not, used, operated, or designed to provide medical diagnosis, treatment, nursing, rehabilitative, or

preventive care, and licensed pursuant to KRS Chapter 216B.

(10) "Health care provider" means any health care facility or provider of health services, including but not limited to, those licensed, certified, or regulated under the provisions of KRS Chapters 211, 216, 311, 312, 313, or 314.

(11) "Life-prolonging treatment" means any medical procedure, treatment, or intervention which:

(a) Utilizes mechanical or other artificial means to sustain, prolong, restore, or supplant a spontaneous vital function; and

(b) When administered to a patient would serve only to prolong the dying process. "Life-prolonging treatment" shall not include the administration of medication or the performance of any medical procedure deemed necessary to alleviate pain.

(12) "Permanently unconscious" means a condition which, to a reasonable degree of medical probability, as determined solely by the patient's attending physician and one (1) other physician on clinical examination, is characterized by an absence of cerebral cortical functions indicative of consciousness or behavioral interaction with the environment.

(13) "Physician" means a person licensed to practice medicine in the Commonwealth of Kentucky.

(14) "Responsible party" means an adult who has authority under Section 6 of this Act to make a health care decision for a patient who has not executed a living will directive.

(15) "Surrogate" means an adult who has been designated to make health care decisions in accordance with Sections 1 to 12 of this Act.

(16) "Terminal condition" means a condition caused by injury, disease, or illness which, to a reasonable degree of medical probability, as determined solely by the patient's attending physician and one (1) other physician, is incurable and

irreversible and will result in death within a relatively short time, and where the application of life-prolonging treatment would serve only to artificially prolong the dying process.

SECTION 2. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) An adult with decisional capacity may make a written living will directive that does any or all of the following:

(a) Directs the withholding or withdrawal of life-prolonging treatment; or

(b) Directs the withholding or withdrawal of artificially provided nutrition or hydration; or

(c) Designates one (1) or more adults as a surrogate or successor surrogate to make health care decisions on behalf of the grantor. During any period in which two (2) or more surrogates are serving, all decisions shall be by unanimous consent of all the acting surrogates unless the advance directive provides otherwise.

(2) Except as provided in Section 7 of this Act, a living will directive made pursuant to this section shall be honored by a grantor's family, regular family physician or attending physician, and any health care facility of or in which the grantor is a patient.

(3) For purposes of Sections 1 to 12 of this Act, notification to any emergency medical responder as defined by KRS Chapter 211 or any paramedic as defined by KRS Chapter 311, of a person's authentic wish not to be resuscitated shall be recognized only if on a standard form or identification approved by the Kentucky Board of Medical Licensure, in consultation with the Cabinet for Human Resources.

SECTION 3. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) A living will directive made pursuant to Section 2 of this Act shall be substantially in the following form, and may include other specific directions which are in accordance with accepted medical practice and not specifically prohibited by any other statute. If any other specific directions are held by a court of appropriate jurisdiction to be invalid, that invalidity shall not affect the directive.

"Living Will Directive

My wishes regarding life-prolonging treatment and artificially provided nutrition and hydration to be provided to me if I no longer have decisional capacity, have a terminal condition, or become permanently unconscious have been indicated by checking and initialing the appropriate lines below. By checking and initialing the appropriate lines, I specifically:

.... Designate .... as my health care surrogate(s) to make health care decisions for me in accordance with this directive when I no longer have decisional capacity. If .... refuses or is not able to act for me, I designate .... as my health care surrogate(s).

Any prior designation is revoked.

If I do not designate a surrogate, the following are my directions to my attending physician. If I have designated a surrogate, my surrogate shall comply with my wishes as indicated below:

.... Direct that treatment be withheld or withdrawn, and that I be permitted to die naturally with only the administration of medication or the performance of any medical treatment deemed necessary to alleviate pain.

.... DO NOT authorize that life-prolonging treatment be withheld or withdrawn.

.... Authorize the withholding or withdrawal of artificially provided food, water, or other artificially provided nourishment or fluids.

.... DO NOT authorize the withholding or withdrawal of artificially provided food,

water, or other artificially provided nourishment or fluids.

.... Authorize my surrogate, designated above, to withhold or withdraw artificially provided nourishment or fluids, or other treatment if the surrogate determines that withholding or withdrawing is in my best interest; but I do not mandate that withholding or withdrawing.

In the absence of my ability to give directions regarding the use of life-prolonging treatment and artificially provided nutrition and hydration, it is my intention that this directive shall be honored by my attending physician, my family, and any surrogate designated pursuant to this directive as the final expression of my legal right to refuse medical or surgical treatment and I accept the consequences of the refusal.

If I have been diagnosed as pregnant and that diagnosis is known to my attending physician, this directive shall have no force or effect during the course of my pregnancy.

I understand the full import of this directive and I am emotionally and mentally competent to make this directive.

Signed this .... day of .... 19...

Signature and address of the grantor.

In our joint presence, the grantor, who is of sound mind and eighteen years of age, or older, voluntarily dated and signed this writing or directed it to be dated and signed for the grantor.

Signature and address of witness.

Signature and address of witness.

OR

STATE OF KENTUCKY)

..........County)

Before me, the undersigned authority, came the grantor who is of sound mind and eighteen (18) years of age, or older, and acknowledged that he voluntarily dated and *signed this writing or directed it to be signed and dated as above.*

Done this .... day of .... 19...

Signature of Notary Public or other officer.

Date commission expires:............

Execution of this document restricts withholding and withdrawing of some medical procedures. Consult Kentucky Revised Statutes or your attorney."

(2) An advanced directive shall be in writing, dated, and signed by the grantor, or at the grantor's direction, and either witnessed by two (2) or more adults in the presence of the grantor and in the presence of each other, or acknowledged before a notary public or other person authorized to administer oaths. None of the following shall be a witness to any advance directive made under this section:

(a) A blood relative of the grantor;

(b) A beneficiary of the grantor under descent and distribution statutes of the Commonwealth;

(c) An employee of a health care facility in which the grantor is a patient, unless the employee serves as a notary public;

(d) An attending physician of the grantor; or

(e) Any person directly financially responsible for the grantor's health care.

(3) A person designated as a surrogate pursuant to an advance directive may resign at any time by giving written notice to the grantor; to the immediate successor surrogate, if any; to the attending physician; and to any health care facility which is then waiting for the surrogate to make a health care decision.

(4) An employee, owner, director, or officer of a health care facility where the grantor is a resident or patient shall not be designated or act as surrogate unless related to the grantor within the fourth degree of consanguinity or affinity or a member of the same religious order.

SECTION 4. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO

READ AS FOLLOWS:

(1) An advance directive made pursuant to Section 2 of this Act may be revoked by:

(a) A writing declaring an intention to revoke, which writing shall be signed and dated by the grantor;

(b) An oral statement of intent to revoke made by a grantor with decisional capacity in the presence of two (2) adults, one (1) of whom shall be a health care provider; or

(c) Destruction of the document by the grantor or by some person in the grantor's presence and at the grantor's direction.

(2) An oral statement by a grantor with decisional capacity to revoke an advance directive shall override any previous written advance directive made.

(3) Any revocation made pursuant to this section shall become effective immediately. An attending physician or health care facility shall not be required to administer treatment in accordance with the revocation until the time notice of the revocation is received. Upon receiving notice of the revocation, the attending physician or health care facility shall record, in the grantor's medical record, the time, date, and place of the notice receipt. No physician or health care facility shall be subject to any liability for acting in good faith upon the knowledge, or lack thereof, of the existence or revocation of an advance directive.

(4) The designation of a health care surrogate made pursuant to Section 2 of this Act may be revoked in whole or in part or the surrogate's powers reduced or limited at any time by the grantor, if the grantor has decisional capacity. A new designation shall revoke any prior designation unless the revocation, in whole or in part, is specifically negated.

SECTION 5. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) A surrogate designated pursuant to an advance directive may make health care

decisions for the grantor which the grantor could make individually if he or she had decisional capacity; provided all the decisions shall be made in accordance with the desires of the grantor as indicated in the advance directive. When making any health care decision for the grantor, the surrogate shall consider the recommendation of the attending physician, and honor the decision made by the grantor as expressed in the advance directive.

(2) The surrogate may not make a health care decision in any situation in which the grantor's attending physician has determined in good faith that the grantor has decisional capacity. The attending physician shall proceed as if there were no designation if the surrogate is unavailable or refuses to make a health care decision.

(3) A health care surrogate may authorize the withdrawal or withholding of artificially provided nutrition and hydration in the following circumstances:

(a) When inevitable death is imminent, which for the purposes of this provision shall mean when death is expected, by reasonable medical judgment, within a few days; or

(b) When a patient is in a permanently unconscious state if the grantor has executed an advance directive authorizing the withholding or withdrawal of artificially provided nutrition and hydration; or

(c) When the provision of artificial nutrition cannot be physically assimilated by the person; or

(d) When the burden of the provision of artificial nutrition and hydration itself shall outweigh its benefit. Even in the exceptions listed in paragraphs (a), (b), and (c) of this subsection, artificially provided nutrition and hydration shall not be withheld or withdrawn if it is needed for comfort or the relief of pain.

(4) Notwithstanding the execution of an advance directive, life sustaining treatment

and artificially provided nutrition and hydration shall be provided to a pregnant woman unless, to a reasonable degree of medical certainty, as certified on the woman's medical chart by the attending physician and one (1) other physician who has examined the woman, the procedures will not maintain the woman in a way to permit the continuing development and live birth of the unborn child, will be physically harmful to the woman, or prolong severe pain which cannot be alleviated by medication.

SECTION 6. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) If an adult patient, who does not have decisional capacity, has not executed an advance directive or to the extent the advance directive does not address a decision that must be made, any one (1) of the following responsible parties, in the following order of priority if no individual in a prior class is reasonably available, willing, and competent to act, shall be authorized to make health care decisions on behalf of the patient:

(a) The judicially appointed guardian of the patient, if the guardian has been appointed and if medical decisions are within the scope of the guardianship;

(b) The spouse of the patient;

(c) An adult child of the patient, or if the patient has more than one (1) child, the majority of the adult children who are reasonably available for consultation;

(d) The parents of the patient;

(e) The nearest living relative of the patient, or if more than one (1) relative of the same relation is reasonably available for consultation, a majority of the nearest living relatives.

(2) In any case in which a health care decision is made under this section, the

decision shall be noted in writing in the patient's medical records.

(3) An individual authorized to consent for another under this section shall act in good faith, in accordance with any advance directive executed by the individual who lacks decisional capacity, and in the best interest of the individual who does not have decisional capacity.

(4) An individual authorized to make a health care decision under this section may authorize the withdrawal or withholding of artificially-provided nutrition and hydration only in the circumstances as set forth in subsection (3) of Section 5 of this Act.

SECTION 7. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) It shall be the responsibility of the grantor or the responsible party of the grantor to provide for notification to the grantor's attending physician and health care facility where the grantor is a patient that an advance directive has been made. If the grantor is comatose, incompetent, or otherwise mentally or physically incapable, any other person may notify the attending physician of the existence of an advance directive. An attending physician who is notified shall promptly make the living will directive or a copy of the advance directive a part of the grantor's medical records.

(2) An attending physician or health care facility which refuses to comply with the advance directive of a patient or decision made by a surrogate or responsible party shall immediately inform the patient or the patient's responsible party and the family or guardian of the patient of the refusal. No physician or health care facility which refuses to comply with the advance directive of a qualified patient or decision made by a responsible party shall impede the transfer of the patient to another physician or health care facility which will comply with the advance directive. If the patient, the family, or the guardian of the patient has requested

and authorized a transfer, the transferring attending physician and health care facility shall supply the patient's medical records and other information or assistance medically necessary for the continued care of the patient, to the receiving physician and health care facility.

(3) No physician, nurse, staff member, or employee of a public or private hospital, or employee of a public or private health care facility, who shall state in writing to the hospital or health care facility his objection to complying with the advance directive of a patient or a health care decision of a responsible party under Sections 1 to 12 of this Act, on moral, religious, or professional grounds, shall be required to, or held liable for refusal to, comply with the advance directive or health care decision as long as the physician, nurse, staff member, or employee complies with the requirements of subsection (2) of this section regarding patient notification and patient transfer.

(4) It shall be unlawful discriminatory practice for any person to impose penalties or take disciplinary action against or deny or limit licenses, certifications, degrees, or other approvals or documents of qualification to any physician, nurse staff member, or employee who refuses to comply with the advance directive of a patient or a health care decision by a responsible party under Sections 1 to 12 of this Act, as long as the physician, nurse staff member, or employee complies with the provisions of subsection (2) of this section regarding notification and transfer.

SECTION 8. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) A health care facility, physician, or other person acting under the direction of a physician shall not be subject to criminal prosecution or civil liability or be deemed to have engaged in unprofessional conduct as a result of the withholding or the withdrawal of life-prolonging treatment or artificially provided nutrition

and hydration from a patient in a terminal condition in accordance with an advance directive executed pursuant to Sections 1 to 12 of this Act. A person who authorizes the withholding or withdrawal of life-prolonging treatment or artificially provided nutrition and hydration from a patient in a terminal condition in accordance with an advance directive shall not be subject to criminal prosecution or civil liability for the action.

(2) An independent investigation of a surrogate's authority shall not be necessary unless a person is in possession of information as to the surrogate's disqualification. No surrogate, responsible party, physician, or health care facility acting in good faith, shall be subject to criminal or civil liability for giving instructions as a surrogate, making a health care decision as a responsible party under Sections 1 to 12 of this Act, or carrying out, or refusing to carry out pursuant to Section 7 of this Act, the surrogate's or responsible party's instructions or acting in reliance on the grantor's designation of a surrogate or a health care decision by a responsible party under Sections 1 to 12 of this Act.

(3) The provisions of this section shall apply unless it is shown by a preponderance of the evidence that the person:

(a) Authorizing or effectuating the withholding or withdrawal of life-prolonging treatment;

(b) Giving instructions as a surrogate;

(c) Making a health care decision as a responsible party under Sections 1 to 12 of this Act;

(d) Carrying out, or refusing to carry out, the surrogate's or responsible party's instructions; or

(e) Acting in reliance on the grantor's designation of a surrogate or a health care decision by a responsible party under Sections 1 to 12 of this Act.

did not, in good faith, comply with the provisions of Sections 1 to 12 of this Act.

(4) An advance directive made in accordance with Sections 1 to 5 of this Act shall be presumed to have been made voluntarily and validly executed unless the attending physician or health care facility has actual knowledge to the contrary.

SECTION 9. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) The withholding or withdrawal of life-prolonging treatment or artificially provided nutrition and hydration from a grantor in accordance with the provisions of Sections 1 to 12 of this Act shall not, for any purpose, constitute a suicide. The making of an advance directive under Sections 1 to 5 of this Act or a health care decision by a responsible party under Sections 1 to 12 of this Act shall not affect in any manner the sale, procurement, or issuance of any policy of life insurance, nor shall it be considered to modify the terms of an existing policy of life insurance. Notwithstanding any term of the policy to the contrary, no policy of life insurance shall be legally impaired or invalidated in any manner by a health care decision made by a surrogate or responsible party or by the withholding or withdrawal from an insured patient any medical procedure or intervention which would serve only to prolong artificially the dying process.

(2) No person, corporation, or governmental agency shall require or induce any person to execute a living will directive or to make a health care decision as a responsible party under Sections 1 to 12 of this Act as a condition for a contract or for the provision of any service, medical treatment, or benefit.

(3) Nothing in Sections 1 to 12 of this Act shall be construed to impose any liability on a surrogate or responsible party for any expenses of the grantor for which the surrogate or responsible party would not otherwise have been liable.

(4) Sections 1 to 12 of this Act shall not create a presumption concerning the intention of an adult who has revoked or has not executed an advance directive with respect to the use, withholding, or withdrawal of life-prolonging treatment if

a terminal condition exists.

(5) Sections 1 to 12 of this Act shall not affect the common law or statutory right of an adult to make decisions regarding the use of life-prolonging treatment, so long as the adult is able to do so, or impair or supersede any common law or statutory right that an adult has to effect the withholding or withdrawing of medical care.

(6) Sections 1 to 12 of this Act shall not preclude or restrict the right of persons to make advance directives outside the provisions of Sections 1 to 12 of this Act; and Sections 1 to 12 of this Act shall not restrict or preclude medical personnel, physicians, nurses, or health care facilities from following other written advance directives consistent with accepted medical practice.

SECTION 10. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

Sections 1 to 12 of this Act shall not be construed to condone, authorize, or approve mercy killing or euthanasia, or to permit any affirmative or deliberate act to end life other than to permit the natural process of dying.

SECTION 11. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

(1) Any person who willfully conceals, cancels, defaces, obliterates, or damages the advance directive of another without the grantor's consent or who falsifies or forges a revocation of the advance directive of another, thereby causing life-prolonging treatment to be utilized in contravention of the previously expressed intent of the patient shall be civilly liable.

(2) Any person who falsifies or forges the advance directive of another, or willfully conceals or withholds personal knowledge of the revocation of an advance directive, with the intent to cause a withholding or withdrawal of life-prolonging treatment, contrary to the wishes of the grantor, and thereby causes life-

<u>prolonging treatment to be withheld or withdrawn and death to be hastened, shall be guilty of a Class B felony.</u>

SECTION 12. A NEW SECTION OF KRS CHAPTER 311 IS CREATED TO READ AS FOLLOWS:

<u>Sections 1 to 12 of this Act may by cited as the "Kentucky Living Will Directive Act."</u>

Section 13. The following KRS sections are repealed:

311.622 Legislative finding.

311.624 Definitions for KRS 311.622 to 311.644.

311.626 Declaration -- Witness.

311.628 Notification of declarant's attending physician of existence of declaration.

311.630 Revocation procedures.

311.632 Exemption of health care facility or physician from criminal prosecution or civil liability for actions.

311.634 Notification of patient when attending physician or health care facility refuses to comply -- Transfer of patient.

311.636 Construction of KRS 311.622 to 311.644.

311.638 Withholding or withdrawal of life-prolonging treatment not to constitute suicide -- Effect of declaration on life insurance.

311.640 Effect of KRS 311.622 to 311.644 on intention or right of adult.

311.642 Civil liability -- Penalty.

311.644 Short title.

311.970 Definitions for KRS 311.970 to 311.986.

311.972 Designation of surrogate -- Resignation -- Persons prohibited from serving.

311.974 Execution of designation.

311.976 Revocation of designation.

311.978 Powers of surrogate -- Limitations.

311.980 Form of designation.

311.982 Refusal of health care provider to comply with designation -- Effect of refusal.

311.984 Liabilities of surrogate -- Effect of designation on life insurance -- Right to make decision as to use of life-prolonging treatment.

311.986 Short title.

KENTUCKY'S 1994 REAL ESTATE TRANSFER TAX STATUTE

GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

REGULAR SESSION 1994

HOUSE BILL NO. 157

WEDNESDAY, FEBRUARY 2, 1994

The following bill was reported to the Senate from the House and ordered to be printed.

AN ACT relating to real estate transfer tax.

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

Section 1. KRS 142.050 is amended to read as follows:

(1) As used in this section, unless the context otherwise requires:

(a) "Deed" means any document, instrument, or writing other than a will and other than a lease or easement, regardless of where made, executed, or delivered by which any real property in Kentucky, or any interest therein, is conveyed, vested, granted, bargained, sold, transferred, or assigned.

(b) "Value" means:

1. In the case of any deed not a gift, the amount of the full actual consideration therefor, paid or to be paid, including the amount of any lien or liens thereon; and

2. In the case of a gift, or any deed with nominal consideration or without stated consideration, the estimated price the property would bring in an open market and under the then prevailing market conditions in a sale between a willing seller and a willing buyer, both conversant with the property and with prevailing general price levels.

(2) A tax upon the grantor named in the deed shall be imposed at the rate of fifty cents ($0.50) for each $500 of value or fraction thereof, which value is declared in the deed upon the privilege of transferring title to real property.

(3) (a) If any deed evidencing a transfer of title subject to the tax herein imposed is offered for recordation, the county clerk shall ascertain and compute the amount of the tax due thereon and shall collect the amount as prerequisite to acceptance of the deed for recordation.

(b) The amount of tax shall be computed on the basis of the value of the transferred property as set forth in the deed.

(c) The tax required to be levied by this section shall be collected only once on each transaction and in the county in which the deed is required to be recorded by KRS 382.110(1).

(4) The county clerk shall collect the amount due and certify the date of payment and the amount of collection on the deed. The county clerk shall retain five percent (5%) as his fee for collection and remit the balance every three (3) months to the county treasurer, who shall deposit the money in the county general fund.

(5) The Revenue Cabinet may prescribe regulations necessary to carry out the purposes of this section.

(6) Any county clerk who willfully shall record any deed upon which a tax is imposed by this section without collecting the proper amount of tax and certifying the date and amount of collection on the deed as required by this section based on the declared value indicated in the affidavit appended to the deed shall, upon conviction, be fined $50 for each offense.

(7) The tax imposed by this section shall not apply to a transfer of title:

(a) Recorded prior to March 27, 1968;

(b) To, in the event of a deed of gift or deed with nominal consideration, or from the United States of America, this state, any city or county within this state, or any instrumentality, agency, or subdivision hereof;

(c) Solely in order to provide or release security for a debt or obligation;

(d) Which confirms or corrects a deed previously recorded;

(e) Between husband and wife, or between former spouses as part of a divorce proceeding;

(f) On sale for delinquent taxes or assessments;

(g) On partition;

(h) Pursuant to mergers of corporations;

(i) By a subsidiary corporation to its parent corporation for no consideration, nominal consideration, or in sole consideration of the cancellation or surrender of the subsidiary's stock;

(j) Under a foreclosure proceeding;

(k) Between individuals and a corporation, with only nominal consideration therefor, if those individuals are the exclusive owners of that corporation; ~~[and]~~

(l) Between parent and child or grandparent and grandchild, with only nominal consideration therefor***; and***

(m) Of property to a trustee, to be held in trust, or by a trustee to a beneficiary of the trust, if a direct transfer from the grantor of the trust to each individual beneficiary of the trust would have qualified for an exemption from the tax pursuant to one of the provisions of this section. As used in this paragraph, "trust" shall have the same definition as contained in KRS 386.800.

SELECTED SOPHISTICATED GIFTING STRATEGIES:

A Checklist Of Ideas

Theodore B. Atlass
Atlass Professional Corporation
Denver, Colorado

SECTION B

SELECTED SOPHISTICATED GIFTING STRATEGIES

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SELECTED SOPHISTICATED GIFTING STRATEGIES: A CHECKLIST OF IDEAS

by

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I. INTRODUCTION TO GIFTING

A. What Constitutes A Gift?

Virtually any direct or indirect gratuitous transfer will constitute a gift for purposes of Chapter 12 (i.e., the gift tax provisions) of the Internal Revenue Code unless such transfer qualifies for some specific exemption.

B. Non-Tax Reasons For Making Gifts

1. Funding Specific Needs Of The Donee

   To assist the donee by providing funds to go to college, purchase a home, start a business, or to otherwise have an enriched life.

2. Facilitating Financial Maturity

   To provide funds for the donee to gain some experience in managing money, making investment decisions, dealing with professional advisors, etc.

3. Testing The Donee's Financial Acumen

   To see what the donee will do with a large gift. If the donee acts responsibly with the gifted property, then the donor may be more generous later. If the donee wastes the gift, then the donor may be very tightfisted with later gifts.

4. Not Requiring The Donee To Wait

   To allow the donee to receive funds while still young enough to benefit from them, as opposed to making the donee wait until the donor's death to receive anything, at which time the donee may be very old.

5. Providing The Donee With Financial Security

To provide the donee with financial security, such as might b accomplished by setting up a trust for the donee which would be protected from the beneficiary's creditors, divorce actions, financial mismanagement, or from death taxes at the beneficiary's death.

6. Anti-Creditor Planning

To get some assets set aside for family members while the donor is solvent, just in case some financial calamity later financially wipes the donor out.

7. Planning To Qualify For Medicaid

To position the donor so that Medicaid will pay for the donor's nursing home costs by gifting non-exempt property away and letting the 36 month waiting period expire.

C. Tax-Motivated Reasons For Making Gifts

1. Income Tax Minimization

To shift income from the donor's income tax return to the another income tax return (i.e., the donor's income tax return or a trust's income tax return) where it will be subject to a lower effective income tax rate.

Example: If assets producing $1,200 in income are gifted by a donor (who is in a 39.6% tax bracket) to a child under age 14 with no other income, $385.20 in annual tax savings will result. The child's taxes on $1,200 would only be $90 (as $600 is exempt and $600 is taxed at 15%, based upon the 1992 kiddie tax rules and 1993 rates). If such $1,200 of income had been retained by the donor and all taxed at 39.6%, of $475.20 of tax would instead be due.

2. Gift Tax Minimization

To shift assets from the donor to the donee at the least (if any) gift tax cost possible so that such assets will be subject to a lowest possible effective transfer tax rate.

Example: Husband and wife, who will ultimately be in a 55% death tax bracket, strongly believe in home ownership and desire to see that each of their children has $100,000 at age 25 to own a home free and clear. They could wait until each child turns 25 to give such child the $100,000. However, even with gift-splitting and use of two annual exclusions, $80,000 of taxable gifts would then be made (which would result in $44,000 additional estate tax at death). Instead, $20,000 per year (less whatever benefit is achieved from appreciation and/or accumulation of net income after taxes) could be made for five years without any taxable gifts being incurred.

3. Estate Tax Minimization

To eliminate (to the extent possible) estate taxes at the client's death and, if such taxes can't be eliminated, then to postpone them until the death of the client's spouse.

Example: Client has a pre-1981 will which leaves one-half of client's $2,000,000 estate to the spouse, and the balance (after estate taxes) to a so-called "family trust" for the surviving spouse and children. The $1,000,000 going to the family trust exceeds the $600,000 exemption-equivalent, and is subject to $153,000 in death taxes (not considering any available credits). The client's estate planning documents (i.e., will and/or revocable trust) can be updated, if desired, to take advantage of the unlimited marital deduction introduced in 1981. This will cause more assets to go to the spouse (or to be set aside in a so-called "marital deduction trust" for the spouse's benefit), and will completely eliminate death taxes upon the client's death, assuming that the client is survived by his or her spouse. It should be noted, however, that assets which qualify for the marital deduction are subject to estate taxation at the surviving spouse's later death, to the extent that they have not been used up or given away by the time of the surviving spouse's death.

Example: Husband and wife have combined assets of $1,200,000, all of which are owned by wife, and simple wills which leave all of their assets to the survivor of them. No estate tax will be due at the first death (i.e., husband has no assets, and wife's estate will not be taxed because of the marital deduction). Whoever dies last will have $1,200,000 to pass on to the children. Only $600,000 of those assets will be sheltered from estate taxation at the survivor's death, with the balance of the assets generating $235,000 in death taxes (not considering any available tax credits). If husband and wife split their assets, so that each of them had a net worth of $600,000, the first to die could put his or her assets into a so-called "family trust" (sometimes also called a "B trust" or "credit shelter trust") for the surviving spouse. The family trust would benefit the surviving spouse, but not be deemed to be an asset of the surviving spouse for estate tax purposes, and $253,000 of estate taxes would be eliminated.

4. Multi-Generational Tax Planning

Thought should also be given to minimizing taxes at the death of the donor's child, grandchild, and possibly even great grandchild by setting up a multi-generational dynastic trust arrangement whereby successive trust beneficiaries have very broad rights to benefit from property held in the trust without having a transfer tax imposed when one beneficiary's interest terminates in favor of the next beneficiary.

Example: In their wills husband and wife each put $1 Million (after estate taxes) into generation-skipping trusts for their descendants. The trusts are to benefit children, then grandchildren, and ultimately pass to great grandchildren. Assume that a 55% estate tax applies. If the $2 Million had been given to the children and remained intact, the estate tax when the children died would be $1.1 Million, leaving $900,000 for grandchildren. The estate tax when the grandchildren died would be $495,000, leaving only $405,000 of the original $2 Million for the great grandchildren. Use of the generation-skipping trust causes no estate taxes to be due when children and grandchildren die, thus resulting in the entire $2 Million (rather than $405,000) being available for the great grandchildren.

II. APPLICABLE TAX RULES

A. Income Tax Implications Of Non-Charitable Gifts

1. Income Shifting Opportunities

a. Income shifting has been made much more difficult in recent years by bracket compression, kiddie tax, trust throwback rules, prohibitions against multiple trusts, elimination of many income shifting devices (Clifford trusts, Rushing trusts, spousal remainder trusts, etc.), taxation gain realized by trust at the grantor's tax rates under certain circumstances, etc.

b. The income tax rates for tax years beginning in 1993 are as follows:

SINGLE INDIVIDUALS (NOT A QUALIFIED SURVIVING SPOUSE OR HEAD OF HOUSEHOLD)

Taxable Income	Computation of Tax
Not over $22,100	15% of the taxable income
$22,100 to $53,500	$3,315.00 plus 28% of the excess over $22,100
$53,500 to $115,000	$12,107.00 plus 31% of the excess over $53,500
$115,000 to $250,000	$31,172.00 plus 36% of the excess over $115,000
Over $250,000	$79,772.00 plus 39.6% of the excess over $250,000

MARRIED FILING JOINTLY AND QUALIFIED SURVIVING SPOUSES

Taxable Income	Computation of Tax
Not over $36,900	15% of the taxable income
$36,900 to $89,150	$5,535.00 plus 28% of the excess over $36,900
$89,150 to $140,000	$20,165.00 plus 31% of the excess over $89,150
$140,000 to $250,000	$35,928.50 plus 36% of the excess over $140,000
Over $250,000	$75,528.50 plus 39.6% of the excess over $250,000

HEADS OF HOUSEHOLDS

Taxable Income	Computation of Tax
Not over $29,600	15% of the taxable income
$29,600 to $76,400	$4,4440.00 plus 28% of the excess over $29,600
$76,400 to 127,500	$17,544.00 plus 31% of the excess over $76,400

$127,500 to $250,000	$33,385.00 plus 36% of the excess over $127,500
Over $250,000	$77,485.00 plus 39.6% of the excess over $250,000

MARRIED INDIVIDUALS FILING SEPARATELY

Taxable Income	Computation of Tax
Not over $18,450	15% of the taxable income
$18,450 to $44,575	$2767.50 plus 28% of the excess over $18,450
$44,575 to $70,000	$10,082.50 plus 31% of the excess over $44,575
$70,000 to $125,000	$17,964.25 plus 36% of the excess over $70,000
Over $125,000	$37,764.25 plus 39.6% of the excess over $125,000

ESTATES AND TRUSTS

Taxable Income	Computation of Tax
Not over $1,500	15% of taxable income
$1,500 to $3,500	$225.00 plus 28% of the excess over $1,500
$3,500 to $5,500	$785.00 plus 31% of the excess over $3,500
$5,500 to $7,500	$1,405.00 plus 36% of the excess over $5,500
Over $7,500	$2,125.00 plus 39.6% of the excess over $7,500

c. It may be possible to maximize income shifting possibilities by combining the use of a trust and a custodianship under UGMA or UTMA for a minor beneficiary. Each year the trustee would determine how many dollars of trust income it would be worthwhile to instead have taxed on the minor beneficiary's Form 1040 instead of on the trust's Form 1041, and such amount could be distributed by the trustee to a custodian under UGMA or UTMA for such child's benefit. The distribution will carry out DNI of the trust, thus shifting taxable income to the child's presumably lower income tax bracket. There is no reason why the trustee couldn't also act as the custodian.

Example: It would be possible to establish a trust which had assets producing $8,800 in income and have such trust distribute $1,200 per year to a child under age 14 (or a custodian under UGMA or UTMA for such child). After the distributions deduction is taken into account the trust would have $7,600 of income, $100 of which would be exempt and $7,500 of which would cause $2,125 of tax to be due by the trust. The child's taxes on $1,200 would be $90 (as $600 is exempt and $600 is taxed at 15%, based upon the 1992 kiddie tax rules and 1993 rates). If such $8,800 of total income had been retained by the donor and all taxed at 39.6%, $3,484.80 of tax would be due. $1,269.80 of annual income tax savings is thus achieved for each beneficiary under age 14.

Example: It would be possible to establish a trust which had assets producing $30,300 in income and have such trust distribute $22,700 per year to a child over age 14 (or a custodian under UGMA or UTMA for such child). After the distributions deduction is taken into account the trust would have $7,600 of income, $100 of which would be exempt and $7,500 of which would cause $2,125 of tax to be due by the trust. The child's taxes on $22,700 would be $3,315 (as $600 is exempt and $22,100 is taxed at 15%, based upon the 1992 kiddie tax rules and 1993 rates). If such $30,300 of total income had been retained by the donor and all taxed at 39.6%, $11,998.80 of tax would be due. $6,558.80 of annual income tax savings is thus achieved for each beneficiary under age 14.

d. Many factors besides bracket differential may impact the amount of tax savings achieved through income shifting, including the kiddie tax rules, trust throwback rules, the percentage limitations on various deductions (medical expenses, charitable deductions, casualty losses, miscellaneous itemized deductions, etc.), the (maximum 80%) disallowance of itemized deductions impacting high income taxpayers, capital and net operating loss carryforwards, phaseout of the $25,000 real estate exception to the PAL rules, AMT consequences, etc.

2. Consequences To The Donor

a. Any income generated on gifted property after the date of the gift is shifted from the donor's income tax return to the donee's income tax return.

b. Any unrealized gain in appreciated gifted property becomes the donee's problem (as the donee receives a carryover basis) unless the gift itself is characterized as a taxable disposition triggering gain to the donor (such as in the case of a gift of an installment obligation).

c. Gift loans (i.e., those containing a below market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a de minimis rule. IRC §7872.

d. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead to be paid by the donee), the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted cost basis in the property. Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981).

e. Where a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that indebtedness exceeds the basis of the property. Winston F. C. Guest, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the nonrecourse obligation, and the fair market value of the property is irrelevant to the computation. Tufts v. Commissioner, 103 S.Ct 1826 (1983).

f. The transfer of an installment obligation by lifetime gift will constitute a disposition and cause an acceleration of the deferred gain for income tax purposes. IRC §453B.

g. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of suspended passive activity losses. IRC §469(j)(6).

3. Consequences To The Donee

a. Gross income does not include the value of property acquired by gift, bequest, devise or inheritance. IRC §102(a).

b. Gross income does include the income derived from any property acquired by gift, bequest, devise or inheritance. IRC §102(b)(1).

c. Gross income does include the amount of such income where the gift, bequest, devise or inheritance is of income from property. IRC §102(b)(2).

d. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating the whether the donee has received gross income. IRC §§61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift made gratuitously and with donative intent is not included in gross income. Helvering v. American Dental, 318 U.S. 322 (1943).

e. Gift loans (i.e., those containing a below market rate of interest) cause the borrower to have imputed interest expense for income tax purposes. IRC §7872.

f. Appreciated property which is given to a trust and subsequently sold within two years (and during the donor's lifetime) by the trust will be taxed to the trust at the grantor's tax rate rather than the trust's tax rate. IRC §644.

4. Adjusted Basis Of Gifted Property

a. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

b. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC §1015.

Example: Assume that the donor gives stock having a basis of $200 and a fair market value of $1,000 to child, and pays $400 of gift tax. The basis adjustment for the gift tax paid is [(1000 minus 200)/1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.

c. The basis of gifted property is increased (but not to above fair market value) by generation-skipping taxes paid. IRC §2654. This basis adjustment for GST taxes paid is applied <u>after</u> the basis adjustment for gift taxes paid pursuant to IRC §1015.

d. Any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis and benefit the donee (although a dual basis may exist, and such addition to basis, to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction). IRC §469(j)(6).

Example: Assume that the donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended PAL of $40. When the asset is gifted, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

e. For purposes of determining loss in a subsequent sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC §1015.

B. Gift Tax Implications

1. General Scheme Of Taxation

a. The gift tax is imposed on the donor with respect to gratuitous transfers. IRC §2501 <u>et</u> <u>seq.</u> Obvious examples include the transfers of cash or other property to members of the donor's family, trusts for such persons benefit, etc.

b. The gift tax is <u>not</u> applicable to transfers such as which are not gratuitous by their nature.

(1) Transactions where fair consideration is received back (i.e., parent gives child $1,000 and receives from child $1,000 worth of stocks in return) do not constitute gifts for gift tax purposes.

(2) Payments made to (or for the benefit of) one family member by another family member in fulfillment of the payor's duty under state law to legally support the person being benefitted (i.e., husband pays wife's grocery or doctor bill, parent buys minor child some clothing, etc.) do not constitute gifts for gift tax purposes.

(3) Payments made by one spouse (or ex-spouse) to the other incident to a divorce property settlement do not constitute gifts for gift tax purposes. IRC §2516.

c. A person who receives a gift or inheritance can turn it down (i.e. disclaim or renounce the gift), which may cause the to go to a default beneficiary (possibly the disclaimant's child). If technical statutory requirements are met (e.g., a timely disclaimer has been made prior to accepting any benefits of the disclaim property, etc.), then the disclaimer will not constitute a gift by the disclaiming party for gift tax purposes. IRC §2518.

2. Available Exclusions, Deductions and Credits

a. The Annual Exclusion

It will be desirable to make gifts each calendar year to as many people as possible. No gift tax will be incurred (nor is a gift tax return due) so long as the total gifts to a particular individual do not exceed $10,000 in any one calendar year. IRC §2503(b). The annual exclusion is $100,000 for gifts made by a person to his or her spouse where the spouse receiving the gift is not a U.S. citizen. Such gifts will not be included in the donor's estate pursuant to IRC §2035, even if the donor dies within three years, unless a life insurance policy on the donor's life was gifted or the donor retained some interest in the gifted property under IRC §§2036, 2037, or 2038.

b. Spousal Gift Splitting

Spouses may consent to split gifts, which causes the amount which the two of them (in the aggregate) can gift tax free each calendar year to become $20,000 per individual donee. IRC §2523. Such election can be made on a late filed gift tax return (as long as it is the first gift tax return filed for the year in question), and if made the election applies to all gifts made during that year while the couple was married.

c. The Exclusion For Medical And Tuition Expenses

Direct payments to the providers for the medical or tuition expenses of another are gifts which qualify for an unlimited gift tax exclusion. Reimbursing the individual who incurred such an expense will not qualify for this special gift tax exclusion. IRC §2503(e).

d. The Marital Deduction

Outright transfers to a spouse (as well as transfers to a properly drafted "marital deduction" trust for a spouse's benefit) will qualify for the gift tax marital deduction and can thus be made on a gift tax free basis. There is no limit on the amount of assets that can be transferred via the marital deduction to a spouse who is a U.S. citizen, but <u>no</u> gift tax marital deduction is allowed with respect to assets transferred to a spouse who is not a U.S. citizen.

e. The Charitable Deduction

Gift taxes are generally not imposed on transfers to qualified charitable organizations. IRC §2522. Unlike the income tax charitable deduction, the gift tax charitable deduction is potentially unlimited (i.e., it is not subject to percentage limitations).

f. Use Of The Unified Credit

Every individual has a unified credit of $192,800 for estate and gift tax purposes which allows transfer tax free gifts of up to $600,000 to be made in addition to whatever gifts have been which were not gift taxable by reason of the annual exclusion or exclusion for direct payment of tuition and medical expenses. To the extent not used during lifetime to shelter otherwise taxable gifts, it is usable at death to shelter transfers from estate taxation.

3. Making Of Gifts Which Cause Gift Tax To Be Due

Gift tax is due when cumulative lifetime taxable gifts in excess of the $600,00 exemption equivalent have been made. Gift tax is less expensive than estate tax, even though the tax rates appear to be the same:

a. This result occurs because lifetime taxable gifts are computed on a "tax exclusive" basis and taxable transfers at death are taxed on a "tax inclusive" basis.

b. As an example, assuming $100 in assets and a 50% flat transfer tax bracket, $66-2/3 could be given away during lifetime with $33-1/3 of gift taxes being paid, but if the same $100 was held until death, only $50 would go to the donee (and $50 of estate taxes would be paid) since the gift tax is based upon the net amount passing to the donee (exclusive of the gift tax itself) and the estate tax is based upon the gross amount of assets passing to the donee (before deducting the estate tax attributable to such assets)

c. However, to prevent persons from making substantial taxable deathbed gifts as a means of circumventing the less favorable estate tax, any gift tax due on gifts made within three years of a decedent's death is taxed as, in effect, a "phantom asset" in the decedent's estate. IRC §2035(c). This nullifies the benefit of having the gifted assets taxed on a "tax exclusive" basis.

d. Another issue to consider is the time value of money. The making of a taxable gift may save estate taxes later, but at the cost of being out of pocket the dollars that must be used to pay gift tax in advance of when the estate tax would otherwise have been due.

C. Estate Tax Implications

Lifetime gifts can have estate tax implications in a number of situations, particularly where the donor has retained some power or interest in the gifted property:

1. Impact Of Completed Transfers

The general rule is that completed transfers are out of the donor's estate. However, even completed transfers have estate tax implications if taxable gifts were involved, as the donor's lifetime use of unified credit (i.e., of the so-called "$600,000 exemption equivalent") will reduce the amount at death that the donor can pass to beneficiaries without incurring death tax. Additionally, the unified nature of the gift and estate tax situation causes lifetime taxable gifts to move the donor's estate up the rate ladder and cause the assets remaining at death to be taxed at a higher rate.

Example: The donor is a single person with one child and has never made any gifts before. Donor gives $410,000 to the child in 1993. $10,000 qualifies for the annual exclusion and $400,000 is a taxable gift. No gift tax is due, as unified credit was used, and the donor's remaining unified credit will allow $200,000 to pass estate tax free at the donor's later death. If the donor died having $300,000, then $100,000 in assets would be subject to a 37% estate tax rate.

2. Impact Of Incomplete Transfers

a. Retained Income Or Use Of Property

IRC Section 2036 will cause assets to be included in the donor's estate for estate tax purposes where the donor retains the right to use the gifted property, the right to the income from the gifted property, the right to designate who can use (or get the income) from the gifted property, or the right to vote gifted securities.

b. Retained Reversionary Interest

IRC Section 2037 will cause assets to be included in the donor's estate for estate tax purposes where the donor retains a reversionary interest in the gifted property and some third party can succeed to such property only by surviving the donor.

c. Power To Alter Or Amend

IRC Section 2038 will cause assets to be included in the donor's estate for estate tax purposes where the donor retains the power to revoke the gift (and get the gifted property back), or the power to alter or amend the time or manner of enjoyment of the gifted property or its income (for the benefit of third parties).

d. Non-Spousal Joint Tenancy Interests

IRC Section 2040 will cause a portion of joint tenancy property to be included in a deceased joint tenant's estate. It doesn't matter whether a taxable gift was made when the joint tenancy was created. A tracing of contribution test (i.e., who originally owned it or who put his or her money into it) determines how much of the property is included in the deceased joint tenant's estate. For example, if mom puts her house into joint tenancy with daughter then nothing is included in the daughter's estate if she dies first, but the entire property is included in mom's estate if she dies first.

3. Gifts Made Within Three Years Of Death

a. The General Rule

Generally, lifetime gifts are <u>not</u> brought back into the donor's estate even if the donor dies shortly after making completed gifts. For example, a dying client could give $10,000 gifts to everybody in the phone book shortly before dying and the gifted property would generate no gift tax liability (by reason of the $10,000 annual exclusion) and would also be out of the grantor's estate for estate tax purposes.

b. Release Of Certain Powers And Interests

IRC Section 2035 will cause assets to be included in the decedent's estate for estate tax purposes where property was transferred (e.g., a right in a trust may have been given up) within three years of the decedent's death and, if such transfer had not occurred, such property would have been included in the decedent's gross estate under IRC §§2036, 2037, or 2038.

c. Transfer Of Life Insurance

IRC Section 2035 will cause life insurance to be included in the decedent's estate for estate tax purposes where such policy was transferred within three years of the decedent-insured's death and, if such transfer had not occurred, such life insurance would have been included in the decedent-insured's gross estate under IRC Section 2042.

d. Gift Tax Liability

IRC Section 2035 will cause any gift tax paid by the decedent or the decedent's estate with respect to gifts made within three year's of the decedent's death to be included as a phantom asset in the decedent's estate for estate tax purposes.

4. Beneficiary Issues Re Withdrawal Powers

The beneficiary of a trust who dies will be deemed to own all (or some portion) of a trust where such beneficiary has a withdrawal right (under a so-called "Crummey" power or five-by-five withdrawal power). The unexercised withdrawal right that is still exercisable at the beneficiary's death will constitute an asset for estate tax purposes, and the beneficiary can be deemed to own a portion of the trust for purposes of determining the beneficiary's gross estate if withdrawal rights exceeding the five-by-five limitation have lapsed in a prior year. IRC §2041.

5. Restoration Of Tax Credits

Where a donor makes a taxable gift and later the gifted property is included in the donor's gross estate at death, the gift tax credits previously used by the donor with respect to such gift (but <u>not</u> the consenting spouse's gift tax credits if gift-splitting was elected) will be restored. IRC §2012.

D. Generation-Skipping Tax Implications

1. Background

a. Complex estate planning issues were introduced by provisions of the Tax Reform Act of 1986 (TRA '86) which impose a generation-skipping transfer (GST) tax on certain wealth transfers made to younger generation beneficiaries. It is a flat tax imposed at the highest estate tax rate (now 55%). The GST tax is in addition to any gift tax or estate tax payable.

b. The TRA '86 retroactively repealed the GST tax introduced by the TRA '76 in favor of a somewhat simplified (but still quite complex) approach to GST taxation that appears likely to remain in effect. The GST tax contains exemptions designed to exclude most persons, estates and trusts from ever having to pay GST tax or file a GST tax return. But it is a brutally expensive tax; in fact, it is viewed by many as confiscatory.

c. The GST tax is contained in Chapter 13 of the Internal Revenue Code (IRC), which consists of IRC §2601 through §2663. Technical corrections were made by TAMRA in 1988, by OBRA in 1989 and by OBRA in 1990. Temporary regulations (now finalized) were issued in 1987. Additional proposed and temporary regulations were issued in 1988 (and corrected later in 1988).

d. Two sets of proposed regulations were issued on December 24, 1992. One set (57 Fed. Reg. 61356) broadly deals with issues such as definitions, how GST tax exemption is allocated, how the inclusion ratio and applicable fraction is computed, the reverse QTIP election, and how single trusts may be separated. The other set of proposed regulations (Fed. Reg. 61353) deals with the liability for GST tax on life insurance where a direct skip occurs at death and with the exercise of special powers of appointment contained in grandfathered trusts. These two sets of proposed regulations are generally effective as to generation-skipping transfers made on or after December 24, 1992, except for: (a) the division of a QTIP trust where a reverse QTIP election was made and GST tax exemption allocated to it prior to December 24, 1992; (b) elections out of an automatic allocation of GST tax exemption to direct skips; and (c) dealing with the GST tax consequences of transfers of non-U.S. situs property by a non-resident alien.

e. Historically, generation-skipping trusts have been the preferred method for the wealthy to perpetuate their family fortune. Prior to the introduction of the first GST tax in the Tax Reform Act of 1976 (TRA '76), the Rule Against Perpetuities provided the only effective time limit on how long property could escape transfer taxation by remaining in trust. It was possible for several successive persons to be given broad interests and powers over property held in a trust without any gift, estate or other transfer tax being due at the time one beneficiary's interest in the trust terminated in favor of a successor beneficiary.

f. The GST tax is designed to minimize transfer tax planning benefits which would otherwise arise from the use of generation-skipping trusts (such as a trust for a child's lifetime benefit that eventually terminates in favor of a grandchild) and from the making of direct gifts to descendants of younger generation beneficiaries (such as a direct gift to a grandchild or great-grandchild).

g. It is possible to inadvertently incur GST tax under even relatively simple estate plans where the client is not trying to engage in tax motivated multi-generational estate planning. Many older persons with large estates are certain to be impacted by the GST tax. Accordingly, the estate plans of all wealthy clients should now be reviewed to determine if potential GST tax liability can be eliminated, minimized or deferred.

h. Multi-generational tax savings trusts have not been entirely eliminated by the generation-skipping tax. Instead a $1 Million limit has been placed on the amount of assets which each person can put into a generation-skipping trust without the new GST tax law applying. There are a number of reasons why such trusts are now viable estate planning vehicles:

   (1) Assets in such a trust are protected from the beneficiary's creditor and divorce problems. Putting some of junior's inheritance in a trust which benefits junior for life and ultimately passes to grandchildren will give junior a safety net of income and assets which cannot be lost.

   (2) Significant tax savings can result, as funds in a trust which is exempted for GST tax purposes will be setup so as not to be subject to gift or death taxes when the child dies and the grandchildren receive the assets (or becomes the new beneficiary of the trust).

Example: Husband and wife each set aside $1 Million (after estate taxes) in generation-skipping trusts for their descendants. The trusts are to benefit children, then grandchildren, and ultimately pass to great grandchildren. Assume that a 50% estate tax applies. If the $2 Million had been given to the children and remained intact, the estate tax when the children died would be $1 Million, leaving $1 Million. The estate tax when the grandchildren died would be $500,000, leaving $500,000 for the great grandchildren. Use of the generation-skipping trust causes no estate taxes to be due when children and grandchildren die, thus resulting in $2 Million (rather than $500,000) being available for the great grandchildren.

i. This outline only attempts to generally familiarize the practitioner with the operation of the GST tax, so that those common estate planning situations in which the GST tax may apply can be recognized. For a detailed analysis of the GST tax, see Kalik and Schneider, *Generation-Skipping Transfer Taxes Under The Tax Reform Act of 1986*, 21 INST. ON EST. PLAN. 900 (1987); Covey, *Generation-Skipping Transfers*, 1149 PRACTICAL DRAFTING (July, 1987); Halbach, *Generation-Skipping: Planning Opportunities and Drafting Problems*, 22 INST. ON EST. PLAN. 900 (1988); Horn, *Planning and Drafting for the Generation-Skipping Tax*, 13 PROBATE NOTES 263 (1988).

2. Terminology

The GST tax is imposed on a "generation-skipping transfer" of property to a "skip person". Under IRC §2611(a), a "generation-skipping transfer" is any "taxable termination", "taxable distribution", or "direct skip".

a. Skip Person

IRC §2613(a) defines "skip person" as a person assigned to a generation which is two or more generations below that of the transferor (e.g., a grandchild or great-grandchild) or any trust where all of the beneficiaries are skip persons. IRC §2613(b) defines a "non-skip person" as any person who is not a skip person.

b. Taxable Termination

IRC §2612(b) provides that a "taxable termination" occurs upon the termination of all of the beneficial interests held by non-skip persons in a trust, if thereafter any of the beneficiaries are skip persons. For example, where a trust is established for the lifetime benefit of the transferor's child and is to eventually be distributed to the transferor's grandchildren, a taxable termination will occur at the child's death.

Transfers that qualify as both a direct skip and a taxable termination (such as a general power of appointment marital trust that terminates in favor of grandchildren at the surviving spouse's death) will be considered to be a direct skip only. Prop. Treas. Reg. §26.2612-1(b)(1)(i).

c. Taxable Distribution

IRC §2612(b) provides that a "taxable distribution" occurs when any distribution of income or principal is made from a generation-skipping trust to a skip person (other than a taxable termination or direct skip). For example, where a discretionary sprinkle trust is established for the transferor's surviving spouse and descendants, any distribution made during the surviving spouse's lifetime to a grandchild or great-grandchild of the transferor is a taxable distribution.

GST tax (plus penalties and interest thereon) paid by a distributing trust shall be an additional taxable distribution in the year in which the original taxable distribution was made. Prop. Treas. Reg. §26.2612-1(c).

d. Direct Skip

IRC §2613(c) provides that a "direct skip" occurs when a transfer subject to federal gift tax or federal estate tax is made to a skip person. For example, where a transfer is made during life or at death to the transferor's grandchild or great-grandchild, a direct skip occurs. However, a transfer to a grandchild of the grantor is not a direct skip if the child of the grantor who is such grandchild's parent is dead at the time of such transfer. This so-called "predeceased child" exception only applies to transfers in trust that are direct skips. If the transferor's child survives the transferor and is a beneficiary of a trust, a taxable termination will occur at the child's subsequent death when the trust assets pass to (or are held in further trust for the benefit of) the deceased child's children.

Only one direct skip occurs where a single transfer of property skips more than one generation. Prop. Treas. Reg. §26.2612-1(a)(1).

A disclaimer cannot be used to cause a living descendant to be deemed to have predeceased the grantor or donor. Prop. Treas. Reg. §26.2612-1(a)(2).

e. Generation Assignment

IRC §2651 provides that a person who is not a lineal descendant of a grandparent of the transferor or the transferor's spouse shall be assigned to a generation on the basis of such person's date of birth. If such person is no more than 12-1/2 years younger than the transferor, such person will be assigned to the transferor's generation. If between 12-1/2 and 37-1/2 years younger than the transferor, such person will be assigned to the first generation younger than the transferor. Similar rules apply for a new generation every 25 years.

3. Excluded Transfers

a. Assets Also Subject To Estate Tax Or Gift Tax

IRC §2611(b)(1) provides that any transfer (other than a direct skip) from a trust is not a generation-skipping transfer to the extent federal estate tax or federal gift tax is imposed on such transfer with respect to a person in the first generation below that of the grantor. For example, if a trust provides for the grantor's child to receive income for life and grants the child a general power of appointment over the remainder, the trust will not be GST taxable at the child's death because the general power of appointment will cause the trust to be included in the child's gross estate for federal estate tax purposes.

b. Educational And Medical Expenses

Any transfer which, if made during life by an individual, would not be treated as a taxable gift by reason of IRC §2503(e) (relating to exclusion of certain educational or medical expenses) is excluded from being a generation-skipping transfer by IRC §2611(b)(2).

c. Prior GST Taxation

In addition, IRC §2611(b)(3) provides that a transfer is not a generation-skipping transfer to the extent the property was subject to GST tax with respect to a prior transfer to a person assigned to the same generation (or a lower generation) as the current transferee if such transfer does not have the effect of avoiding the GST tax.

d. Annual Exclusion Gifts

Gifts that qualify for the $10,000 gift tax exclusion escape GST taxability by reason of IRC §2642(c), which excludes such transfers from the GST tax base. However, a special provision prevent most gifts subject to a so-called "Crummey" withdrawal power from being excluded from the GST base by requiring that no portion of the corpus or income of the trust can be distributed to anyone other than the "Crummey" power holder and that, if such "Crummey" power holder dies before the trust terminates, the trust assets must be included in his gross estate for federal estate tax purposes.

Example: Client creates a single trust for the benefit of his four children while they (or any of them) are alive, and which is ultimately to go to grandchildren after all children have died. A $1 million life insurance policy on client's life is owned by the trust, and the client will contribute $20,000 per year to the trust to enable it to pay the life insurance premium on such policy. Each of client's four children have a Crummey power to withdraw $5,000 each year (i.e., 1/4th each of the $20,000 added to the trust each year). If this was the client's only gift, no beneficiary would have received a gift of more than $5,000 in a given year and no gift tax return would be due. But it would be necessary to file a gift tax return to elect to apply $20,000 of the client's GST tax exemption each year.

An initial transfer to a Crummey trust constitutes a completed transfer for gift tax purposes of the entire amount, and the lapse of a withdrawal power (to the extent in excess of the 5 by 5 limitations) will also cause the Crummey beneficiary to be the transferor to the extent the lapse is treated as a taxable gift. Prop. Treas. Reg. 26.2652-1(a)(5), Example 5.

4. Available Exemptions

a. $1,000,000 GST Tax Exemption

Each transferor has a $1 million GST tax exemption (GST exemption) which IRC §2631(a) allows such individual to allocate in any manner desired. Any GST exemption not used during life is available to the transferor's estate. Once made, any GST exemption allocation is irrevocable. If no allocation of GST exemption is made by the transferor or his executor, a mandated allocation of GST exemption is provided in IRC §2632.

Prior regulations indicated that the election out of the automatic allocation rules was revocable. Such election has now been made irrevocable, and transitional relief is provided. Prop. Treas. Reg. §26.2632-1(b)(1).

Formula allocations of GST tax exemption are now allowed, which will be very helpful where hard to value assets are involved. Additionally, except in the case of charitable lead annuity trusts, allocations in excess of the amount needed to obtain a zero inclusion ratio are void. Prop. Treas. Reg. §26.2632-1(b)(2).

In the case of a lifetime transfer where a late allocation of GST tax exemption to a trust is being made, the fair market value of the trust assets (except with respect to life insurance) may (by election) be deemed to be the value of such assets on the first day of the month during which the late election is made. Prop. Treas. Reg. §26.2643-2(a)(2).

After death a timely election of GST tax exemption with respect to lifetime transfers can be made by the personal representative on a timely filed gift tax return -- which is the earlier of the due date for the Form 706 or Form 709. A late allocation of GST tax exemption by the personal representative with respect to lifetime *transfers can be made on Form 706 -- it is effective as of the date of the transferor's death, and not on the date it is made. Prop. Treas. Reg. §26.2632-1(d)(1).*

Exceptions to the automatic allocation rules at death have been added to prevent GST tax exemption from being automatically allocated in such a way as to be wasted for a certainty at the time the Form 706 is due, but such rules won't save you from affirmatively allocating GST tax exemption in a wasteful way. Prop. Treas. Reg. §26.2632-1(d)(2).

After death GST tax exemption can be allocated to a trust created at or after death even if the trust is not yet funded when the Form 706 is filed, by formula, if the notice of allocation clearly identifies the trust and the amount of GST tax exemption being allocated to such trust. Prop. Treas. Reg. §26.2632-1(d)(1).

b. Gallo Amendment Transfers

A special $2 million per grandchild GST exemption (the so-called "Gallo Amendment") is available for pre-1990 transfers to grandchildren by IRC §1433(b)(3) of the TRA '86. Such transfers can be made by lifetime gift or at the transferor's death. Both outright transfers and transfers in trust (provided that the grandchild is the sole beneficiary to whom distributions can be made during the grandchild's lifetime, that the trust will be included in the gross estate of the grandchild if he dies after the trust's termination, and that - as to transfers made after June 10, 1987 - the trust's income must be distributed to the grandchild at least annually after age twenty-one) will qualify for Gallo Amendment transfers.

5. Computation Of Tax Due

a. Overview

In the case of a taxable termination or taxable distribution, the GST tax is computed on a tax inclusive basis (i.e., the GST tax base or "taxable amount" is the value of the property to be distributed, with certain deductions allowed by IRC §2621 or §2622, but with no deduction for the GST taxes payable from such distribution). In the case of a direct skip, IRC §2623 provides that the GST tax is computed on a more favorable tax exclusive basis (i.e., the GST tax base or "taxable amount" is the value of the property actually received by the transferee and is not grossed up by the GST taxes owed by the transferor).

b. Applicable Definitions

The GST tax due is defined by IRC §2602 as the taxable amount multiplied by the "applicable fraction". Under IRC §2641, the applicable rate is the product of the maximum federal estate tax rate (now 50%) and the "inclusion ratio". IRC §2642 provides that the inclusion ratio is 1.0, minus the "applicable fraction", and that the applicable fraction has a numerator equal to the GST exemption allocated to the trust or direct skip and a denominator equal to the value of the property transferred to the trust (or involved in the direct skip), reduced by the sum of (1) any federal estate tax or state death tax actually recovered from the trust attributable to such property, and (2) any charitable deduction allowed under IRC §2055 or §2522 with respect to such property. IRC §2604 allows a state death tax credit, not to exceed 5% of the federal GST tax, for state GST taxes paid on transfers (other than direct skips) occurring by reason of death.

In determining the denominator of the applicable fraction with respect to testamentary transfers, estate tax values are generally used (but special rules may require the fair market value of property subject to a Section 2032A election to be used). Prop. Treas. Reg. §26.2642-2(b).

Special new rules for pecuniary payments have been implemented to determine the denominator of the applicable fraction. Date of distribution values must be used or else the pecuniary payment must be satisfied so as to fairly reflect appreciation and depreciation. If the pecuniary payment is made in cash, the denominator is the pecuniary amount. If an in kind distribution is made to satisfy a pecuniary gift, the pecuniary gift must be satisfied either using property on the basis of the value of the property: (a) on the date of distribution, or (b) if it is a date other than the date of distribution, using values that are fairly representative of appreciation and depreciation in the assets of the estate or trust at such time, and such gift must be valued and satisfied at date of distribution values. Prop. Treas. Reg. §26.2642-2(b)(2).

Complex new rules govern the computation of the denominator where a residual transfer follows a pecuniary payment (such as a $1,400,000 estate that provides for $400,000 to wife and the balance to a GST trust). The pre-residuary pecuniary bequest must carry "appropriate interest". If satisfied in kind, date of distribution values must be used <u>or</u> the pecuniary amount must be adjusted so as to be fairly representative of appreciation or depreciation in the assets of the estate or trust. Otherwise, adverse adjustments are made in the computation of the fraction. Prop. Treas. Reg. §26.2642-2(b).

c. Computations

An example is helpful. Assume a lifetime transfer of $1 million is made to a trust which is to pay its income to the transferor's child for life and thereafter be distributed to the transferor's grandchildren. The normal gift tax rules will apply at the time the trust is created. If $400,000 of the transferor's GST exemption is allocated to the trust at its inception and the trust is valued at $2 million when the child dies, $660,000 of GST tax will be payable when the trust terminates at the child's death. A 55% GST tax bracket is assumed to apply.

The applicable fraction is .40 (400,000/1,000,000)
The inclusion ratio is .60 (1.0 minus .40)
The applicable rate is .33 (55% times .60)
The GST tax due is $660,000 (.33 times 2,000,000)
The maximum state death tax credit is $33,000 (5% times 660,000)

A different result would occur if the same transfer were instead taxable as a direct skip upon the creation of such a trust for the sole benefit of the transferor's grandchildren. Assuming the Gallo Amendment is not applicable, GST tax of $330,000 (i.e., the applicable rate multiplied by the value of the trust at the time of the GST taxable event occurs) would be due upon the creation of the trust. In addition, IRC §2515 provides that the amount of the gift for federal gift taxes is increased by the $330,000 of GST tax imposed as a result of such gift.

6. Procedural Issues

a. Who Pays The Tax

IRC §2603(a) provides that the transferor is liable for any GST tax due upon a direct skip other than from a trust, and that the distributee is liable for any GST tax due in the case of a taxable distribution. If the trust making a taxable distribution pays the GST tax due by the distributee, such GST tax paid will constitute an additional taxable distribution. Trustees now need to consider the establishment of a GST tax reserve when making certain types of distributions, as IRC §2603(a) makes the trustee liable for any GST tax due upon a taxable termination or direct skip from a trust.

In the case of a direct skip occurring at death with respect to property held in a trust arrangement such as life insurance, the personal representative must file the GST tax return and pay the GST tax to the extent that the total value of the property included from such insurance company causes a direct skip with respect to the trustee of the trust to the extent of the first $250,000. Prop. Treas. Reg. §26.2662-1(c)(2)(iii).

b. Reporting Requirements

(1) GST Reporting During Life By Donor

Form 709 is used by the donor to allocate GST exemption on transfers occurring during lifetime, and to report and compute the GST tax due on direct skip transfers occurring during lifetime. Form 709 must be filed and the tax paid between January 1 and April 15 of the year following the calendar year when the lifetime direct skip occurred.

(2) Reporting Direct Skip At Death

Form 706 is used by the executor to allocate GST exemption on transfers occurring at death and to report and compute the GST tax due on direct skips occurring at death. Form 706 must be filed and the tax paid within nine months of the decedent's date of death.

Schedules R and R-1 are the specific Form 706 schedules relating to the GST tax.

(3) Reporting Taxable Distribution

Form 706 GS (D-1) is used by the trustee to report a taxable distribution and to inform the distributee of the distribution. Form 706 (D) is used by the recipient of a taxable distribution to report and compute the GST tax on taxable distributions. Form 706 GS (D) and 706 GS (D-1) must be filed and the tax paid between January 1 and April 15 of the year following the calendar year when the taxable distribution occurred.

(4) Reporting Taxable Termination

Form 706 GS (T) is used by the trustee to report and compute the GST tax due on taxable terminations of trusts. Form 706 GS (T) must be filed and the tax paid between January 1 and April 15 of the year following the calendar year when the taxable termination occurred.

c. Effective Date Provisions

(1) General Rules

IRC §1433 of the TRA '86 makes the GST law applicable to every generation-skipping transfer occurring after October 22, 1986. However, any lifetime transfer made after September 25, 1985 and on or before October 22, 1986, is treated as if made on October 23, 1986 and is therefore subject to the GST tax.

(2) Exceptions

Transfers are exempt from the GST tax if made (1) from trusts that were irrevocable on September 25, 1985 (to the extent not made from additions to corpus occurring after that date), (2) under a will executed before October 22, 1986, if the testator died before January 1, 1987, or (3) under a will of, or trust included in the gross estate of, a decedent who at all times from October 22, 1986 until his death lacked the legal capacity to change the disposition of his property.

III. GIFTING TIPS, TRICKS, AND TRAPS

A. Know The Tax Advantages Of Lifetime Gifting

1. Income from gifted assets is shifted from the donor's income tax return to the donee's income tax return, where presumably it will be taxed at a more favorable (or no worse) effective income tax rate in most circumstances.

2. Gifts qualifying for the $10,000 ($20,000 if married and gift-splitting is elected) annual gift tax exclusion completely escape both gift taxation and estate taxation.

3. Income and growth on gifted assets which occur subsequent to the making of a gift escape death taxation in the donor's estate.

4. Paying gift taxes (because the gift tax is computed on a more favorable tax exclusive basis, but estate taxes are imposed on a tax inclusive basis) are a bargain compared to the estate tax if the donor lives three years after making a gift upon which gift taxes are due.

B. Know The Disadvantages Of Lifetime Gifting

1. The donor will not want to give away assets that may be later needed by the donor for his or her own support, as there is no assurance that the donee will still have the gifted assets and then be willing to help the donor.

2. It is best to give away assets that are expected to appreciate between the date of gift and the donor's later death. It would be very wasteful to utilize unified credit and/or pay gift taxes on the lifetime gift of assets that subsequently decline in value.

3. The tax advantages of lifetime gifting are somewhat lessened by the loss of stepped-up basis at the donor's death where appreciated assets have been given away during lifetime.

C. Practical Pointers

1. Unintentional Gifts Should Be Avoided

Assets are often retitled for a non-tax purpose (such as probate avoidance), with no appreciation for the fact that a taxable gift may have been made when another person's name was added to the title. Proper planning can assure that no unintended tax results occur. If probate avoidance is desired, the use of a funded revocable trust or nominee agreement might be advisable in lieu of joint tenancy.

Example: An elderly widow wants to avoid probate on her $1,500,000 farm, so she decides to place title in the names of herself and her 4 children. She has made the children the owners of 80% of the farm, worth some $1,200,000, and substantial gift tax will be due.

Example: Unintended gift tax consequences arise where one person pays the premiums on a policy owned by another, and at the insured's death where the beneficiary of the policy differs from the owner of the policy. This would happen where wife owns a life insurance policy on husband's life that she makes payable to their children at husband's death. See Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

2. Selecting The Right Assets To Gift Away

a. Cash Need Not Be Given Away

It is not necessary to give away cash. Many more people would make gifts if they realized that stocks, partial interests in real estate, etc. can be gifted away.

b. Illiquid Assets Make Ideal Gifting Candidates

Illiquid assets, such as stock in a family business or an interest in real estate, can make especially good gifting vehicles. This is because gifts of only a small piece of such assets will probably qualify for a number of special discounts, including a minority discount and lack of marketability discount.

c. Assets with the most growth potential should be given away. All income and growth which occurs after a completed gift is made will escape gift and estate taxation.

d. Avoid Making Gifts From Revocable Trusts

Annual exclusion gifts should not be made directly from a revocable trust, as the death of the grantor within three years may cause the gifted assets to be included in the grantor's estate under IRC Section 2035 on the theory that an IRC Section 2036 or 2038 power or interest lapsed when the gift was made. See PLR 8609005, TAM 9117003, and TAM 9139002. Section 602 of H.R. 3419 (introduced on November 1, 1993) would eliminate this potential problem if passed. In the meantime, have clients with assets in revocable trusts do a two step transfer (i.e., take assets from trust, first transfer into trust grantor's name, then have trust grantor individually make the gift).

3. Control Of Gifted Property

a. Donees Need Not Get Immediate Benefits Or Control

The gifted assets can be held in trust for the intended beneficiary if it is not desired that the beneficiary have immediate access to such assets. Non-controlling interests in corporations and partnerships can be given (i.e., non-voting stock, limited partnership interests, etc.) can be given away (either directly to the beneficiary or to a trust). Family limited partnerships and second classes of non-voting stock are often created solely to facilitate the client's gifting program.

b. Sometimes The Donor Can Keep Control

The grantor can often keep control of gifted assets if that is important. For example:

(1) The grantor could gift limited partnership interests and retain control of the partnership by being general partner.

(2) The grantor could gift non-voting stock (or a minority of the voting stock) and still control the corporation by reason of the retained voting stock.

(3) The grantor can be trustee of a trust holding assets gifted by the grantor if the grantor's powers to distribute are limited by so-called ascertainable standards. However, there are many possible traps if the grantor acts as trustee (e.g., the trust couldn't hold life insurance on the grantor-trustee's life or voting stock in a controlled corporation, and complex income tax implications may arise).

c. Cutting Strings Is Sometimes Necessary

It is often necessary and/or advisable, from both an estate tax and income tax standpoint, for the donor to cut all strings over gifted assets in order to cease owning such assets for estate tax purposes (under IRC §§2036-2042) and income tax purposes (under IRC §§671-678).

Example: Donor has been faithfully making $10,000 gifts each year to custodianships for each of the donor's three children. Each child now has $100,000 sitting in an account under the Uniform Gifts to Minors Act (UGMA) and the donor is acting as custodian of such accounts. When donor dies, all funds in the custodial accounts will be included in donor's gross estate for purposes of the federal estate tax by reason of the broad powers which donor retained over the gifted property as custodian under UGMA. IRC §2038.

4. Gifting Should Be Timed For Maximum Benefit

a. Make A Series Of Annual Gifts

It is obviously better to make a series of smaller gifts which qualify for the $10,000 annual gift tax exclusion over a period of years, as opposed to making occasional larger gifts that use up unified credit and/or generate gift tax liability.

b. Make Gifts Early In The Year

Generally, gifts should be made as early in the year as is possible, so that the annual exclusion for such gifts will be obtained before the donor can die or Congress can change the rules.

c. Beware Of Year End Gifts.

It is essential that the gift be completed prior to the end of the calendar year if annual exclusion for that year is to be utilized, or prior to the donor's death if exclusion from the donor's estate is sought. Beware of last minute transfers requiring that a check clear or a deed or stock certificate be retitled. Consider bank wire transfers, use of certified checks (not cashier's checks) actually delivered to the donee, etc.

d. Leapfrog Gifts To Minimize Appraisal Costs

If the donor is healthy (i.e., no reason to expect imminent death) and is gifting hard to value assets (such as interests in a family partnership or corporation) requiring a formal appraisal, then consideration should be given to updating the appraisal late in the year every other year to minimize appraisal costs.

Example: Client is planning to make periodic and significant gifts of a hard to value asset starting in late 1992. The December, 1992, appraisal can be used for both 1992 and early 1993 gifts made. The client can then wait until late 1994, update the appraisal (at a lower cost for an update then was first incurred for the appraisal), and use the updated appraisal for both late 1994 and early 1995 gifts.

5. Miscellaneous Considerations

a. Gifting By Incompetents Is Possible

It will generally be possible to cause gifts to be made by a wealthy but incompetent older person in order to minimize his or her expected estate tax liability.

(1) Gifts can be made with the incompetent's money on behalf of the incompetent by the incompetent's attorney in fact (acting under a durable power of attorney signed by the incompetent before becoming incompetent, provided that the power specifically authorizes the making of gifts. Note --- Care must be taken to limit the ability of the person holding the power of attorney to make gifts to himself or herself, as a real tax disaster could occur if the power holder died first having a

general power to gift an unlimited amount of assets to himself or herself.

(2) Gifts can generally be made by a court appointed guardian or conservator on behalf of an incompetent after being authorized by the court. It will be necessary to convince the court that the incompetent's assets are sufficient to last for the incompetent's life, to demonstrate that tax savings will result, and to show that such gifts do not serve to defeat the incompetent's estate plan (i.e., a historical pattern of gifting will be continued, the same persons will receive the lifetime gifts as would receive the incompetent's assets at death, etc.

(3) It may be possible for the trustee of the incompetent's revocable living trust to make gifts from such trust. However, absent the passage of pending changes proposed to be made to IRC §2035, it will be necessary to first transfer such funds to the incompetent's name so that the gift can be made by an attorney in fact (acting under a durable power authorizing the making of gifts) or conservator (with proper court authority). [See III(C)(2)(d) above].

b. Maximizing Deathbed Gifts

The donor may wish to treat each branch of the family equally (i.e., each child and such child's descendants will usually be intended to be treated equally). It is possible to make unequal distributions during lifetime that qualify for the annual exclusion, and to make up the difference at death.

Example: An dying client has a son and a daughter. The son is married and has five children. The daughter is single and childless. Consideration should be given to giving son, son's wife, daughter, and each of the five grandchildren $10,000, and making an additional gift of $60,000 to the daughter (during lifetime as a taxable gift, or in the client's will) to equalize total gifts between the two branches of the family. This way, $80,000 escapes taxation at marginal rates as high as 60%.

c. Avoid Trying To Be Too Cute

Do not be too cute by trying to make gifts where you haven't really made a gift. For example, giving the intended donee a $10,000 note payable executed by the donor or gifting cash to the donee which is immediately lent back to the donor can not be expected to effectuate a valid gift.

D. Immediate Pre-Mortem Tax Planning

1. Gifts That Might Be Made

a. Non-Appreciated Property Might Be Gifted Away

If the dying client is going to make lifetime gifts, it will usually be desirable to make gifts of property which is neither highly appreciated property (and would thus be entitled to stepped up basis at death if retained by the donor) nor loss property (since the donee's basis for loss purposes cannot exceed the fair market value of the property at the time of gift). IRC §§1014 and 1015.

b. Appreciated Property Should Generally Be Kept

The dying client will want to retain appreciated property that will be entitled to stepped up basis at death. IRC §1014.

c. Certain Charitable Gifts Might Be Made During Life

The client may wish to make charitable gifts planned to be made at death instead as lifetime gifts, so as to both get a charitable income tax deduction for such gift and remove such gifted property from the taxable estate. Charitable gifts at death may be taken as an estate tax deduction, but are not entitled to be taken as an income tax deduction.

2. Gifts That Might Be Received

a. Appreciated Property Might Be Received As A Gift

The dying client without an estate tax problem (i.e., because his or her gross estate is under $600,000, or because the marital deduction will be used to eliminate the estate tax) may wish to receive gifts of appreciated property prior to death. Such property will be entitled to stepped up basis at the decedent's death unless reacquired by the transferor by inheritance within one year. IRC §1014(e). It appears that such property could be given to the dying spouse by the other spouse within one year of the dying spouse's death and qualify for stepped up basis if such property were left by the decedent to children or to a properly structured (totally discretionary sprinkle) family trust for the surviving spouse and children.

3. Rearranging Joint Tenancy And Community Property Interests

a. Sever Certain Joint Tenancies With Non-Spouses

It may be desirable to sever certain joint tenancies between owners who are not married to each other. This is because IRC §2040, dealing with the taxability of joint tenancy interests between owners who are not married to each other, requires a tracing of contribution to determine what portion of the property is to be included in a deceased joint tenant's estate.

Example: Mom paid $40,000 for her house in 1960 and retitled it shortly after its purchase (in 1960) when it was still worth $40,000 so that it would be owned by mom and her three children as joint tenants. The house is now worth $400,000. If mom now dies, IRC §2040 causes a $400,000 inclusion in mom's estate, and IRC §1014 causes the children to have a $400,000 basis in the home after mom's death. This isn't a bad result if the house is mom's only asset, so that the $600,000 exemption equivalent causes no estate tax to be due.

Example: Assume the same facts as above (i.e., that mom had given the house away in 1960 and is now on her deathbed), except also assume that mom is in a 55% estate tax bracket. If mom now dies, $220,000 of estate tax will be due upon mom's death and the children will get stepped up basis. However, assume that mom and the children convert the joint tenancy ownership in the house to tenancy in common ownership while mom is still alive. No gift is made by converting to tenancy in common, as they each still have a 25% interest in the house, but mom's will controls where her 25% interest goes rather than having it automatically go to the children via joint tenancy. Only mom's 1/4th interest (i.e., $100,000) will be included in her estate, causing $55,000 of estate tax due. The children will have historic cost basis in their 3/4th of the house (i.e., $30,000) and stepped up basis in the 1/4th of the house included in mom's estate (i.e., $100,000). Estate taxes due at mom's death are reduced by $165,000 with no gift tax due as a result, but the children have $270,000 less basis).

b. Sever Certain Joint Tenancies Between Spouses

Tax rules now in effect provide that one-half of property held by husband and wife as joint tenants is included in the estate of the first spouse to die and that the deceased spouse's one-half interest is subject to having its basis adjusted. IRC §§1014 and 2040. However, a recent case has held that joint tenancy property acquired by a husband and wife prior to 1977 is subject to the pre-1977 rules which require a tracing of contribution to determine what portion of it is included in the deceased spouse's gross estate and subject to basis adjustment. Gallenstein v. United States, 91-2 USTC ¶60,088 (D.C. Ky. 1991), affirmed 92-2 USTC ¶60,114 (C.A. 6, 1992). The IRS does not agree with the Gallenstein result. It may thus be possible to pick and choose the desired tax result, and during life to sever a pre-1977 spousal joint tenancy (by making it into a tenancy in common or by titling the entire property in one name or the other) in order to give the surviving owner of the property maximum income tax basis.

c. Create Community Property With Appreciated Separate Property

It may be desirable to convert appreciated separate property into community property if the client is married and lives in a community property state. This will be appealing because under IRC §1041 the conversion of separate property to community property is not a taxable event, and under IRC §1014(B)(6) both the decedent's interest and the survivor's interest in community property has its basis adjusted to fair market value at the death of either spouse.

d. Partition Community Property Which Has Depreciated

Conversely, it may be desirable to convert depreciated community property into separate property if the client is married and (because they lived in a community property state at some time) has community property. This results because IRC §1014(b)(6) results in a stepped down basis adjustment for both halves of community property at the death of either spouse, and such a conversion to separate property will allow the surviving spouse to perpetuate his or her higher historic cost basis in property which has declined in value.

E. Applicable Valuation Principles

1. The General Rule

The fair market value of property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Determination of fair market value will often require the assistance of one or more appraisal experts.

2. Discounts And Premiums

Interests in closely-held businesses are inherently less marketable than interests in a publicly traded company. A lack of marketability discount is thus available in valuing such business. Additionally, a minority interest in a closely-held business is particularly hard to sell, and a minority discount for a non-controlling interest is available. However, a majority interest will usually have a premium attached to it. Significant transfer tax savings result if a series of transfers causes only minority interests in a closely-held business to be subject to gift and/or estate taxation.

Example: Client has 4 children, has a closely-held business worth $1,000,000, and will be in a 50% death tax bracket. If client keeps the business until death there will be $500,000 of estate tax due. If client gifts 15% of the business to each child, then a substantial minority valuation discount (lets assume 30%) will be available on the gifted stock for gift tax purposes. The client will later die owning only a minority interest (i.e., 40% of the stock) in the business, and a similar minority discount will be available for estate tax purposes. $300,000 in value has thus never been subject to taxation because of the minority and lack of marketability discounts, resulting in tax savings of $150,000.

Example: Client has a parcel of land worth $100,000 and wants to give as much of it as is possible to client's child under the $10,000 annual exclusion rule. A discount for an undivided interest in land, perhaps 15%, may be taken. This means that a 11.76% interest in the land, <u>not</u> merely a 10.00% interest in the land, can be valued at $10,000 and given away without gift tax consequences each year.

3. Procedural Issues

Some form of contemporaneous expert appraisal should also be obtained for hard to value assets (i.e., closely-held business interests, real estate, valuable art work, etc.) whenever the client is making lifetime gifts or dies. The extent of the appraisal may vary according to the facts. For example, where an IRS audit is expected an MAI may be useful in valuing real estate. But where the decedent had less than $600,000 and value is only relevant in establishing the successor's basis, then a letter from an experienced realtor may suffice.

F. Getting The Client To Act

1. Quantify The Benefits

Clients cannot be expected to fully appreciate the value of making lifetime gifts unless the taxes owed and the tax savings are quantified. Running the tax savings numbers will often surprise even the tax planning professional and cause many clients to decide to proceed with gifting plans who otherwise would have done nothing.

Example: Assume that husband (age 50) and wife (age 45), Bill and Sally Moneybags, each have $5,000,000 worth of assets that are expected to appreciate (after income taxes and consumption) at a rate of 6% per annum. Assume that husband and wife live out their life expectancies under the IRS unisex mortality tables, will use marital deduction estate planning, and will each annually make $10,000 gifts to each of their four children. Without gifting the survivor's taxable estate would total $90,739,588 at the second death, causing $49,906,773 in estate taxes to be due. With gifting such taxable estate would total $78,721,584 at the second death, causing $43,296,871 in estate taxes to be due. The estate tax savings total $6,609,902 if gifts are made.

Example: Assume that husband (age 60) and wife (age 60), Joe and Mary Sample, each have $1,000,000 worth of assets that are expected to appreciate (after income taxes and consumption) at a rate of 4% per annum. Assume that husband and wife live out their life expectancies under the IRS unisex mortality tables, will use marital deduction estate planning, and will each annually make $10,000 gifts to each of their four children. Without gifting the survivor's taxable estate would total $4,526,608 at the second death, causing $1,937,635 in estate taxes to be due. With gifting such taxable estate would total $1,069,871 at the second death, causing $181,647 in estate taxes to be due. The estate tax savings total $1,755,988 if gifts are made.

Example: Assume that a 60 year old widow, Merry Widow, has $500,000 worth of assets that are expected to appreciate (after income taxes and consumption) at a rate of 5% per annum. Assume that she lives out her life expectancy under the IRS unisex mortality table, and that she will annually make $10,000 gifts to each of her two children. Without gifting her taxable estate would total $1,612,550 at death, causing $413,648 in estate taxes to be due. With gifting her taxable estate would total $613,506 at death, causing $4,997 in estate taxes to be due. The estate tax savings total $408,651 if gifts are made.

Example: Client is in flat 50% gift and estate tax brackets, and has been told that paying gift taxes is a better deal than paying estate taxes because gift taxes are computed on a tax exclusive basis, while estate taxes are computed on a tax inclusive basis. Assuming that the client has $1,000,000 to dispose of (via donative transfers and payment of taxes), the client can give $666,666.67 via a taxable gift (since the $333,333.33 gift tax is imposed on the net amount passing to the donee), by only $500,000 via an estate taxable transfer (since the $500,000 estate tax is imposed on the gross amount of assets before the estate tax is subtracted). However, deathbed taxable gifts will not achieve this savings, as IRC §2035 will cause the $333,333.33 of gift tax incurred within three years of death to be included as a phantom asset of the estate, thus eliminating the benefit if the donor died within three years of making the gift.

Example: Even last minute gifting strategies can achieve significant estate tax savings. Assume that it is December and an 87 year old client in very poor health has three children in their sixties (all married), eight grandchildren in their thirties and forties (six of whom are married), twelve great grandchildren aged between 10 and 25 (two of whom are married), and two young great great grandchildren. The client has 25 living lineal descendants and 11 spouses of living lineal descendants. Such 36 beneficiaries will allow $360,000 to be removed from the client's taxable estate with simple $10,000 gifts and no gift splitting and double that amount if the client is married and gift splitting is elected. Additionally, such gifts can be made again on January 1st of the next calendar year (only some two weeks off). This is in addition to any direct payment of tuition or educational expenses, use of discounts (discussed below), use of unified credit, etc.

2. Illustrate The Benefits

The old saying "One picture is worth a thousand words" has great application when explaining the tax benefits of engaging in a long term gifting strategy to the client. See the attached exhibits hereto. They were prepared using Estate Forecast Model, software available from ViewPlan, Inc., a San Diego company (800-826-2127).

3. The "KISS" Principle

Some clients cannot or will not tolerate a complex estate plan. For such persons, it is better to utilize one or two of the simpler (i.e., "Keep it simple, stupid!") gifting techniques than to do nothing at all. Significant tax savings will still result over time.

IV. SPECIFIC LIFETIME GIFTING TECHNIQUES

A. Transfers Which Generate No Gift Tax Liability

1. Annual Exclusion Gifts

It will be desirable to make gifts each calendar year to as many people as possible. No gift tax will be incurred (nor is a gift tax return due) so long as the total gifts to a particular individual do not exceed $10,000 in any one calendar year. IRC §2503(b). Such gifts will not be included in the donor's estate pursuant to IRC §2035, even if the donor dies within three years, unless a life insurance policy on the donor's life was gifted or the donor retained some interest in the gifted property under IRC §§2036, 2037, or 2038. IRC §2035(d)(2).

2. Spousal Gift-Splitting

Spouses may consent to split gifts, which causes the amount which the two of them (in the aggregate) can gift tax free each calendar year to become $20,000 per individual donee. IRC §2523. Such election can be made on a late filed gift tax return (as long as it is the first gift tax return filed for the year in question), and if made the election applies to all gifts made during that year while the couple was married.

3. Payments For Medical Expenses And Tuition

Direct payments to the providers for the medical or tuition expenses of another are gifts which qualify for an unlimited gift tax exclusion. Reimbursing the individual who incurred such an expense will not qualify for this special gift tax exclusion. IRC §2503(e).

4. Use Of The Unified Credit

It will often make sense for the client to make taxable gifts during lifetime (i.e., gifts in excess of $10,000 annual exclusion gifts), thus utilizing all or part of the $192,800 unified credit (sometimes called the "$600,000 exemption equivalent"). No gift taxes will be due, although it will be necessary to file a gift tax return to report the amount of unified credit used. But all income and growth in value on the gifted assets that occurs after the date of the gift will escape estate taxation at the client's death. Additionally, the client won't have to worry about the law changing (so as to lower the amount of unified credit) if it had already been used prior to any change in the law.

5. Creation Of Income Tax Defective Trusts

It is possible to gift assets to a trust in such a way as to make a completed and effective gift for gift and estate tax purposes while, at the same time, keeping some minor power over the trust (such as the right to later substitute property of equivalent fair market value for property owned by the trust) which causes the trust to be a so-called "defective" grantor trust for income tax purposes. This causes the trust's income to be taxed to the grantor, rather than to the trust itself, which in effect allows the grantor to indirectly make an additional (but gift tax free) gift to the trust when the grantor pays income taxes which the trust would normally have to pay.

Example: Grantor always makes $10,000 annual gifts to each of the grantor's two children. Additionally, grantor gifts $600,000 to an intentionally defective grantor trust for the benefit of grantor's children. The trust invests in 8% taxable bonds and has $48,000 of taxable income. Assume that the trust would normally pay combined state and federal income taxes of 40%, or $19,200, per year. The grantor is technically income taxed on the trust's income since the trust was structured as a defective grantor trust. The grantor thus effectively transfers $39,200 to his or her children each year (i.e., $20,000 of annual exclusion gifts and the $19,200 of income taxes paid).

6. Qualified Disclaimers

It is possible to turn down an inheritance by making a qualified disclaimer of it. Such a disclaimer must be made within nine months of the decedent's death an before any benefits (such as income from the gifted property) relating to the gift have been accepted. IRC §2518. Disclaimed property automatically goes to the next beneficiary as if the disclaiming beneficiary had already died.

Example: Sally is a wealthy 65 year old widow has been diligently making $10,000 annual gifts to each of her two children in order to minimize the estate taxes which will be due at her death. Sally's 90 year old mother dies leaving her entire $500,000 estate to Sally, if she is alive, otherwise to Sally's children. Sally may wish to disclaim all (or part) of the gift from her mother, as Sally doesn't need the money and it will generate as much as $300,000 of additional estate taxes in Sally's estate. It would take Sally 25 years to get $500,00 to he two children via $10,000 annual gifts, but a disclaimer allows her to do it immediately with no gift or estate tax due.

7. Opportunity Shifting

An incredibly good business opportunity will sometimes arise. It may make sense to cut the children or grandchildren (or trusts for their benefit) in at the start. If a new business is being formed, why not give away some of the stock (perhaps nonvoting stock or a minority interest) before any significant value arises?

8. Other Techniques

It may be possible to enhance the value of assets held by other family members without making a taxable gift in the process.

Example: A wealthy oil and gas investor has purchased the rights to drill on a promising large tract of land. Perhaps he wants to assign his drilling rights to the northern portion of the property to a trust for his children prior to the commencement of any drilling. He will then drill an exploratory well on his retained southern portion of the property near the border with the children's portion of the property. If the exploratory well is successful, the value of the children's property will be enhanced. If unsuccessful, the children didn't spend any of their money drilling a dry hole.

B. Methods To Effectuate Gifts

1. Do Nothing At All During Life

The easiest method of gifting is to do nothing during lifetime, so that the assets merely pass at death via will, the state intestate statute if no will is in force, via joint tenancy survivorship, or via beneficiary designation.

a. The advantage of doing nothing is that it easy to do.

b. The disadvantage of doing nothing is that the tax benefits associated with lifetime gifting will not be achieved.

2. Outright Gifts To Individuals

Outright gifts can be made directly to a responsible adult donee, which is a very simplistic approach to gifting since no trusts need to be created to hold such gifted assets.

a. The advantages of outright gifting are many --- it's simple, the donee has unrestricted access to the funds (also a possible disadvantage), value is removed from the donor's estate (i.e., the amount of annual exclusion as well as the income and appreciation subsequent to the gift), the income from the gifted asset is shifted to the donee's return where it may be income taxed at a lower rate, etc.

b. The disadvantages of outright gifting are also many --- the donee has unrestricted access to the funds (also a possible advantage), the gifted assets will be at risk to the donee's lawsuits and divorces, the limited benefits of having the trust as a separate taxpaying entity will not exist, the assets will be subject to estate taxation at the donee's death, etc.

3. Bargain Sale Transactions

If the client cannot afford to totally give an asset away, then consideration should be given to making a bargain sale (i.e., part gift, part sale) of the asset to the desired beneficiary.

4. Net Gift Transactions

Gift tax is the legal liability of the donor. However, it is possible to make a gift (called a "net gift") where the donee is required to pay the gift tax as a condition of the gift. This may be useful where the older family member has illiquid assets such as stock or land.

5. Gifts To Custodianship

Gifts to a minor (21 in most states for this purpose) can be made to a custodian for such minor under the Uniform Gifts to Minors Act or (if enacted in your state) the Uniform Transfers to Minors Act.

a. The advantages of gifting to a custodianship are many --- such an arrangement is easy to create (via signature card at a bank or stock brokerage firm) and gifts to the custodian qualify for the annual $10,000 gift tax exclusion as if made directly to the minor beneficiary.

b. The principal disadvantage of gifting to a custodianship is that when the Income is reported in the minor's Form 1040. The custodian can dole out the money to the minor as the custodian sees fit until the minor turns 21, at which time the assets must all be turned over the beneficiary.

6. Gifts To Conservatorships

A conservatorship (in some states called a "guardianship of the property") is a court-supervised arrangement for running the assets of a minor or incompetent. Gifts to such an arrangement will qualify for the annual exclusion and the income will generally be taxed on the beneficiary's Form 1040. The beneficiary becomes entitled to the assets upon becoming an adult (usually age 18 for this purpose) or regaining competency.

7. Gifts To Section 2503(b) Trusts

Although rarely used, it would be possible to create a trust for a minor beneficiary under IRC 2503(b). Such a trust need only mandate that its net fiduciary accounting income be paid to its beneficiary, at least annually. The net present value of the future income payments will qualify for the annual gift tax exclusion. The trust will file a Form 1041. Payments to the minor could be made to a custodian under the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act, or to a court appointed conservator for the minor.

8. Gifts To Section 2503(c) Trusts

A trust for a minor beneficiary can be created under IRC §2503(c). Such a trust must grant the trustee reasonable authority to expend funds for the minor prior to the minor turning age 21. The beneficiary must have the right (and actually be informed of such right) to take all of the trust's assets at age 21 (although it can be a right for a limited period of time, after which the funds can be mandated to stay in trust until some later age chosen by the grantor of the trust). Gifts to the trustee of such a trust qualify for the $10,000 gift tax exclusion as if made directly to the minor beneficiary. Income is reported on the trust's Form 1041.

9. Gifts To Crummey Trusts

A more traditional long term "Crummey" trust could also be used for a minor beneficiary. Such a trust could last past age 21 and not qualify under the provisions of IRC §2503(c). Instead, gifts to it would be subject to a so-called "Crummey" withdrawal right. This is a provision in the trust that allows the trust's beneficiary or beneficiaries the right, for a reasonable time (say 30 days) and after receiving notice of such right, to withdraw gifts that have been made to the trust. Such a right is given in order to qualify gifts to the trust for the $10,000 annual gift tax exclusion, but generally with the expectation that such right will not actually be exercised. A parent, guardian, or conservator can act under most such clauses on behalf of a minor beneficiary.

10. Gifts To Irrevocable Life Insurance Trusts

a. Client Situation

Where the decedent (or if married and the unlimited marital deduction is used, the decedent's surviving spouse) will have an estate large enough to be subject to death taxes, it is desirable to structure life insurance ownership so that the proceeds will not be included in the insured's (nor in the surviving spouse's) taxable estate.

b. Mechanics Of Arrangement

An irrevocable life insurance trust would be created, and would be the owner and beneficiary of the insurance on the grantor's life. The grantor's surviving spouse could be the trust beneficiary (and trustee if desired) for life, with the assets passing to the grantor's descendants thereafter. The trust would be carefully drafted so as to keep its contents from being taxed in either the grantor's estate or in the grantor's surviving spouse's estate. During his or her lifetime, the grantor can give the trust money to pay the insurance premiums or, if arranged properly, can pay the premiums directly. Estate liquidity is achieved by empowering the trustee to buy assets from, or loan money to, the insured's probate estate.

c. Preserving Flexibility

The biggest drawback in using an irrevocable life insurance trust is that the document, by its terms, must be irrevocable and unamendable. Flexibility can be provided by:

(1) Granting broad discretionary powers of distribution to the trustee (including the right to cancel policies or distribute policies to a beneficiary during the grantor's life).

(2) Granting special powers of appointment to someone other than the grantor, so as to allow for termination of the trust during the grantor's life.

(3) Defining the term "spouse" generically, so as to provide for the death or divorce of the spouse prior to the insured's death.

(4) Providing a means of qualifying the insurance proceeds for the marital deduction if the grantor should die within three years and have trust insurance proceeds included in the grantor's gross estate for estate tax purposes.

d. Post-ERTA "Crummey" Clauses

ERTA's increased annual gift tax exclusion (i.e., from $3,000 to $10,000) does not necessarily mean that it is desirable to increase the available "Crummey" clause exclusion to $10,000. It may be better to limit any withdrawal rights to the 5 x 5 limitation imposed under IRC §§2041 and 2514 (usually $5,000 per year for each donee of an irrevocable life insurance trust) to minimize the beneficiary's potential estate tax exposure.

e. Newly-Acquired Insurance

It is essential that the trustee of the trust acquire (as the initial owner, applicant, and beneficiary) any new policies. If the insured bought the policy and assigned it to the trust there would be a three year period during which the policy proceeds would be included in the insured's estate for tax purposes. IRC §2035(d)(2). However, if the trustee is the initial owner of the policy, the insured's death within three years will not cause estate taxability. Leder v. Commissioner, 893 F.2d 237 (10th Cir. 1989); Chapman v. Commissioner, T.C. Memo 1989-105; Perry v. Commissioner, T. C. Memo 1990-294; Headrick v. Commissioner, 93 T.C. 171 (1989).

f. Generation-Skipping Tax Consequences

In order to get maximum leverage from the one million dollar exemption available under the generation-skipping tax law, it is desirable that an election should be made to use enough of such exemption as will completely exempt the trust from generation--skipping tax consequences.

11. Gifts To Charitable Remainder Trusts

Clients will often have stock or real estate that is highly appreciated in value and produces little current income. One way to dispose of such an asset without incurring capital gains taxes at the time of sale, so that all of the net sales proceeds can be reinvested in something else that will produce more income, is to contribute such property to a charitable remainder trust prior to its sale. A charitable remainder trust is a special trust which property is gifted to and periodic distributions are made to the donor and/or some other person(s), either for life or for a preset number of years. When the trust terminates, a charity is the beneficiary.

a. Client Situation.

Assume $1,000,000 in properties with a zero cost basis and low current yield are owned by a person desiring to convert them to a high yield investment by (1) selling them and investing the net sales proceeds, or (2) utilizing an inter vivos charitable remainder trust. Assume the person is a female age 56, in good health, in 50% death and 28% income tax brackets and that an 8% pre-tax yield will be earned on the sale proceeds.

b. Situation If No Charitable Remainder Trust.

The $1,000,000 in assets would (after income tax on the gain) leave $720,000 for investment. With an 8% pre-tax yield the client would receive $57,600/year of income before taxes and $41,472 after income taxes. At death, the client's family would receive $360,000 after estate taxes.

c. Situation With Use Charitable Remainder Trust.

The $1,000,000 property would be put into an inter vivos charitable remainder unitrust with an 8% annual payment retained by the client and the remainder to go to charity at the client's death. This means that the client gets annual payments equal to 8% of the trust's value, as redetermined each year (i.e., if the trust appreciates to $1,200,000, then the trust pays the client $96,000 in the next year). The trust would sell the property and not be liable for a capital gains tax. IRC §644, which taxes certain gains recognized within two years of the transfer of the property to the trust at the grantor's tax rates, is specifically not applicable to sales by charitable remainder trusts.

If the trust has an 8% pre-tax yield the client would receive $80,000 per year of income before taxes and $57,600 per year after income taxes. Additionally, the client will receive a charitable income tax deduction of $243,610 to offset personal income tax liability (which would result in income tax savings of $68,211 if the charitable deductions were fully deductible).

At death, the client's family would not receive anything (as the property goes to charity). However, at a cost of approximately $9,000/year for ten years, $360,000 life insurance on the client's life can be purchased for the children's benefit (through an estate tax exempt irrevocable life insurance trust) to replace the assets that would have gone to them in the absence of the charitable trust.

d. Summary If Use Charitable Remainder Trust.

(1) The client gets an income tax charitable deduction of $243,610 which saves $68,211 of income tax if the deduction can be fully utilized;

(2) $280,000 of capital gains taxes are avoided if the property is put into a charitable remainder trust prior to its being sold.

(3) The client's ongoing annual after tax cash flow is increased by $16,128 per year if no life insurance premiums are paid and is increased by $7,128 per year if life insurance premiums are paid.

(4) Estate taxes at the client's death are reduced by $360,000 (assuming the client would make a lifetime sale of the property) by reason of the property having been transferred to the charitable remainder trust prior to death.

(5) The children get the same $360,000 after estate taxes (if life insurance premiums are paid) that they would have gotten if the property had been sold directly by the client prior to death.

(6) Charity ultimately gets $1,000,000 at the client's death, and the client will no doubt get the appropriate recognition and perks while alive because of this eventual gift.

(7) This technique will only be used with a portion of the client's assets since enhanced lifetime payments are obtained only by giving up access to the underlying assets.

12. Gifts To Charitable Lead Trusts

Clients will sometimes be making substantial charitable gifts on regular annual basis. It may be possible to use a charitable lead trust to combine charitable gifting with family gifting to achieve overall tax savings. A charitable lead trust is a special trust which property is gifted to and from which periodic distributions are made to charity for a preset number of years. When the trust terminates, the grantor's children (or trusts for the grantor's children or grandchildren) receive the assets of the trust.

Example: Assume that the client has (among substantial other assets) $500,000 worth of bonds or notes receivable which earn 8% (i.e., $40,000) per year, and that the client donates to charity (and is able to deduct) the entire $40,000 each year. In 20 years the client will still have the $500,000 worth of bonds and notes in his or her estate. Assume that a 50% gift or estate tax will have to be paid in order to ultimately pass ownership of such bonds and notes to the children or grandchildren.

Example: Alternatively, assume that the $500,000 worth of bonds and notes were transferred to a charitable lead trust which would pay $40,000 per year to a designated charity (perhaps even the client's own family foundation).

a. The $40,000 per year of income is no longer on the client's income tax return (as the charitable lead trust now has the income and takes a deduction for it when it is paid to charity).

b. If the client sets up a 20 year charitable lead trust (as either a fixed 20 year term or for the grantor's lifetime, which happens to be 20 years under the applicable IRS mortality tables), then the IRS tables (using a 6.4% rate) say that the right of the children (or other beneficiaries) to get the bonds and notes in 20 years is worth 11.146% of it's current value. A gift tax return would be filed reporting a $55,736 gift. No gift tax would be due unless client had already used up the $600,000 exemption equivalent.

c. At the end of the 20 year term the children get the charitable lead trust assets. If the client instead had kept the bonds and died in 20 years, then making a $55,736 gift prevented $250,000 of death taxes at the client's death (i.e., $500,000 of bonds taxed at a 50% rate). Setting up the trust used up tax credits that would otherwise have been available at death and, in effect, caused death taxes to be increased by $27,883 on the client's remaining assets at death. Net tax savings are thus $223,117. It is assumed that the assets actually yielded (i.e., had a total return) of 8% per annum during such 20 year period.

d. Income tax savings result during the client's lifetime if the grantor's income is such that up to 80% of the client's itemized deductions are being disallowed pursuant to IRC §68. Absent the use of the charitable lead trust as much as $32,000 per year of charitable deductions could be wasted (i.e., 80% of $40,000 in deductions is disallowed), causing $12,672 per year of income taxes (i.e., 39.6% tax rate on $32,000 of additional income since that amount of charitable deductions would be disallowed) that could be avoided if instead ownership of the income producing assets could be shifted to the charitable lead trust (i.e., the $40,000 of income is taken off of the grantor's return) where the trust would be able to deduct them in full.

13. Gifts To Grantor Retained Income Trusts

a. Prior to the enactment of IRC §2702, grantor retained income trusts ("GRITS") were used to reduce the estate and gift tax cost of transferring assets to family members.

b. Property would be transferred to a trust wherein the grantor retained the right to the trust's income (as defined for fiduciary accounting purposes) for a fixed number of years, after which the trust assets passed to the remainderman (usually the children or a trust for the children. Only the present value of the remainder interest constituted a taxable gift, and more funds than were supposed to (based upon the actuarial assumptions required to be used) could pass to the remainderman if the funds were invested so as to minimize current yield and maximize growth in value. If the grantor outlived the retained income term then significant savings would result, but if the grantor died during the retained income term then the trust would be included in the grantor's estate pursuant to IRC §2036 (with any gift tax credits used by the donor being restored).

c. Recently enacted IRC §2702 effectively eliminated GRITS as a planning device when the remainder beneficiary is the grantor's spouse, a lineal descendant of the grantor or the grantor's spouse, or the spouse of any such descendant. However, they are still a useful device for other beneficiaries, such as a niece or nephew of the grantor.

Example: A 50 year old grantor transfers $100,000 to a trust which provides for the grantor retain income payments for 15 years. If the grantor dies within the 15 year period then the trust assets revert to the grantor's estate. If the grantor outlives the 15 year term then the trust assets go to the grantor's niece. Assume a 6.0% IRC §7520 rate, a 55% death tax rate, and that the trust assets will appreciate in value by 5% per year (after taxes). A $35,153 gift will be reported when the trust is established, but $207,893 can be expected to pass to the niece when the trust terminates, resulting in approximately $95,007 in potential death tax savings.

14. Gifts To Qualified Personal Residence Trusts

A relatively new tax planning vehicle authorized in IRC §2702 is the qualified personal residence trust. It involves transferring a principal or second residence to a trust wherein the grantor retains the right to live in the residence for a fixed number of years, after which such rights terminate and the children (or some other designated beneficiary, such as a trust for grandchildren) own the residence. Significant estate tax savings can result if the grantor lives long enough for his or her rights to use the residence to terminate. It's really better than it sounds!

Example: Assume that a 55 year old client owns a $400,000 Snowmass vacation home and is in a 50% estate tax bracket. Assume that the Snowmass home will appreciate at 4% per year. If the client does nothing and lives until age 80, then the house will be worth $1,066,335 and $533,117 of death tax will be due.

a. If the client sets up a 15 year qualified personal residence trust, then the IRS tables (using a 6.4% factor) say that the right of the children (or other beneficiaries) to get the residence in 15 years is worth 30.4627% of it's current value. A gift tax return would be filed reporting a $121,851 gift. No gift tax would be due unless client had already used up the $600,000 exemption equivalent.

b. At the end of the 15 year term the children own the residence. If the client dies at age 80 then making a $121,851 gift prevented $533,117 of death taxes from being due (although setting up the trust used up tax credits that would otherwise have been available at death and, in effect, caused death taxes to be increased by $60,926 on the client's remaining assets at death). Net tax savings are thus $472,191.

c. The client might die during the first 15 years. Because the client would have died while still having the right to use the residence the entire transaction is unwound (i.e., the residence is included in the client's taxable estate, the tax credits used when the trust was established are restored, and the death tax result is as if no trust was setup). The client would, however, be out the appraisal and legal fees incurred hen the trust was established.

d. The client may want to continue to use or own the residence when the trust terminates at the end of 15 years. This could be accomplished by renting the residence back from the children at a fair rental rate (which would get more money out of client's estate) or by repurchasing the residence from the trust at its then fair market value (presumably $720,377 in 15 years if it had appreciated at 4% per year). No capital gain will be incurred by the trust if the repurchase takes place prior to the end of the 15 year period (as the trust is deemed to be a defective grantor trust for income tax purposes), as the client would only be entitled to his or her original historic cost basis in the residence.

15. Gifts To GRATs And GRUTs

Congress felt that the ability to establish a GRIT and engineer the investments (so that there was no accounting "income" to pay to the grantor and capital gains instead are generated to pass to the remainderman) was to good to allow. Except in the case of personal residence trusts, no interest in a trust retained by the grantor is deductible in determining the gift tax value of the interests in the trust which will pass to the remainderman unless the grantor has retained an annuity interest (i.e., fixed periodic payments, which cause the trust to be a grantor retained annuity trust or "GRAT") or a unitrust interest (i.e., periodic payments equal to a fixed percentage of the trust's annually redetermined fair market value, which cause the trust to be a grantor retained unitrust or "GRUT"). IRC §2702.

16. Gifts To Near Zero Gift GRATs

Recently enacted IRC §2702 imposes actuarial assumptions for gift tax purposes that can be used to the taxpayer's advantage (via a device called a "near zero gift GRAT") if a higher rate of return than is assumed earned can be actually be earned in a trust which ultimately passes to children or grandchildren.

Example #1: Assume that the client has a hot investment that could hit a real home run (perhaps a penny stock that might appreciate at 30% per year during the next two years). If that month's 120% of mid-term AFR rate (i.e., the IRS assumed trust investment return) is 6.4% and gift taxes are determined based on that up front assumption, then little or no gift tax will be due if the trust is intentionally structured to have payments going to the grantor with net present value almost equal to the entire initial value of the trust.

If the client creates a trust with $100,000 worth of the speculative investment and directs that the trust pay the grantor $55,000 per year at the end of years one and two, the IRS assumes that at the end of two years there will be almost nothing (i.e., less than $1,000.00) left in the trust when whatever is left passes to the client's children. However, if the trust earns more than a 6.4% return then the excess, in effect, passes to the children in two years entirely gift tax free. For example, a 30% annual return means that a taxable gift of $1,000 was reported but approximately $42,000 is actually passing to the children when the trust terminates in two years. But if less than 6.4% per year is earned, then it was wasteful to report a $1,000 taxable gift because there is less than that left in the trust for the children. Is it worth taking a flyer and reporting a $1,000 taxable gift to possibly get $42,000 to the children? You won't know until two years later when the trust's investment results are in. But this planning technique is basically a heads, the taxpayer wins, tails, it didn't cost much (just the attorney fees to establish the trust and the gift tax relating to a $1,000 taxable gift), arrangement.

The grantor retained annuity trust (i.e., "GRAT") can be a very useful estate planning device if the client has an asset that generates a lot of cash flow which can actually be distributed. Ideal vehicles would be S corporation, limited partnership, and limited liability company interests. Commercial real estate, alarm companies, and cable television companies are examples of the types of assets that generate good cash flow if not highly leveraged. The GRAT is a particularly viable technique where the property gifted to the GRAT can be discounted (for lack of marketability, minority interest, etc.).

Example #2: Assume that a 50 year old client owns 100% of an S corporation which is valued at $1 million (i.e., ten times cash flow) and which can distribute all of such cash flow in the form of dividends. Also assume that 120% of the mid-term AFR rate (i.e., the IRS assumed investment return) is 6.4% and that a combined discount for lack of marketability and minority interest of 40% would be appropriate if less than 50% of the stock were gifted to a GRAT.

Assume that the client puts 40% of the corporation's stock into a GRAT which is to pay $40,000 per year (i.e., all of the cash flow attributable to such interest) to the client for eight years and then go to (or be held in trust for) the client's children. Such stock would be valued at $240,000 (i.e., $400,000 less the discount of 40%) and would have $40,000 per year of cash dividends. The remainder interest of the children would be valued at about $6,040.65 for gift tax purposes at the time of creation of the trust. The client may complain that the business needs the cash. Inasmuch as all of the cash will be in client's hands individually, surely some method of getting the cash into the business can be devised.

If the client lives for more than 8 years, the client's children end up owning 40% of the corporation. The amount of assets subject to transfer taxation will have been reduced by 98.49%. If the client dies within such eight year period then the trust property reverts back to the grantor's estate and the trust's assets will be included in the client's taxable estate as if nothing had been done. According to Leimberg's Number Cruncher software, a male age 50 has a 92.6% chance of living to age 58 and a female age 50 has a 95.5% chance of living to age 58.

Example #3: Assume that the pre-discounted value of the client's business interests was $80,000,000 in the above example, making the value $48,000,000 after a 40% discount. The taxable gift at creation would be $1,208,130.84, which means that a gift-splitting couple could remove an asset worth $80,000,000 from their taxable estates in eight years by utilizing their unified credits and reporting a taxable gift of $8,131 (which involves paying gift tax of $3,008)!

C. Other Value Shifting Techniques

1. Loans To Family Members

It may be possible to loan funds to a family member at the lowest interest rate possible under IRC §7872 and to shift value free of transfer taxes if the borrower has investment opportunities that will yield more than the interest that must be paid.

2. Private Annuities

It may be possible to enter into a private annuity transaction with a family member and shift value free of transfer taxes if the transferor hasn't a life expectancy shorter than that contained in the IRS actuarial tables or if the obligor on the annuity can obtain a higher yield than is assumed by the IRS in valuing the annuity for gift tax purposes.

a. General Overview

A private annuity usually involves the transfer of appreciated property to a relative in exchange for an unsecured promise to make payments to the annuitant.

b. Tax Consequences To Annuitant

Where appreciated property is transferred in exchange for a private annuity, a "capital gain element" is added to the usual "recovery of basis" and "annuity element" which are relevant in the case of annuities purchased by individuals from commercial annuity issuers. Rev. Rul. 69-74, 1969-1 C.B. 43.

Example: A 65 year old owns property worth $100,000 having a basis of $10,000 and wishes to engage in a private annuity transaction at a time when the IRS table rate for such transactions is 8.2% and life expectancy according to the IRS unisex mortality table is 20.0 years. The annuitant will receive payments of $12,464 per year for life, of which $500.00 will be a tax-free return of basis (until basis is fully recovered), $4,500 will be capital gain, and $7,464 will be ordinary income.

c. Tax Consequences To Obligor

All annuity payments made by the obligor are treated as capital expenditures and are nondeductible. Payments exceeding basis are not deductible until the property is sold. Complex basis determinations must be made if the property is sold prior to the annuitant's death. Rev. Rul. 55-119, 1955-1 C.B. 352.

d. Unrecovered Basis In Annuity At Death

The decedent's unrecovered investment in an annuity is available as a deduction on the deceased annuitant's final Form 1040. IRC §72(b)(3)(A).

3. Installment Sales

It may be possible to sell assets to a family member and achieve transfer tax savings if the assets sold subsequently appreciate at a higher rate than the interest rate that must be charged on the funds borrowed to finance the purchase. The seller may choose to leaseback the assets (but beware that a higher rate of interest may be required on the financing), and the note might be setup to self-cancel at the holder's death if not yet paid off (but see the Frane case concerning the income tax consequences to the holder's estate).

4. Arrangements Impacted By "Anti-Freeze" Rules

Beyond the scope of this outline are corporate and partnership recapitalization techniques that have historically been used as estate freezing techniques. The goal of such arrangements (where, for example, the older generation keeps preferred stock and the younger generation gets the common stock) is to shift future growth to someone else. See IRC §2701.

D. Dynastic Estate Planning Strategies

1. Overview

The keys to GST tax planning are to take full advantage of those transactions which are grandfathered and not subject to the GST tax law, to maximize use of transfers which are excluded from being subject to GST taxation, and to utilize all of the exemptions which are available to shelter transfers which would otherwise be subject to GST taxability. A thorough review of all existing wills, revocable trusts and gifting strategies is necessitated, as estate planing strategies that might have been appropriate under prior law may be detrimental, or without effect, under the GST tax law.

2. Drafting Exempt Trusts For Maximum Flexibility

Trust benefits which can be granted are so broad as to be tantamount to ownership of the trust assets for most purposes. They include:

a. The right to receive all trust income;

b. The right to receive discretionary distributions of trust principal (self-determination of needs was possible if the beneficiary was acting as pursuant to an ascertainable standard;

c. The right to exercise a five-by-five right of withdrawal (with estate taxability only to the extent such right was unexercised in the year of death);

d. The right to possess a broad inter vivos and/or testamentary special power of appointment (which must only exclude the holder, the holder's creditors, the holder's estate, and the creditor's of the holder's estate as objects of the power);

e. The right to direct trust investments and vote trust securities; and

f. The right to hire and fire trustees (beware of the IRS position, enunciated in Rev. Rul. 79-353 and later rulings but rejected by the Tax Court in the Wall case, that the trustee's powers will be attributed to the beneficiary if the beneficiary can hire and fire trustees).

3. Taking Advantage Of Grandfathering

a. Overview

Trusts which are grandfathered from GST taxability by the effective date provisions of TRA '86 are valuable tax planning vehicles which should be perpetuated if at all possible. The assets of a grandfathered trust should be invested for growth and only distributed to non-skip persons if it is not possible to make such distributions from a non-grandfathered trust.

b. Utilize Annual Gift Tax Exclusion

In order to maintain their wholly exempt status, no additions to a grandfathered trust should be made unless the addition qualifies under the $10,000 annual gift tax exclusion as a nontaxable gift, or GST tax exemption equal to the value of the addition is allocated to the trust. The lapse of a five-by-five right of withdrawal over a grandfathered trust will not constitute an addition to that trust for GST tax purposes.

c. Special Powers Of Appointment

The exercise of a special power of appointment over a grandfathered trust may allow the imposition of all transfer taxes to be postponed if the power is exercised so as to cause the appointive property to be held in a new trust with an extended termination date. There are many trusts that were irrevocable on the effective date of the GST law and which will eventually terminate in favor of the current income beneficiary's children if an available special power of appointment is not so exercised. Great care must be taken when a special power of appointment is exercised in favor of a trust, as the maximum duration that the new trust can last under the Rule Against Perpetuities will be the same limitation imposed on the original trust.

d. Continuous Mental Disability

Every effort should be made to document the continuous mental disability of an individual who did not have the competence to change the disposition of his property on October 22, 1986, or at any time during his life thereafter. It is not necessary that the person be adjudged mentally incompetent, although it may be helpful.

4. Maximizing Excluded Transfers

a. Gift Tax Exclusion Gifts

Annual exclusion gifts made to GST tax exempt trusts, rather than outright, are less useful than prior to technical corrections, as it is now necessary to either elect the use of GST exemption or draft the trust in such a manner as will cause the "Crummey" power holder to be subject to estate taxability on the trust assets resulting from such lapsed "Crummey" power. Also, it may be necessary to consider the timing of outright gifts and "Crummey" gifts made to a beneficiary during a calendar year before any outright gifts are made in order to avoid application of the rule which states that it is the first $10,000 of gifts made to a donee in a particular calendar year that qualify for the annual $10,000 gift tax exclusion.

b. Trusts should be drafted to allow direct payment of the tuition and medical expenses of skip persons. If such items could be paid from more than one trust, the trustee must consider the potential transfer tax consequences when choosing the trust from which payment is to be made.

5. Making Optimal Use Of Exemptions

a. Overview

The GST exemption should be utilized as early as is possible in order to cause the maximum amount of income and appreciation occurring after the transfer to escape gift, estate and GST taxation. The benefit of the GST exemption can be maximized if it is used for assets with the most appreciation potential (i.e., the GST exemption could be leveraged and result in the sheltering of significantly more than $1 million if allocated to gifts made to an irrevocable life insurance trust). A mandated allocation of GST exemption should be avoided, as no allowance will be made for the likelihood of various trusts having differing potentials for appreciation or the occurrence of generation-skipping transfers.

Example: Client puts $1,000,000 of highly speculative stock into a generation-skipping trust. During client's lifetime the stock grows in value to $5,000,000. The $4,000,000 of appreciation is not subject to gift tax, is not estate taxed in client's estate, and is not subject to GST tax later when grandchildren or great grandchildren receive distribution of the trust's assets.

Example: Assume a couple purchased $2 Million of survivorship life insurance at a cost of $14,400 per year for 10 years. If that insurance had been purchased via a generation-skipping trust then only $144,000 of GST exemption would need to be allocated by each in order to get $2,000,000 down to grandchildren or great grandchildren free of GST tax. It is thus important to allocate GST exemption to those transfers having the most potential leverage.

b. Avoiding Gift Tax

A significant gift tax liability is possible if the GST exemption is fully utilized during life, so most clients will postpone transfers in excess of the $600,000 exemption equivalent until death. However, IRC §2652(a) provides that split-gifts pursuant to IRC §2513 of the gift tax law will be deemed to have been made one-half by each spouse for GST tax purposes, so it is possible for a married couple to make transfers of $1,200,000 without incurring any gift tax or GST tax.

c. Reverse QTIP Election

If the transferor is survived by a spouse, traditional marital deduction estate planning will cause a $600,000 bypass trust to be created, with the balance of the estate being paid to (or placed in a marital deduction trust for the benefit of) the surviving spouse. It is usually desired to completely avoid transfer tax at the death of the first spouse, which means that $400,000 of the transferor's GST exemption may be wasted. IRC §2652(-a)(3) permits the transferor to create a QTIP trust and elect to be treated as its transferor for GST tax purposes. It is likely that $400,000 QTIP trusts will now be established under circumstances where they would not otherwise be desired. Any marital deduction gift in excess of $400,000 should be distributed outright or held in a separate marital trust.

At the death of a surviving spouse no constructive addition will be deemed made to a trust for which a reverse QTIP election was made at the first spouse's death if the estate taxes attributable to such trust are paid other than from such trust. Prop. Treas. Reg. §26.2652-1(a)(3).

Where a reverse QTIP election was made prior to December 24, 1992, and GST tax exemption has been allocated to a single QTIP trust, such single QTIP trust may be treated as two separate trusts (for GST tax purposes only) by reason of a transitional rules if the appropriate election is made on or before April 15, 1993. Prop. Treas. Reg. §26.2652-2(c); 26.2654-1(a).

6. Other Planning Considerations

a. Subject Assets To Estate Or Gift Tax

It may be advantageous to cause assets to be subject to estate taxation rather than GST taxation. The value of the unified credit and lower estate tax bracket of the beneficiary of a GST trust will be wasted at the death of a beneficiary who has minimal personal assets. The GST tax is imposed at the top estate tax bracket and significant transfer tax savings can result if some assets are given outright to the beneficiary rather than placed in a GST trust. It would also be possible to give the beneficiary a general power of appointment over some portion of the GST trust in order to cause trust assets to be subject to estate taxation rather than GST taxation.

b. Use Of Disclaimers

Disclaimers will now potentially cause the imposition of GST tax, as disclaimed property often passes from a child to a grandchild of the transferor. The use of disclaimers will probably be reduced, although it is possible that no GST tax will be due by reason of the grandfather rules, unused GST exemption or the availability of the Gallo Amendment prior to 1990.

c. Miscellaneous Considerations

Complexities introduced by the GST tax law will cause many changes to be made in the way that wills and trusts are drafted. It is likely that future administrative powers will routinely grant discretion to allocate GST exemption, to allow the final distribution of a trust to be postponed until the satisfaction of all GST liability for which the trustee may be liable, and to allow trustees to augment taxable distributions by an additional amount to cover GST taxes due by the distributee. Issues such as the apportionment of GST tax due, the allocation of GST exemption between potentially adverse beneficiaries, multi-generational survivorship presumptions, the creation of both GST tax exempt and GST taxable trusts where one trust would have sufficed in the past, and the use of a special QTIP trust to prevent a transferor's GST exemption from being wasted create new and unresolved drafting problems.

E. Combining Various Gifting Techniques

Each of the lifetime gifting techniques discussed has its own pros and cons. The typical client's estate planning objectives can usually be achieved only by using a variety of techniques having a significant combined tax impact.

QUALIFIED PLANS AND SUBSTITUTES THEREFOR IN ESTATE PLANS

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Qualified Plans and Substitutes Therefor in Estate Plans

James E. Hargrove, JD, CPA

THE PENSION PLANNING/ ESTATE PLANNING PARADOX

- PENSION PLANNING GOAL:
- ....Wealth Creation
- ESTATE PLANNING GOAL:
- ....Wealth Transfer

PENSION PLANNING

- To Accumulate Wealth
- To Use for Retirement
- Not to Use as a Tool to Transfer the Wealth

PARADOX PLANNING

The Possible Solutions

- Timing of Distributions
- Proper Beneficiary Designations
- Pension Plan Alternatives

PARADOX PLANNING
Everyone Says Defer, Defer, Defer

- Accountants Say DEFER Plan Distributions
- Lawyers Say DEFER Plan Distributions
- Financial Planners Say DEFER Plan Distributions

PARADOX PLANNING
Defer and Pay Dearly

- Defer and Pay Federal Estate Tax
- Defer and Pay State Death Tax
- Defer and Pay Federal Income Tax
- Defer and Pay State Income Tax
- Defer and Pay Federal Excess Retirement Accumulations Tax

THE LOST IRA/PENSION ACCOUNT

CURRENT VALUE	$1,000,000
LESS: Federal Estate Taxes	$415,000
LESS: Kentucky Inheritance Taxes	$135,000
LESS: Federal Income Taxes	$170,000
LESS: Kentucky Income Taxes	$30,000
LESS: Excess Accumulation Tax	$35,000
REMAINING BALANCE	**$215,000**

PARADOX PLANNING
Using Plan Assets to Fund the Estate Plan

- To Fund Annual Giving Plan
- To Fund Charitable Giving Plan
- To Fund Liquidity Protection Plan

PARADOX PLANNING

Knowing When to Defer and When to Distribute

If Estate Plan can be funded using non-qualified assets, then fund it with those assets.

If Estate Plan cannot be funded using non-qualified assets, then fund it with distributions from Qualified Plans or IRAs.

PARADOX PLANNING

Minimizing the Five Taxes

- Planning to Avoid Excess Accumulation Tax
- Planning to Defer Income Taxes
- Planning to Avoid Death Taxes

"MRD"

Minimum Required Distribution

- Determines when Distributions Begin (RBD)
- "RBD" = Required Beginning Date
- Plan or IRA may be more Restrictive

"MRD"

Other Rules

- Distributions Prior to RBD are NOT Credits
- A MRD Payment CANNOT be "Rolled Over"
- Failure to Comply with MRD = 50% Excise Tax

"MRD"
Effect on IRAs

- Generally Three Payout Options
- Single Life Annuity (No Estate Taxes)
- QJSA (Qualifies for QTIP - No Estate Taxes)
- Installment Payments (May Generate Estate Taxes)

"RBD"
Required Beginning Date

- Determines When Distributions Must Begin
- April 1st Following Age 70 1/2
- Must be Distributed or Commenced by RBD
- Exceptions:
  ...If Born Before 7/1/17 and < 5% Owner
  ...If Benefit & Bene. Designated b/f 1/1/84

"QJSA"
Qualified Joint & Survivor Annuity

- Single Life Annuity or QJSA Required
- Unless:
  ....Plan Provides Other Options
  ....AND...Participant Elects Such Option
  ....AND...Spouse Consents
- QJSA Qualifies for Marital Deduction as QTIP

THE FIVE YEAR RULE
What is it?

- GENERAL RULE: If death occurs before RBD or start of distributions, then entire interest must be paid out within 5 years
- EXCEPTION 1: Paid over life of Designated Beneficiary ("DB") over life expectancy of DB or less
- EXCEPTION 2: If Spouse is DB, paid over his or her life but can wait until Spouse reaches 70 1/2

THE FIVE YEAR RULE
Other Issues

- The Plan Controls and Can Override 5-Yr Rule.
- If spouse dies after Participant but b/f payout begins and is the DB, then it will be as if the spouse was the Participant.

BENEFICIARY DESIGNATIONS
The Spouse: Advantages

- Continued Tax Deferral
- Greater Flexibility to Spouse

BENEFICIARY DESIGNATIONS
The Spouse: Disadvantages

- Loss of Control
- Excess Accumulations Tax

BENEFICIARY DESIGNATIONS
Children: Advantages

- Greater Tax Deferral
- Protect Assets for Children
- But....Spousal Consent

BENEFICIARY DESIGNATIONS
Children: Disadvantages

- Death Tax Sooner
- Pre/Postnuptial Agreements
- But....Spousal Consent

BENEFIT DECISIONS
The Rights & Rules

- The RBD is Last Day to Select Benefit
- "At Least As Rapidly" Rule
  ....After Participant's Death
  ....Payout CANNOT be Lengthened
- If Participant Elects Installment Payout
  ....Will Not Qualify for Marital Deduction Unless
  ....Spouse can Accelerate Payments

BENEFICIARY DESIGNATIONS
Watch Out For...

- Tax Allocation Clauses if Beneficiary of Plan is Different From Beneficiary of Residue
- Availability of Sufficient Cash to Pay the Tax Under Current Designation

BENEFICIARY DESIGNATIONS
Review

- Who are the current beneficiary designations?
- Are they valid under plan & current law?
- Is there a Pre/Postnuptial Agreement?
- Is there a Property Settlement Agreement?

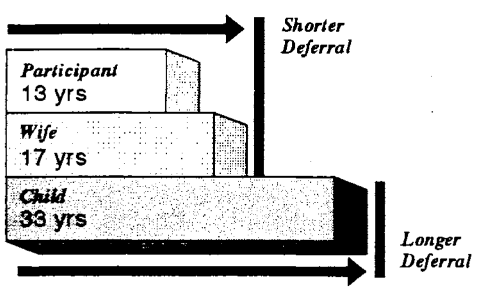
BENEFICIARY DESIGNATIONS
Spousal Consent

- Must be Within 90 Days of When Payments Are to Begin
- Prenuptial Agreement NOT Valid Consent (Treas. Reg. 1.401(a)-20, Q&A 28)
- Not Required in IRA's and SEPP's

DESIGNATED BENEFICIARY
What Is It?

- A Qualifying Beneficiary - Life Expectancy
- Used in Calculating Retiree's Payments
- Allows Longer Deferral of Taxes
- Avoids 5-Year Rule

DESIGNATED BENEFICIARY
The Difference it Makes



DESIGNATED BENEFICIARY ("DB")
Other Rules

- Determined at RBD or Death of Participant
- New DB = New Life Calculation if Shorter
- Exception: If New DB b/c of Death of Old DB
- If Multiple DB's:
  ...All Must Qualify
  ...Take Shortest Life (Watch Qualified Trusts)
- If DB Can Be Changed After Death, NO DB

DESIGNATED BENEFICIARY
Who Can It Be?

- General Rule: Individuals Only
- Exception: "Qualified" Trusts

QUALIFIED TRUSTS
Types

- Qualified Terminable Interest Property Trust
  ....."QTIP" Trust
- Exemption Equivalent ("EE") Trust

QUALIFIED TRUSTS
What Are They?

- Must Be Valid Under Local Law
- Must Be Irrevocable
- Beneficiaries Must Be Identifiable
- Copy of Instrument Must Go to Plan

QUALIFIED TRUSTS
Exemption Equivalent (EE) Trust

- Important When Non-plan Assets Are < $600,000
- Accelerates Tax (Compared to Spouse as Bene.)
- Always Fund EE Trust With Other Assets First
- Secondary Bene. Behind Spouse (Use Disclaimer)
- WATCH OUT USING DISCLAIMER IF:
  ....Payments have already started
  ....Election is in effect to recalculate
  Result is ALL assets in Plan are taxed

QUALIFIED TRUSTS
QTIP Trust

- May Be of Limited Value
- Why QTIP in First Place? CONTROL
- Trust = DB Status if Part. Dies Before RBD
- Trust = DB Status in All Cases if Irrevocable at RBD or When It Is Named
- Requires Plan Approval & Spousal Consent

QUALIFIED TRUSTS
QTIP Trust Hazards

- QTIP & Plan Must Both Pay "All Income" to Spouse
- Check Definition of "Income" in QTIP Trust
- May Be Difficult for Large Corp. Plan to Assist
- Watch Out For Income in Respect of a Decedent if Plan Benefits Are Used to Satisfy Pecuniary Bequest

DESIGNATED BENEFICIARY ("DB")
IRA Separate Account Planning

- Allows Separate Accounts With Different Beneficiaries
- Some May Be DBs and Some May Not
- MRD Determined for Each Account
- Best to Divide Before RBD
- May Result in Loss of Deferral of Excess Accumulations Tax

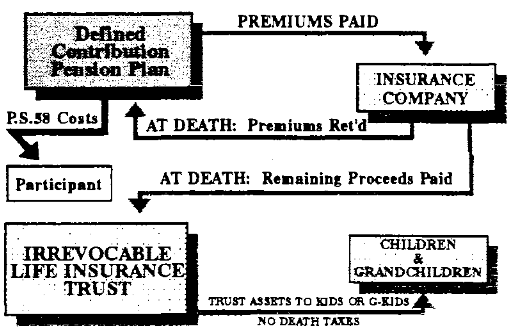
EXCESS ACCUMULATIONS TAX
What is it?

- 15% tax
- Excess Retirement Accumulations Tax: 15%
- $150,000 Annual Floor
- $750,000 Lump Sum
- Exceptions:
  .....Death Benefit From Insurance
  .....QDRO Payments
  .....Spouse's Election to Defer

EXCESS ACCUMULATIONS TAX
How to Avoid or Minimize

- Do Not Double Up Payment at 70 1/2
- Take Distributions Before Age 70 1/2
- Change Designated Beneficiary Designation
- In Defined Contribution Plans
  Consider the Purchase of Life Insurance
- Take Advantage of QDRO

Avoiding Excess Accumulations Tax
(With the Use of Life Insurance)



Avoiding Excess Accumulations Tax
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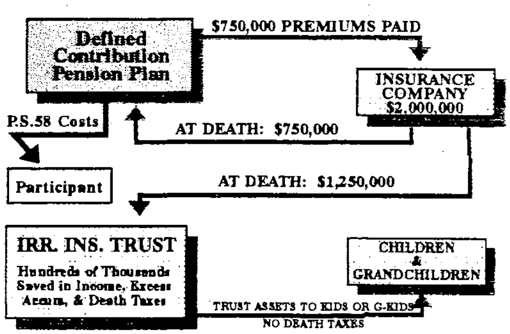


SELECTING THE PAYOUT OPTION
Do You Dare Advise?

- Review Summary Plan Description
- Review Disclosure Statement (IRA)
- Investment Advisor? Financial Planner?

QUALIFIED PLAN ALTERNATIVES

- Non-Qualified Plans
- Charitable Remainder Trusts

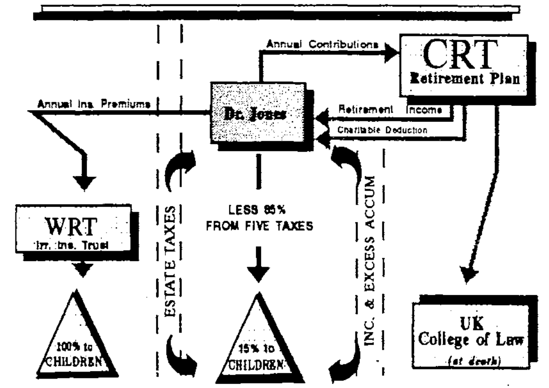
NON-QUALIFIED PLANS
Alternatives

- Executive Bonus Retirement Plan
- Split-Dollar Retirement Plan
- Supplemental Employee Retirement Plan (SERP)
...Nonqualified Deferred Compensation plan

CHARITABLE REMAINDER TRUSTS
A Creative Retirement Alternative

- No Limit on Amount Contributed
- Participant Can Discriminate
- Often Less Administrative/Legal Expense
- Less Government Regulation
- No 15% Excess Accumulations Tax
- Avoidance of Estate Taxes if WRT Used
- Creates Charitable $$ Where None Existed

CHARITABLE REMAINDER TRUST RETIREMENT PLAN



SETTING AND DEDUCTING FEES IN AN ESTATES PRACTICE

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SECTION D

SETTING AND DEDUCTING FEES IN AN ESTATES PRACTICE

TABLE OF CONTENTS

SETTING AND DEDUCTING FEES IN AN ESTATES PRACTICE

Jerold I. Horn*
April 12, 1994

I. SYSTEMS FOR CALCULATION.

The systems that lawyers most frequently use to calculate their fees are relatively few and easy to describe. Respectively, they are time-oriented, percentage-oriented and product-oriented. However, the variations are numerous.

A. Time-Oriented.

A time-oriented system has two components, (i) units of time and (ii) rate per unit. The second component varies among attorneys. Surprisingly, the first component often varies as well. Usually, but not always, it is a function of time. The second component is a function of the market.

1. "Straight" Time.

Example: 10 hours, multiplied by $250 per hour = $2,500.

The first component of a "straight"-time system is, simply, an amount of elapsed time, measured on a clock. The starting point is the commencement of the work. The ending point is the cessation of the work. Use of a minimum unit, i.e., a tenth of an hour or a quarter of an hour, causes some deviation from a strict, straight-time system. A straight-time system involves (i) allocation directly to a client of only the marginal (i.e., additional) time that the attorney directly expends for the client,

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 The author used a prior version of this outline in conjunction with his presentation at the Philip E. Heckerling University of Miami Estate Planning Institute in January, 1990.

(ii) allocation of other time (including research and development work and preparation of forms and systems) to office overhead and (iii) calculation of the fee by multiplying the marginal time that directly is expended for the client by the hourly rate.

The first component of a straight-time system also serves another function. Overhead, in terms of dollars, divided by workable hours produces the amount of dollar overhead per workable hour. Dollar overhead per workable hour multiplied by hours worked gives some view of the amount of dollar overhead that a particular matter consumes.

2. Addition of Factor for Research and Development.

Example: (10 hours of marginal time plus .5(10), i.e., a factor for research and development), multiplied by $200 per hour = $3,000.

The "time-expended" component of a time-oriented system can include an additional factor for time expended upon research and development. Direct time (i.e., marginal time expended for a particular client) is multiplied by a percentage. The resulting number of hours is subtracted from those hours of research and development that are allocated to office overhead. The hours thus subtracted from office overhead are reallocated to the particular client.

Obviously, a given rate per hour will produce a higher charge under this system than under the straight-time system. Conversely, an attorney who uses this system can announce an hourly rate that nominally is less, but can produce a fee that actually is more, than the attorney who uses a straight-time system.

3. Standard Units.

Example: 15 hours (the time that is deemed required to prepare the work, even though time actually expended is 10 hours), multiplied by $200 per hour = $3,000.

Some attorneys charge for "time" on the basis of standard units, i.e., a particular number of units for a particular task. The concept is similar to the manner of charging for body work on automobiles.

Obviously, the first component of this system can deviate markedly from, or bear little relation to, the first component of a straight-time system. The name, "time," is the only inherent similarity between the units of time that are used in this system and the units of time that are used in a straight-time system.

This writer understands that some attorneys who use this system charge for many more "hours" than exist in a working day. Obviously, a given rate per "hour" will produce for these attorneys a higher charge than the same rate will produce for any attorney who uses a straight-time system.

B. Percentage-Oriented.

Examples: a) Assets of $1,000,000, multiplied by 3% = $30,000.

b) Assets of $900,000 (consisting of probate assets of $800,000 plus 50% of nonprobate assets of $200,000), multiplied by 3% = $27,000.

A percentage-oriented system also has two components, (i) a value base and (ii) a percentage. Often, the first component consists solely of a number of dollars. However, it also can include subjective elements. While the first component might include all probate assets valued at fair market value, it might include only a percentage of nonprobate assets that are included in one or more tax returns. These subjective elements of the first component are functions of the market. The second component always is a function of the market.

C. Product-Oriented.

Example: $2,500.

A product-oriented system has one component, a fixed fee for a particular item. This component usually is a function of someone's judgment of value. However, ultimately, it is a function of the market.

D. Hybrid Systems.

Some systems of fee determination combine two or more of the orientations.

1. Product-Oriented and Time-Oriented.

Examples: (a) $1,250, plus (10 hours, multiplied by $125 per hour) = $2,500.

(b) $2,500, plus (11 hours minus 10 hours, multiplied by $250 per hour, being $250 for each hour in excess of ten) = $2,750.

A hybrid system that is both product-oriented and time-oriented includes a form of each of the constituent systems. The product-oriented portion compensates the lawyer for his ability efficiently and expertly to repeat what he has done before. Perhaps, it is in the nature of a charge for a document or for the lawyer's ability to perform a series of procedures. The time-oriented portion compensates the lawyer for marginal effort that he expends for the particular job.

The product-oriented portion provides compensation for products, i.e., elaborate procedures and documents based upon accumulated expertise and research and development. The time-oriented portion provides compensation for services, i.e., time-consuming undertakings for single uses.

The hybrid arrangement depicted in the first example causes a client always to pay both a component that (given the nature of the work) is fixed in advance and a component that is variable. The hybrid system depicted in the second example imposes a variable charge only if the expenditure of time exceeds a "normal" amount. The system depicted in the second example is in the nature of a fixed, minimum charge plus a contingent, variable charge.

2. Percentage-Oriented and Time-Oriented.

Example: (a) (Assets of $1,000,000, multiplied by 1½%), plus (120 hours, multiplied by $125 per hour) = $30,000.

(b) The greater of (i) (assets of $1,000,000, multiplied by 3%) and (ii) (130 hours, multiplied by $250 per hour) = $32,500.

A hybrid system that is both percentage-oriented and time-oriented includes a form of each of the constituent systems. The percentage-oriented portion compensates the attorney for his responsibility and for the value that he tends to create or preserve. The time-oriented portion compensates the attorney for marginal effort that he expends for the job.

The hybrid arrangement depicted in the first example causes a client always to pay both a component that (given the value base) is fixed in advance and a component that is variable. The hybrid system depicted in the second example imposes a variable charge only if the expenditure of time exceeds a "normal" amount. The system depicted in the second example is in the nature of a fixed, minimum charge plus a contingent, variable charge.

3. Product-Oriented and Percentage-Oriented.

Example: $1,250 plus (assets of $1,000,000, multiplied by .2%) = $3,250.

A hybrid system that is both product-oriented and percentage-oriented includes a form of each of the constituent systems. Given the nature of the work and the value base, each portion is fixed in advance. The product-oriented portion compensates the lawyer for his ability efficiently and expertly to repeat what he has done before. The percentage-oriented portion compensates the attorney for his responsibility and for the value that he tends to create or preserve.

4. Time-Oriented, Product-Oriented and Percentage-Oriented.

Example: $1,250 plus (assets of $1,000,000, multiplied by .2%), plus (11 hours minus 10 hours, multiplied by $250 per hour, being $250 for each hour in excess of ten) = $3,500.

A hybrid system that is time-oriented, product-oriented and percentage-oriented includes a form of each of the constituent systems. Compared to the product-oriented, percentage-oriented system discussed in the preceding paragraph, it additionally imposes a variable charge which compensates the attorney for marginal effort if the expenditure of time exceeds a "normal" amount.

E. <u>Evaluation</u>.

1. Time-Oriented.

Time-oriented systems tend to reward the expenditure of time, <u>per se</u>. Thus, they tend to reward inefficiency and to disadvantage efficiency.

Except to any extent that the value of a product or service is directly proportional to the lawyers' time that is spent to make or render it, a time-oriented system tends to produce a fee that has only a random relationship to value. Increased use of systems and technology to deliver a lawyer's products additionally attenuates the relationship between time and value.

An attenuated relationship between value, on the one hand, and the marginal time that a lawyer needs to perform a job, on the other, particularly inheres in estate planning. Systems, technology, research and nonlawyer services are relatively important to, and costly components of, the highest quality of estate planning compared to the highest quality of other types of legal work.

Differences in reputation of individual attorneys tend to cause courts, firms and clients to countenance fees that are based on different hourly rates. However, the increments that the courts are approving, that clients are paying and that firms are charging fall within a range that is much narrower than the range of value that one attorney's work, compared to another attorney's work, brings to a client.

Estate planning and estate administration are more efficient, and provide better results, when they include use of inputs other than lawyers' time. These other inputs include elaborate procedures that, themselves, are the product of time and other inputs. Any attorney who uses these procedures must avoid using a straight-time system of charging if he is to receive compensation commensurate with his efficiency. This writer perceives that the better attorneys indeed do tend to use these procedures and do tend to avoid straight-time charges for estate planning and estate administration. He also perceives that some attorneys who are unable to avoid the straight-time system are falsifying the hours they are expending or are expending hours indiscriminately. Although the fees that these attorneys charge are not relatively low, their nominal rates are. Among unknowledgeable consumers, and among unknowledgeable courts, this, of course, tends to disadvantage the expert who is honest and efficient.

2. Percentage and Product-Oriented.

Percentage-oriented fees and product-oriented fees reward efficiency directly.

If the value of a lawyer's work is a function of the value of the property that the lawyer is preserving or creating, a percentage-oriented fee tends to bear a direct relationship to the value that the client receives. Similarly, if both consumers and producers adequately are informed, the market should tend to cause a product-oriented fee to bear a direct relationship to the value that the client receives.

Malpractice insurers and the law of professional responsibility indicate that responsibility and compensation for breach of responsibility are functions of the number of dollars that are involved. The legal measure of an attorney's responsibility seems also an appropriate basis for an attorney's calculation of his compensation. Regardless of what some courts and some consumers may think, the market is saying that, <u>other things being equal</u>, an attorney should receive more compensation for working with a larger value than for working with a smaller value.

Product-oriented fees and percentage-oriented fees additionally have the advantage of tending to provide certainty to both attorney and client. Additionally, each tends to avoid the significant variations that appear when fees are based solely upon time.

3. Hybrid Systems.

The first version of the product-time hybrid and the first version of the percentage-time hybrid present the same disadvantages, although diluted, that the time-oriented systems present. However, the second version of the product-time hybrid, the second version of the percentage-time hybrid and the time-product-percentage hybrid use the time orientation only as a contingency. Thus, they offer the advantage of assuring compensation to the lawyer who must expend an abnormally large amount of time.

The product-percentage hybrid blends the two systems that reward efficiency. It directly compensates for expertise, responsibility and creation or preservation of value.

F. <u>Rules of Professional Conduct</u>.

The Model Rules of Professional Conduct, promulgated by the American Bar Association, neither require nor prevent the use of any of the systems. They direct only that, "A lawyer's fee shall be reasonable."

"The factors to be considered in determining the reasonableness of a fee include the following:

"(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

"(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

"(3) the fee customarily charged in the locality for similar legal services;

"(4) the amount involved and the results obtained;

"(5) the time limitations imposed by the client or by the circumstances;

"(6) the nature and length of the professional relationship with the client;

"(7) the experience, reputation, and ability of the lawyer or lawyers performing the services;

"(8) whether the fee is fixed or contingent . . . ." Rule 1.5.

Although rule 1.5 imposes parameters that alter the market, the rule itself recognizes that it operates in the context of the market.

G. <u>Antitrust Laws</u>.

Similarly, the antitrust laws do not require or prevent the use of any of the systems. The collusive determination of fees, including by use of a fee schedule, is illegal. <u>Goldfarb v. Virginia State Bar</u>, 421 U.S. 773 (1975). However, the noncollusive determination of fees, including by use of a fee schedule, is not illegal.

II. CONTROL BY A COURT.

A. Right to Review.

When the personal representative and the beneficiaries refuse to approve an attorney's fee for probate work, the court clearly has the right to review and to disallow the fee. Some courts would argue that they also have this right even if the fee is agreed and the administration is unsupervised.

B. Scope of Review.

Usually, the scope of appellate review of a probate court's determination of the reasonableness of an attorney's fee is narrow. If the appellate court finds that the local court applied the proper criteria, the appellate court usually will not overturn the local court's determination.

C. Fee-For-Time Ceiling.

Some courts attempt to disallow all fees in excess of a certain rate per hour. They determine the maximum rate in advance, with little regard to the lawyer's responsibility, competence, efficiency or reputation and with little regard to the nature of the work. An hourly rate ceiling compounds all of the problems that inhere in a time-oriented system. It often applies arbitrarily as well as perversely. Whereas a time-oriented system, per se, emphasizes the lawyer's expenditure of time, the addition of a ceiling tends to prevent the lawyer from using the other inputs that are essential to production of work of the highest quality.

An hourly rate ceiling ignores the one or more bases upon which the attorney actually determines the fee. It substitutes time (i.e., a number of hours) as the sole criterion. The use of time as the sole criterion inherently presupposes, and the use of time as a principal criterion tends to presuppose, that time is fungible. However, one attorney's time is not fungible qualitatively with any other attorney's time. Indeed, the comparison of the straight-time system and the standard-unit system demonstrated that one attorney's "time" is not necessarily fungible quantitatively with another attorney's time.

An hourly limit will tend to affect most adversely the most efficient lawyers. These are precisely the lawyers that the system most should encourage. Since a principal purpose of the system is to promote efficient transmission of wealth at death, a ceiling that undermines this purpose should be unreasonable, per se.

A simple test can resolve many questions of reasonableness without laborious analysis. A ceiling is unreasonably low if the judge, himself, would have to charge more in order personally to generate his own salary, office costs, benefits and emoluments.

Tests that directly use the concept of efficiency are more difficult. However, they are no less telling.

Efficiency is the rate of output per unit of input. Input is measurable in terms of dollars as a medium of exchange, regardless of whether the input consists of dollars spent (i.e., out-of-pocket expenditures) or dollars foregone (i.e., opportunity costs incurred because of expenditure of time in one manner rather than another).

Maximization of output per unit of input might or might not occur within the limits of a fee-for-time ceiling that a court imposes. The lower the ceiling, the less is the likelihood that the maximization can occur within it. Stated differently, if (i) the cost or the composition of input that maximizes efficiency is greater than the cost or different from the composition of input that maximizes the lawyer's net income when the lawyer charges an hourly rate that is within the ceiling and (ii) the lawyer attempts to maximize net income, the ceiling impedes efficiency. Accordingly, a judge who solely determines whether a fee is less than a certain number of dollars per hour will tend to harm the very person, the lawyer's client, whom the judge professes to help.

A ceiling that is based upon lawyers' time tends to inhibit the use of all inputs other than lawyers' time. Since maximization of output per unit of input requires use of inputs other than lawyers' time, a time-based ceiling tends to impede efficiency.

Since a lawyer's time is the only production factor that is not expandable in relationship to a unit of time, any effort to improve output per unit of time must increase the use of one or more production factors that are expandable in relationship to a unit of time. This increase will necessitate an increase in cost per unit of time. Therefore, a fee-for-time ceiling will tend to cause any increase in ratio of output to input to decrease the lawyer's net income. Conversely, it will tend to force a lawyer to decrease efficiency in order to increase net income.

If two attorneys produce different outputs during the same period of time, the better producer will tend to use more input, e.g., supplies, equipment, office space, secretarial services, research and development. Obviously, a system that compensates each at the same rate per unit of time will provide each with an identical amount of gross income but will provide a greater amount of net income to the lawyer who produces less.

The problem also is describable in terms of a single lawyer. Assume that this lawyer's preparation of an estate plan formerly consumed $1,000 of expenses and ten hours of the lawyer's time. He charged a fee of $2,500, or $250 per hour, and he generated net income of $1,500, or $150 per hour. This lawyer's infusion of additional input other than his time permits him now to prepare the plan for an expenditure of $1,500 and five hours of his time. He uses the five hours that he saves to prepare a second plan, and the second plan also requires expenditures of $1,500. If he charges the same fee, $2,500, for each plan, he generates gross receipts of $5,000, or $500 per hour, costs of $3,000 and net income of $2,000, or $200 per hour. The changed mix of production factors does not increase the fee that the client pays but does increase the lawyer's output and does increase the lawyer's net income even though the lawyer increased his costs both absolutely and in relation to his time. Why should a court complain?

Assume that the facts remain as described in the preceding paragraph except that the lawyer reduced his fee to $2,375 for each plan. He would generate gross receipts of $4,750, or $475 per hour, costs of $3,000 and net income of $1,750, or $175 per hour. The changed mix of production factors would have decreased the fee the client paid, increased the lawyer's output and increased the lawyer's net income even though the lawyer increased his costs both absolutely and in relation to his time and even though the lawyer reduced somewhat his fee per plan. The changes would have benefitted both the consumer and the lawyer. Again, why should a court complain?

Last, assume that the facts remain the same except that the lawyer reduced his fee to $2,250 for each plan. He would generate gross receipts of $4,500, or $450 per hour, costs of $3,000 and net income of $1,500, or $150, the same as before any change. The changed mix of production factors increased the lawyer's output and did not change the lawyer's net income even though the lawyer increased his costs both absolutely and in relation to his time. If one lawyer prefers the first method of operating and a second prefers this method, why should a court permit the first to operate as he wishes but prevent the second? The same arguments apply to the administration of a decedent's estate.

The market system can determine more efficiently and less intrusively than the judicial system the best mix of production factors and the best levels of outputs and fees. Whereas the market can accommodate two lawyers who produce different outputs and use different production factors but charge the same price, a fee-for-time ceiling that a court imposes will tend to prefer the producer who uses less cost per unit of his time or, stated more simply, less cost and more of his time. Since neither method is better than the other, the preference is arbitrary. Courts should not indulge it.

A legal fee that a court or an attorney decrees but that ignores the market will produce, ultimately, a misallocation of legal services compared to those that consumers would purchase if the edict did not exist. It also will produce a misallocation of production factors compared to those that lawyers would use if the edict did not exist. Any system that focuses solely upon a lawyer's time, the one input that the lawyer cannot expand per unit of time, tends to distort the lawyer's use of all production factors.

The market inexorably is present even if a court or lawyer refuses to recognize it. Wise judges realize that they should defer to it.

> "Proceeding presumptively with the firm's own rates allows the court to avoid the essentially impossible task of selecting one rate over another from a wide range of 'market' rates, it limits the power of the trial judge arbitrarily to reward or punish attorneys by setting rates virtually at will, and it allows the parties and the court to avoid a 'second major litigation' over the rate-making process. The marketplace best measures 'market value'; appraisal by no other method has as much claim to veracity and objectivity." <u>Laffey v. Northwest Airlines, Inc.</u>, 746 F. 2d 4, 18 (D.C. Cir. 1984)

Courts should permit the compensation for legal services to take into account the output as well as the input. Only then will lawyers focus principally upon expanding the expandable production factors in order to enhance efficiency and to increase value to the client and net income to the lawyer.

The appropriate function of a court in reviewing a fee is to prevent overreaching. Unless the lawyer has agreed with the client to impose a ceiling upon <u>himself</u>, no direct relationship is apparent between a court's imposition of a fee-for-time ceiling and its prevention of overreaching.

D. <u>Lawyer's Challenge</u>.

A lawyer can accept a disallowance or can challenge it. The only course that will produce greater problems, with client and court, than to accept a disallowance is to challenge a disallowance meekly and to lose. Accordingly, a lawyer should have a bias in favor of challenging and of attempting to do whatever is necessary to win.

An attorney who is aware that a local court is considering a disallowance should make a record that both will tend to persuade the court not to disallow and, if the court does disallow, will tend to support a reversal. Arbitrariness is the basis upon which local courts seem most vulnerable. Therefore, if necessary, the record should include testimony of experts concerning appropriate bases and amounts of fees and testimony of local practitioners (subpoenaed, if necessary) that the court generally uses an arbitrary ceiling. An effective defense of an hourly charge by an attorney who calculated a fee solely on the basis of the time that he directly expended for the client probably should include a disclosure of how other attorneys charge rates that nominally are lower but that actually are the same or higher. Failure to disclose how other attorneys calculate a fee for time permits the court to use a meaningless comparison between things that inherently are dissimilar, the proverbial apples and oranges.

E. Avoiding the System - and the Problems.

Arguably, an attorney can avoid the problems by avoiding the system. Avoidance of probate by means of a revocable, noncourt trust should avoid the court's control. Similarly, the prompt movement of all assets from the probate estate to a noncourt trust might permit the attorney to render most of his services for the trustee and not for the personal representative and, therefore, might permit the attorney to charge most of his services to the trustee and to avoid the inspection of a court.

F. Written Agreements.

As a practical matter, a written agreement between lawyer and client, obtained before the services are performed or in any event before the lawyer asks a court to approve the fee, will tend to avoid a client's challenge and a court's disallowance.

III. CONTROL BY INTERNAL REVENUE SERVICE: DEDUCTIBILITY OF FEES FOR ESTATE PLANNING.

A. Statutory Authority.

If a deduction is available for the cost of legal services that consist of estate planning, the statutory authority is section 212 of the Internal Revenue Code:

> "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year---
>
> "(1) for the production or collection of income;
>
> "(2) for the management, conservation or maintenance of property held for the production of income; or
>
> "(3) in connection with the determination, collection or refund of any tax."

Portions (1) and (2) grant a deduction for the cost of operating a revocable trust. Similarly, they should grant a deduction for the cost of creating the trust.

Portion (2) allows a deduction for expenses for the management of income-producing property. How portion (2) applies to an unfunded trust is unclear. If a revocable trust is revoked, its post-death dispositive provisions never will operate. Therefore, arguably, all of the fee attributable to the trust is described in portion (2). The function of a power of attorney for property management is to facilitate the management of property. Therefore, arguably, all of the fee for it is described in portion (2).

Portion (3) allows a deduction for expenses incurred in connection with the determination of any tax. Courts have held that portion (3) provides a deduction for the cost of general tax advice. Carpenter v. United States, 64-2 USTC ¶9, 842 (Ct. Cl. 1964); *cf*. Merians v. Commissioner, 60 T.C. 187 (1973), and reg. §1.212-1. Accordingly, portion (3) arguably permits a deduction for the portion of the fee that is attributable to tax advice and is not deducted under another portion of section 212.

B. <u>Merians</u>.

Sidney Merians hired an attorney to prepare an estate plan. The Internal Revenue Service <u>assumed</u> that any portion of the fee that was attributable to tax advice was deductible. Therefore, according to the Tax Court, the only question was what portion of the unitemized fee was attributable to tax advice. <u>Merians v. Commissioner</u>, 60 T.C. 187 (1973). However, some of the judges disagreed with the Service's assumption that portion (3) of section 212 provided a deduction for general tax advice.

C. <u>Code §67</u>.

An individual's "miscellaneous itemized deductions for any taxable year [are] allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Code §67(a). "Miscellaneous itemized deductions" includes deductions under section 212. Code §72(b) and reg. §1.67-1T(a).

IV. CONTROL BY INTERNAL REVENUE SERVICE: DEDUCTIBILITY OF ADMINISTRATION EXPENSES CONSISTING OF ATTORNEY'S FEES AND EXECUTOR'S COMMISSIONS

A. Choice Between Deduction for Estate Tax Purposes and Deduction for Income Tax Purposes.

1. Attorney's fees and executor's commissions that are administration expenses are deductible either for estate tax purposes or for estate or trust or individual income tax purposes, but not for both estate tax purposes and income tax purposes.

   "(g) DISALLOWANCE OF DOUBLE DEDUCTIONS. - Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents)."

   Code §642(g).

2. The statutory authority for the deduction for estate tax purposes is found in Code section 2053.

   * * *

   "(a) GENERAL RULE. - For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts -

   * * *

   "(2) for administration expenses,

   * * *

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered."

3. The statutory authority for the deduction for income tax purposes is Code §212, quoted above in III.A.

4. Generally, costs for the administration of an estate or trust are subject to the two-percent-of-adjusted-gross-income limit of Code section 67. However, these costs are fully deductible in determining the adjusted gross income of the estate or trust to the extent the costs "would not have been incurred if the property were not held in such trust or estate . . . ." Code §67(e).

5. Is an excess deduction, under Code section 642(h), on termination of an estate or trust subject to the two-percent limitation of Code section 67?

   a. A beneficiary, not the estate or trust, claims the Code section 642(h) deduction. However, if the estate or trust were in existence, it, not the beneficiary, would claim a deduction for these items.

   b. This formulation would seem to allow the use of qualifying costs of administration, without the limitation, to reduce what, but for the termination, would be the estate's or the trust's adjusted gross income.

   c. However, does it impose the two-percent limitation with respect to any costs of administration that generate what, but for Code section 67, is a deduction under Code section 642(h)?

   d. An affirmative answer would seem to create untenable differences.

      i. It would appear to impair the deductibility of costs of informal administration (i.e., administration without probate) more than it would impair the deductibility of costs of probate administration.

ii. It would appear to impair a deduction under Code section 642(h) and thus to tend to prolong the administration of trusts and estates.

6. Deduction for income tax purposes of items that alternatively are deductible for estate tax purposes as costs of administration requires a statement that

(i) the items have not been allowed as deductions for estate tax purposes, and

(ii) the taxpayer waives the right to claim the items at any time as deductions for estate tax purposes.

Code §642(g).

a. The statement must be filed in duplicate. Reg. §1.642(g)-1.

b. It must be filed (i) with the return that claims the deduction or (ii) alternatively, with the district director for the district in which the return was filed, for association with the return. Id.

c. The statement is due before the expiration of the statute of limitations that applies to the taxable year for which the deduction is sought. Id.

d. Until a deduction is finally allowed for estate tax purposes, the taxpayer may claim the deduction for income tax purposes even if a claim of it for estate tax purposes is pending. Id.

e. However, the filing of the statement that is required to claim the item as a deduction for income tax purposes does preclude all claim of the item as a deduction for estate tax purposes. Id.

f. A taxpayer may claim some items as deductions for income tax purposes and others as deductions for estate tax purposes and may claim part of an item for one purpose and part of it for another purpose. Reg. §1-642(g)-2.

7. Other things being equal, the taxpayer should select the deduction that will have the higher present value.

   a. The present value of the deduction is the same as the present value of the property that the deduction can permit to inure to the benefit of the beneficiaries of the decedent rather than to the United States.

   b. Two rules of thumb tend to facilitate the choice.

      i. First, tend to claim the deduction for the purpose that first will produce a tax benefit.

         (a) If the decedent's spouse survives the decedent and the decedent gives to other than the spouse a gift that is defined in terms of the largest amount that does not increase estate tax, deduction of administration expenses for estate tax purposes will not save any tax upon the decedent's death.

            (i) However, it will exclude from the decedent's taxable estate the amount thus deducted for estate tax purposes and, compared to a deduction of this amount for income tax purposes, will decrease _pro tanto_ the marital disposition and increase _pro tanto_ the property that is available to benefit the family because of the shelter of the unified credit.

(ii) Accordingly, while this deduction for estate tax purposes will not produce a tax benefit immediately upon the death of the predeceasing spouse, it will produce a tax benefit upon the death of the surviving spouse.

(b) A deduction for income tax purposes can save tax upon the decedent's death regardless of whether the decedent's taxable estate is sufficient to generate liability for estate tax.

(i) It will include in the taxable estate the amount thus deducted for income tax purposes and, compared to a deduction of this amount for estate tax purposes, will reduce _pro tanto_ the property that is available to benefit the family because of the shelter of the unified credit and will increase _pro tanto_ the marital disposition.

(ii) Accordingly, while this deduction for income tax purposes will produce a tax benefit immediately upon the death of the predeceasing spouse, it will produce a tax detriment upon the death of the surviving spouse.

ii. Second, if both a deduction for income tax purposes and a deduction for estate tax purposes will produce a benefit immediately upon the decedent's death, claim the deduction that will produce the larger saving.

B. Nature of the Inquiry.

Regardless of how courts describe the process, whether an expense is deductible for estate tax purposes requires a two-part inquiry.

1. First, is the expense of a type that is deductible?

2. Second, if the expense is of a proper type, what amount of it is deductible?

3. Circuit Courts of Appeal have disagreed about how to determine whether particular expenses are deductible.

   a. Some have said that an expense is deductible if the expense is allowable according solely to state law. Estate of Park v. Commissioner, 475 F. 2d 673 (6th Cir. 1973), 73-1 USTC ¶12,913; Jenner v. Commissioner, 577 F. 2d 1100 (7th Cir. 1978), 78-2 USTC ¶13,251; and Ballance v. Commissioner, 347 F. 2d 419 (7th Cir. 1965), 65-1 USTC ¶12,283.

   b. Others have said that an expense is deductible only if the expense is allowable according to both state law and federal law. Love v. Commissioner, 91-1 USTC ¶60,056 (4th Cir. 1991); Hibernia Bank v. United States, 581 F. 2d 741 (9th Cir. 1978), 78-2 USTC ¶13,261; and Pitner v. United States, 388 F. 2d 651 (5th Cir. 1967), 68-1 USTC ¶12,499; see also Smith v. Commissioner, 510 F. 2d 479 (2d Cir. 1975), 75-1 USTC ¶13,046, cert. denied, 423 U.S. 827 (1975).

   c. Some authority has held that this dispute is material only to determining whether the expense is of a type that is deductible and is not material to determining reasonableness (i.e., the amount that is allowable). Bank of Nevada v. United States, 80-2 USTC ¶13,361 (D. Nev. 1980); see also Hibernia, supra, at 85,933, fn. 6.

d. However, other authority, discussed below, has held that the dispute also is material to determining reasonableness. Pitner, supra; and United States v. White, 853 F. 2d 107 (2d Cir. 1988), 88-2 USTC ¶13,777, certiorari granted, ___ U.S. ___ (1989), certiorari dismissed, ___ U.S. ___ (1989).

C. What Types of Expenses Are Deductible?

Attorney's fees and executor's commissions are not deductible for estate tax purposes unless they are "administration expenses." Code §2053(a)(2); see generally DeWitt v. Commissioner, 54 TCM 759 (1987).

1. Expenses are not administration expenses unless (i) they are incurred in the administration of the estate and (ii) they are not incurred for the personal benefit of beneficiaries.

> "(a) In general. The amounts deductible from a decedent's gross estate as 'administration expenses' of the first category (see paragraphs (a) and (c) of §20.2053-1) are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in paragraphs (b) through (d) of this section."

Reg. §20.2053-3(a).

* * *

> "(3) Attorney's fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate within the meaning of paragraph (a) of this section. An attorney's fee not meeting this test is not deductible as an administration expense under section 2053 and this section, even if it is approved by a probate court as an expense payable or reimbursable by the estate."

Reg. §20.2053-3(c)(3).

2. Fees that are billed after a client's death for work performed during the client's life are not administration expenses and, therefore, are not reportable on Schedule J of the United States estate tax return and are not deductible under Code section 2053(a)(2).

    a. Rather, these items are reportable as debts on Schedule K of the United States estate tax return and, if all conditions are satisfied, are deductible under Code section 2053(a)(3).

        i. Such of these items as the decedent could have deducted for income tax purposes during his life if the decedent had paid them are deductions in respect of a decedent by the party that pays them after the decedent's death. Code §691(b).

        ii. Accordingly, contrary to administration expenses, these items can produce a deduction for estate tax purposes and also a deduction for income tax purposes. <u>See</u> Code §642(g).

    b. Upon disallowance of a deduction for an attorney's fee as an administration expense, the attorney might attempt to justify the deduction by arguing that part of the fee was for services rendered during the client's life.

i. This type of argument presents a trap in those jurisdictions in which the Circuit Courts of Appeal have said that consideration of post-death events is appropriate and that enforcement of a claim is a prerequisite to the granting of a deduction for it. United States v. Jacobs, 34 F. 2d 233 (8th Cir. 1930), 1 USTC ¶380; Commissioner v. Shively, 276 F. 2d 372 (2d Cir. 1960), 60-1 USTC ¶11,940; Gowetz v. Commissioner, 320 F. 2d 874 (1st Cir. 1963), 63-2 USTC ¶12,165; Estate of Hagmann, 492 F. 2d 796 (5th Cir. 1974), 74-1 USTC ¶12,996; and Revenue Ruling 60-247, 1960-2 C.B. 272.

(a) The timely filing of a claim might be a precondition to its deduction in these jurisdictions.

(b) Typically, any attempt of the Internal Revenue Service to disallow the deduction will occur after the time has expired for the filing of claims.

(c) However, if the jurisdiction permits informal handling of agreed claims, the attorney might argue that the amount of the fee was agreed within the requisite time. See e.g., Thompson v. Commissioner, 84-1 USTC ¶13,568 (7th Cir. 1983).

ii. This problem does not exist in those jurisdictions in which the Circuit Courts of Appeal have said that consideration of post-death events is inappropriate and whether the claim was enforceable at the time of the decedent's death, not whether the claim actually was enforced after the death, determines whether a deduction is available under Code section 2053(a)(3). United States v. Propstra, 680 F. 2d 1248 (9th Cir. 1982), 82-2 USTC ¶13,475;

Commissioner v. Strauss, 77 F. 2d 401 (7th Cir. 1935), 35-1 USTC ¶9,266; and Russell v. United States, 260 F. Supp. 493 (N.D. Ill. 1966), 66-2 USTC ¶12,418; see also Ithaca Trust Company v. United States, 279 U.S. 151 (1920), 1 USTC ¶386; cf. Greene v. United States, 78-1 USTC ¶13,240 (N.D. Ill. 1978).

D. What Amount Of An Expense of a Proper Type Is Deductible?

If an expense is of a proper type, such amount of it is permitted as a deduction as is "allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered." Code §2053(a)(2).

1. Deduction is authorized even if a local court has not approved the commission or fee.

   a. "On the other hand, a deduction for the amount of a bona fide indebtedness of the decedent, or of a reasonable expense of administration, will not be denied because no court decree has been entered if the amount would be allowable under local law."

   Reg. §20.2053-1(b)(2).

   * * *

   "(b) Executor's commissions. (1) The executor or administrator, in filing the estate tax return, may deduct his commissions in such an amount as has actually been paid, or in an amount which at the time of filing the estate tax return may reasonably be expected to be paid, but no deduction may be taken if no commissions are to be collected. If the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the final audit of the return, to the extent that all three of the following conditions are satisfied:

   "(i) The district director is reasonably satisfied that the commissions claimed will be paid;

"(ii) The amount claimed as a deduction is within the amount allowable by the laws of the jurisdiction in which the estate is being administered; and

"(iii) It is in accordance with the usually accepted practice in the jurisdiction to allow such an amount in estates of similar size and character.

"If the deduction is disallowed in whole or in part on final audit, the disallowance will be subject to modification as the facts may later require. If the deduction is allowed in advance of payment and payment is thereafter waived, it shall be the duty of the executor to notify the district director and to pay the resulting tax, together with interest."

Reg. §20.2053-3(b)(1).

* * *

"(c) <u>Attorney's fees</u>. (1) The executor or administrator, in filing the estate tax return, may deduct such an amount of attorney's fees as has actually been paid, or an amount which at the time of filing may reasonably be expected to be paid. If on the final audit of a return the fees claimed have not been awarded by the proper court and paid, the deduction will, nevertheless, be allowed, if the district director is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable remuneration for the services rendered, taking into account the size and character of the estate and the local law and practice. If the deduction is disallowed in whole or in part on final audit, the disallowance will be subject to modification as the facts may later require."

Reg. §20.2053-3(c)(1).

b. Whether the administration was formal or informal does not affect the deductibility of the fee or commission. Pitner, supra.

2. If a local court has not approved the commission or fee, the Internal Revenue Service has broad power to determine deductibility. Reg. §§20.2053-1 (b)(2), 20.2053-3(b)(1) and 20.2053-3(c) (1).

a. While section 2053(a) of the Code and the regulations (see the last sentence of regulation section 20.2053-1(b) (2) and all of regulation sections 20.2053-3 (b)(1) and 20.2053-3(c)(1)) require the Internal Revenue Service to defer to local law for principles to determine deductibility, the Internal Revenue Service is required to defer only to the pronouncement of those principles by the highest court of the state.

i. Commissioner v. Bosch, 387 U.S. 456 (1967), 67-2 USTC ¶12,472, held "that where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination of such property interest by a state trial court." Id. at 85,550.

ii. While the Internal Revenue Service must apply the law of the state, it has considerable latitude to formulate that law.

b. Additionally and most importantly, the Internal Revenue Service has exclusive authority to determine the facts.

3. Arguably, if a local court has approved the commission or fee, the Service's power to determine deductibility is more limited.

a. According to regulation section 20.2053-1(b) (2), "(2) Effect of court decree. The decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends. If the court does not pass upon those facts, its decree will, of course, not be followed. For example, if the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing the validity and amount of the claim. However, the decree will not necessarily be accepted even though it purports to decide the facts upon which deductibility depends. It must appear that the court actually passed upon the merits of the claim. This will be presumed in all cases of an active and genuine contest. If the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. If the decree was rendered by consent, it will be accepted, provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, if given by all parties having an interest adverse to the claimant. The decree will not be accepted if it is at variance with the law of the State; as, for example, an allowance made to an executor in excess of that prescribed by statute. . . ."

b. Regulation section 20.2053-1 (b)(2) dissipates Bosch to such extent, if any, as the regulation provides a result that differs from that which Bosch, in the absence of the regulation, would provide.

i. No regulation affected the result in Bosch.

ii. Here, on the other hand, regulation section 20.2053-1 (b)(2) specifically requires the Internal Revenue Service to defer, in certain circumstances, to the order of the local court.

iii. The critical question, of course, is whether, and to what extent, regulation section 20.2053-1(b)(2) provides a result that differs from that which Bosch would provide if the regulation did not exist.

c. Regulation section 20.2053-1(b)(2) forecloses Internal Revenue Service inquiry only if certain criteria are met.

i. The local court must pass upon the facts upon which deductibility depends.

(a) This is presumed in a genuine contest.

(b) A determination of the local court that is procured by fraud is not a determination on the facts.

(c) A consent decree is acceptable if, according to the regulation, "the consent was a bona fide recognition of the validity of the claim."

(i) The consent of all parties adverse to the claimant creates a presumption that the consent was a bona fide recognition.

(ii) This requirement disallows a deduction for what essentially is a gift.

ii. The Internal Revenue Service will not accept a decree that "is at variance with the law of the State; as, for example, an allowance made to an executor in excess of that prescribed by statute." Reg. §20.2053-1(b)(2).

(a) The scope of this exception is uncertain.

(i) Arguably, the exception was intended to apply to a commission that was determined on a percentage basis in excess of that which a statute prescribed.

(ii) The date of the regulation, June 23, 1958, lends credence to this supposition.

(b) If the exception also applies to a commission that is not percentage-determined, it always permits the Internal Revenue Service independently to determine the applicable law.

(c) If the exception always permits the Internal Revenue Service independently to determine the applicable law, what, if anything, is the function of the regulation?

(i) If the local court properly has determined and applied the law, the regulation appears to prevent the Internal Revenue Service from redetermining the facts.

(ii) This foreclosure, and, indeed, whether or not a local court order even exists, seem unimportant if the particular fee or commission is determined on a percentage basis according to a statute.

(iii) However, the foreclosure is potentially significant if the fee or commission is not determined on a percentage basis.

(d) Most compensation that is not determined on a percentage basis is determined on the basis of what is "reasonable."

(i) Determination of "reasonable" compensation appears to present <u>both</u> questions of law <u>and</u> questions of fact.

(I) Arguably, "reasonableness" subsumes various criteria that the court must identify, weigh and apply as a matter of law.

(II) Additionally, the court must determine, as a matter of fact, whether, based upon the criteria thus defined and evaluated, the compensation is "reasonable."

(ii) Stated differently, the quest for "reasonableness" seems inherently, and uniquely, to involve a tension between where, in the contemplation of the regulation, law ends and facts begin.

(iii) The results, if not the language, of many decisions indicate that courts of review often have treated the inquiry about reasonableness as consisting more of a determination of fact than a determination of law and, therefore, have deferred to the orders of the local courts. See, e.g., Rev. Rul. 69-551, 1969-2 Cum. Bull. 177; Bank of Nevada v. United States, supra; Craft v. United States, 80-1 USTC ¶13,327 (5th Cir. 1979), affirming per curiam, 68 T.C. 249; First National Bank of Nevada v. United States, 77-2 USTC ¶13,207 (D. Nev. 1977); J.M. Underwood v. United States, 69-1 USTC ¶12,591 (6th Cir. 1969); Cadden v. District Director, 62-1 USTC ¶12,058 (6th Cir. 1962); Estate of S.E. Bosworth, Executor v. United States, 57-1 USTC ¶11,662 (W.D. Wash. 1956); Estate of Charles F. Goodwin v. Commissioner, 53-1 USTC ¶10,886 (6th Cir. 1953); Schmalstig v. Collector, 42-2 USTC ¶10,205 (W.D.S.D. Ohio 1942); Estate of William G. Miller v. Commissioner, 21 T.C.M. 43 (1962); Estate of Minnie S. Pridmore, 20 T.C.M. 47 (1961); and Estate of Reuben J. Freed v. Commissioner, 6 T.C.M. 216 (1947).

(I) Courts of review often have asked whether the trial courts applied the proper law, i.e., did they determine whether the compensation was "reasonable."

(II) However, the reviewing courts generally have not reviewed the legal criteria that might underlie "reasonable."

(iv) One court of review appears to have moved, at least in its language if not its holding, far in the other direction. See United States v. White, supra.

(I) The Second Circuit in White stated that the regulation did not prevent the type of inquiry that Bosch, in the absence of the regulation, would permit.

(II) Expressed in the parlance of a bifurcation between determinations of law and determinations of fact, the Second Circuit appears to have treated the search for "reasonableness" as consisting more of a determination of law than a determination of fact.

(III) Thus, it allowed the Internal Revenue Service to probe the fact of reasonableness even though the Service apparently did not demonstrate that the local court misdetermined or misapplied the appropriate criteria.

(e) Treatment of reasonableness principally as a question of law tends to render regulation section 20.2053-1 (b)(2) a nullity.

(f) Stated differently, if (i) local law provides for "reasonable" fees or commissions and (ii) the Internal Revenue Service can ignore a local court's determination of what is reasonable, when, if ever, will regulation section 20.2053-1(b)(2) require the Service to defer to the determination of a local court?

d. The Seventh Circuit Court of Appeals, without mentioning or applying regulation section 20.2053-1(b)(2), has said that Code section 2053(a), _per se_, requires deference to local court orders. _Jenner_, supra.

i. _Jenner_ is among the cases that, in the context of the conflict about whether only state law or both state and federal law determine whether a particular expense is deductible, looked only to state law.

ii. The more important aspect of _Jenner_ for purposes of this part of the discussion is that the Seventh Circuit indicated that it generally would determine the applicable law of the state by deferring to the decree of a local probate court _if_ such a decree existed.

iii. According to Jenner,

> "As a general rule the decree of a probate court approving expenditures as proper administrative expenses under state law will control. This court held in Ballance v. Commissioner [65-2 USTC ¶12,331], 347 F.2d 419, 423 (7 Cir. 1965), that to ascertain whether a particular expenditure 'constitutes an allowable expense of administration' 'recourse must be had to [state] law . . . .
>
> "The Sixth Circuit has also concluded that the deductibility of the expense is governed by state law alone. Estate of Park v. Commissioner [73-1 USTC ¶12,913], 475 F.2d 673, 676 (6 Cir. 1973). . . ." 78-2 USTC ¶13,251 at 85,879.

iv. Since (i) the Seventh Circuit in Jenner did not mention or apply regulation section 20.2053-1(b)(2) and (ii) the action of the local court in Jenner arguably was weaker than that to which the regulation would require deference, the Seventh Circuit appears inherently to have said that (a) Code section 2053(a), per se, countermanded Bosch and dissipated whatever effect Bosch might have had in the absence of the statute and (b) the Seventh Circuit also would have required deference to the order of a local court in situations (including most allowances of fees and commissions) in which regulation section 20.2053-1(b)(2) clearly applied.

E. Internal Revenue Service Position.

The Internal Revenue Service has treated Code section 2053(a) and regulation section 20.2053-1(b)(2) as though they have not, or in some cases have but should not have, impeded seriously the Service's ability independently to determine the deductibility of a fee or commission that a local court has approved. The focus of the controversy is threefold.

1. First, the Service has rejected the <u>Jenner</u> view of Code section 2053(a).

2. Second, the Service has asserted that neither Code section 2053(a) nor regulation section 20.2053-1(b)(2) has prevented it from redetermining the ultimate conclusion about whether a fee or commission was "reasonable."

3. Third, the Service has asserted that both state and federal law determine whether an expense is of a proper type and, if it is, the amount of it that is deductible and that, in jurisdictions that accept this doctrine, a determination of a local court concerning the allowance of fees or commissions always is subject to federal law.

4. Perhaps the Service stated its position most comprehensively in two technical advice memoranda, 8636100 dated December 31, 1985, and 8838009 dated June 17, 1988.

    a. The latter amplified the former.

    b. The Service's amplification of the prior ruling was curious, since

        (i) the statute of limitations expired in June of 1986,

        (ii) the prior pronouncement was merely a private ruling and, thus, nominally neither usable nor citable as precedent and

        (iii) the latter ruling did not alter the Service's conclusion about the particular controversy.

    c. Technical Advice Memorandum 8636100 held that the Internal Revenue Service was required to defer to the determination of the local court.

        i. The Illinois Supreme Court had not "established a definite standard as to what constitutes reasonable compensation generally in probate matters."

ii. Therefore, according to the Service, Bosch permitted the Service independently to determine the applicable law.

iii. However, by noting that the Illinois Supreme Court had "ruled . . . that, in order to alter the amount of a fee allowance, a reviewing court is required to find that the trial court's determination is manifestly or palpably erroneous," the Service indicated that Bosch required the Service to defer to the local court to the same extent that the Illinois Supreme Court required appellate courts in Illinois to defer to a determination of a fee or commission by a local court in Illinois.

iv. The Service in any event reviewed Illinois law and was unable to determine that the local court had misconstrued it.

v. Additionally, since the Seventh Circuit in Jenner had indicated that even without regard to regulation section 20.2053-1(b) (2) it would defer to a state court decision, the Service believed that the Seventh Circuit would refuse to redetermine whether the fees and the commissions were reasonable.

e. Technical Advice Memorandum 8838009 reached the same holding as 8636100, but it amplified the earlier ruling.

i. "Under section 20.2053-1 and section 20.2053-3 of the regulations, in order for an administration expense to be deductible, the expense must be found to be reasonable both for purposes of (1) state probate law, and (2) federal estate tax law."

ii. "The Internal Revenue Service may independently determine the reasonableness of claims for administration expenses for purposes of section 2053 of the Code."

iii. "However, where, as here, the Seventh Circuit has ruled that there is no separate federal standard on the reasonableness of claims for administration expenses for purposes of section 2053, the issue is to be resolved solely on the basis of the state law standard of reasonableness."

f. The Service, in TAM 8838009, relied for its "amplification" on Pitner, supra, Smith, supra, and Hibernia, supra.

i. Pitner, supra, Smith, supra, and Hibernia, supra, are within the line of cases that refers both to state and to federal law to determine whether a particular expense is of a type that is deductible according to Code section 2053(a).

ii. Park, supra, Jenner, supra, and Ballance, supra, are within the opposite line of authority, i.e., the cases that hold that only state law determines whether expenses are deductible according to Code section 2053(a).

iii. In Hibernia, for example, the administrator of a decedent's estate borrowed funds to maintain the decedent's mansion until the administrator could sell it. The administrator was unable to sell it until seven years after the decedent died. The probate court approved the administrator's payment of interest for this purpose. However, the Internal Revenue Service disallowed the administrator's deduction of the interest for estate tax purposes. The only question was whether the interest payments were a type of expense that properly was deductible according to Section 2053(a) of the Code and section 20.2053-3(a) of the regulations. 78-2 USTC ¶13,261 at 85,931. The Ninth Circuit Court of Appeals believed that deductibility of the interest required that it be allowable under state law and also that it be an "administration expense" under federal law. Id. at 85,932. The district court had found that (i) the administrator had kept the estate open much longer than necessary, (ii) the administrator's expenditure of interest was largely for the convenience and benefit of the individual beneficiaries rather than of the estate and (iii) therefore, the expenditure was not an "administration expense" under Section 2053(a) of the Code.

g. Some of the line of authority that refers both to state and federal law to determine whether an expense is of a type that is deductible does not necessarily hold that the Internal Revenue Service independently can redetermine whether a fee or commission is reasonable.

   i. Neither Love nor Hibernia, for example, involved the question of whether the reasonableness (as opposed to the characterization) of an expense was a matter only of state law or a matter of both state and federal law. See Love, 91-1 USTC ¶60,056 at 18,354; Hibernia, 78-2 USTC ¶13,261 at 85,933, fn. 6; cf. Pitner, supra, and United States v. White, supra.

   ii. Bank of Nevada, supra, clearly addressed the question of what law determined the reasonableness of executor's commissions and attorney's fees.

      (a) The United States District Court for Nevada, which decided Bank of Nevada, is located in the Ninth Circuit.

      (b) Thus, as the court properly observed, Hibernia was binding upon it.

      (c) According to the court,

"Thus, the issue before the Court as framed is: did the District Director of Internal Revenue have the power under the facts of this case to go behind the final order of the [probate court] with respect to the award of Plaintiff's attorney's fees, either as a matter of state or as a matter of federal law?

"I must answer this two-part question in the negative both times. Accordingly, I grant Plaintiff's Motion for Summary Judgment." 80-2 USTC at 85,819.

* * *

"As I read [regulation section] 20.2053-3(c)(1), once an executor or administrator is awarded attorney's fees by the probate court and those fees are paid, and the executor or administrator actually deducts the amount on the Federal Estate Tax Return, all further inquiry by the Internal Revenue Service as to those fees must cease. . . ." Id. at 85,821.

5. A recent authority with respect to the effect of a local court decision concerning the amount of the deduction (rather than only the determination of whether the expense was an administrative expense) is United States v. White, 88-2 USTC ¶13,777 (2d Cir. 1988), certiorari granted, ____ U.S. ____ (1989), certiorari dismissed, ____ U.S. ____ (1989), supra, reversing and remanding, United States v. White, 87-1 USTC ¶13,710 (W.D.N.Y. 1987).

   a. The Second Circuit in White found that the Internal Revenue Service issued summons to the estate's attorney for a legitimate purpose, and, therefore, it ordered enforcement of the summons.

   b. The examiner had requested the attorney's time records or other documentation of legal work undertaken for the estate and had stated that the attorney was required to justify his fees notwithstanding that a local court had approved them.

c. The summons sought all records and documents that related to the administration of the estate, including records of the respondent's activities as attorney and as executor.

d. When the respondent refused to comply, the Service disallowed a deduction for his attorney's fee and disallowed a portion of the deduction the estate had claimed for his executor's commission.

e. Since the estate paid the deficiency and brought a refund action that was pending at the time that the Second Circuit rendered its decision, it is unclear whether the purpose of enforcement of the summons was to facilitate determination of the deductibility of the fees and commissions or was to facilitate the audit of the estate tax return generally.

f. Contrary to the Seventh Circuit in <u>Jenner</u>, the Second Circuit found that Code section 2053(a) and regulation section 20.2053-1(b) (2) merely indicated that Congress (in the case of the statute) and the Internal Revenue Service (in the case of the regulation) intended to absorb the state law into federal law and that the principles of <u>Bosch</u> permitted the Internal Revenue Service to determine the state law.

g. Perhaps most importantly, the Second Circuit said that although the highest court of the state had announced certain criteria as the appropriate basis for determining whether the fee was reasonable and the Service had to accept these criteria, <u>Bosch</u> permitted the Service to refuse to accept the manner in which the local court had <u>applied</u> the criteria.

h. Stated in the parlance of the division between questions of law and questions of fact, the Second Circuit apparently was saying that Bosch did not permit the Service to disregard the holding of a local court unless it disagreed with the court's construction of the law but that application of the law to the facts was itself a question of law and not a question of fact.

i. The Second Circuit appears to have said that regulation section 20.2053-1(b)(2) independently permitted the same scope of review as the statute and Bosch.

(i) Therefore, according to the Second Circuit, the regulation did not inhibit the Service from doing whatever it could have done if the regulation did not exist.

(ii) This interpretation, of course, tended to render the regulation a nullity.

j. As an independent basis for enforcement of the summons, the Second Circuit said that it believed that the Service had the right to investigate the existence of facts upon the basis of which, according to the regulation, the Service ordinarily would accept the decree of the local court.

6. The Service revealed in its Action on Decision for Bank of Nevada, supra, a different position with respect to regulation section 20.2053-1(b)(2).

a. Although the memorandum criticized the ratio decidendi, it recommended that the government not appeal.

b. According to the Action on Decision,

> "... neither do we read [the regulations] to endorse an inquiry under any and all instances of court awarded fees. The provision in Treas. Reg. §20.2053-1(b)(2) for ordinarily accepting the probate court's decree seems to require that

> in the absence of unusual circumstances, the decree be followed."
>
> * * *
>
> "While we disagree with the holding with respect to the scope of the district director's discretion, the outcome here is essentially correct. A fee of five percent of the estate is not unreasonable."

F. Planning.

Regulation section 20.2053-1(b)(2) and the Jenner interpretation of Code section 2053(a), where it applies, have planning implications. Before or when a dispute concerning deductibility arises, the lawyer should attempt to foreclose the dispute by obtaining the order of a local court.

1. If local law provides for "reasonable" fees, the lawyer should ask the court to determine that the fees are reasonable.

2. The lawyer should ask the court to recite as the basis for the determination such criteria for reasonableness as clearly are known or are unobjectionable.

3. The lawyer should consider asking the court in any event to recite that the fee is "reasonable considering all appropriate factors."

V. OTHER ISSUES.

An attorney additionally might argue that (i) the use of time (and time records) as the exclusive basis or as a principal basis for determining reasonableness is inappropriate, (ii) the system fails to accommodate the court's or the Service's right to obtain information and the attorney's duty not to disclose it, (iii) percentage-oriented fees and commissions are not illegal and (iv) an attack on the percentage-oriented commission of a particular executor requires an attack on the commissions of most executors. Even if the court or the Service is unwilling to say that it accedes to any of these arguments, it might wish to avoid the highly charged political issues that can reside at the margins of a court's attempt to disallow a fee or the Service's attempt independently to determine the deductibility of a fee or commission that a local court has approved.

A. Ethical Constraints.

Ethical constraints might prevent an attorney from disclosing the requested information.

1. Almost every sizable estate involves numerous tax questions and issues.

2. Only some of the issues are disclosed in tax returns.

3. Divulgence of an attorney's time and other records can divulge each and every tax issue or question (whether or not disclosed in a tax return) to which the attorney has devoted any attention.

4. Mandatory divulgence might lead to an untenable situation or to a drastically changed system of keeping of records.

5. A court probably can disallow a fee if a lawyer fails affirmatively to justify it.

6. Similarly, since the taxpayer has the burden of establishing entitlement to deductions, an attorney's refusal to comply with a request for information concerning an item for which a deduction is sought can lead to the denial of the deduction.

B. Right to Information.

The Internal Revenue Service might have a right to obtain some of the attorney's records, and other information in the attorney's hands, to enable it to audit the return generally, even assuming that the estate foregoes all deductions. See generally United States v. Lawless, 83-1 USTC ¶13,527 (7th Cir. 1983); and White, 88-2 USTC ¶13,777, supra; cf. United States v. Arthur Young & Co., 84-1 USTC ¶9305 (Sup. Ct. 1984).

1. The Seventh Circuit in Lawless, supra, for example, held that the attorney-client privilege did not prevent the Internal Revenue Service from obtaining

the information that the client had transmitted to the attorney to enable the attorney to prepare the estate tax return.

a. Although a distinction exists between (i) material that the attorney prepared and (ii) material that a client transmitted to the attorney, an attorney's records and files easily can integrate the two.

b. The attorney should consider preparing records and files so that compliance with the rationale of Lawless will not force the attorney to disclose his work product even if the estate is willing to forego a deduction for the cost of its preparation.

2. White, itself, is unclear about whether it presented the situation in which the Service's request for records was for the purpose of undertaking a general audit.

a. The estate had paid the deficiency that resulted from the Service's denial of deductions for a fee and a commission, but the Second Circuit nevertheless ordered enforcement of the summons.

b. The information that the Service had requested was not limited to that which might have justified the deductions.

c. Nevertheless, the Second Circuit's opinion focused solely on the Service's ability independently to determine the deductibility of the attorney's fee and the executor's commission.

C. Percentage-Based Fees.

Much of the support for imposition of time-oriented fees and some of the challenges to deductions apparently are based partly upon an erroneous assertion that percentage- oriented fees are illegal or unreasonable, *per se*, as a matter of federal law. *Cf*. *Goldfarb v*.

Virginia State Bar, 421 U.S. 773 (1975). Any implication that percentage fees are unreasonable, _per se_, probably would be a shock to the many fiduciaries and attorneys that, consistently with the laws of the states in which they operate, always or often charge on this basis.

D. _Ad Hoc Challenges_.

An effective attack against the disallowance of an executor's commission because it is based on the size of the estate might include a showing that most corporate fiduciaries render a percentage-based charge for services, that the disallowance solely of the commission of the particular fiduciary is _ad hoc_ and unprincipled and that other corporate fiduciaries might have a significant interest in the dispute.

1. The charge is based upon the rate schedule of the particular bank.

2. While each of the schedules is based upon the size of the particular estate, each generally is somewhat different as to amounts.

3. Some banks consider other factors including, without limitation, complexity, special problems, expertise and responsibility.

4. Each bank charges (or reserves the right to charge) additionally for any extraordinary work.

5. This writer's experience is that the corporate fiduciaries with which he works often maintain records of time expended, but they generally use these records for internal accounting rather than for calculating a fee in a particular case.

SETTING FEES IN AN ESTATES PRACTICE

Workshop Materials To Accompany
21st Annual Midwest/Midsouth Estate Planning Institute
Presentation By:

Jerold I. Horn
Law Office Of Jerold I. Horn
Peoria, Illinois

SETTING FEES IN AN ESTATES PRACTICE

Jerold I. Horn
April 13, 1994

WORKSHOP

1. X, a person who is unknown to the lawyer, telephones the lawyer and says, solely, (i) (a) can the lawyer write a "will", or, alternatively, (b) X needs two wills, two living trusts, two powers of attorney for property management, two living wills, and (ii) what will it or they cost. How should the lawyer respond?

2. Repeat #1, except X additionally asks if the lawyer will meet with X for one hour at no charge. How should the lawyer respond?

3. Repeat #s 1 and 2, except X does not ask what the work will cost. How should the lawyer respond?

4. Repeat #s 1, 2 and 3, except X additionally says that he has a "simple" situation and that his assets approximate $80,000 including face value of life insurance. How should the lawyer respond?

5. X, a person who is unknown to the lawyer, telephones the lawyer, says he would like to hire the lawyer to plan his estate and wants to know the cost. How should the lawyer respond?

6. If the lawyer wishes to charge a particular rate per hour for planning the estate of a particular client but believes that the fee will aggregate a particular amount, how should the lawyer present the fee to the client? Should the lawyer present the fee on the basis of a number of dollars per hour or on the basis of the total fee or on the basis of both?

Questions similar to these were used for a workshop conducted at the Philip E. Heckerling University of Miami Estate Planning Institute in January, 1990.

7. If the lawyer wishes to charge a particular number of dollars for planning the estate of a particular client, how should the lawyer present the fee to the client?

   (a) Should the lawyer render separate charges (for different services and documents) that aggregate the amount?

   (b) Alternatively, should the lawyer render a single charge for the amount and list (without separate charges) the services and documents for which the single charge is rendered?

   (c) If the former, should the lawyer (i) submit, in advance, a menu of "unbundled" services and products, and their costs, (ii) merely estimate, in advance, the aggregate fee, or (iii) not give any estimate in advance?

   (d) If the latter, should the lawyer estimate the fee in advance?

8. Judge Y is known to limit lawyer fees for probate work to $85 per hour. X wants to hire the lawyer to perform probate work in Judge Y's jurisdiction and is willing to pay the lawyer's charges of (i) $250 per hour or (ii) Z percent of the estate's assets (which rate aggregates more than $85 per hour). Can the lawyer charge more than $85 per hour? Consider:

   (a) Agreement between X and the lawyer that the lawyer will perform the work at a rate of (i) $250 per hour or (ii) Z percent of the estate's assets (which rate aggregates more than $85 per hour).

   (b) "Quick" probate.

   (c) Avoidance of probate.

   (d) Charge of (i) $250 per hour or (ii) Z percent of the estate's assets (which rate aggregates more than $85 per hour), presentation of the fee for approval, justification of the fee, appeal of adverse decision.

9. During the audit of an estate tax return, the Internal Revenue Service tells the lawyer that it wishes to review each of the following, in the alternative:

   (a) The lawyer's time records;

   (b) All material that the executor submitted to the lawyer;

   (c) The lawyer's "matter" file; and

   (d) All of the lawyer's information concerning the matter.

   How should the lawyer respond?

10. Repeat #9, except a probate court, not the Internal Revenue Service, is making the inquiry.

FAMILY PARTNERSHIPS IN ESTATE PLANNING

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SECTION E

FAMILY PARTNERSHIPS IN ESTATE PLANNING

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FAMILY PARTNERSHIPS IN ESTATE PLANNING

July, 1994

1. Where To Begin.

a. As estate planners, we use tools of many different kinds to help our clients reach their estate planning goals. These tools include wills, trusts, and direct interests such as life estates and remainder interests. Sometimes, corporations have been employed when an entity was desired, often to allow transfers of increments of value while retaining unity of title and management control. But corporations tend to be somewhat rigid, and moving in and out of a corporate vehicle can be both difficult and expensive, and the repeal of the "General Utilities" doctrine in 1986 and resulting increase in tax cost of transferring assets out of corporations has led to an increased interest in partnerships for this purpose.

b. Family estate planning often means dealing not only with an individual but also with a spouse and other family members. When a closely held business is a part of the picture, it is not unusual for other family members to be involved. Often the level of participation varies substantially among those family members who are involved in the family business. Sometimes, their involvement is direct, in that there is active participation in the business management or its operation. However, it is not unusual to find objects of the client's bounty who are not involved in the business at all. This can lead to a need to separate the value and benefit of assets from their management or control. In such situations, an entity between the assets and owners is necessary. Trusts are frequently employed, but their use is generally confined to investment assets. Corporations, partnerships, and, now, limited liability companies, are better suited to operating businesses than trusts.

c. In determining whether an entity would be helpful in a given setting, it is important to focus on the client's purposes, goals and abilities. The most intricate and technically competent plan is useless if it does not help reach the client's goals. Once it is determined that the estate plan could benefit by the establishment of a new entity, the process of developing and implementing a plan should be systematic, with careful attention being given to the selection of the entity, the structuring of the entity, and the implementation of the plan.

2. Overview of Partnerships.

Partnerships are familiar organizations, with almost everyone being a partner in some enterprise at some time. Partnerships fall into two broad categories, general partnerships and limited partnerships. If the requisite formalities are observed, some of the partners in the organization may have their exposure to business risks limited in a limited partnership. If those steps are not taken, the result is a general partnership, and each of the partners will have full responsibility for all of the obligations of the organization.

a. General Partnerships.

(1) General. The Uniform Partnership Act defines a general partnership as the association of two or more persons to carry on a business as co-owners for profit. Joint ventures are sometimes described as partnerships with a singular purpose or activity, but they are, nevertheless, partnerships.

(a) For many purposes, a general partnership is treated as a separate business entity; a general partnership may own its own property and conduct its own business in its own name. However, for other purposes, the partnership is treated as an aggregation of the individual partners rather than an independent unit in and of itself.

(b) Due to the mixture of individual and aggregate characteristics associated with partnerships, partnership law can be described as a case of multiple personalities.

(2) Formation. The formation of a general partnership is relatively simple and often happens as a result of the conduct of the parties or other informal arrangement rather than by written agreement. Because of the ease and informality of formation, general partnerships are a popular form for conducting business. Generally, except for any requirements for registration of assumed or business names and local business licenses, no formal filing with any public office is required and the arrangement among the partners can be very simple. Partnership agreements need not be written, but written partnership agreements are always recommended; a clear written record of the arrangements between the partners is strongly suggested, so that the rights and relationships of the partners among themselves are well defined. Each partnership agreement should at least address issues as term, continuity, management, contributions to capital, and sharing of profits and losses.

(a) Under the Uniform Partnership Act, generous flexibility is allowed in the development of the governing structure for a partnership. Notwithstanding general rules requiring the agreement of all partners for many important matters, the partners may agree that those general rules be modified or customized to fit their particular needs. Partnership agreements range from very short and simple arrangements to very lengthy and highly technical agreements incorporating precise and detailed provisions dealing with matters such as governance, delegation of authority, and other matters.

(b) Management and participation in control rights are often addressed in great detail; in large partnerships, there is likely to be some form of centralized management.

(3) Control. Management authority and control in a general partnership is dispersed among the partners rather than centralized. Each partner is treated as the agent of all other partners and the partnership.

(4) Fiduciary Duties. General partners have important duties to each other in connection with their partnership activities. These fiduciary-like obligations of good faith, loyalty, and fairness balance the broad authority each individual partner has to bind the other partners. These responsibilities also reflect the degree of trust required in order to create and operate an effective partnership.

(5) Liability. A consequence of the mutual agency concept is unlimited liability of all partners for partnership obligations and the acts of the other partners. The impact of one partner's conduct on the treatment of other partners can be both surprising and severe.

(6) Transferability. The interests of the partners in a general partnership are seldom transferable with any degree of freedom. Because of the close relationship arising out of the mutual agency of partners, many events, such as the admission of a new partner, occur only with the approval of all partners. As a result, an interest in a general partnership is illiquid and cannot be sold or transferred without the approval of the other partners. Even in large partnerships where many management functions are centralized by agreement, it is unusual for partners' interests to be freely transferable.

(7) Continuity of Life. Although the life of a partnership may be extended by agreement of remaining partners, it remains finite. Dissolution of a partnership occurs in a variety of circumstances, such as a death of a partner, but dissolution does not necessarily lead to a termination of a partnership if the business is continued by the remaining partners. On the death of a partner, the decedent's estate succeeds to the decedent's interests in the partnership but does not become a partner. Of course, surviving partners have a duty to account to the successors of the deceased partner. Buy-sell arrangements can and are used to simplify this process and provide for greater certainty.

(8) Income Taxation. Partnerships are largely transparent for federal income tax purposes, in that partnership income or loss is passed through the partnership to the respective partners based upon their agreement for sharing such matters. Code § 702. As noted, substantial flexibility is allowed and the partners may vary their respective interest in different items.

(a) The determination of whether a state law partnership will be characterized as a partnership for income tax purposes is made under Code § 7701. In general, finding an organization to have a majority of the corporate characteristics set out in the Regulations results in the organization being treated and taxed as a corporation, even though it is a partnership under local law. The testing process examines the following characteristics: (i) centralization of management, (ii) limited liability, (iii) continuity of life, and (iv) free transferability of interests. Regulation § 301.7701-2.

(b) Ordinarily, there are no tax consequences in the contribution of property to a partnership or in the distribution of property by a partnership to a partner. Code §§ 721 and 731. Special rules are provided for contributions of appreciated property, so that the inherent gain or loss in such property is allocated to the contributing partner, and for contributions of encumbered property. Code §§ 704 and 752. Special rules for accounts receivable and appreciated inventory are provided at Code § 751.

(c) Their great flexibility makes partnerships a very common form of business organization. In cases where one partner contributes capital while another contributes services and the partners agree to share the income or loss of their venture equally, the individual accounting for capital used in partnerships rather than accounting for capital for the entity as a whole easily accommodates the arrangement.

(d) Within the framework of the extensive Treasury Regulations dealing with allocations among partners and whether the provisions have substantial economic effect, profits and losses and other interests in the partnership may be allocated and shared among the partners in a variety of different ways within the same partnership. See Regulation § 1.704.

(e) Notwithstanding the general rules that gain or loss is not recognized upon the contribution of property to a partnership, a shifting of capital contributed by one partner to the credit of a partner providing services looks like and is likely to be treated as compensation to the service partner. Regulation § 1.721-1(b)(1). On the other hand, in the context of a family partnership, the shifting of a capital interest may be viewed as a gift.

(9) Raising Capital. Broad mutuality and joint and several liability limit the ability of general partnerships to raise capital from unrelated sources. By definition, ownership of an equity interest in a general partnership equates with the status of a general partner. And outside investors generally insist that their exposure to business risks be limited to no more than their investment.

(a) To the extent adequate capital cannot be borrowed by the partnership, expansion of businesses organized as general partnerships must rely upon the income generating power of the partnership or the ability of its partners to fund such capital needs from personal assets or from personal borrowings.

(b) Capital needs may dictate a different form of organization.

(10) Securities. Ordinarily, securities law issues do not arise in the context of general partnerships, as an interest in a general partnership does not usually meet the tests for finding a security.

(a) The fundamental test of whether an interest is a security is called the risk capital test; one statement of this definition is stated as an "investment made in an enterprise with the expectation of making a profit from the efforts of others".

(b) As a result of the mutual agency and the rights of all partners to be involved in management and control, and the resulting absence of separation between capital from control, an interest in a general partnership usually is not a security. Thus, the disclosure and registration requirements of state and federal securities laws do not generally apply to interest in a general partnership. However, because of the broad flexibility allowed in partnership agreements, it is possible to turn a general partnership interest into a security governed by such law.

(c) When forming a partnership with centralized management features and limited management participation by most partners, inclusion of investment representations on the part of the capital partners is recommended.

b. Limited Partnerships.

(1) General. Limited partnerships are a form of partnership having both general and limited partners. General partners retain the same mutual agency and broad responsibility for partnership obligations discussed in the context of partners in general partnerships. On the other hand, limited partners are prohibited from participation in the management of the business and are not responsible for the obligations and debts of the business beyond their agreement to contribute capital to the partnership.

(2) Formation. Formation of a limited partnership is more objective and formal than with a general partnership; formation requires the preparation and filing/recording of a certificate of limited partnership with a designated public office. Ordinary practice is to limit the certificate to the elements required by statute and to gather the substantive provisions dealing with the relationship among the partners, such as term, management, capitalization, and sharing of profits and losses in a separate limited partnership agreement which need not be filed or recorded.

(3) Control. Management of a limited partnership is centralized in the general partner or partners, and the limited partners are not permitted to participate in the management of the partnership's business without losing their protection as limited partners. This separation of ownership and management is one of the principal differences between limited partnerships and general partnerships. Some limited participation through voting on major issues is generally permitted.

(4) Fiduciary Duties. As with general partnerships, the general partners in a limited partnership have important duties to each other and to their limited partners in connection with their partnership activities. Fiduciary-like obligations of good faith, loyalty, and fairness balance the broad authority of the general partners to bind the other partners. These responsibilities also reflect the degree of trust required in order to create and operate an effective partnership.

(5) Liability. While the general partners in a limited partnership retain the same full responsibility for partnership obligations of partners in a general partnership, limited partners ordinarily are at risk only to the extent of their agreement to contribute to the partnership's capital.

(6) Transferability. While the interests of limited partners are more readily transferred than is the case with general partners, free transferability of those interests is seldom allowed in order to protect the income tax status of the partnership. As is the case with general partnerships, free transferability of the interests of general partners in a limited partnership is rarely provided.

(7) Continuity of Life. Although the life of a limited partnership may be extended by agreement, its life remains finite. Continuation of a limited partnership by the terms of the agreement does not necessarily indicate an unlimited life.

(8) Income Taxation. Like general partnerships, limited partnerships are largely transparent for federal income tax purposes.

(a) While most limited partnerships organized under local law will be characterized as partnerships for income tax purposes, the characterization for tax purposes of a limited partnership can be a closer question than with a general partnership and it is possible to be too clever in drafting.

(i) Because only the general partners participate in control, centralization of management is present in a limited partnership. Regulation § 301.7701-2(c).

(ii) Limited liability for this purpose does not exist even with a limited partnership _if_ any partner is personally liable for the partnership's obligations. Regulation § 301.7701-2(d). Use of a shell corporation owned by the limited partners as the general partner in a limited partnership may change the result and yield a finding of limited liability. Regulation § 301.7701-2(d)(2).

(iii) Limited partnerships formed under the Uniform Limited Partnership Act generally lack continuity of life for these purposes. Regulation § 301.7701-2(b).

(iv) Where the limited partnership agreement restricts the transferability of limited partner interests by not allowing the transferee the benefits of being a limited partner in the absence of the approval of the other partners, free transferability of interests should not be found to exist. Regulation § 301.77-1-2(e)

(b) Once characterized as a partnership, the tax attributes of a limited partnership are much the same as for a general partnership.

(9) Raising Capital. The separation of ownership or capital interests from management and liability works in favor of the limited partnership when it comes to raising additional capital. The standard requirement of outside investors that their risks be limited to their invested capital can generally be met using a limited partnership.

(a) In some businesses, notably the operation of rental real estate and others which can easily be operated through hired management, the limited partnership form of conducting business has been used often due to the transparency of the entity for income tax purposes while retaining liability protection for investors uninvolved in management.

(b) However, excesses in earlier decades with syndicated real estate limited partnerships have led many to dislike the limited partnership form for doing business.

(10) Securities. At least as to the limited partners, the risk capital test addressed earlier is met in the case of a limited partnership, as the limited partners by definition make their investment seeking a profit through the efforts of the general partners. As a result, federal and state securities laws generally do apply to those interests and, unless an exemption is found, limited partnership interests are required to be registered under applicable securities laws before they are sold. Note that exemption from these registration requirements is not an exemption from the disclosure and anti-fraud rules of state or federal securities laws.

(a) The most often relied upon exemptions from the registration requirements of federal securities laws include the intrastate exemption and private placement exemption. State securities laws generally provide similar exemptions from registration requirements. For example, Tennessee securities laws exempt placements involving $100,000 or less and placements to 15 or fewer persons for investment purposes from the otherwise mandatory requirement for registration.

(b) Inclusion of investment representations on the part of the limited partners is recommended.

(c) Once an interest is characterized as a security, the anti-fraud provisions of the various securities laws must also be addressed in connection with the sale of any limited partnership interest, as there are no exemptions from those requirements.

3. Making the Choice.

a. The decision to use an entity and the choice of which form of entity to use in the context of estate planning is a highly subjective process. Some considerations in selecting the entity are:

(1) When the nature of the assets or business or other reasons suggest a need for limited liability, use of an entity is indicated. If ownership is already separated from management, a corporation may be suitable. However, if the client and/or family members are directly involved in operations, a partnership may also prove suitable. Low risk investment activities and passive operations with readily insurable risks favor selection of more flexible partnerships over corporations. When a trust is involved, a limited partnership or corporation is generally indicated to separate the fiduciary from operations. If the business is already operating in corporate form, a limited partnership with the owner/donor as the general partner may be indicated as a means of facilitating gifts without loss of control.

(2) Separation of ownership from control can be achieved with trusts and corporations as well as with limited partnerships. However, while trusts are very effective when funded with investment assets, they tend to be cumbersome vehicles for the operation of a business. Also, retention of valuable interests by the donor yields adverse estate tax consequences. With corporations, a shift in voting control can result from a systematic gift making program involving the transfer of stock. Limited partnerships allow control

to be lodged with the general partner(s) without regard to the amount of value shifted through transfers of limited partner interests. A limited partnership can also be useful where it is important to vest control of the family business in one group or to isolate others from management while providing them with the benefits of ownership.

(3) It may be necessary to fragment value in order to engage in a regular gift making program. When a client's business is most of the client's net worth, or when the growth of the business hampers available liquidity, the ability to engage in a routine gift making program is reduced. Organization of the business into limited partnership form provides the means to make gifts without impacting liquidity or control.

(4) Capital structure and income allocation goals of the client are important factors to consider. Within a class, stockholder interests in a corporation are necessarily uniform. However, the interests of each partner in capital and income can be tailored to fit specific needs or circumstances. Some limited shifting of income may be achieved within the limitations of the family partnership rules; retention of income for the donor partner through employment and similar arrangements can provide further benefit. The flexibility of individual capital accounting in partnerships facilitates contributions and distributions of property by partners.

(5) Protecting operating assets from creditors of a participant can be important. Creditors of a limited partner are in much the same position as the creditors of a shareholder; distributions made can be reached but the creditor generally has no ability to reach the assets and properties of the entity. Limited partnership agreements typically place tight restrictions upon the transfer of general partner interests, but the protection for assets of a transferor general partner is not as complete.

(6) Basis and other income tax aspects on formation, operation, and termination of an entity vary widely between corporations and partnerships. Most important among those differences is the "inside tax" upon the disposition of assets by a corporation, whether from a sale or upon a distribution to shareholders or at liquidation, without regard to the "outside" basis of the equity owner in the shares. Upon the death of a partner, the step up in the "outside" basis of the partner can be shifted to assets without an "inside tax".

(7) Without any doubt, the client's ability and willingness to observe the requisite formalities and details of the recommended plan is an important factor in selecting an entity. Some clients simply don't belong in the middle of a complicated entity of any kind. Careful explanations can assist the unfamiliar client and be the difference between success and failure. Licensing requirements and the dictates of existing loan and other contracts should be carefully reviewed to discern their impact on planning alternatives.

(8) Reduction in estate settlement costs can be a significant benefit of using an entity in estate planning. Bringing multiple assets under a single umbrella can greatly relieve the executor. When a trust is desirable for other reasons, the use of a limited partnership for the ownership of an operating business can separate the difficulties of managing that business from an otherwise reluctant fiduciary.

(9) Obtaining discounts in valuing interests from the value of the underlying assets is an important aspect of estate planning for clients. Discounts increase the leverage of gift making, but don't forget they are allowed because they are real. With the bunching of taxes at the second death for a married couple, the ability to shift increments of ownership at reduced value can result in significant tax savings even when the discount is small.

b. When considering use of a family partnership as an estate planning tool, the basic characteristics of partnerships should be considered along with these factors and more traditional estate planning goals in formulating a plan.

4. Selected Partnership Income Tax Issues.

a. Family Partnership Rules. The provisions of Code § 704(e) were originally intended to prevent the shifting of income among family members at a time when income tax rates were substantially higher than today. These rules are applied to determine the validity of the partnership on a partner-by-partner basis for income tax purposes. The application of these requirements and transactions among family members may receive close scrutiny. Regulation § 1.704-1(e)(1)(iii).

(1) While the transfer of a naked interest in the profits of a partnership may not be respected, a person holding an interest in partnership capital will be recognized as a partner for income tax purposes if capital is a material factor in producing the partnership's income. Code § 704(e)(1).

(2) Capital is a material factor in the production of a partnership's income if a substantial part of the partnership's gross income is derived from capital employed in the business, whether in the form of inventory, equipment, or plant. Regulation § 1.704-1(e)(1)(iv).

(3) When capital in not a material factor in the production of the partnership's income, allocation of partnership income to non-participants may be challenged under the provision requiring income to be allocated to those who earn it. Regulation § 1.704-1(e)(1)(i).

(4) Under the Regulations, separate capital accounts are established for each of the partners. Beginning with a zero balance, these capital accounts are then credited with contributions made by a partner to the partnership's capital and with the partner's share of partnership profits; the capital account is also debited with the amount of distributions made to the partner and with the partner's share of partnership losses. Regulation § 1.704-1(b)(2)(iv)(b).

(a) By providing in the family partnership agreement for the transfer of a proportionate amount of capital with any transfer of an interest in the partnership, proportionality between interests in the partnership's capital and its profits can be maintained.

(b) Purchases of partnership interests by one "family" member from another are treated as if acquired by the purchaser by gift from the seller. Code § 704(e)(3).

(c) For these purposes, "family" includes a person's spouse, ancestors, and lineal descendants. Code § 704(e)(3).

(5) Even if the foregoing tests are satisfied, a donor's retention of excessive control can result in the partnership not being recognized as to the affected partner. Regulation § 1.704-1(e)(2)(ii) provides a listing and discussion of various factors to be considered in judging whether a donee is to be recognized as a partner.

(6) When the subject of the gift is an interest in a limited partnership, restrictions and limitations consistent with those applicable to other limited partners and with those found in ordinary business relationships should not prevent recognition of the donee as a partner. Regulation § 1.704-1(e)(2)(ix).

b. <u>Disguised Sales.</u> Under Code § 707(a), a partner may engage in transactions with a partnership and obtain the same tax treatment that would be obtained without the relationship. Thus, a partner may sell or lease property to his own partnership and be treated as a seller or landlord. However, in the context of an estate planning partnership, properties are usually contributed to the partnership and sale treatment is neither intended nor desired. As noted earlier, contributions of property by a partner to a partnership and the distribution of property by a partnership to a partner generally are non-recognition transactions for income tax purposes.

(1) In general, Code § 704(c) directs that any unrealized appreciation at the time of the contribution of property to a partnership is to be suspended and then in effect specially allocated to the contributing partner when the partnership disposes of the property.

(2) And, notwithstanding the general rule for non-recognition of gain or loss on the contribution of property to a partnership, the distribution of contributed property by a partnership within 5 years of its contribution to a partner other than the partner who made the original contribution may be treated as a sale of the property by the original contributing partner at its then fair market value. Code § 704(c)(1).

c. <u>Investment Company.</u> The general rule of non-recognition of gain or loss by a partner upon the contribution property to a partnership is also not available where the transfer is to an investment company. Code § 721(b).

(1) To be an investment company for these purposes, more than 80% of the partnership's non-cash and non-debt assets must be readily marketable stocks or securities or interests in regulated investment companies or REITs. Regulation §1.351-1(c)(1)(ii).

(2) To be a transfer to an investment company, the transfer must also result in diversification of the transferring partner's interests to be denied non-recognition treatment. Regulation §1.351-1(c)(1)(i). Transfers of identical assets do not result in diversification. Regulation §1.351-1(c)(5). This has led to the suggestion that when marketable securities are involved in the formation of a family partnership, the diversification element can be avoided by pre-contribution gifts of the same securities to the other partners, who then contribute the securities to the partnership.

d. Taxable Year. Special rules establishing the taxable year of a partnership are set out in Code § 706.

(1) When planning for any transfer of an interest in a partnership, careful attention must be paid to special rules for closing a partnership's taxable year with respect to a partner and the rules for allocating partnership items between the transferor and transferee. Code § 706(c).

(2) Note that the taxable year of a partnership does not close due to the death of a partner. Code § 706(c)(1). Thus, partnership income or loss for the entire taxable year of the partner's death will be reflected on the decedent's estate income tax return and not on the partner's final individual return. Regulation § 1.706-1(c)(3).

5. The Special Valuation Rules of Chapter 14.

a. Code § 2701. Gifts are frequently contemplated as a part of an estate plan. That is especially true in those estate plans which invoke the use of a family partnership as a tool, as the reason for doing so is often to facilitate making "gifts by the slice".

(1) Generally, whether a gift has been made is determined under Code § 2511 and the value of a gift is determined under Code § 2512 by reference to the value of the interest transferred to the donee. However, when the subject of the gift is an interest in a partnership and the transfer is to a "member of the family", the application of the special rules of Code § 2701 must be considered.

(2) The provisions of Code § 2701 are directed at partnerships which have been structured to allow the shift of future growth while "freezing" the value of the interest retained by the donor partner at a fixed amount.

(a) Such "freeze" partnerships are structured with preferred or senior interests and common interests. Like in the case of their corporate counterparts, the preferred interests may provide for preferential distributions in a fixed amount, which may or may not be cumulative, and for a priority claim on the distribution of assets at liquidation. Such interests may also include the right to cause the interest to be redeemed upon certain events. These "senior" interests tend to depress the current value of the junior or common interests, allowing such junior interests to be given to other, usually younger, family members at a reduced value.

(b) The purposes of Code § 2701 are accomplished by preventing the use of unreasonably low valuations of such transfers through a mandated subtractive valuation methodology. Regulation § 25.2701-3(b). In simplified form, the value of a gift subject to Code § 2701 is determined by first valuing the interests in the partnership held by the transferor and then subtracting the value of certain qualified retained interests after the gift is made; all retained interests other than certain qualified interests are valued at zero, increasing the value of the interest transferred to the donee. Code § 2701(c)(3).

(3) By using two distinct definitions of various family members, the application of Code § 2701 is limited to transfers by the transferor to a member of the same or a lower generation as the transferor, "member of the family", in which a member of the same or a higher generation as the transferor, "applicable family member", is left with an "applicable retained interest".

(a) "Members of the family" includes the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and the spouses of such descendants. Code § 2701(e)(1).

(b) "Applicable family member" is separately defined to include the transferor's spouse, ancestors of the transferor and transferor's spouse, and the spouses of such ancestors. Code § 2701(e)(2).

(c) In general terms, an "applicable retained interest" is a senior equity interest, involving either a liquidation, put, call, or conversion right or a distribution right.

(4) Notwithstanding the complexity of these provisions, the exceptions to the application of Code § 2701 provide relief to many family partnerships.

(a) Though not usually of significance in the context of a family partnership, exception is provided if either the transferred interest or the retained interest is readily marketable on an established securities market. Code § 2701(a)(2)(A).

(b) Exception is made when the interest retained by the donor partner is of the same class as the transferred interest. Code § 2701(a)(2)-(B). Thus, gifts of limited partner interests by a partner who holds limited partner interests after the transfer are excluded from Code § 2701.

(c) Exception is also made when the interest retained by the donor partner is proportionately the same as the interest transferred. Code § 2701(a)(2)(C). In applying this exception, the Code directs that non-lapsing differences in management and limitations on liability be ignored. As the principal differences between general and limited partner interests are their differing rights as to management and limitations on liability, the effect is to except from the application of Code § 2701 those straight partnerships having only general and ordinary limited partners. Regulation § 25.2701-1(c)(3).

(5) To balance the impact should Code § 2701 apply, provision is made for appropriate adjustments to be made to prevent double taxation upon the later transfer of a retained interest artificially valued at zero. Code § 2701(e)(6).

b. Lapsing Rights. Prior to the enactment of Chapter 14, the Tax Court allowed a substantial valuation discount for estate tax purposes of a partnership interest where the partnership agreement provided that the decedent's right to cause the liquidation of the partnership lapsed at his death. Estate of Harrison, 52 TCM 1306 (1987).

(1) Code § 2704 now directs that the lapse of voting or liquidation rights is to be treated as a gift or transfer at death if the holder of the right at the time of its lapse and such holder's family control the entity before and after the lapse. Code § 2704(a)(1).

(a) In the case of a family-controlled partnership, the lapse of voting or liquidation rights of one partner arising from an amendment to a partnership agreement would be treated as a gift.

(b) Members of the family for this purpose are defined to include the holder's spouse, ancestors and descendants of the holder or the holder's spouse, siblings of the holder or the holder's spouse, and any spouse of any such ancestor, descendant, or sibling. Code § 2704(c)(2).

(c) As under Code § 2701, control in the case of a partnership is defined as a 50% or larger interest in partnership capital or profits or, in the case of a limited partnership, any interest as a general partner.

(2) The value of the transfer is to be the value of the interest immediately before the lapse reduced by its value immediately after the lapse. Code § 2704(a)(2). As a result, a partnership agreement provision converting a general partner's interests in a partnership at death to a limited interest with reduced voting and/or reduced liquidation rights, would not provide any reduction in value for estate or generation-skipping transfer tax purposes.

(3) Note the grant of broad rule making authority to apply this treatment to other restrictions. Code § 2704(a)(3).

c. Valuation Adjustments. Transfer tax schemes are generally based upon the application of a progressive rate structure to the fair market value of the interests transferred. Code §§ 2512 and 2031. And, the valuation process often relies upon comparisons to transfers of similar assets between other persons, whether that marketplace is large, such as with listed stock, or much smaller as with real estate.

(1) Discounts for minority interests are allowed in order to properly reflect the impact of fragmenting ownership upon the value of an asset as a whole.

(2) Premiums have been accorded to interests in corporations which, even though representing less than 100%, constituted control. Estate of Chenoweth v. Comm'r, 88 T.C. 1577 (1987).

(3) Discounts for lack of marketability are allowed in order to properly reflect the impact upon the value of an asset of restricting the marketplace for its disposition.

(4) Reversing a long held position, the IRS now allows minority discounts in transfers without regard to the family relationship of the donees. In a transaction where the donor gave a 20% interest in the entity to each of his five children, the interests of the donees were not aggregated and a minority discount was allowed for each of the five gifts. Rev. Rul. 93-12, IRB 1993-7, 13.

(a) Although Rev. Rul. 93-12 involved corporate shares, it should apply equally well in the case of gifts of partnership interests.

(b) Note the Rev. Rul. 93-13 is also a two-edged sword, effectively reducing the amount of a deductible transfer, such as a bequest otherwise qualifying for a marital or charitable deduction, when the gift is funded with a minority interest. TAM 9403005.

6. Control Related Issues.

a. Present Interest Exclusion. Concern has been expressed about whether the gift of a limited interest in a limited partnership qualifies for the present interest exclusion under Code § 2503 when the donor is a general partner.

(1) In LTR 9131006, the IRS held that when the donor does not retain any dominion or control over the limited interest, the gift is complete and qualifies for the annual exclusion even when the donor remains a general partner.

(2) The same result was reached in LTR 9415007.

b. Retained Powers. Concern has also been expressed about whether a transferred limited interest in a limited partnership would be includible in the donor general partner's estate under Code § 2036 or § 2038 on the basis of retained control in the donor's capacity as general partner. Citing U.S. v. Byrum, 408 U.S. 125 (1972), and referring to the fiduciary duties of a general partner, in LTRs 9131006 and 9415007 the IRS held that the interests transferred were not subject to Code § 2036 or § 2038 and, thus, that the transferred limited partner interests remained outside the donor's estate at death.

7. The Family Partnership.

a. Ethics. As with any estate planning matter, careful attention should be focused upon all applicable ethical considerations. By definition, each situation where a partnership might be considered in the context of estate planning will involve at least two partners. Identification of the client can be difficult in these circumstances. While the difficulties may be no more than ordinarily encountered as long as the only partners are husband and wife, once interests are given to others, the complexities can escalate dramatically. It is suggested that at a minimum each person involved should be provided with a written description of the plan and transactions and of the potential for future conflict.

b. Implementation. Once developed, implementation of the plan should take into account the client's goals and the outcome of considering the various planning factors noted earlier. Documentation should be complete and all necessary formalities should be followed.

(1) Exposition of the principle goals and purposes of the plan in the preamble or recital portion of the partnership agreement will not only assist the client to keep these factors in mind but also will help establish the business purpose of the transaction.

(2) Structure the provisions for allocating income and loss among the partners with a view to Code § 704, both as to "substantial economic effect" and as to the family partnership rules of Code § 704(e).

(3) Consider restrictions and other provisions needed to implement the client's intent as to matters such as the circumstances and method for removal of a partner, rights of first refusal and other restrictions on disposition of interests in the partnership, and management.

(4) Determine to what extent outside appraisals are desirable and make recommendations to client.

(5) Carefully review all documents for compliance with local requirements and to assure that the entity created is indeed a partnership, both under local rules and for income tax purposes.

c. Follow-up. Once organized, follow through with all necessary conveyances to the partnership. In the event of gifts, gift tax valuation and return requirements should be addressed.

d. Caveat. Family partnerships have received a great deal of attention in recent years. Articles have appeared in Business Week, Forbes, and other business publications in addition to increasing attention in professional publications and programs. This atmosphere leads me to suggest that careful attention be paid by the practitioner to basics in each family partnership, because the Internal Revenue Service will be doing just that. For example, remembering that partnerships are based upon business and profit purposes and the recital of those purposes and generalized goals in the agreement may be wise steps in the event the client taxpayer is called upon to demonstrate the business purpose behind formation of the entity. Such care should go far in avoiding the result in Estate of Murphy where the Tax Court held that transactions with no purpose or effect other than their tax impact should be disregarded for those purposes. Estate of Murphy, 60 TCM 645 (1990).

USE OF LIMITED LIABILITY COMPANIES IN ESTATE PLANS

- Federal Income Tax Treatment of Operating As A Limited Liability Company -

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FEDERAL INCOME TAX TREATMENT OF OPERATING AS A LIMITED LIABILITY COMPANY

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FEDERAL INCOME TAX TREATMENT OF OPERATING AS A LIMITED LIABILITY COMPANY

Charles J. Lavelle, Esq., Greenebaum Doll & McDonald and Lady E. Booth, Esq., Ogden Newell & Welch

I. INTRODUCTION TO CLASSIFICATION ISSUES

The structure and usefulness of a Limited Liability Company ("LLC") is usually dependent upon the determination that it will be treated as a partnership under federal tax law. Therefore, a practitioner must be familiar with the rules governing classification in order to structure an LLC that meets the needs of the owners without unwittingly triggering corporate taxation.

The Internal Revenue Code ("I.R.C.") recognizes and provides rule for the taxation of four general categories of taxpayers:

a) Individuals;[1]

b) Corporations (which includes "associations taxable as corporations");[2]

c) Partnerships;[3] and

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[1] I.R.C. Subchapters A and B.

[2] I.R.C. Subchapter C.

[3] I.R.C. Subchapter K.

d) Trusts and Estates.[4]

Entities that do not clearly fall into one of these categories are classified to fit within one of these categories and taxed accordingly.

The classification rules are embodied in the "Kintner" regulations.[5] These regulations distinguish between structures by reference to six characteristics:

1) Associates;

2) An objective to carry on a business and divide the gains thereof;

3) Limited liability;

4) Free transferability;

5) Continuity of life; and

6) Centralized management.

Under the Kintner regulations, corporations and partnerships are deemed to share two of these characteristics: associates and an objective to carry on a business and divide the gains thereof.[6] Thereafter, in order to distinguish a partnership from an association taxed as a corporation, the structure is reviewed to determine the number of the four remaining characteristics that it bears. In a purely

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[4] I.R.C. Subchapter J.

[5] Treas. Reg. § 301.7701-2(a)(1) *et seq.*

[6] Treas. Reg. § 301.7701-2(a)(2).

mechanical test, if the structure bears more than two of these four characteristics, it will be classified as an association taxable as a corporation.[7] If, on the other hand, the structure has two or fewer of these characteristics, it will be classified as a partnership.[8] Under this formulation, no characteristic is given greater weight than any other characteristic in the classification process.[9]

Within these broad outlines, it is necessary to understand what particular facts will and will not give rise to these characteristics. For that understanding, it is important to appreciate the environment in which the Kintner regulations were drafted.

II. THE BACKGROUND OF THE KINTNER REGULATIONS

Throughout the 1940's and 50's, professionals were forbidden by statutes and professional rules from incorporating. However, during this same time frame, professionals sought to utilize tax favored employee benefit plans that were restricted to corporations.[10] As such,

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[7] Treas. Reg. § 301.7701-2(a)(3).

[8] Treas. Reg. § 301.7701-2(a)(3).

[9] *Larson v. Comm'r,* 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.

[10] "The urge to incorporate personal service enterprises generally reflected the desire to take advantage of Code provisions that granted more generous deductions or other tax allowances for corporate employee benefit plans than for similar plans created by self-employed individuals." BITTKER

professionals sought to create structures which would be viewed as corporations for tax purposes, but would not be state law corporations which would run afoul of those professional rules and regulations. The Service unsuccessfully fought a series of court battles to treat these structures as partnerships, eventually culminating in *United States v. Kintner*.[11] In *Kintner*, a group of physicians formed an unincorporated association with sufficient corporate characteristics to, under the prevailing tax law, cause it to be classified as a corporation. The Service sought to classify the association as a partnership but was unsuccessful at the trial and appellate levels. Unwilling to accept this loss and those which had preceded it, the IRS refused to acquiesce in the *Kintner* ruling.[12]

A year later, still without acquiescing in *Kintner*, the Service stated that so-called "Kintner associations" would be classified under the "usual test," and that a subsequent revenue ruling would further explain the "usual test."[13] The

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& EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS. ¶ 2.06

[11] 216 F.2d 4018 (9th Cir. 1954), *aff'g*, 107 F.Supp. 97 (D.Mont. 1952).

[12] Rev. Rul. 56-23, 1956-1 C.B. 598, *obsolete by* Rev. Rul. 72-92, 1972-1 C.B. 407.

[13] Rev. Rul. 57-546, 1957-2 C.B. 886.

promised revenue ruling was never issued; rather, the Kintner regulations were proposed.[14]

Due to the environment in which they were drafted, these regulations demonstrate a clear bias in favor of partnership classification. This bias is demonstrated by the need for a preponderance of the corporate characteristics in order for a structure to be classified as an association taxable as a corporation.[15] As limited liability can be obtained only through a state organizational statute, an unincorporated entity could obtain corporate classification only if the association had continuity of life, free transferability of interests and centralized management. The response of professionals seeking to be recognized as corporations was largely to abandon the use of so-called "Kintner associations," instead persuading state legislatures to authorize the organization of professional service corporations.[16]

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[14] T.D. 6503, 1960-2 C.B. 409.

[15] As observed by Judge Dawson in *Larson*, "I think the current regulations were drafted for the purpose of *limiting* the ability of a partnership or other entity to qualify as a corporation for tax purposes. In fact, it might even be said that the [Kintner] regulations are weighed *against* qualification for corporate status." 66 T.C. at 187 (italics in original).

[16] McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 3.06[1].

III. LLCs AND THE KINTNER REGULATIONS

The first LLC statute passed by Wyoming in 1977 with the express intention that LLCs be taxed as partnerships. This objective was dealt a near death blow in 1980 when the Treasury Department proposed revisions to the Kintner regulations that would classify as a corporation any structure that enjoyed limited liability.[17] During the pendency of this proposal, Florida passed a second LLC statute in 1982. In 1983 the Treasury Department withdrew the proposed amendments, and announced a reexamination of the test used to classify unincorporated businesses.[18] Further development of the LLC languished until 1988 when the Service announced that it would not revise the classification methodology,[19] and issued Revenue Ruling 88-76,[20] confirming that Wyoming LLCs would be taxed as partnerships.

For several years thereafter, the Service issued no binding rulings on the tax classifications of LLCs. Then, beginning in early 1993, the Service began issuing a series of additional revenue rulings addressing LLCs formed under a

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[17] Prop. Treas. Reg. § 301.7701-2(a), 45 Fed. Reg. 75,709 (Nov. 17, 1980).

[18] Ann. 83-4, 1983-2 I.R.B. 31 (January 10, 1983).

[19] Ann. 88-118, 1988-38 I.R.B. 26 (September 19, 1988).

[20] 1988-2 C.B. 360.

variety of state statutes.[21] In addition, the Service has also issued numerous private letter rulings on the issue of whether or not a particular LLC will qualify for partnership qualification.

Currently, the classification dispute has shifted its focus from whether an LLC can be taxed as a partnership to what facts and circumstances will or will not give rise to the existence of a particular Kintner characteristic.

A. LIMITED LIABILITY

As limited liability characteristic is the centerpiece of each LLC statute, there is no question that it is present in an LLC.

It should be noted that the personal liability of an individual for his or hers own acts does not support an argument that the LLC on whose behalf that individual was

[21] Virginia, Rev. Rul. 93-5, 1993-1 C.B. 227 (January 19, 1993); Colorado, Rev. Rul. 93-6, 1993-1 C.B. 229 (January 19, 1993); Nevada, Rev. Rul. 93-30, 1993-1 C.B. 231 (April 19, 1993); Delaware, Rev. Rul. 93-38, 1993-1 C.B. 233 (May 24, 1993); Illinois, Rev. Rul. 93-49, 1993-2 C.B. 308 (July , 1993); West Virginia, Rev. Rul. 93-50, 1993-2 C.B. 310 (July 19, 1993); Florida, Rev. Rul. 93-53, 1993-2 C.B. 312 (August 2, 1993); Rhode Island, Rev. Rul. 93-81, 1993-2 C.B. 314 (November 29, 1993); Utah, Rev. Rul. 93-91, 1993-2 C.B. 316 (December 20, 1993); Oklahoma, Rev. Rul. 93-92, 1993-2 C.B. 318 (December 27, 1993); Arizona, Rev. Rul. 93-93, 1993-2 C.B. 321 (December 27, 1993); Louisiana, Rev. Rul. 94-5, 1994-2 I.R.B. 21 (January 10, 1994); Alabama, Rev. Rul. 94-6, 1994-3 I.R.B. 11 (January 18, 1994).

acting lacks limited liability. As defined in the Kintner regulations, limited liability exists when the personal assets of the members are not liable to make up any shortfall of a claim against the entity and its assets.[22] The personal liability of the party whose actions or inactions give rise to a claim is separate and distinct from the liability of the entity (and its owners) to the injured party.[23]

Contractual agreements, as contrasted with local law, to limit a creditor's recourse to the assets of the entity or to its insurance coverage do not give rise to limited liability.[24]

B. FREE TRANSFERABILITY OF INTERESTS

Free transferability of interests exists if a member, without the consent of the other members, may transfer to a non-member all of the attributes of ownership of an interest in the entity.[25] Free transferability is lacking, on the other hand, if a member may transfer to a non-member only the

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[22] Treas. Reg. § 301.7701-2(d)(1).

[23] Rev. Rul. 93-91 (personal liability of professional for his or her own performance does not abrogate presence of limited liability); Rev. Rul. 93-93 (personal liability of professional for his or her own performance or of that of those under his or her supervision or direction does not abrogate presence of limited liability).

[24] Tech. Adv. Mem. 7951006 (August 21, 1979).

[25] Treas. Reg. § 301.7701-2(e)(1).

prospective economic rights of membership, but not the managerial rights. If the transfer of such managerial rights may be accomplished <u>only</u> with the approval of the other members, free transferability is lacking.

1. The "Separate Interest" Test

The separate interest test examines the degree to which the owners of an entity are independent of one another, that independence adding substance to the contingent nature of the vote on transferability. Where the relationship among members is overlapping to the degree that restrictions on transferability are illusory, free transferability is deemed to be present.

The separate interest test was first recognized in Rev. Rul. 77-214,[26] wherein the Service considered the classification of a GmbH formed by two subsidiaries of a single corporate parent. The Service found that as one entity controlled the outcome of a vote on transferability and continuity, and as limited liability was indisputedly present, the GmbH should be classified as corporation.

There is some question as to whether the separate interest test will be applied to LLCs. Although the Service has ruled that domestic and foreign entities are classified

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[26] 1977-1 C.B. 408.

under the same rules,[27] in Private Letter Ruling 9404021 (November 1, 1993), the Service held that an LLC lacks free transferability even though its sole members are two corporations, one the wholly owned subsidiary of the other. This ruling appears to conflict with Revenue Ruling 77-214.

Revenue Ruling 77-214 was modified in Revenue Ruling 93-4[28] to delete its application to continuity of life, and may be further restricted by the Service.

2. Restricting the Right to Deny Consent

The right to deny consent to a transfer may be restricted only at the risk of supporting a finding of free transferability of interests. In *Larson v. Comm'r*, the Tax Court found free transferability where the consent of a general partner to the transfer of a limited partnership interest could not be unreasonably withheld.[29]

3. Who Must Approve a Transfer

It is not necessary that the approval of a transfer be by the entirety of the membership. Rather, it has been held proper to vest the authority to approve or disapprove a transfer in a group smaller than the entire membership, such

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27 Rev. Rul. 73-254, 1973-1 C.B. 613; Rev. Rul. 88-8, 1988-1 C.B. 40; Gen. Couns. Mem. 36910 (November 4, 1976).

28 1993-1 C.B. 225 (January 19, 1993).

29 66 T.C. at 183.

as a majority in interest of the members.[30] The approval or disapproval must be by the members; this power may not be delegated to non-members.

4. Rights of First Refusal

A right of first refusal in either the entity or other members to purchase an interest offered to a third party is not in and of itself a sufficient restriction to avoid free transferability. Rather, such a right of first refusal is defined in the Kintner regulations as "a modified form of free transferability."[31] Regardless of its "modified" form, the presence of this characteristic with two others will give rise to preponderance of the characteristics, leading to the treatment of the LLC as an association taxable as a corporation.[32]

Therefore, while a right of first refusal may exist in an LLC, it must be structured so that the failure of the entity or the other members to buy the interest will not authorize the current member to transfer anything more than the prospective economic rights of membership to the third party.

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[30] Priv. Ltr. Rul. 9210019 (December 6, 1991); Priv. Ltr. Rul. 9218078 (January 31, 1992).

[31] Treas. Reg. §§ 301.7701-2(e)(2), -2(g) Examples 4, 5 and 6.

[32] Priv. Ltr. Rul. 8828022 (April 13, 1988) (right of first refusal in other stake holder in foreign limited liability company constituted a modified form of free transferability).

5. Transfers Pursuant to State Law

Depending on their nature, transfers pursuant to state law may or may not give rise to free transferability of interests. For example, transfers pursuant to the laws of descent and distribution are permitted without giving rise to free transferability.[33] However, a transfer of an interest pursuant to a merger or consolidation of a member to the entity surviving the merger or consolidation will give rise to free transferability.[34]

6. What Interest Must be Restricted

In order to avoid free transferability, it is not necessary that every interest be restricted. In Revenue Procedure 92-33,[35] the Service took the position that, for advance ruling purposes, free transferability is absent if at least 20% of the interests are subject to restrictions on transferability. To date the Service is not responded to an effort by an LLC to use this provision.

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[33] *See, e.g.*, Priv. Ltr. Rul. 9253013 (September 30, 1992).

[34] Gen. Couns. Mem. 38012 (July 13, 1979) (the ability of one corporate member of a business trust to substitute another corporate member by merging the former into the latter or consolidating the former with the latter will constitute a modified form of free transferability.).

[35] 1992-1 C.B. 782.

C. CONTINUITY OF LIFE

For purposes of tax classification, continuity of life is lacking if the structure is subject to dissolution upon a "change in the relationship between its members as determined under local law."[36] An alteration in the relationship that the members may come about as a consequence of the "death, insanity, bankruptcy, retirement, resignation, or expulsion of any member."[37] While such a disassociation may bring about a dissolution of the LLC, the LLC may be reconstituted with a new member relationship, permitting it to continue to carry on its business. The contingent nature of the vote to reconstitute and continue the business is the cornerstone of the continuity of life analysis.

1. Maximum Duration

LLC organizational statutes either permit or require the LLC to have a maximum period of duration. In early LLC statutes there is a mandatory durational limit of thirty years. It would appear these provisions were included as a fail safe measure to insure that the LLC would lack continuity of life. However, such a provision is not necessary, and in fact does not contribute to the argument that there is not continuity of life. An organization that has a limited life,

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[36] Treas. Reg. § 301.7701-2(b)(3).

[37] Treas. Reg. § 301.7701-2(b)(1).

but whose life may not be shortened by a dissolution brought by a member, will have continuity of life.[38]

2. The "Separate Interest" Test

Under Rev. Rul. 77-214, the separate interest test was applied to questions of continuity of life and free transferability of interest. However, in Rev. Rul. 93-4[39] the Service amended Rev. Rul. 77-214 to provide that the separate interest test would not be applied to continuity of life.

3. Continuation Vote Requirements

It is clear that continuity of life can be avoided if the LLC requires the unanimous vote of the non-disassociating members to continue the LLC after a dissolution.[40] Furthermore, the requirement of a majority of the members to continue after dissolution is sufficient to avoid continuity of life.[41] The question then becomes how the "majority" is measured. There is evidence, albeit no clear statement, that the Service will require that the majority be of the total

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[38] Treas. Reg. § 301.7701-2(b)(3); Treas. Reg. § 301.7701-2(g) example (5); Gen. Couns. Mem. 36910 (November 4, 1976).

[39] 1993-1 C.B. 225.

[40] Rev. Rul. 88-76, 1988-2 C.B. 360; Rev. Rul. 94-6, 1994-3 I.R.B. 11.

[41] Rev. Rul. 93-91, 1993-2 C.B. 316; Rev. Rul. 93-92, 1993-2 C.B. 318.

interests, and not merely a majority of the members measured on a per capita basis, in order to avoid continuity of life.[42]

4. Limiting Events of Disassociation

In order to avoid continuity of life, it is not necessary for the entity to undergo dissolution upon the occurrence of any and all of the events of disassociation listed in the Kintner regulations. Rather, an entity may limit the possible disruptive effects of a dissolution, and the consequent need for a vote on continuing the business, by making itself subject to dissolution only upon the occurrence of less than all, or even only one, of the events of disassociation listed in the Kintner regulations.[43] In the context of an LLC, the Service has ruled that there would not be continuity of life where dissolution is restricted to the disassociation by bankruptcy of a corporate manager-member.[44]

Another possibility for restricting the events of disassociation would be to limit dissolution to the

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[42] *Majority in Interest, and Not Majority in Number, Must Vote to Continue Partnership Business Under New Continuity of Life Regulation,* 34 TAX. MGMT. MEMO. (BNA) 241 at 242 (August 9, 1993).

[43] *MCA, Inc. v. U.S.*, 502 F.Supp. 838 at 842 (C.D. Ca. 1980), *rev'd on other grounds*, 685 F.2d 1099 (9th Cir. 1982) ("if any <u>one</u> of these factors *does* cause dissolution of the organization 'continuity of life' is *not* present.") (italics in original, underline added).

[44] Priv. Ltr. Rul. 9210019 (December 6, 1991).

disassociation of members holding a certain percentage interest in the LLC.[45]

5. **Business Continuation Agreements**

Another possible mechanism for limiting the potential disruption associated with dissolution and the need for a continuity vote is to contractually limit the member's freedom to reject continuation. Under such an agreement, the members bind themselves, in the event of a disassociation, to vote to continue the LLC. Breach of such an agreement opens the dissenting member to contractual damages, but the agreement cannot be enforced by an award of specific performance. Under this rationale, despite the agreement of a member to vote to continue the entity after dissolution, the power of the member to breach that agreement, thereby bringing about a failed vote to continue and the dissolution of the entity, is sufficient to avoid continuity of life.[46]

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[45] Priv. Ltr. Rul. 7812058 (December 20, 1977) (limited liability partnership formed under Saudi Arabian law lacked continuity of life when dissolution limited to insolvency, dissolution or bankruptcy of a partner with at least a 50% ownership interest).

[46] *Zuckman v. U.S.*, 524 F.2d 729 at 735 (U.S. Cl. Ct. 1975) (no continuity of life even though general partners of a limited partnership, as a condition to certain financing arrangements, contracted to continue the limited partnership); *Foster v. Comm'r.*, 80 T.C. 34, 188 (1983), *aff'd in part and vacated in part on other grounds*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986) ("[a]lthough a partner who wrongfully dissolves a partnership may be answerable in damages and may forfeit his right to wind up the

The Service has informally expressed reservations as to whether an LLC with a business continuation agreement can lack continuity of life.[47]

D. CENTRALIZED MANAGEMENT

Centralized management exists if any group not coextensive with the membership has the continuing exclusive authority to make management decisions necessary to conduct of the business.[48] Conversely, where all members of an entity act as agents of and take part in the management of the business, centralized management is lacking.[49]

In the context of LLCs, the Service has explained centralized management the least. One revenue ruling has affirmed the position, already clear from the Kintner regulations, that centralized management is absent when

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partnership's affairs, ... the fact remains that such a partner has the power to dissolve the partnership. And it is the power, not the right, to dissolve which is the touchstone of the regulation.")

[47] Letter from Paul E. Kugler, Assistant Chief Counsel, Pass Throughs & Special Industries, Internal Revenue Service to Edward I. Cutler, Esq., Chair of the Uniform Limited Liability Company Act Drafting Committee of the National Conference of Commissioners of Uniform State Laws (July 26, 1993).

[48] Treas. Reg. § 301.7701-2(c)(1).

[49] Treas. Reg. § 301.7701-2(c)(4).

management and agency authority are reserved to the members.[50] With only one exception, all other revenue rulings examine an LLC in which three of twenty-five members are elected managers, but without discussing the percentage interest represented by those three members. Under the centralized management test applied to limited partnerships, the determination of whether there has been centralized management has been dependent on the size of the interest held by the general partners.[51] This analysis is carried over into Revenue Procedure 89-12[52] § 4.06, which, with respect to an advance ruling on the existence of centralized management, looks to whether the general partners hold an interest of at least 20% of the total interests in the limited partnership. The only other revenue ruling to examine a different fact situation was Revenue Ruling 93-6.[53] There, the Service reviewed the somewhat unique Colorado LLC statute which, by its structure, does not permit management to be retained to the members.

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[50] Rev. Rul. 93-38.

[51] *Glensder Textile Co. v. Comm'r.*, 46 BTA 176 (1942), *acq.* 1942 -1 C.B. 8.

[52] 1989-1 C.B. 798.

[53] 1993-1 C.B. 229.

IV. ONE MEMBER LLCs

A question currently under debate at the Service is whether an LLC may have only one member. The basis of this question is whether a one-member LLC can have "associates". A number of judicial decisions have held that an entity classified as a partnership must have at least two stakeholders.[54] A one-member LLC would provide an alternative to the S corporation for instances in which a limited liability, pass-through structure is sought by a sole equity owner.

V. REVENUE PROCEDURE 89-12

One of the principle challenges facing particular LLCs seeking a private letter ruling on classifications has been Rev. Proc. 89-12; an unincorporated entity seeking classification as a partnership must comply with this revenue procedure.[55] However, this revenue procedure was drafted primarily to address the classification of general and limited partnerships, and contains only minimal direction with respect to its application to other structures. On the issue of complying with Rev. Proc. 89-12, several requirements appear

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[54] *Morrissey v. Comm'r.*, 296 U.S. 344 (1935); *Comm'r v. Culbertson,* 337 U.S. 733 (1949); *Knoxville Trust Sales & Service, Inc. v. Comm'r.*, 10 T.C. 616 (1948); *Hynes v. Comm'r.*, 74 T.C. 1266 (1980).

[55] Rev. Proc. 89-12 1989-1 C.B. 798, §1.02.

inapplicable to LLCs. For example, sections 4.01 and 4.03, respectively, relate to allocations to and the capital accounts of the "general partners." However, these requirements are inapplicable at least to those LLCs which have been chosen to be managed by a non-member.

The Service recognizes the problems involved in requiring LLCs to comply with Revenue Procedure 89-12 and the need for a classification procedure tailored to the structure of LLCs, and is crafting a responsive Revenue Procedure.[56]

VI. METHOD OF ACCOUNTING

One early, and to a certain extent still lingering, cloud over the use of LLCs has been whether such entities will be forced to use accrual method, rather than the often preferred cash method, of accounting. This issue arises due to the question of whether certain LLCs will, for purposes of this analysis, be treated as "tax shelters."

As a general rule, taxpayers are permitted to calculate their taxable income either under the cash or accrual method.[57] However, C-corporations, partnerships which have a C-

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[56] IRS News Release NB 2142, Partnerships, item 6 (January 6, 1993); *IRS Likely to Issue Limited Liability Guidelines Early This Year, Official Says*, DAILY TAX RPTR. (BNA) January 11, 1994, G-3.

[57] I.R.C. § 446(c).

corporation as a partner and tax shelters are required to use accrual method accounting.[58]

A "tax shelter" is defined[59] to include a "syndicate,"[60] which in turn is defined as a "partnership" or entity "other than a corporation which is not an S corporation" if more than thirty-five percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs within the meaning of section 464(e)(2).[61] A "limited entrepreneur" is defined as "a person who has (A) an interest in an enterprise other than as a limited partner and (B) does not participate in the management of such enterprise."[62] Alternately, an entity may be a "tax shelter" if it meets the definition of that term.[63]

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[58] I.R.C. § 448(a). Professional service corporations structured as C-corporations are exempt from the requirements to use accrual method accounting (I.R.C. § 448(b)(2)), as are partnerships having a C-corporation PSC as a partner (I.R.C. § 448(a)(b)(2)).

[59] I.R.C. § 448(d)(3) refers to the definition of a "tax shelter" in I.R.C. § 461(i)(3).

[60] I.R.C. § 461(i)(3)(B).

[61] I.R.C. § 1256(e)(3)(B).

[62] I.R.C. § 464(e)(2).

[63] I.R.C. § 6662(c)(ii) (An entity, partnership, plan or arrangement "if the principal purpose ... is the avoidance or evasion of Federal income tax.")

If LLC members are deemed equivalent to either limited partners or limited entrepreneurs, these rules would compel accrual method accounting by the LLC. If the LLC is deemed equivalent to a limited partnership lacking a general partner "there being no entity or individual generally liable for the obligations of the LLC," 100% of the losses would be allocated to deemed limited partners. Under this analysis an LLC would be considered a syndicate, and in turn a tax shelter required to use accrual method accounting. If the Service were to analyze members under the limited entrepreneur provisions, it would be necessary to review the allocation of losses between the manager and non-member managers; if more than thirty-five percent of the losses are to be allocated to non-manager members, and if these non-manager members are determined to be "limited entrepreneurs," the LLC could be viewed as a syndicate.

Regardless of the method of analysis applied, a determination by the Service that accrual method accounting is necessary would make an LLC a much less attractive vehicle for operating many types of businesses.[64]

[64] This issue is especially sensitive to those professional practices which have sought to use the LLC rather than the general partnership or, more recently, the registered limited liability partnership. Cash method accounting is generally preferred by professional practices because of the time lag in collections and a broad unwillingness to charge and collect finance charges on late payments for professional

Several private letter rulings, all issued to professional LLCs, have stated that cash method accounting could continue to be used.[65] However, guidance with respect to non-professional LLCs has not been forthcoming. This issue remains particularly troubling with respect to the application of the limited entrepreneur provisions to manager-managed LLCs.

VII. OPERATIONAL TAX ISSUES

If the LLC is properly structured to be classified as a partnership for income tax purposes, it will be taxed under Subchapter K of the Internal Revenue Code.

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services. Upon conversion from a general partnership utilizing the cash method to an LLC required to use accrual method, the entity would be forced to accelerate into current taxable income all outstanding receivables, thereby giving rise to an immediate tax liability without necessarily receiving the funds with which to satisfy that liability. The relief from accrual of amounts that experience indicates will not be collected, while helpful, does not alleviate the tax liability on the remaining outstanding receivables. *See* I.R.C. § 448(d)(5); Treas. Reg. § 1.448-2T.

[65] Priv. Ltr. Rul. 9321047 (issued February 25, 1993; released May 28, 1993); Priv. Ltr. Rul. 9328005 (issued December 21, 1992; released July 16, 1993); Priv. Ltr. Rul. 9350013 (issued September 15, 1993; released December 17, 1993); Priv. Ltr. Rul. 9407030 (issued November 24, 1993; released February 18, 1994); Priv. Ltr. Rul. 9415005 (April 15, 1994) (100-year old law firm with consistent record of profitability held not a syndicate under I.R.C. § 1256(e)(3)(B) for any year in which it does not incur losses). *See generally*, Banoff, Sheldon I., *New IRS Ruling Encourages Professionals to Form Limited Liability Companies*, 79 J. TAX'N 68 (August, 1993); *Use of Cash Method by Limited Liability Company Not Precluded by §448*, 34 TAX MGMT. MEM. 242 (August 9, 1993).

A. CONTRIBUTIONS

1. Contributions of Money or Property

Generally, LLC members will recognize no gain or loss upon contributing cash or property to the LLC in exchange for a capital interest.[66] Even if a member contributes property encumbered with debt in excess of the property's basis, the member will be entitled first to a increase in its outside basis in the LLC to the extent of the member's share of the debt transferred plus the property's basis; the member then receives a deemed distribution, decreasing its outside basis, by the amount of the debt encumbering the property. Thus the contributing member will recognize gain only to the extent that the amount of the debt exceeds the member's share of the debt at the LLC level plus the basis of the contributed property.[67]

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[66] I.R.C. § 721. The basis of the contributing member's interest in the LLC ("outside" basis) generally will be the amount of cash and the adjusted basis of the property contributed plus gain, if any, recognized under I.R.C. § 721(b). I.R.C. § 722.

But, beware of I.R.C. § 707(a)(2)(B) and the Treasury Regulations thereunder, wherein deemed distributions from contributions of encumbered property may trigger gain under the "disguised sale" rules.

[67] I.R.C. §§ 731(a) and 752(b); Treas. Reg. § 1.752-1(f). Note that the LLC differs from the S Corporation in this respect; shareholders contributing encumbered property to the latter will recognize gain to the full extent that the transferred debt exceeds the contributed property's basis. An S corporation shareholder may not increase his or her outside basis by an amount of debt assumed by the corporation. See

If a member contributes property with a fair market value in excess of or less than its adjusted basis upon contribution, the built-in gain or loss must be allocated back to the contributing partner.[68]

2. Contributions of Services

The Internal Revenue Service issued guidance last year, in Rev. Proc. 93-27,[69] providing that the receipt of a partnership profits interest in exchange for services to the partnership generally does not trigger ordinary income recognition by the contributing partner.[70] Prior case law had established that the receipt of a partnership *capital* interest in exchange for services rendered to a partnership caused the immediate recognition of ordinary income by the contributing partner, and the case law had been somewhat divided over the issue of the taxability of receipt of a profits interest.[71] These authorities should apply equally to LLCs.

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[68] I.R.C. § 704(c).

[69] 1993-2 C.B. 343 (June 9, 1993).

[70] Exceptions are for, *inter alia*, profits interests relating to a "substantially certain and predictable stream of income from partnership assets," or the receipt of a profits interest by a partner who disposes of the interest within two years of receipt. Rev. Proc. 93-27.

[71] *See Diamond v. Commissioner,* 492 F.2d 286 (7th Cir. 1974), *Campbell v. Commissioner,* 943 F.2d 815 (8th Cir. 1991), *St. John v. United States,* 84-1 USTC ¶ 9158 (C.D. Ill. 1983).

B. ALLOCATIONS

Like partnerships, LLCs will not be subject to tax at the entity level. Instead, each member of the LLC must recognize on a current basis his or her distributive share of the LLC's income, gain, loss, deduction or credit.[72] The member's outside basis in the LLC is increased by income and gain recognized and decreased by losses and deductions recognized.[73] Losses may not be recognized in excess of a member's outside basis in the LLC.[74]

The LLC's operating agreement may provide for the allocation of the LLC's profits and losses in accordance with the wishes of the LLC members, so long as the agreed upon allocations have substantial economic effect.[75] The substantial economic effect test applies to allocations that are not attributable to nonrecourse deductions (as will be discussed below), and generally requires that: (1) the members maintain capital accounts; (2) liquidating distributions be made in accordance with positive capital account balances; and (3) a member with a negative capital

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72 I.R.C. §§ 701 and 702.

73 I.R.C. § 705.

74 I.R.C. § 704(d). Other limits on a member's ability to recognize losses include the PAL (passive activity loss) limitations and the at-risk rules, as will be discussed below.

75 I.R.C. § 704.

account have an obligation to restore the deficit in his or her capital account under certain circumstances specified in the Treasury Regulations.[76] If the allocations provided for in the operating agreement do not have substantial economic effect, the distributive shares will be reallocated among the members according to their economic interests in the LLC.[77]

A different set of rules applies to the allocation of losses and deductions that reduce the basis of property securing nonrecourse debt below the principal amount of the nonrecourse note ("nonrecourse deductions"). Because no member bears the economic risk of loss if the LLC cannot pay the nonrecourse liability, the allocation of nonrecourse deductions cannot have "economic effect" under the principles of the regulations as applied to other types of losses and deductions. Thus the regulations provide an alternative safe harbor that deems allocations of nonrecourse deductions to be according to the members' economic interests in the LLC if: (1) the nonrecourse deductions are allocated among the members in a manner that is reasonably consistent with allocations, which have substantial economic effect, of some other significant distributive share item attributable to the

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[76] *See* I.R.C. § 704(a) & (b); Treas. Reg. § 1.704-1(b)(2)(ii).

[77] I.R.C. § 704(d).

property securing the nonrecourse debt; and (2) the operating agreement provides a minimum gain chargeback requirement, which requires that income be allocated eventually to the members that were allocated the nonrecourse deductions.[78]

Nonrecourse debt of an LLC that is guaranteed by a member, or someone related to a member, is treated as "partner nonrecourse debt;" deductions attributable to such debt must be allocated to the member who bears the economic burden if the LLC cannot pay the liability. Additionally, minimum gain chargeback requirements must be imposed upon such member,

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[78] Treas. Reg. §§ 1.704-2(e) and 1.752-2. Because the liability of all LLC members is limited under state law to the members' capital contributions, it would appear that all LLC debt is nonrecourse for purposes of the allocation rules, absent a guarantee of the debt by an LLC member. Even debt secured by all LLC assets should be considered nonrecourse under the regulations, which distinguish between recourse and nonrecourse debt according to whether any partner ultimately bears the "economic risk of loss" with respect to partnership debt. Treas. Reg. § 1.752-2. Contrast the debt of a limited partnership that is secured by the general assets of the partnership; in that case the debt is typically allocated to the general partner or partners, who bear ultimate responsibility for repayment of the debt. The general partners only, and not the limited partners, may enjoy the basis increase brought about by the allocation of this debt. Similar debt of an LLC, treated as nonrecourse because all members have limited liability, will be allocated, and permit a basis increase, among all members according to their interests in the LLC.

Although the IRS has not yet had occasion to rule on the application of these regulations to the LLC, commentators appear to concur in the appropriateness of this analysis as applied to the LLC. *See, e.g.,* KEATINGE, ROBERT R. & RIBSTEIN, LARRY E., RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Vol. 1, Ch. 17.07 at 17-33 (1994).

similar to the minimum gain chargeback rules applicable to nonrecourse debt.[79]

C. DISTRIBUTIONS

Liquidating and operating distributions of property usually do not result in recognition of gain to the members. Instead, distributions reduce the member's outside basis by the amount of money and the inside basis of property distributed.[80] Thus the LLC is not saddled with the *General Utilities* repeal tax burden that S corporations and C corporations must bear upon the distribution of appreciated property.[81]

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[79] Treas. Reg. § 1.704-2(b)(4) & -2(i).

[80] I.R.C. § 733. Exceptions are: (1) distributions of proceeds from a "disguised sale" of contributed property under I.R.C. § 707(a)(2)(B), which trigger gain; (2) distributions that represent a disguised fee for services performed in a third party capacity rather than a member capacity, taxed as ordinary compensation income under I.R.C. § 707(a)(2)(A); (3) certain distributions that alter the member's interest in the LLC's ordinary or capital assets, which trigger gain under the disproportionate distribution rules, I.R.C. § 751(b); and (4) distributions that trigger built-in gain recognition with respect to contributed property under I.R.C. §§ 704(c)(1)(B) and 737.

[81] *See* I.R.C. § 331(b). The so-called *General Utilities* doctrine allowed the corporate level tax on the appreciation in the value of property to be avoided by the distribution of the asset in kind (*see* I.R.C. §§ 311(a), 333, 336 (1954)), or when the gain was realized by a sale incident to a 12-month plan of complete liquidation (*see* I.R.C. § 337 (1954)). *See General Utilities & Operating Co. v. Helvering,* 296 U.S. 200 (1935), which gave its name to the non-

D. PASSIVE ACTIVITY LOSS LIMITATIONS

For LLC members that are individuals, trusts, estates, or personal service corporations, a distributive share of the LLC's losses from a "passive activity" that exceeds the member's income from the passive activity will be suspended until the member has passive income to offset the loss.[82] The passive activity loss (PAL) rules prohibit taxpayers from using net losses from passive activities to offset other taxable income, specifically, portfolio income (*e.g.*, interest, dividends, and certain royalties) and active income (*e.g.*, salary, and wages). Passive activities include rental activities (except certain real estate rental activities in which a member "actively participates") and trade or business activities in which the member does not "materially participate."[83] Material participation is generally defined as active involvement in the operations of the business on a regular, continuous and substantial basis.[84] Treasury

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recognition rules even though the Court had refused to rule on the issue of corporate gain recognition. The *General Utilities* doctrine, which had begun to erode years earlier, was finally eliminated by legislation in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 331, 100 Stat. 2085 (1986).

[82] I.R.C. § 469. The passive loss rules also apply, but in a less restrictive way, to certain closely held C corporations.

[83] I.R.C. § 469(c).

Regulations set out seven brightline, alternative tests that a taxpayer may use generally to establish material participation.

However, the regulations apply a more stringent material participation test to limited partners than is applied to general partners and S corporation shareholders; the test requires that the partner participate in the activity for more than 500 hours during the year or during a certain minimum number of prior years.[85] The regulations broadly define limited partner to include all holders that are not personally liable for the entity's debts, even if the entity is not a state law limited partnership.[86] Thus the question is raised whether this more stringent material participation test will apply to an LLC member by virtue of the broad regulatory definition of a limited partner. Strong policy arguments can be made that the LLC member is more analogous to a general partner or an S corporation shareholder than a limited partner for this purpose -- because the LLC permits active involvement by LLC members in the management of the business. Until the IRS addresses the issue, however, LLC members should plan to meet the stricter material participation test applicable to

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84 I.R.C. § 469(h).

85 Temp. Treas. Reg. § 1.469-1T(e)(2)

86 Temp. Treas. Reg. § 1.469-5T(e).

limited partners to ensure that the losses flowing through the LLC are not subject to the PAL limitations.

The Revenue Reconciliation Act of 1993 liberalized the passive activity loss rules as applied to rental real estate. Rental real estate will no longer be a passive activity, *per se*, if the taxpayer satisfies two tests: (1) more than one-half of the taxpayer's services must be performed in real property trades or businesses in which the taxpayer materially participates and (2) the taxpayer must perform more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates.[87] To be considered for the 750 hour and one-half of personal services requirements, participation in an activity must be *material* participation. Thus, an LLC member must materially participate under the restrictive rules discussed above in each rental real estate activity that is to be counted toward the rental real estate material participation test.[88]

[87] I.R.C. § 469(c)(7)(B). Real property trades or businesses include development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage businesses. I.R.C. § 469(c)(7)(C).

[88] I.R.C. § 469(c)(7)(A).

E. THE AT-RISK RULES

Another limitation on the ability of individuals and certain closely held C corporations that are members of an LLC to deduct losses flowing from the LLC is the limitation imposed by the "at-risk" rules.[89] Losses may be deducted by such a member of an LLC only to the extent that the member is "at-risk" with respect to each separate activity of the entity. A member is considered at-risk to the extent of money and the adjusted basis of property contributed to the LLC, as well as any share of the LLC's debt for which the member is personally liable.[90]

Thus, a member will be at-risk with respect to its share of LLC debt that it guarantees.[91] The LLC member will not be at-risk, however, with respect to LLC debt that is nonrecourse and for which he or she is not personally liable unless the debt is attributable to a real estate activity and is "qualified nonrecourse financing."[92] Qualified nonrecourse

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89 I.R.C. § 465.

90 I.R.C. § 465(b).

91 The LLC member will be at risk with respect to such guaranteed debt only if the guarantee renders the member personally liable under state law and there are no contribution or subrogation rights to inherit from others. *See* Prop. Treas. Reg. § 1.465-24(a)(2); *see also Edwin D. Abramson v. Comm'r*, 86 T.C. 360 (1986) (limited partner is at risk with respect to nonrecourse debt that he guaranteed).

92 I.R.C. § 465(b)(6)(C).

financing is financing borrowed from a qualified person (generally a person in the business of lending money) for the activity of holding real property. Except as provided in regulations, no person can be personally liable for the loan. Thus, an LLC member will be at-risk with respect to a traditional nonrecourse loan secured by a particular piece of property, used for the activity of holding the real property. Note that it is unclear, however, whether a loan secured by all of the LLC's assets would qualify under these rules, given that no "person" can be personally liable for the debt (which person may include the LLC). This is another area in which many practitioners are eagerly awaiting IRS guidance on how these rules will be applied explicitly to the LLC. In the meantime, however, it appears that this exception to the general at-risk rules should make the LLC an attractive vehicle for real estate ventures.

F. SELF-EMPLOYMENT TAXES AND OTHER ISSUES

A limited partner's distributive share of income or loss from a limited partnership, other than a guaranteed payment, is excluded from earnings for self-employment tax purposes.[93] The effect of this provision of the Code is that self-employment tax is generally not owed by limited partners with

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[93] I.R.C. § 1402(a)(13).

respect to income of the partnership that is not a guaranteed payment; such income is also not included for purposes of determining the amount of contributions to or benefit from a qualified retirement plan, however.

It is unclear how this provision will be applied to members of an LLC. The recurring issue is again revisited: whether a member of an LLC should be treated as a limited partner or a general partner for purposes of the self-employment tax. The provision was designed to prevent *passive* investors from including investment income in earnings on which social security benefits are based. Thus, an LLC member, particularly an active member of a professional LLC, does not fall within the rationale of this rule.[94] No guidance has as yet been issued by the IRS on this issue. The recently proposed Clinton Health Security Act contains modifications to the definition of net income from self-employment that will affect both limited partners and shareholders in S corporations. Thus IRS guidance will likely await action on the Health Security Act.

Other issues to be considered in planning or structuring an LLC are the following rules that currently are applicable to partnerships: (1) a member may deduct one-half of self-

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[94] An LLC could avoid application of this rule by making guaranteed payments to its LLC members, as do limited partnerships.

employment taxes paid;[95] (2) members may not participate in cafeteria plans;[96] (3) a member may deduct 25% of health insurance benefits paid prior to January 1, 1994;[97] and (4) a member will not be entitled to exclude group term life insurance benefits.[98]

G. MERGERS AND CONVERSIONS

1. Partnership to LLC

The IRS has ruled privately that the conversion of a partnership to an LLC will be analyzed as a partnership to partnership transaction.[99] The Service has recognized that general and limited partnerships can convert from one form to the other without causing a termination, if the old partnership's business is continued after the conversion.[100] The partners are deemed to exchange their interest in the partnership for a new interest in a partnership in a transaction covered by I.R.C. § 721. If the partners' shares

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95 I.R.C. § 164(f).

96 Prop. Reg. § 1.125-1(a)(4).

97 *See* Section 13174 of the Revenue Reconciliation Act of 1993.

98 I.R.C. § 79.

99 *See, e.g.,* PLRs 9029019 and 9010027.

100 Rev. Rul. 84-52, 1984-1 C.B. 157.

in the new partnership's liabilities are the same as their shares in the previous partnership's liabilities, their outside bases will not change and there will be no gain recognition. A reduction in a partner's share of the partnership's liabilities, however, is treated as a distribution of cash, and will trigger taxable income to the partner if the release from liabilities is larger than the partner's basis in his or her partnership interest.[101]

The IRS has ruled that partnerships converting to LLCs do not terminate if the above rules are met. Thus, a simple conversion of a partnership to an LLC should not result in the recognition of gain or loss to the LLC or its members unless a former partner's share of partnership debt is reduced beyond the partner's adjusted basis in his or her LLC membership interest as a result of the conversion. Note that this may happen to general partners to whom all recourse debt has been allocated, if the debt is converted to nonrecourse debt upon conversion of the entity to an LLC (pursuant to creditors' approval). Assuming the former general partner remains personally liable for the debt after the conversion, however, the gain recognition can be avoided.

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101 I.R.C. § 752(b).

2. Corporation to LLC

The conversion of a corporation to an LLC and the merger of corporations into LLCs are taxable events. Whether the transaction is structured as a merger under state law, or as a liquidation of the corporation followed by a contribution of assets to an LLC, gain will be recognized on the disposition of any appreciated assets.[102] The corporation must recognize gain or loss on the distribution of corporate assets as if it had sold such property and the shareholders of a C corporation must recognize gain to the extent of the excess of the fair market value of the assets (or LLC interest) they receive over their bases in the stock. If an S corporation is converted to or merged with an LLC, the corporation's gain is passed through to its shareholders who recognize their pro rata share of the gain and receive a corresponding basis increase in their stock. This prevents additional gain when the stock is exchanged for an interest in the LLC. Thus, S corporation conversions will incur only one level of tax whereas C corporations could potentially incur two levels of tax upon the conversion or merger. Again, this tax burden is incurred only if the converting entity in fact has appreciated assets

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[102] I.R.C. § 336. Alternatively, the transaction can be structured as a contribution of assets from the corporation to the LLC in exchange for LLC interests which are then distributed to the shareholders. The tax analysis is the same under this structure as that described above.

(or assets that have been depreciated). For professional service corporations converting to LLCs, appreciated assets will likely include accounts receivable and goodwill.

H. SELLING AN LLC INTEREST - 754 ELECTION

If an interest in an LLC with appreciated assets is sold, exchanged or passed by inheritance, the transferee may make an election under I.R.C. § 754, which election gives the transferee a stepped-up basis (to fair market value) in the LLC's assets.[103] The purpose of this election is to prevent an incoming member from recognizing taxable gain due to appreciation that occurred before its interest was acquired.

I. CONTRAST OF TRANSFER OF A CORPORATE INTEREST VS. LLC INTEREST ON DEATH

1. Corporation

The estate of a decedent obtains a basis equal to the fair market value of the stock of the corporation on the date of death (or alternate valuation date). The corporation continues to have its same basis in its assets.

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[103] *See* I.R.C. § 743(b). This step-up in basis applied only to purchasing member's share of the assets' inside basis, of course.

2. LLC Treated as Partnership

The estate of a decedent obtains a basis equal to the fair market value of an interest in an LLC, LLP, limited partnership or general partnership on the date of death (or alternate valuation date) plus the decedent's share of the entity's liabilities. If a decedent holds an interest in an LLC treated as a partnership, the LLC may make a section 754 election which will permit it to step up (to fair market value) the basis of its assets attributable to the decedent's interest. Thus, assume such an LLC has depreciable assets with a zero basis; further assume that decedent's interest had a fair market value of 100. If the LLC made a section 754 election, then the LLC's basis attributable to the estate's share of such assets is 100; and such basis in such assets may be depreciated. The depreciation will be allocated 100% to the estate. The same would apply if the decedent had an interest in an LLP, limited partnership or general partnership. The same applies to any transfer to any transferee (except for a redemption). The partnership may make the section 754 election.

J. CONTRAST OF CORPORATION VS. LLC ON PAYMENTS TO RETIRING EQUITY HOLDERS

1. Corporation

A payment by a corporation to a retiring shareholder in exchange for his or her stock will normally be treated as a capital gain to the recipient and not be deductible to the corporation. A payment by a corporation to a retiring shareholder as reasonable compensation for services previously rendered is ordinary income to the shareholder and deductible by the corporation.

2. LLC Treated as a Partnership

A payment by a partnership to a retiring partner had traditionally been treated as a distributive share or guaranteed payment, thus effectively deductible to the partnership, unless it was for partnership property. Payments for partnership property are not deductible by the partnership. Previously, unrealized receivables and goodwill were not treated as partnership property for this purpose, unless the partnership agreement provided for a payment for goodwill.

I.R.C. § 736 was amended by the 1993 Tax Act to provide that payments for unrealized receivables and goodwill would generally be treated as payments for property: thus, the payments would be nondeductible to the partnership. However, the amended I.R.C. § 736 will not apply if capital is a material income producing factor and the retiring partner is a general partner. Thus, payments to a departing general partner should be deductible by a professional partnership. It is unresolved whether a member of an LLC will be treated as a general partner for this purpose. This is one area where there is a decided advantage to the LLP rather than the LLC in terms of certainty.

K. USE OF LIFE INSURANCE

Life insurance proceeds paid to a C corporation are generally not taxable under I.R.C. § 101. However, they are generally included in adjusted current earnings (ACE) for alternative minimum tax computations. Treas. Reg. §1.56(g)-1(c)(5). Life insurance proceeds paid to an LLC treated as a partnership or LLP are generally not taxable for either regular tax purposes (I.R.C. § 101) or for alternative minimum tax purposes (because ACE only applies to C corporations.) Life insurance proceeds lose some of their tax-free status if the policy has been transferred for value to an impermissible transferee. It will be taxable to the extent that the proceeds exceed the transfer price and subsequently paid premiums. Permissible transferees include partners of the insured, but not co-shareholders. Accordingly, using an LLC treated as a partnership permits more flexibility than using a corporation. Such an LLC permits an insurance policy which would fund a buy-sell agreement to be transferred to the members so that it can be used for a cross purchase arrangement.

L. ADDITIONAL CONSIDERATIONS IN SELECTING AN LLC

LLCs, like most other business entities, permit the division of the ownership among various entities. This permits the ability to transfer a portion of the ownership to family members. Fractional ownership interests are subject to discounts in valuation upon transfer, either during the transferor's life or at death. Available discounts may include a minority interest discount and a discount for lack of marketability.

There is a broad ability to allocate income and expense, and determine distributions, among the different classes of owners of LLCs that are treated as partnerships for federal income tax purposes. The limited liability of all members makes the LLC a superior vehicle to the general and limited partnerships and its ability for all members to participate in management make the LLC a superior vehicle to the limited partnership. After the 1993 Tax Act, the desirability of accumulating funds in a trust is significantly reduced because the top marginal tax rate of 39.6% is imposed upon all taxable income beginning at $7,500. LLCs treated as tax partnerships would be subject to the family partnership rules if the requirements of I.R.C. § 704(e) are met. Similarly, they would also be subject to I.R.C. Chapter 14 (I.R.C. § 2701, et. seq.).

APPENDICES

COMPARISON OF LLC REVENUE RULINGS

Satisfaction of Kintner Characteristics

Revenue Ruling	Limited Liability	Continuity of Life	Free Transferability	Centralized Management
88-76 1988-2 C.B. 360 (9/19/88) Wyoming	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to admit transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-5 1993-1 C.B. 227 (1/19/93) Virginia	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to admit transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-6 1993-1 C.B. 229 (1/19/93) Colorado	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to admit transferee as a member	Centralized management found where all members were elected managers as management carried on "in their capacity as managers rather than as members."
93-30 1993-1 C.B. 231 (4/19/93) Nevada	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to admit transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests

* Statute is flexible; Revenue Ruling conclusion on partnership classification is binding only to the extent the LLC Operating Agreement does not differ from statutory defaults.

Revenue Ruling	Limited Liability	Continuity of Life	Free Transferability	Centralized Management
93-38* 1993-1 C.B. 233 (5/4/93) Delaware	Found pursuant to statute	In first fact situation, no continuity of life -- unanimous consent of members required to continue after dissolution event In second fact situation, continuity of life present -- LLC to continue following dissolution event without the need for approval or consent of the members	In first fact situation, no free transferability of interests -- unanimous vote of members required to admit transferee as a member In second fact situation, free transferability of interests present -- transferee admitted as member by his or her unilateral act without the need for approval or consent of the other members	In first fact situation, no centralized management where management authority reserved to the members In second fact situation, centralized management found here management vested in 3 of 25 members, no reference to the size of their interests
93-49* 1993-2 C.B. 308 (1/19/93) Illinois	Found pursuant to statute	No continuity of life -- unanimous consent of members required to continue after dissolution event	No free transferability of interests -- unanimous consent of members required to admit a transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-50 1993-2 C.B. 310 (7/19/93) West Virginia	Found pursuant to statute	No continuity of life -- unanimous consent of members required to continue after dissolution event	No free transferability of interests -- unanimous consent of members required to admit a transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests

* Statute is flexible; Revenue Ruling conclusion on partnership classification is binding only to the extent the LLC Operating Agreement does not differ from statutory defaults.

Revenue Ruling	Limited Liability	Continuity of Life	Free Transferability	Centralized Management
93-53 1993-2 C.B. 312 (8/2/93) Florida	Found pursuant to statute	No continuity of life -- unanimous consent of members required to continue after dissolution event	No free transferability of interests -- unanimous consent of members required to admit a transferee as a member	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-81* 1993-2 C.B. 314 (11/29/93) Rhode Island	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-91* 1993-2 C.B. 316 (12/20/93) Utah	Found pursuant to statute	No continuity of life - consent of the members holding a majority of the interests required to continue after dissolution event	No free transferability of interests - consent of the members holding a majority of the non-transferring interest required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-92* 1993-2 C.B. 318 (12/27/93) Oklahoma	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - consent of the members holding a majority of the non-transferring interest required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
93-93 1993-2 C.B. 321 (12/27/93) Arizona	Found pursuant to statute	No continuity of life - consent of the members holding a majority of the interests required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests

* Statute is flexible; Revenue Ruling conclusion on partnership classification is binding only to the extent the LLC Operating Agreement does not differ from statutory defaults.

Revenue Ruling	Limited Liability	Continuity of Life	Free Transferability	Centralized Management
94-5* 1994-2 I.R.B.21 (1/10/94) Louisiana	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to the size of their interests
94-30 1994-30 I.R.B.6 (5/9/94) Kansas				
94-6* 1994-3 I.R.B. 11 (1/18/94) Alabama	Found pursuant to statute	No continuity of life - unanimous consent of members required to continue after dissolution event	No free transferability of interests - unanimous consent of members required to approve a transfer	Centralized management found where management vested in 3 of 25 members, no reference to their interests

* Statute is flexible; Revenue Ruling conclusion on partnership classification is binding only to the extent the LLC Operating Agreement does not differ from statutory defaults.

COMPARISON OF LLC PLRs

Satisfaction of Kintner Characteristics

An unincorporated entity may have up to two of the characteristics and be classified as a partnership

PLR (In chrono-logical order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
8106082 (Wyoming) (11/18/80)[1] (NA)[2]	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Not discussed (pre-dates Rev. Proc. 89-12)
8304138[3] (no state specified) (10/29/82) (NA)	Found pursuant to statute	No dissolution events - continuity of life found	Not discussed	Centralized management found where one member was manager, no discussion of his interest	Not discussed (pre-dates Rev. Proc. 89-12)
8937010 (Florida) (6/16/89) (9/15/89)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes

1 Letter Date

2 Release Date

3 This is the only PLR released to date in which an LLC did not receive partnership classification.

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9010027 (No state specified) (12/7/89) (3/9/90)	Found pursuant to statute	Continuity of life found - majority vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	No centralized management where management reserved to members in proportion to their interests	Yes (PLR also addresses conversion of limited partnership into LLC; IRC §§ 708, 721)
9030013 (Florida) (4/5/90) (7/27/90)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed (managed by non-member managers)	Yes, except § 4
9029019 (no state specified - internal references would indicate Florida) (4/19/90) (7/20/90)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes, in particular §§ 4.01 and 4.03 (PLR also addresses division of general partnership, conversion of one segment into LLC; IRC §§ 708, 721)
9052039 (no state specified) (10/2/90) (12/28/90)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Not discussed

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9119029 (no state specified) (2/7/91) (5/10/91)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes (PLR also addresses conversion of general partnership into LLC; IRC § 721)
9147017 (no state specified) (8/12/91) (11/22/91)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes
9210019 (Texas) (12/6/91) (3/6/92)	Not discussed in PLR but provided for by statute	No continuity of life - dissolution restricted to bankruptcy of corporate manager, unanimous vote of members to continue after dissolution event	No free transferability of interests - consent of Manager or, if manager not a member, majority interest of members required to approve a transfer	Not discussed	Not discussed
9218078 (Texas) (1/31/92) (5/1/92)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - approval of member/manager or 2/3rds of interest of members required to approve a transfer	Not discussed	Yes, in particular §§ 4.01 and 4.03

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9219022 (Utah) (2/6/92) (5/8/92)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - majority interest of members required to approve a transfer	Not discussed	Not discussed
9226035 (no state specified) (3/26/92) (6/26/92)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous consent of all managers and majority consent, by number and voting interest, of members to continue after dissolution event	No free transferability of interests - interests are not transferable	Not discussed	Yes (PLR also addresses conversion of general partnership into LLC; IRC § 721)
9227033 (Nevada) (4/8/92) (7/3/92)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed (managed by non-member managers)	Yes, except § 4
9242025 (Texas) (7/22/92) (10/16/92)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Not discussed

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9308027 (no state specified) (11/27/92) (2/26/93)	Recognized but not discussed	No continuity of life - majority vote of managers and majority (by interest and number) of members to continue after dissolution event	No free transferability of interests - LLC has two classes, A & B, of members - unanimous vote of members of other class required to approve a transfer	Not discussed	Yes, "to the extent applicable"
9313009 (no state specified) (12/17/92) (4/2/93)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - interests are not transferable except to limited transferees who may not subsequently transfer interest	Not discussed	Yes, "to the extent applicable"
9321047 (Arizona) (2/25/93) (5/28/93)	Not discussed in PLR but provided for by statute	No continuity of life - majority interest of members required to continue after dissolution event	No free transferability of interests - interests are not transferable	Not discussed	Yes, except § 4 (PLR also addresses conversion of general partnership into an LLC; IRC §§ 708, 721 and method of accounting; IRC § 448)
9320045 (Utah) (2/24/93) (5/21/93)	Not discussed in PLR but provided for by statute	No continuity of life - acceptance of transferee as a substitute member and unanimous vote of all members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, except § 4

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9308039 (West Virginia) (12/2/92) (2/26/93)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes, "to the extent applicable"
9318011 (no state specified) (2/3/93) (5/7/93)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, "to the extent applicable"
9320019 (Utah) (2/18/93) (5/21/93)	Not discussed in PLR but provided for by statute	No continuity of life - acceptance of transferee as a substitute member and unanimous vote of all members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, except § 4
9321070 (Utah) (3/3/93) (5/28/93)	Not discussed in PLR but provided for by statute	No continuity of life - acceptance of transferee as a substitute member and unanimous vote of all members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, except § 4

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9325039[4] (Illinois) (3/26/93) (6/25/93)	Not discussed in PLR but provided for by statute	No continuity of life - written consent of 2/3rds of members, by number, required to continue after dissolution event	No free transferability - unanimous consent of Executive Committee required before interest could be made subject to voluntary or involuntary transfer[5]	Not discussed	Yes, "to the extent applicable"
9325048 (Utah) (3/30/93) (6/25/93)	Not discussed in PLR but provided for by statute	No continuity of life - acceptance of transferee as a substitute member and unanimous vote of all members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, except § 4
9331010 (no state specified) (5/5/93) (8/6/93)	Not discussed in PLR but provided for by statute	No continuity of life - majority interest of members required to continue after dissolution event	No free transferability of interests - unanimous vote of members required to approve a transfer	Not discussed	Yes, "to the extent applicable"

4 This PLR has been revoked pending reconsideration of the issue.

5 No discussion of vote, if any, necessary to approve admission of transferee as a member.

PLR (In chronological order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9333032 (Illinois) (5/24/93) (8/20/93)	Not discussed in PLR but provided for by statute	No continuity of life - affirmative vote of 2/3rds of members by number, which must also represent majority in interest, required to continue after dissolution event	No free transferability - unanimous consent of Executive Committee required before interest could be made subject to voluntary or involuntary transfer	Not discussed	Yes, "to the extent applicable"
9335032 (Delaware) (6/4/93) (9/3/93)	Not discussed in PLR but provided for by statute	No continuity of life - majority interest of members required to continue after dissolution event	Not discussed	No centralized management where management reserved to members in proportion to their interests	Yes, except § 4
9335062 (no state specified) (6/11/93) (9/3/93)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interest - unanimous vote of members required to approve a transfer	Not discussed	Yes, "to the extent applicable"
9335063 (no state specified) (6/11/93) (9/3/93)	Not discussed in PLR but provided for by statute	No continuity of life - unanimous vote of members required to continue after dissolution event	No free transferability of interest - unanimous vote of members required to approve a transfer	Not discussed	Yes, "to the extent applicable"

PLR (In chrono-logical order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9350013 (no state specified)[6] (9/15/93) (12/17/93)	Not discussed in PLR but provided for by statute, limited liability stipulated to by LLC	No continuity of life - majority interest of members required to continue after dissolution event	No free transferability of interests - majority interest of members required to approve a transfer	Centralized management stipulated to by LLC	Yes, "to the extent applicable" (PLR also addresses conversion of general partnership into an LLC; IRC §§ 708,721 and method of accounting; IRC § 448)
9417009 (no state specified) (1/17/94) (4/29/94)	Not discussed in PLR but provided for by statute	No continuity of life-unanimous vote of members to continue after dissolution event	No free transferability of interests-must have consent of the managing members to transfer	Not discussed	Yes, subject to compliance
9416028 (no state specified) (1/18/94) (4/22/94)	Not discussed in PLR but provided for by statute.	No continuity of life-unanimous vote of members to continue after dissolution event	No free transferability-must have consent of managing members	Not discussed	yes to "extent applicable"
9416025 (Delaware) (1/18/94) (4/22/94)	Not discussed in PLR but provided for by statute.	No continuity of life-unanimous vote of members to continue after dissolution	No free transferability-unanimous vote of members required to be admitted as member	Not discussed	yes, subject to compliance

6 This PLR was sought by a Minnesota organized LLC.

PLR (In chrono-logical order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9415005 (Delaware) (1/10/94) (4/15/94)	Not discussed in PLR but provided for in statute.	No continuity of life-majority vote of members required to continue after dissolution event	No free transferability-unanimous approval by members for transfer or compliance with any procedure provided for in LLC agreement	Not discussed	Not discussed
9412030 (no state specified) (12/2/93) (3/25/94)	Not discussed in PLR but provided for in statute.	No continuity of life-unanimous vote by remaining members with majority interest to continue after dissolution event	No free transferability-unanimous approval by members for transfer.	Not discussed	Not discussed
9409014 (Louisiana) (11/29/93) (3/4/94)	Not discussed in PLR but provided for in statute	No continuity of life-unanimous vote by remaining members to continue after dissolution event and if membership reduced to 1 - the admission of one or more members	No free transferability - no member may assign, attempt to do so will result in dissolution	Not discussed	Yes to "extent applicable"
9409016 (Louisiana) (11/30/93) (3/4/94)	Not discussed in PLR but provided for in statute	No continuity of life-unanimous vote by remaining members to continue after dissolution event and if membership reduced to 1 - the admission of one or more members	No free transferability - no member may assign, attempt to do so will result in dissolution	Not discussed	Yes to "extent applicable"

PLR (In chrono-logical order of release)	Limited Liability	Continuity of Life	Free Transferability	Centralized Management	Compliance With Rev. Proc. 89-12 Required
9407030 (no state specified) (11/24/93) (2/18/94)	Not discussed in PLR but provided for in statute	No continuity of life-must have at least 2 remaining members and majority vote of members required to continue after dissolution event	No free transferability-unanimous approval by members for transfer (complete restriction of membership to certain relatives of members)	Not discussed	Not discussed
9404021 (Louisiana) (11/1/93) (1/28/94)	Not discussed in PLR but provided for in statute	No continuity of life-unanimous vote by remaining members to continue after dissolution event and if membership reduced to one - the admission of one or more members	No free transferability-no member may assign, attempt to do so will result in dissolution	Not discussed	Yes to "extent applicable"
9416026 (Delaware LCC Act) (1/18/94) (4/22/94)	Not discussed in PLR but provided for in statute	No continuity of life-unanimous vote of members required to continue after dissolution event.	No free transferability - unanimous vote of members required to approve a transfer	Not discussed	Yes to "extent applicable"

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"KINTNER" CORPORATE CHARACTERISTICS

Limited Liability	Continuity of Life
Free Transferability of Interests	Centralized Management

An LLC, which has limited liability, must avoid two of the remaining three corporate characteristics in order to be taxed as a partnership.

	Limited Liability	Limited Liability and Pass Through	Limited Liability, Pass Through and Avoid Limited Partnership and S Corp Restrictions
Sole Proprietorship			
General Partnership			
C Corp	✓		
Limited Partnership	some	some	
S Corp	✓	✓	
Limited Liability Company	✓	✓	✓

MAY AN LLC USE THE CASH METHOD OF ACCOUNTING?

Code §448(a):

These taxpayers **cannot** use cash method
(must use the accrual method):
1) C Corporation (except certain PSC's)
2) Partnerships with a C corporation partner
3) **Tax Shelter**

Q: Is an LLC a Tax Shelter?

"**Tax Shelter**" (Code §461(i)(3))
= 1) A registered offering enterprise
2) A §6662(d)(2)(C) tax shelter (principal purpose = tax avoidance or evasion) (PLR 9415005 held: an LLC is not a § 6662(d)(2)(c) tax shelter solely by virtue of its LLC structure) or
3) Any **syndicate**

Q: Is an LLC a syndicate?

"**Syndicate**" (Code §1256 (e)(3)(B))
= any form of business in which more than 35% of losses are **allocable** to:

limited partners or **limited entrepreneurs**

Q: Is an LLC member a "limited partner"?

Probably Not.

Q: Is an LLC member a limited entrepreneur?

"**Limited Entrepreneur**" (Code §464)
= person who:
1) Is not a limited partner and
2) Does not actively participate in management

Q: Are > 35% of LLC losses allocable to non-manager members? If so, must the LLC use the accrual method of accounting?

See PLRS: 9415005
9321047
9328005
9350013
9407030

USE OF LIMITED LIABILITY COMPANIES IN ESTATE PLANS

- The Accountant's Perspective -

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SECTION G

USE OF LIMITED LIABILITY COMPANIES IN ESTATE PLANS

- The Accountant's Perspective -

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I. ASSET PROTECTION PLANNING

A. Charging Order

1. KRS Chapter 275, Section 52

   "On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's limited liability company interest with payment of the unsatisfied amount of judgment with interest thereon. To the extent so charged, the judgment creditor shall have only the rights of an assignee of the member's limited liability company interest. This chapter shall not deprive any member of the benefit of any exemption laws applicable to the member's limited liability company interest."

2. Analysis

   An unsecured creditor can obtain from a court a "charging order" which is similar to an attachment or garnishment against a member's interest. A charging creditor has the rights of an assignee.

B. Other Statutory Provisions

1. Member's interest in the LLC is personal property, not an interest in specific LLC assets. KRS Chapter 275, Section 50.

2. Member's interest is assignable. The assignee will not become a member of the LLC without the unanimous consent of all other members. KRS Chapter 275, Section 53.

3. The assignee is entitled to receive distributions to which the assignor would be entitled. An assignment of an LLC interest does not allow the assignee to participate in the management of the LLC. KRS Chapter 275, Section 51.

C. Analysis

1. Adequate statutory foundation exists for use of LLC as an asset protection devise.

2. Body of case law to be developed.

D. Comparison to Limited Partnership

1. LLC member is not exposed to the internal liabilities of the LLC.

2. However, the LLC may hold assets that are capable of generating their own liabilities.

E. Current Drawbacks to Use of LLC as an Asset Protection Devise

1. LLC statutes have not been adopted in all states.

2. No uniform LLC statute.

3. Limited operational experiences.

4. Result: uncertainty.

II. CHOICE OF BUSINESS ENTITY

A. The Essence of LLC

1. Provides insulation from liability to the same extend as a corporation.

2. Is treated as a partnership for tax purposes.

3. Provides members the option of participating directly in management or electing other members or non-members as managers.

B. Comparison to S Corporation

	S Corp.	LLC
1. Ownership interest	one class	unlimited
2. Subsidiaries	no	yes
3. Investors	35	unlimited
4. Types of investors	limited	unlimited

NOTE: LLC avoids the possibly burdensome requirements of a subchapter S trust (QSST). All income of a QSST must be distributed.

	S Corp.	LLC
5. Basis for deducting losses	stock plus debt	investment plus liabilities
6. Contributions of property	potential taxable event	no gain or loss
7. Distribution of appreciated assets	corporate taxation	no gain or loss

Conclusion: LLC is more flexible than S corporation.

C. Comparison to Family Limited Partnership

1. IRC Section 2704(b)(1).

   Any applicable restriction is ignored in determining the estate or gift tax value of an interest in a corporation or a partnership transferred to, or for the benefit of, a member of the transferor's family.

2. Applicable restriction is a limitation on the ability to liquidate the entity, in whole or in part, that is more restrictive than the limitation that would apply under state law generally applicable to the entity in the absence of the restriction. IRC Section 2704(b)(3)(B) and Reg. 25.2704-2(b).

3. State law contains significant limitations on the transfer of a general or limited partner's interest absent a contary provision in the partnership agreement.

   The limitations may be more restrictive than the limits imposed on LLC's.

4. The flexibility of LLC may create an applicable restriction under IRC Section 2704(b).

III. BUSINESS APPLICATIONS FOR LLC

A. In General

The investor who wants more flexibility than what is available with an S corporation and who wants more control than what is available with a limited partnership.

B. Businesses that Require Active Management

1. All members can actively participate in the management of the LLC without loss of limited liability protection.

2. Examples

   a. start-up businesses
   b. entrepreneurial businesses
   c. professional service firms
   d. joint ventures

C. Businesses that Need to Accommodate Passive Investors

1. LLC can be structured with centralized management.

2. Examples.

   a. investment partnerships
   b. real estate investments
   c. theatrical and entertainment investments

3. Consider passive activity loss limits.

D. Businesses where Retaining Control is Important.

1. LLC member may not transfer membership interest without consent of a significant percentage interest of the remaining members, unless otherwise provided for in the operating agreement.

2. Member rights to profits are generally freely transferable which provides some degree of liquidity.

3. Examples.

   a. family businesses
   b. professional service firms

E. Situations that Cannot Accommodate the S corporation

1. See II B.

2. Examples.

   a. use of trusts as LLC members
   b. multi-tiered corporate structure
   c. foreign investors

F. Real estate transactions

1. Investor objectives

   a. limited liability
   b. management control
   c. non-recourse debt

2. Consider at-risk rules

IV. CONVERSION TO LLC

A. Partnership to LLC

1. IRS Ltr. Rul. 9210019.

   a. Partnership ceases to exist
   b. LLC succeeds to all of the partners' assets and liabilities
   c. Partners become members of the LLC
   d. Conversion is tax free

2. Conversion of partnership to LLC is treated like conversion of general partnership to limited partnership. Rev. Rul. 84-52.

   a. IRC Section 721 exchange treatment
   b. IRC Section 708 no partnership termination

3. Tax impact on partners/members

   a. If LLC classified as a partnership for tax purposes, and
   b. no change in partners'/members' shares of the entity's liabilities as a result of the conversion, then
   c. no gain or loss to

      (1) partnership
      (2) LLC
      (3) partners/members

B. Corporation to LLC

1. Requires a liquidation of the C or S corporation.

2. Gain or loss

   a. shareholders. IRC Section 331
   b. corporation. IRC Section 336

C. Merger of Subsidiary into LLC

1. Facts

Parent owns all outstanding stock of Subsidiary, which Parent wants to convert to LLC.

Parent forms Newco and contributes assets for Newco stock.

Parent and Newco form LLC.

Subsidiary is merged into LLC in a statutory merger.

2. IRS Ltr. Rul. 9409014

a. LLC taxed as a partnership
b. No gain or loss to either Subsidiary or LLC under IRC Section 721
c. No gain or loss to Parent under IRC Section 332

3. Result is the merger is treaded as

a. contribution of capital to partnership, followed by
b. distribution of a partnership interest to Parent in complete liquidation of Subsidiary

V. PROFESSIONALS AND SERVICE ORGANIZATIONS

A. The problem

The operation of a service organization as a general partnership results in unlimited liability.

Owners/professionals want protection from contractual and malpractice related liabilities.

No form of business entity will protect the owner/professional from his or her own mistakes, negligence or malpractice.

Professional corporations and partnerships of professional corporations have been used as a shield against potential legal liabilities and to create opportunities for settlements. The conversion from general partnership to professional corporation can be achieved without significant adverse tax consequences.

B. The LLC solution of Ltr. Rul. 9350013

1. Facts

   Law firm partners exchanged general partnership interest for LLC interest equal in value.

   LLC operating agreement requires written majority in interest approval for any transfer to a non-member.

   State law restricts transfer of ownership interests to lawyers.

LLC operating agreement is specific about continuing the "practice" by majority in interest of the remaining lawyers.

Death
Insanity
Bankruptcy
Retirement
Resignation
Expulsion
Liquidation
Dissolution
Termination
Fail Safe Continuation

2. Results

a. Partnership under Rev. Rul. 88-76

1. No continuity of life

Death of a member results in dissolution of LLC unless majority in interest of surviving lawyers agree to continue the practice.

2. Ownership interest not fully transferable

Transfer of LLC interest to a non-member (new lawyer owners) required the approval of majority in interest (existing lawyer owners).

b. No gain or loss on conversions from general partnership to LLC.

See IV A 2

3. Accounting method

a. The typical law firm partnership is not

1. C corporation
2. partnership with a C corporation partner
3. tax shelter

b. So the cash method used by the law firm partnership can be continued by the law firm LLC.

VI. A PUNCTURE PROOF CORPORATE VEIL?

A. To what extent will courts pierce the corporate veil of LLC limited liability?

1. New statute

2. No case law experience

3. Injured and aggressive plaintiffs

B. Will evidence of professional liability insurance be a requirement for continuing state registration and licensing?

WILL CONTESTS
Anticipation vs. Litigation

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SECTION H

WILL CONTESTS

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I. **PROCEDURE FOR CONTESTING A WILL:** In circuit court, within two years of district court's probate action; must name all beneficiaries who are "necessary parties"; may restrain further distributions

A. Filing The Will Contest

KRS 394.240(1): "Any person aggrieved by the action of the district court in admitting a will to record or rejecting it may bring an original action in the circuit court of the same county to contest the action of the district court. Such action shall be brought within two (2) years after the decision of the district court."

-- A person is "aggrieved" so as to create standing only if the will deprives the person of some benefit the person would otherwise receive, such as by intestacy or under a previous will. Wells v. Salyers, Ky., 452 S.W.2d 392 (1970); Egbert v. Egbert, Ky., 217 S.W. 365 (1920).

-- Although Kentucky law formerly required that all beneficiaries must be named as parties in a will contest, that is no longer required under KRS 394.260. West v. Goldstein, Ky., 830 S.W.2d 379 (1992) (contestant must only name a beneficiary who is a "necessary party" within meaning of CR 19.01).

-- Statute further provides that "The parties may, in the same action, or in a separate action if the validity of the will is not in issue, seek construction, interpretation or reformation of a will." Thus, unlike previous statutory framework before Judicial Article was passed, a will contest suit is "no longer strictly limited to whether the particular instrument probated or rejected in the district court is the will of the testator." West v. Goldstein, Ky., 830 S.W.2d 379, 381 (1992).

-- Cf. Mullins v. First American Bank, Ky. App., 781 S.W.2d 527, 528 (1989) (upholding circuit court decision that it lacked jurisdiction to rule on validity of codicil neither admitted nor rejected by district court; "it should be clear that **the statutes, read together, require (1) that all proceedings for the admission to probate of a will or codicil be commenced in the district court; (2) that the district court must either admit or reject the instrument; and (3) that the district court retains jurisdiction over the matter until such time as a will contest, or** adversary proceeding, is commenced in the circuit court."

-- Pursuant to KRS 394.240, contestant should lodge notice of the action "in the office of the county clerk of the county in which the will was admitted to probate or rejected," although failure to do so will not justify dismissal, Justice v. Conn, Ky. App., 724 S.W.2d 227 (1987), discussed in West v. Goldstein, Ky., 830 S.W.2d 379, 381 (1992).

B. Restraining Further Distributions

KRS 394.250: "An Action filed in the circuit court, pursuant to KRS 394.240, shall not, unless taken within twelve (12) months from the entry of the district court's order, prevent the appointment of an administrator or executor by the district court or the settlement, distribution, and division of the decedent's estate. The circuit court in which proceedings are pending may make an order restraining the further distribution and division of the estate. ... ."

II. **CUSTOMARY GROUNDS FOR CONTESTING A WILL:** Especially lack of testamentary capacity and undue influence

A. Insufficient Age, Improper Execution or Revocation

B. Lack of Capacity

-- "The right of a testator to make a will according to his own wishes is jealously guarded by the courts, regardless of a court's view of the justice of the chosen disposition." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing New v. Creamer, Ky., 275 S.W.2d 918, 920 (1955).

-- **"The inquiry as to capacity is three-fold. First, did the testator know the natural objects of his bounty, and his obligations to them. Second, could he make a rational survey of his estate. Third, did he dispose of that estate according to a fixed plan of his own."** Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing Bennett v. Kissinger, 231 S.W.2d 74, 75 (1950).

-- "Testamentary capacity requires a lower degree of mental capacity than contractual or business capacity, especially so where the plan of the testamentary disposition in the will and codicil at hand was so simple and uncomplicated. [Citations omitted.] And mere weakness of mental power will not prevent a person from making a valid will." Warren v. Sanders, Ky., 287 S.W.2d 146, 149 (1956)

-- Evidence of "lucid interval" may permit probate of will by otherwise incapable testator; however, "evidence of the testator's mental status both before and after the execution of the will are admissible so long as they have a reasonable tendency to indicate his mental condition at the time of the execution of the will." Pardue v. Pardue, Ky., 227 S.W.2d 403, 405 (1950), cited in Hendren v. Brown, Ky., 364 S.W.2d 329, 331 (1962)

C. Undue Influence

-- "Undue influence is influence such that the testator's free agency is destroyed." ... It is not influence derived merely from acts of kindness, appeals to feeling, or arguments addressed to the understanding." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989)

-- [T]he undue influence must be exercised at the time of the will's execution." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing Williams v. Vollman, Ky. App., 738 S.W.2d 849, 850 (1987).

-- "There have been listed certain so-called 'badges' of undue influence. They include[:]

a physically weak and mentally impaired testator,

a will unnatural in its provisions,

a lately developed and comparatively short period of close relationship between the testator and the principal beneficiary,

participation by the beneficiary in the physical preparation of the will,

the possession of the will by the beneficiary after it was written,

efforts by the beneficiary to restrict contacts between the testator and the natural objects of his bounty and

absolute control of testator's business affairs by a beneficiary."

Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing Belcher v. Somerville, Ky., 413 S.W.2d 620 (1967); Golladay v. Golladay, Ky., 287 S.W.2d 904, 906 (1955).

-- "Undue influence is a subtle thing and can rarely be shown by direct proof. In many instances the facts and circumstances leading up to the execution of the desired instrument must be relied upon to establish its existence." Creason v. Creason, Ky., 392 S.W.2d 69, 74 (1965), quoting McKinney v. Montgomery, Ky., 248 S.W.2d 719 (1952).

-- On the other hand, "Mere opportunity of the wife, even though coupled, as here, with an aged and physically weak condition of the testator, is not sufficient to establish undue influence." Golladay v. Golladay, Ky., 287 S.W.2d 904, 906 (1955) (noting "There was no evidence of keeping the testator in seclusion, or of restriction of his contacts with his sons, such as to permit exercise of constant and undisturbed influence by the wife or to isolate him from the normal influences resulting from contact with this children.")

III. RELATED PRACTICE ISSUES: Burdens of proof; lay and expert testimony

A. Burden Of Proof

1. Initial Burden of Establishing Due Execution and Rationality of Disposition is on Proponent

-- Proponent of the will must establish due execution of the will. Williams v. Vollman, Ky. App., 738 S.W.2d 849, 850 (1987).

-- "If a will (or, in this case, a codicil) appears rational, proof of proper execution creates a presumption of its legality." Cruse v. Leary, Ky. App., 727 S.W.2d 408, 411 (1987), citing Simpson v. Sexton, Ky., 311 S.W.2d 803 (1958).

2. When Distribution Appears "Unnatural"

-- "The burden of proof is on appellees, as proponents of the will, to explain the disposition. Gibson v. Gipson, Ky., 426 S.W.2d 927, 929 (1968); and Sutton v. Combs, Ky., 419 S.W.2d 775, 776 (1976). There is not, however, a per se unnatural will. Clark v. Johnson, 268 Ky. 591, 105 S.W.2d 576, 580 (1937). Instead, it is a factual issue which can be explained satisfactorily by proponents. Nunn [v. Williams, Ky.,] 254 S.W.2d [698,] at 700 [(1953)]." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 646 (1989).

3. Contestants Next Bear Burden of Challenging Will

-- The burden of proof is on contestants to overcome the presumption of capacity by substantial evidence. Wallace v. Scott, Ky. App., 844 S.W.2d 439 (1992); Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing New v. Creamer, Ky., 275 S.W.2d 918, 920 (1955); Cruse v. Leary, Ky. App., 727 S.W.2d 408, 411 (1987) ("A testator is presumed to possess the requisite capacity, it being the burden of the challenging party to prove otherwise.").

-- "Again, the burden of proof is on appellants [contestants] to establish undue influence with evidence of substance. That proof must go beyond mere opportunity." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 645 (1989), citing Nunn v. Williams, Ky., 254 S.W.2d 698, 700 (1953).

4. Burden Easier to Carry When There is Evidence of Multiple Grounds for Contesting Will

-- "There is authority for the proposition that mere assertion of challenges based upon both undue influence and lack of capacity makes it easier for contestants to get to the jury. Creason v. Creason, Ky., 392 S.W.2d 69 (1965); and Gibson [v. Gipson, Ky.,] 426 S.W.2d [927,] at 928 [(1968)]. But the evidence presented must not merely be a scintilla. It must be of sufficient character, substance, and weight to furnish a firm foundation for a jury's verdict." Fischer v. Heckerman, Ky. App., 772 S.W.2d 642, 646 (1989).

-- "When a contest is pitched on both mental incapacity and undue influence, evidence that tends to show both need not be as convincing as would be essential to prove one or the other alone." Creason v. Creason, Ky., 392 S.W.2d 69, 74 n.1 (1965), quoting Roland v. Eibeck, Ky., 385 S.W.2d 37 (1964).

-- "[A]n unequal or unnatural disposition by itself is not enough to show undue influence, but when coupled with slight evidence of the exercise of undue influence ... it is sufficient to take the case to the jury." Williams v. Vollman, Ky. App., 738 S.W.2d 849, 851 (1987), quoting Bennett v. Bennett, Ky., 455 S.W.2d 580, 582 (1970).

-- "[W]here there is gross inequality in the disposition of the estate among the natural objects of testator's bounty, or where the will is unnatural, such facts, when unexplained and when corroborated by even slight evidence of want of testamentary capacity, or of undue influence, are sufficient to take the case to the jury." Pardue v. Pardue, Ky., 227 S.W.2d 403, 406 (1950), quoting Allen v. Henderson, Ky., 184 S.W.2d 885, 886 (1945).

B. Lay Witnesses And Expert Testimony

1. Lay Testimony

-- Declarations of the testator are generally admissible. Atherton v. Goslin, Ky., 239 S.W. 771 (1922). The Dead Man's Statute, KRS 421.210(2), does not apply to will contest cases, so the parties may freely testify about their relations, conversations and transactions with the testator. Gay v. Gay, Ky., 215 S.W.2d 92 (1948).

-- Opinion testimony about capacity from lay witnesses is admissible so long as opinions are based on facts which themselves are both admissible and sufficient to support finding of capacity or incapacity. See Hendren v. Brown, Ky., 364 S.W.2d 329, 332 (1962) ("opinion testimony as to the mental capacity of [the testator] is admissible to the extent it is based upon observable conditions"); Warren v. Sanders, Ky., 287 S.W.2d 146, 148 (1956) ("Opinions of witnesses are insufficient to take a will contest case to the jury, unless the facts upon which the opinions are based tend to establish lack of mental capacity."), quoting Tate v. Tate's Executor, Ky., 275 S.W.2d 597, 600 (1955).

-- A wide range of proof involving the testator's background and relations with the parties is allowed in undue influence cases. Welch's Administrator v. Clifton, Ky., 172 S.W.2d 221 (1943).

2. Expert Testimony

-- Johnson v. Liberty National Bank & Trust Co., Ky. App., 1994 Ky. App. LEXIS 48 (May 6, 1994) (not final), petition for discr. rev. filed (May 26, 1994) (Expert testimony not sufficient to sustain burden of proof where foundation facts not present; "the contestors place a lot of stock on the testimony of their expert witness; however, expert opinion testimony cannot by itself sustain the burden of proof required. There must be other probative facts conjunctive with expert opinion to satisfy the burden of proof to reform the instrument. <u>See</u> <u>Sloan v. Sloan</u>, 303 Ky. 180, 197 S.W.2d 77 (1946).").

-- <u>Fischer v. Heckerman</u>, Ky. App., 772 S.W.2d 642 (1989) (testator suffered heart attack and stroke on February 7, 1986, and executed will during hospital stay on February 14, 1986. He died on April 8, 1986, leaving none of $1 million estate to his two surviving relatives, who challenged will based on lack of mental capacity and undue influence by one or more of the beneficiaries. Court of Appeals ruled that expert testimony should have been permitted to address effects of medical developments on testator's capacity because those effects "are beyond the pale of common knowledge.").

IV. RELATED ISSUES INVOLVING ATTORNEYS' FEES AND DISTRIBUTIONS

A. <u>Who Pays Attorneys' Fees In Will Contest</u>

1. <u>Executor's fees</u>

a). Where executor retains counsel to defend will:

-- "[I]t is the duty of an executor to defend any suit contesting the validity of the instrument he has been appointed to execute and ... **the expense of such a defense is a proper charge against the whole estate,"** <u>Harrell v. Westover</u>, Ky., 283 S.W.2d 197, 200 (1955)

-- **except**: "(1) Where the executor was the sole beneficiary under the will or (2) where the executor acted in bad faith," <u>Harrell v. Westover</u>, Ky., 283 S.W.2d 197, 200 (1955); <u>accord</u>, <u>Creason v. Creason</u>, Ky., 392 S.W.2d 69, 75-76 (1965) ("[C]osts and attorney fees of the executor's attorneys ... are proper charges against the estate when incurred in good faith for the purpose of upholding a will. The fact that [the testator] was either mentally incompetent or that the will was caused to be executed by undue influence of the appellant, or both, indicates that appellant acted in bad faith from the beginning in obtaining execution of the will and deed. Under these circumstances coupled with the fact that appellant was the principal beneficiary and the only one who stood to gain if the will was upheld, the appellant is not entitled to have the fees and costs charged against the estate."); see also Clay v. Eager, Ky., 444 S.W.2d 124, 128 (1969) (executor/attorney may be individually charged with court costs if court determines that no suit should have been necessary) (settlement suit) (citing Hill v. Roberts, Ky., 311 S.W.2d 569, 572 (1958))

-- By contrast, in suit by executor to obtain declaration of meaning of will, executor's costs are chargeable to estate, even if executor would personally benefit from one interpretation of will, under theory that expenses were incurred to guide executor in final disposition of estate, Harrell v. Westover, Ky., 283 S.W.2d 197, 199 (1955).

b). legal fees probably may be charged to heirs in different proportions than their actual beneficial shares: "There is authority for the proposition that one who involves an estate in unnecessary litigation should pay the attorney fees and costs incurred by the personal representative." Skinner v. Morrow, Ky., 318 S.W.2d 419, 425-26 (1958) (involving settlement suit)

2. Beneficiary's fees

-- Beneficiaries may be required to pay proportionate share of attorneys' fees incurred by other beneficiary who obtains relief for all, Clay v. Eager, Ky., 444 S.W.2d 124, 128 (1969) (citing KRS 412.070); Skinner v. Morrow, Ky., 318 S.W.2d 419, 426-27 (1958) (in settlement suit, attorney for certain heirs awarded fees assessed against entire estate where he provided services that "benefited the entire estate, as distinguished from the personal interests of his own clients," even though fees limited because settlement suit by heirs "did accomplish very little that could not have been accomplished satisfactorily by the administrator"; court also indicates that in appropriate circumstances, fee award could have been made against other heirs in different proportions than their distributive shares); Harrell v. Westover, Ky., 283 S.W.2d 197, 200 (1955) (estate required to pay attorneys' fees incurred by beneficiaries in settlement suit).

-- Compare Johnson v. Ducobu, Ky., 258 S.W.2d 509, 510 (1953) (no fee awarded where no showing of unreasonable delay by the administrator in the settlement of the estate, and it appeared that the settlement suit was fruitless and unnecessary) (discussed in Skinner v. Morrow, Ky., 318 S.W.2d 419, 427 (1958))

B. Amount of Compensation for Counsel

1. If counsel is not also serving as executor/personal representative:

-- Attorney should be allowed "reasonable compensation," Morgan v. Meacham, Ky., 130 S.W.2d 992 (1939); Harding's Administrator v. Harding, 116 S.W. 305 (1909); see also Skinner v. Morrow, Ky., 318 S.W.2d 419, 425 (1958) (fee of more than four percent permitted in addition to five percent for administrator; "It is true, as stated by the trial judge in his findings and conclusions, that much of the litigation was needless and useless, and that an unnecessarily large and involved record was built up. However, this was not the fault of the administrator or its attorney. ... [I]t was necessary that the administrator participate in the proceedings through its attorney. The administrator had the duty to see that the estate was properly administered and distributed, and could not simply stand back and let the heirs conduct the litigation to suit themselves.")

-- However, attorney's compensation not fixed by executor, but rather is subject to court review, Robinson's Executors v. Robinson, 179 S.W.2d 886 (1944) (executor does not have the authority to fix amount due to attorney he employs; instead, fee fixed by court in making a reasonable allowance to the executor to cover the attorney's fee)

2. If counsel _is_ also serving as executor/personal representative:

a). An attorney providing legal services for an estate may be limited to only one fee when he or she also provides services as administrator and executor, _Clay v. Eager_, Ky., 444 S.W.2d 124, 127 (1969); _Slusher v. Weller_, Ky., 151 S.W. 685 (--)

-- _unless_: "the testatrix had designated [counsel] as attorney and executor and therefore contemplated that he would be reimbursed for his services in both capacities," _Clay v. Eager_, Ky., 444 S.W.2d 124, 127 (1969) (_distinguishing_ _Morgan v. Meacham_, Ky., 130 S.W.2d 992 (1939))

-- or _possibly unless_: the attorney who defends the will contest is deemed to have performed "special legal services" in addition to customary legal services performed for an estate, _Clay v. Eager_, Ky., 444 S.W.2d 124, 127 (1969)

-- _see_ KRS 395.150(2): "[T]he court may allow to the executor, administrator or curator such additional compensation as would be fair and reasonable for the additional services rendered, if the additional services were: (a) Unusual or extraordinary and not normally incident to the administration of a decedent's estate ... ."

b). An attorney providing legal services for an estate and also serving as executor and administrator is subject to the statutory maximum for fee, KRS 395.150, of five percent of estate plus five percent of the income collected by the executor, _Clay v. Eager_, Ky., 444 S.W.2d 124, 127 (1969)

-- "The statute in other words establishes a ceiling, not a base," _Clay v. Eager_, Ky., 444 S.W.2d 124, 127 (1969)

-- "[W]hen an administrator delays or neglects the settlement of an estate or the payment or distribution of funds in his hands when same becomes payable, or otherwise neglects his duty, the Courts may disallow any commission or compensation, or allow a less compensation than would or should have been allowed if the administrator had properly administered his duties," Clay v. Eager, Ky., 444 S.W.2d 124, 127 (1969) (attorney/executor allowed commission of three percent where "he made efforts to locate the beneficiaries under the will and also collected the sums owing to the estate ... [although] no unusual or extraordinary labors were imposed upon [him] in collecting the note"), citing Greenway's Administrator v. Greenway, 98 S.W.2d 283 (1936) (administrator allowed commission of one percent); see also Skinner v. Morrow, Ky., 318 S.W.2d 419 (1958), award slightly in excess of five percent disallowed where estate consisted mainly of securities, and no extraordinary trouble or effort involved in handling of estate; only five percent permitted

V. RECENT CASES INVOLVING WILL CONTESTS

A. Wallace v. Scott, Ky. App., 844 S.W.2d 439 (1992)

-- Widow involved in litigation beginning in 1955 with her two children after she paid half of the purchase price but was made only one-third owner under the deed. Upon resolution of that litigation, she stated "That's the last they'll ever get off me." Shortly afterwards, man began working on the farm, and ten years later he moved into the house with her. In 1973, widow prepared will, and prepared codicil in 1975, leaving life estate to man, with remainder to Methodist Home. After she died in 1988, two children challenged will based upon lack of mental capacity and exercise of undue influence. Trial court granted summary judgment and Court of Appeals affirmed (even after Steelvest, Inc. v. Scansteel Service Center, Inc., Ky., 807 S.W.2d 476 (1991)).

-- Court noted "appellants were unable to discover any evidence of sufficient probative value to demonstrate even the slightest indication of lack of mental capacity." Court emphasized that "The burden of proof is on contestants ... to overcome the presumption of capacity by substantial evidence." Likewise, reviewing the "badges" of undue influence enumerated in Golladay v. Golladay, Ky., 287 S.W.2d 904 (1955), Court again noted that "the burden of proof is on appellants to establish undue influence with evidence of substance," and found no basis for such a finding.

B. **Burke v. Burke, Ky. App., 801 S.W.2d 691 (1991)**

-- Husband widowed after 53 years of marriage in February 1985, moved from Ohio to Pike County in June 1985, and decided to remarry several weeks later to woman he had not known previously. Remarried on July 20; executed new will on July 27 leaving everything to her; died August 17. Two children challenged new will on grounds of undue influence and lack of testamentary capacity; conflicting evidence concerning whether testator began drinking heavily and was incapacitated by grief after first wife's death. Jury found "the document probated was not the will of" the decedent. Widow appealed that there was a "complete lack" of evidence of either undue influence or incapacity. Court of Appeals affirmed, although acknowledging that "we are not unmindful of the possibility that the jury invalidated this will simply because it seemed unfair."

-- Court candidly notes "A survey of the law on this subject yields a series of contradictory statements and policies. On the one hand courts stoutly proclaim the policy of carrying out the wishes of the deceased, even if they are arbitrary or unfair. ... The testator must have sufficient mind to know his property, the objects of his bounty and his duties to them ... ; but he is perfectly free to ignore the latter if he is otherwise of sound mind. 'Every man possessing the requisite mental powers may dispose of his property by will in any way he may desire, and a jury will not be permitted to overthrow it, and to make a will for him to accord with their ideas of justice and propriety.' ... There must be some specific evidence of circumstances from which it can be reasonably inferred that undue influence was in fact exercised. ... To justify setting aside a will the influence exercised must be such that it 'obtains dominion over the mind of the testator to such an extent as to destroy his free agency in the disposal of his estate, and constrains him to do that which he would not have done if left to the free exercise of his judgment.' ...

"After issuing these stern admonitions, however, the law reverses itself somewhat to lower the contestant's burden of proof when allegations of undue influence are coupled with an unequal or unnatural disposition, allegations of mental incapacity, or both. ... '[W]hen slight evidence of the exercise of undue influence and the lack of mental capacity is coupled with evidence of an unequal or unnatural disposition, it is enough to take the case to the jury.'" (Citations omitted.)

C. <u>Fischer v. Heckerman</u>, Ky. App., 772 S.W.2d 642 (1989)

-- Decedent suffered heart attack and stroke on February 7, 1986, and executed will during hospital stay on February 14, 1986. He died on April 8, 1986, leaving none of $1 million estate to his two surviving relatives, who challenged will based on lack of mental capacity and undue influence by one or more of the beneficiaries. After trial court granted summary judgment to beneficiaries, Court of Appeals reversed on both grounds.

-- As to lack of capacity, Court ruled that expert testimony should have been permitted to address effects of medical developments on testator's capacity because those effects "are beyond the pale of common knowledge." Moreover, Court held that there was a genuine issue of fact about capacity presented by lay testimony.

D. Williams v. Vollman, Ky. App., 738 S.W.2d 849 (1987).

-- Testator died at 91 on February 19, 1985. Both testator's wife and one daughter had died in May 1984, and testator had never been told. Appellant, a granddaughter, challenged the will prepared four or five months before testator's death by her cousin, a grandson, on grounds of lack of mental capacity and undue influence. The will disinherited the testator's only living child and all of his grandchildren except one, to whom the testator left his house and an adjoining lot to the grandson. After trial court granted directed verdict to grandson on grounds that there was no evidence of probative value of mental incapacity or undue influence, Court of Appeals reversed on grounds that there was evidence of undue influence.

-- Mere fact that testator did not know his wife and daughter had predeceased him -- which arguably showed he did not know the natural objects of his bounty -- was not adequate he did not have capacity to know the objects of his bounty. Otherwise, evidence showed his mental faculties were intact.

-- "It is not sufficient that it be shown that there was merely an opportunity to exercise undue influence, but some evidence must be adduced showing circumstances from which it can reasonably be inferred that undue influence was exerted." Williams v. Vollman, Ky. App., 738 S.W.2d 849, 850 (1987), quoting Copley v. Craft, Ky., 312 S.W.2d 899, 900 (1958) (emphasis added in Williams).

VI. **SAMPLE JURY INSTRUCTIONS:** Taken from West v. Goldstein, Ky., 830 S.W.2d 379 (1992) (Westerfield, Jeff. Cir. Ct.), which are evidently drawn from 2 J. S. Palmore & R. W. Eades, Kentucky Instructions to Juries, § 50.01-.03, at 393-95 (4th ed. 1989).

Instruction No. 1: For purposes of these instructions:

1) A person has testamentary capacity in making a will if at the time of its execution she has such mental capacity as to enable her to know the natural objects of her bounty, her obligation to them, the character and value of her estate, and to dispose of it according to a fixed purpose of her own.

2) Undue influence is any influence obtained over the mind of the deceased to such an extent as to destroy her free agency and lead her to do against her will what she would otherwise refuse to do, whether exerted at one time or another, directly or indirectly, if it so operated upon her mind at the time she signed the paper. [But any reasonable influence resulting from acts of kindness or from appelas to the feeling or understanding, and not destroying free agency, is not undue influence.]

Instruction No. 3:

Do you believe from the evidence that [testator] lacked testamentary capacity at the time she executed the Codicil dated January 5, 1984 or that she was induced by undue influence exerted upon her by [executor] to sign said codicil? YES/NO _____

Instruction No. 4:

Only if you have answered "yes" to any one of the questions set forth in the Instructions above, you are further instructed to determine whether you believe, by clear and convincing evidence, that the transfers to [executor] and her family as set forth below were each fair and were freely and voluntarily entered into by [testator]. If you so believe, you shall answer the following questions Yes, otherwise you shall answer No.

... The check from [testator]'s Trust Account, ultimately used for the purchase of a certificate of deposit in the amount of $10,000 on December 11, 1986. YES/NO _____

REVIEWING INSURANCE PROPOSALS

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SECTION I

REVIEWING INSURANCE PROPOSALS

TABLE OF CONTENTS

I. INTRODUCTION

Until recently, choosing among life insurance companies or products was like putting together a child's puzzle with big pieces. Advisors merely put together the same puzzle with the same pieces for each client. For many, the decision was narrowed to which company a participating whole life policy would be placed.

Today all that has changed with company failures such as Executive Life, Mutual Benefit and of course Kentucky Central, great emphasis is being placed on due diligence. Not only on the company, but the products, marketing and proposals of those companies. The effects of Prudential Securities' limited partnerships and Metropolitan Life's Tampa, Florida office selling whole life insurance disguised as retirement accounts are only starting to be felt.

Add to this the history insurers' have had with investments in long-term bonds in the early 1980's, junk bonds in the late 1980's and commercial mortgages and real estate in the early 1990's. Recent developments in CMOs and derivatives are equally disturbing and will almost surely bring more federal oversight to the industry.

Combine the above with Risk Based Capital requirements, higher corporate income taxes (DAC) and the sharp drop in long-term interest and inflation rates over the past several years and you begin to realize the necessity for new and improved products. But these products are like new puzzles, much harder to put together with many smaller pieces and sometimes an unknown picture.

This outline will attempt to help advisors review proposals using concepts and techniques quite peculiar in some instances and routine in others. Caution is urged for the inexperienced advisor using yesterday's guides in evaluating proposals and conducting due diligence on current products and company financials. Today it is possible to be sued over life insurance advise you <u>didn't</u> provide and considering the leveraged nature of insurance, where a small premium provides substantial coverage, the stakes are high.

II. LIFE INSURANCE BASICS

A. <u>Proposals vs Policy</u>

Relying on a policy illustration is an extremely hazardous way to buy life insurance. The most powerful sales tool an agent has is an illustration of future values or ledger statement. It shows how a policy is supposed to perform over a 20, 30 or 40 year time period. Suppose to, but almost certainly will not. Nothing obligates the insurer to deliver on the projected values, and almost nothing inhibits the imagination in making them.

Suppose you're thinking of buying 1,000 shares of General Electric, and your stockbroker hands you a computer generated printout showing what the investment will be worth in 30 years. Ridiculous, right? Yet that's precisely how life insurance is sold.

There are three items a company may use to create or alter cash value and death benefits. These are; expenses, mortality and interest rate (investments) each will be covered in detail later. For now, it is only necessary to know these items can be anything an agent or company <u>wants</u> them to be in an illustration — not what they actually are.

The policy itself, on the other hand, is the contract and therefore will spell out in specific terms which elements are indeed factual. Comparing the differences between the proposal and policy will shed light on the vast discrepancies and provides an excellent beginning to explore them.

B. <u>Assumptions in Illustrations</u>

Small adjustments in assumptions can magnify into large numbers, particularly in the later years of a policy proposal. The magic of compound interest works well for a ledger statement as it will project values out 30 to 40 years. Advisors should instruct clients to pay no attention at all to far-out projections as they are at best, a guess.

As an example, a 1% interest rate increase assumed on an illustration would show a 30% increase in cash value in 40 years. For someone age 45 buying a permanent life insurance policy, this one percent would artificially create a 41% increase in cash value at age 95 on a ledger statement.

Assumptions in interest rates, mortality and expense charges in illustrations need not be based on any actual expectation or reality. In cases where all three components have been artificially manufactured the results, although actuarially feasible, are mathematically impossible. This is not suggesting all illustrations are inherently skewed, but both agents and actuaries get caught up in a vicious cycle trying to make their policies look better than the competition's.

Agents are competing, so they go back to their companies' marketing department, which then puts pressure on actuaries to build a better illustrating policy. Every few months the process starts over again as everyone is leapfrogging everyone else. In response to this gamesmanship, the National Association of Insurance Commissioners (NAIC) in April decided to move ahead with a proposal to prohibit showing any future projections not guaranteed. Regulators voted to allow companies to illustrate past performance, but only by using a common index (yet to be developed) for comparison purposes.

If regulators succeed in passing these changes it would mean a radical departure from current practice. At first glance, this appears to be beneficial — but some additional concerns soon surface. The common index to be developed may be as meaningless as the existing net payment cost and surrender cost indexes. Would current scales be allowed so consumers will not confuse past with future performance? What will showing the past performance — during a bull market offering rates of 10%-15% — due to consumers expectations? Focusing all attention on illustration guarantees might well lead to companies raising guaranteed values to a point where it is not fiscally prudent. Illustration reform is needed but unlikely to be resolved soon. And while the current system makes it difficult for individuals to judge on their own, simply being aware of the problems may help you avoid the most obvious situations.

C. Persistency From a Historical View

The average life of a life insurance policy is between 5-7 years. A Life Insurance Marketing and Research Association (LIMRA) study of Whole Life policies revealed that after 10 years, only 27% of those policies were still in force. (See Exhibit 1.)

The late 1970s and early 1980s was the beginning of the "replacement era" and led to a phenomenal increase in lapses of low yielding Whole Life policies. Universal Life was much more attractive as the high current interest rates projected much higher values over an extended time period. This has obviously skewed the persistency statistics, but perhaps not as much as one might originally believe.

Let's imagine a typical insurance sale to a 35 year old head of the household and follow an imaginary trail of subsequent events. P.J. was approached in 1975 by a friendly insurance agent and purchased a participating Whole Life policy. In 1982, P.J. was revisited and shown the benefits of replacing that policy with a high interest Universal Life policy. In August 1987, the same agent returned to explain an even better opportunity — replace the U.L. policy with a Variable Universal Life contract. Then in 1993, our agent returns with the college funding concept of borrowing from the life insurance. P.J. is now 53, facing another child going to college in two years and is unsure of the market. Wisely, the friendly insurance agent suggests the safety of a participating Whole Life policy and completes the paperwork.

Although fictional this is not an unrealistic picture of an event seen all too often. While the agents feel they have done a service for their client, in reality, after surrender charges and the foregone future dividends of the original policy, P.J. is actually worse off than staying in the first policy. The agent however is planning to send a postcard from his vacation home in Hawaii. Over the long run there should be little investment differences between whole and universal life, and therefore no significant advantages for the different types of cash value policies. Whole life policies may have higher dividend scales (compared to universal life) when interest rates are heading down, but the opposite is probably true when rates are heading up.

Jumping from one type of policy to another due to presumed interest or dividend crediting advantages is not a good idea. Insurance, though illustrated for the long-term accumulation features for the consumer, is adversely affected by the short-term (first year) commission incentives for an agent. As long as current commission scales are used, with yield hungry consumers scrambling for high returns in a low interest rate environment, persistency will remain an issue for insurance companies.

III. PIECES OF THE PUZZLE

A. Expenses

The actual cost of owning a policy over a period of time is made up of expenses, including commissions and home office overhead — plus the mortality charges (cost of insurance protection). These costs are offset to some extent by the policy's investment return. These elements — expenses, mortality and investment are the primary components of all cash value policies and referred to as the "EMI" factors.

1. Acquisition Costs

Commissions make up the largest part of expense for insurance and include the selling agent and his general agent. Although these vary widely by the type of policy and company, first year commissions average from 55%-110% of the first year premium for cash value policies. Renewal commissions are typically much less and can be a flat percentage (5%) of the policy life or graded — 10% years 2-5, 8% years 5-10 and 2% after 10 years. Another form of commission called expense reimbursement or allowance is in addition to the first year commission.

Besides commissions, policies include marketing expenses — which basically are all costs of selling, excepting commissions, and include fringe benefits, underwriting, accounting and actuarial expenses. Office overhead, recruiting and training, advertising and investment management are also factors of the expense equation and affect policy performance. Policy expenses are usually 150%-200% of the first year premium and explains why there is little or no cash value in the early years. (See Exhibit 2.)

2. Lapses

A major indirect expense and a determinant of a policy's ultimate cost is policy lapses. It can take up to 20 years for an insurance company to recover the cost of issuing a policy, and when they terminate early, the remaining policyholders bear the cost of unrecovered expenses on those policies. Lapse rates vary dramatically among companies. Some encourage replacement — while others discourage it. Surrender charges are applied in an attempt to control the adverse financial repercussions.

When evaluating proposals complications often arise in this area. Surrender charges result in no actual cash values for several years after issue. This may be due to high expenses that must be recovered, but it may also be a deliberate strategy to justify higher illustrated values in later years. In effect, the company withholds money from policyholders who surrender early to be distributed later to those who remain — a sort of sinking fund. If fewer people surrender then the company anticipates, there is less money to be distributed later to those who remain. Although the policy illustration may show higher long-term values, this only works if enough policies lapse in early years.

3. Policy Reserves

Another indirect pricing factor (expense) is policy reserves, the minimum amount a company must keep on hand to cover future claims, and is mandated by state law. An average of 34 cents of each income dollar goes to reserves. Since these are not currently paid out to policyholders, it is important to know what the company's reserves are and what the minimum reserve requirement is. This isn't always easy to find out. Most of the home office personnel won't know what you're talking about and of those that do (or should) — many won't want to divulge the information.

4. Expense Assumptions in Proposals

Improvements in future expenses are often assumed in proposals and therefore it is necessary to determine what this assumption is based upon. One is to assume that economies of scale (more policies) will in the future reduce each policy's burden of overhead expense. Another is re-organization or re-engineering of a part of the field sales force or home office. The important thing to remember is this is an assumption only and can be made even in the face of rising expenses. Again, these assumptions are an attempt to reflect future expectations — but overly optimistic assumptions are usually the result of competitive pressures and future cash values or death benefits are then distorted.

B. Mortality

Current and guaranteed mortality charges are based on insurance company's own experience and mortality tables which estimate the cost of paying death claims for all policyholders of all ages for the same type of policy. The actuaries who devise these tables make certain statistical assumptions about death rates which allows the company to develop pricing that will, if accurate or conservative, bring in more revenue than paid out in death benefits.

The table being used as the basis for a particular policy is paramount to predicting the future cash value. If the company has used an optimistic table, therefore underestimating costs, there is a chance more policyholders will die than expected. As a result, policyholders still living will have to make up the deficit resulting in lower cash values. This situation is quite common. Life expectancy increased steadily after WW II, but the rate of improvement has slowed to where it is almost flat on a graph and its future course is unknowable. Mortality charges are probably as low as they're going to be for the foreseeable future, yet proposals may, and do, illustrate the same rate of mortality improvement from the past 50 years for the next 50 years.

1. Financial Effects of Table Use

There are various mortality tables used in the insurance industry today and their costs per $1,000 of coverage vary widely. One version is the non-smoker/smoker version of the 1975-80 Select and Ultimate Basic Table NAB which is derived from actual industry experience and is a standard pricing table used by actuaries. The most common is the 1980 CSO table, which replaced the 1958 CSO table. A derivative of the 1980 CSO table is the 1980 CSO Basic Table, which is based on the same mortality experience but does not include the safety margins. Another table is the 1980 U.S. Life Table, which reflects the actual mortality experience of the entire U.S. population.

For illustrative purposes, a quick calculation shows just how variable the costs in a policy can be, based solely on mortality tables. The cost per $1,000 for a 55 year old male using the 1980 CSO Basic Table is $8.28. The U.S. Life Table rate for the same person is $12.18 per $1,000. For a $1 million policy that is a difference of $3,900 which could be used to show a substantial (20%-25%) reduction in premium over a competing product. Or it could be used to inflate the cash values illustrated. The $3,900 could be assumed to be included in the cash value (as additional premium) and compounded at 8.5% would show an additional $1,251,181 at age 95.

2. Rating Classifications

a. Select, Super Select, Preferred

Enhancements to the mortality tables or assumptions used by various carriers include rating classifications such as: select, super select and preferred. These are based on the assumption that recent insurance buyers are healthier than the rest of the population of the same age, because the rest of the population did not have to pass the company's medical exam or questionnaire. Proposals using a table with select or preferred factors will produce a less expensive premium, high cash values or both.

Often agents will quote using only the best rating classification however unlikely the proposed insured is to actually receive the rating. The older the client the more likely the highest (best) classifications will fail to be achieved. Examples of some requirements are: no family deaths (parents or siblings) prior to age 60; no blood pressure or cholesterol history; strict height and weight guidelines; no more than two moving vehicle violations and the typical no-smoking, no alcohol and standard underwriting criteria.

b. Non-Tobacco, Non-Smoking and No Cigarettes

These are other rating classifications used by actuaries to further define risks for pricing of insurance costs. Note that each are separate and distinct from each other in that someone who smokes a pipe or cigars may qualify for the best rate in one company but not for another. Care must be taken in reviewing proposals to determine which company rating is being used vs another.

The non-smoker/preferred risk classification is a relatively new category and no experience is available from any company over a 10 year period. This results in the assumptions being more aggressive from a pricing standpoint and will have a tendency to increase the risk of future cash values not being attained or of higher premiums should actual experience be less than expected experience.

3. Gender

Another mortality issue that can affect the price of a policy is gender difference. Based on mortality experience which indicates women live longer than men, women would pay less for life insurance than men. Some states however consider it discriminatory to charge premiums based on gender. The issue is legislated by state, so it is critical for an advisor evaluating life insurance proposals to know whether mortality charges are based on a unisex or sex distinct table. Some states offer the choice of using either. Careful attention to this factor will sometimes expose a situation where one proposal using unisex rates is being compared to another using sex distinct rates. The effect will be to increase cash values or decrease the premium amount for a male using the lower unisex tables.

C. Investments (Interest)

1. Portfolio Composition

Assets in the portfolio of an insurer help to determine the interest rate or dividend scale declared for allocation to policy cash values or policyholders. Advisors must realize however that a company's net rate of investment income is NOT the rate that is credited to a policy. Nor is a company likely to have just one investment portfolio for all products. When a company offers multiple lines of product, investments are usually allocated to each line. Various products then have various portfolios which in turn will produce different rates of return. You could buy two products from the same company and get very different results.

To understand the investment performance of a single company, it maybe helpful to begin with information about the industry as a whole. Although the specific asset mix in investment portfolios vary greatly among companies, the trends are clear. In 1975 government securities made up 5% of the typical portfolio, by 1985 this was up to 15% and in 1993 was 20%. At the same time, long-term mortgages dropped from 31% in 1975 to 21% in 1985 to 17% in 1993. Corporate bonds continue to be the largest single asset group with 34% in 1975, 37% in 1985 and 45% in 1993. Stocks declined from 10% to 9% to 5% in 1993 according to the American Council of Life Insurance and the 1993 Life Insurance Facts Book.

The difference between portfolios of yesteryear and those of today reflect significant changes in the returns as well as for the mix. From 1950 to 1985, the net rate of investment income — gross income minus expenses — increased steadily from 3.13% to 9.63%. Net investment yield on mean invested assets in 1993 however was 8.04% as reported by the Townsend & Schupp Co. composite of 130 major companies. This reduction in net investment yield is explained by several factors: less junk bonds, less real estate investments and mortgages; the calling of high rate bonds and their replacement by much lower yielding ones;

increased capital requirements and higher corporate income taxes. Yet little change has been seen to date in the dividend projections of participating companies.

We saw earlier the effect mortality alone could have on future projections in a policy illustration. Million Dollar Round Table magazine published a chart showing the effects interest rates and mortality have on a Universal Life policy, assuming all other factors being equal. These are illustrated in Exhibit 3 and are based upon four illustrations. Two assumed a credited interest rate of 9.5% and two assumed 8.5%. One of the 9.5% and 8.5% policies assumed a projected mortality table, where the other two assumed current mortality figures. Under the best assumption, 9.5% interest rate and projected mortality, the 40 year cash value was $525,000. Lowering the interest rate one percent, cash value dropped to $300,000 close to a 43% reduction. The 9.5% interest rate and current mortality illustration produced $150,000 cash value, a 71% decrease while the 8.5% and current mortality generated less than $1,000 — a startling 99.8% reduction from the best assumption. Even seemingly minor differences among companies in the level of expenses, mortality tables or assumptions and investment returns on credited interest rates or dividend scales — become critical factors when they are projected over a long period of time.

2. Portfolio Changes

As the composite of insurers' portfolios have changed over time, the effects of these changes must be viewed as to the results they have on policyholders and of course, the projections used in a policy illustration. The most obvious and somewhat recent example is the junk bond escapade of insurers and the financial impact on Executive Life, First Capital and Fidelity Bankers among others. These changes occurred as the marketplace became more focused on returns and companies responded by seeking higher yields than available in the traditional bond market. The effects of this particular strategy on the industry in general and policyholders especially needs no more discussion. But what are some other areas which should be viewed with an equally jaundiced eye and grave concerns for similar, if not more sever, consequences?

a. Real Estate

Perhaps the Travelers Life story is best used as an example of how real estate and mortgage loan problems can impact a company. The ratio of problem mortgages and foreclosed real estate to total surplus for Travelers in 1992 was 151%, as compared to a 23% composite of 30 companies. Travelers was taken over by Primerica as liquidity was impacted, asset values declined, vacancies rose and contract holders surrendered policies.

Exhibit 4 shows the 10 companies with the largest dollar increase in holdings of foreclosed real estate in the first nine months of 1993 and their percentage change. The four largest dollar increases were by major insurers Metropolitan, Prudential, Principal and Teachers — but their percent changes were enormous — ranging to as high as 77% by Met. This compared to an 11% gain for the composite group. These 10 companies total holdings rose

$1.5 billion for the first nine months of 1993, while the other 120 companies in the Life Insurance Business Risk Analysis review had a $0.3 billion decrease.

Foreclosed and delinquent real estate, and restructured and delinquent mortgages, result in lost investment income. This depresses investment yields, operating earnings and policyholder returns. Net investment yield for the life insurance industry dropped from 8.44% in 1992 to 8.04% in 1993. Of the top 10 companies in 1990, ranked by the ratio of mortgages and real estate to total surplus, (six with such assets equal to 8 to 10 times surplus) two are in conservation, one merged, one demutualized, one restructured and one received a $700 million surplus infusion.

b. CMOs/Derivatives

While junk bonds and mortgages have decreased as a percentage of surplus for the insurance industry, CMOs are the fastest growing area of new investments in the industry today and it has been predicted that they will present the next problem asset class for insurers. The General Accounting Office (GAO) has just issued a report, two years in the making, which calls for Congress to "bring the currently unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies." The report also found the growth rate of OTC and exchange-traded derivatives for insurance firms from 1990-1992 was 100% and expected to rise.

CMOs are a package of mortgage loans which have either been divided into tranches or where principal and interest payments have been stripped from the package and marketed as separate bond issues. If mortgage loans are split into components, a CMO may be an Interest-Only strip (IO), a Principal-Only strip (PO), or a Residual strip. Although simplified, this definition will suffice for the purpose of a basic understanding of the concept.

How great of a risk do CMOs poise to life insurers and/or their policyholders? An interesting comparison can be made between CMOs as a percentage of total surplus to the historical percentage to total surplus for junk bonds, and for mortgages and real estate. As of 12/31/93, the top 10 companies of CMOs with the highest percentage to total surplus, such assets equaling 5 to 8 times surplus, included some well known carriers as Aetna, Transamerica and IDS Life. Thirteen major life insurers had CMO bonds exceeding 472% of total surplus or higher. In comparison, 12/31/90 figures for junk bonds and mortgage/real estate ratios to total surplus, shows that of the 4 junk bond holders and 2 mortgage loan holders that went into conservatorship, each had such assets equal to 9 times surplus. Whether or not a leverage ratio of CMO bonds equal to 5 times surplus is risky or sound will depend on the types of CMOs and remains to be seen. By any standard, it certainly raises an issue for concerned advisors providing insurance analysis or advice.

3. New Money or Portfolio Rates

The traditional method of crediting interest on whole life and many universal life policies is the portfolio average. Under this method, new and old policyholders of a particular product line share one portfolio regardless of when their premiums were paid and investments were purchased. With this method, investments are not assigned to policyholders or tracked by investments made in any year. Someone purchasing a policy in 1994 will receive credited interest this year from investments made in 1990, 1991 and any other year the investment remains in the portfolio. The insurer using the portfolio average method will usually invest longer term than an insurer using another method.

In some situations, the portfolio average method can be seen as a benefit for the insurance buyer. This is true when the average return on a company's investment portfolio is 10%, but new investments in 1994 are only paying 7.5%. When all previous and current investments are commingled, the portfolio average rate may be close to 9.5% — much higher than the rate on new investments.

The other method of crediting interest to policyholders is called the new money method, which came into vogue with Universal Life — even though some Universal Life policies use the portfolio average method. With this method, many portfolios are created as policyholders who pay premiums in 1994 for example, receive interest based upon the investments made in that year. New policyholders do not receive returns on old investments. The new money portfolios are typically weighted towards sorter term investments.

Which method is best? Obviously, the new money method will look better in an illustration when market rates are higher than the portfolio yield. As an example, remember in the mid-1980s when interest rates on U.L. contracts were being illustrated at 12% and higher, but Whole Life credited rates or dividends were only 6-8%? Now we see the opposite situation as interest rates have dropped from 9% to 5% and lower on shorter maturities, the portfolio average rate will illustrate a much higher dividend or interest rate. Over a period of time there should be no significant advantage to either method as they will tend to average themselves. Illustrations however will not assume this and project the current economics (high interest or portfolio rate) over the next 30-40 years.

IV. WHICH TYPE OF COMPANY

A. Mutual or Stock

After an insurance company receives income from portfolio returns, premiums and other sources, it pays its costs, takes a profit for itself and then credits the rest as interest or dividends. In a nonparticipating policy, after interest is credited to policy cash values, profits are sent to the company's shareholders as dividends. If the insurer is a mutual (participating) company the policyholders receive dividends.

1. Dividends vs Interest Rates

Historically mutual companies have increased dividends regularly based primarily on the uninterrupted rise in portfolio yields. Portfolio yields are now decreasing based upon several factors, many of which have been discussed. Some others are risk based capital requirements, higher taxes, interest sensitive products, increasing expenses and decreasing profit margins. Based on these factors dividend scales will be reduced and some companies are doing so. Many others however are still illustrating in proposals, assumed continued increases as in the past or projecting current portfolio returns over the next several decades. This is no different than the assumption of 12% interest rates over the life of a policy in U.L. proposals a few years ago.

Questions which need to be addressed in this area are whether dividends or interest rates are based on gross or net returns; before or after deduction for taxes; before expenses or net of expenses, and of course if the portfolio average or new money methodology is used.

2. Tax Status of Dividends

Dividends are defined by IRC Section 72; "Dividends on a participating life insurance policy are tax exempt as return of investment. Dividends are considered to be a partial return of basis; hence they reduce the cost basis of the contract. This reduction in cost must be taken into account in computing gain or loss upon sale, surrender, exchange or maturity."

Dividends to policyholders almost always are illustrated as purchasing paid-up additions. This strategy has been shown to support the increase in cash values for illustrative purposes and face amounts for inflation purposes. It is often necessary for this technique to be used to substantiate the borrowing/loan scenarios as it obviously increases the cost basis of the policyholder and therefore reduces or eliminates any taxable event resulting from this practice. In contrast, dividends used to reduce premiums or paid in cash reduce the policyholders basis and using the illustration figures, could result in a taxable event. This strategy can negate the benefits of banding, as the purchase of additional coverage is at an older age and higher dollar amounts.

Dividends can be compared to the overpayment of income taxes. Many individuals have more tax withheld than necessary in order to receive a "refund." Dividends paid to policyholders are tax exempt as return of investment — meaning policyholders have overpaid their premiums and have given the insurer an interest-free loan similar to the overpayment of withholding taxes. The insurer keeps the interest earned on this excess amount and returns, via a dividend, only the excess premium. The "dividend" would be reported as taxable income if it represented a return on capital vs a return of capital.

3. Dividend/Interest Payment History

Mutual insurers have increased policy dividend scales since 1950 during uninterrupted increases in aggregate portfolio yields. They now are being faced with reducing dividends scales to reflect the need to build surplus to support sales growth and meet RBC requirements. Home office expenses have increased and interest-sensitive products require investments with much shorter durations than traditional products. These shorter time investments followed by the decline in interest rates, inflationary expenses in the group health business, AIDS and higher taxes are all causes for recent dividend reductions.

Dividend scales rise by policy duration (as aggregate interest earnings grow) and by calendar year (if portfolio yields rise). But net investment yield for the life industry has fallen from almost 10% in 1985 to 8.04% in 1993. Net yield for the industry is expected to fall as investment income is lost on non-performing mortgage loans and bonds are acquired at much lower rates. Dividends peaked in 1990 but fell in 1992 and 1993 below the level paid in 1989 as interest rates (the key component of dividend scales) continued their downward mood.

4. Dividends/Interest Determined by Marketing Strategy

Most industries are finding the current economic environment difficult. Rising costs and an increased demand for quality have reduced profit margins. Consumers are looking for the best bargain and rarely abide to brand loyalty. The life industry is no exception to this reality, and because of the downturn in new sales, it may face worse than other businesses. Adjusted for inflation, new life premiums have decreased 23.7% since 1987 — a record period of decline.

In an era of declining interest rates, such as we now face, some insurers will take discretions in setting interest rates or dividend scales. The effect is to temporarily subsidize new policyholders with interest earned on existing policyholders' money. This assumed rate is projected for the life of the policy — even though it is destined to average down over time. Assume an insurer sold many policies years ago when Treasuries were yielding 10%. Now rates have fallen to 8%, causing old bonds to increase in value. In a mutual fund, old policyholders would get the higher rate and a windfall capital gain. But using the portfolio average method for a product the carrier wants to sell, the insurer blends the new 8% bonds with the old 10% bonds and illustrates a 9.5% dividend rate. If a company wants to make a whole life product more attractive to potential customers, the carrier can simply assume and illustrate a higher dividend scale using the portfolio average.

Another approach, used primarily with U.L policies, is to assume an interest rate bonus to be credited at certain stages in a policy. Interest rate bonuses of 1/2%, 1% and 1.25% may be credited at the tenth, fifteenth and twentieth years, respectively. When it comes time to pay, the company may drop its current interest rate or raise mortality charges or increase the expense deduction. But some companies guarantee this bonus rate in their contract, right? Well, imagine an employment contract that works like this: First year you get a salary of $100,000. Second year you are guaranteed a bonus of $50,000, but the salary is not guaranteed. So your employer could cut your base pay in half the second year at the same time it gives you a "bonus." What kind of guarantee is that?

5. Dividends/Interest Paid from Earnings or Surplus

In 1992, for the first time in eight years, every major mutual life insurance company earned its policyholder dividend payments based on information in The Mutual Life Insurance Industry Handbook. Each of 78 mutual life insurers with more than $100 million in assets had operating earnings (before dividends, income taxes and interest maintenance reserves) which exceeded their policy dividends paid in 1992. This score (78-0) benefited from excluding companies in conservation (Mutual Benefit & Fidelity Mutual) and by the conversion of Equitable Life from a mutual to a stock company.

These facts give insight that dividends are sometimes not currently "earned" but nonetheless may still be used as assumptions in an illustration. The payment of dividends may indeed come from surplus, if investment or portfolio income is inadequate to sustain a high projected scale. Capital gains are often used to support dividend scales and the recent interest rate decline and corresponding call of high rate bonds has been used to prolong a dividend rate which is higher than the portfolio return. This explains why some companies have dividend or interest rates that make no sense in today's interest rate environment. Net capital gains of 6.1 billion were reported in 1993 up from 2.2 billion in 1992.

B. Capital Structure

1. Access to Capital

Mutuals lack parent companies and access to capital markets to solve liquidity problems. Compared to stock life insurers, mutuals have a lower net investment yield rate, lower asset mix in investment grade bonds, higher asset mix in junk bonds, real estate and mortgages and lower net cash flow ratios — according to Townsend & Schupp, an investment banking and credit research firm specializing in the insurance industry. Poor liquidity exacerbated runs on the bank at both Mutual Benefit and Fidelity Mutual. From 1989-1992, the 100 largest stock life insurers received surplus infusions of $.9, $1.9, $3.8 and $3.7 billion respectively. Mutual companies conceptually have a large margin to absorb contingencies because policy dividend scales may be reduced, although companies are reluctant to do so. Policyholders then represent, at least from a historical perspective, the only access to capital for mutual insurers.

2. Demutualization or Surplus Notes

The lack of access to capital markets and poor liquidity spurred Equitable to demutualize and become a stock company. The need to raise capital is partly caused by the

RBC standards and can only be accomplished by mutuals by (1) demutualizing, which is expensive and slow or (2) issuing surplus notes.

Surplus notes are unsecured debt securities approved as surplus in an issuer's state of domicile. Surplus notes, offer the advantage of being capital even though they are also debt — and people wonder why insurance is difficult to understand! Insurers pay interest on these notes only if the company has earnings, as well. Surplus notes enable mutual companies to access cheap money as current interest rates are low and the spreads are good.

The issuance of surplus notes is not yet a trend but there has been increased activity. In 1993, Mass. Mutual, Prudential and Metropolitan issued notes for $250 million, $300 million and $700 million, respectively. Reasons cited for the issues include raising capital at favorable rates, preparing for health care reform and in Prudential's case, for post-retirement employee benefit obligations. In the first quarter of 1994, six mutual insurers have issued surplus notes totaling $1.163 billion and two companies, Midland Mutual and State Mutual, are seeking to demutualize. The number of mutual life insurers has fallen 39%, from 171 in 1953 to 105 in 1993, according to American Council of Life Insurance data. This number is even less now due to recent demutualizations and to mutual failures and mergers. A June 6, 1994 editorial by National Underwriter editor, Stephen Pointek, raises the question of an outmoded mutual structure and exploring the idea of establishing stock companies as the industry norm.

3. Risk Based Capital Requirements

The RBC requirements are just being felt as the filing of 1993 statutory statements has just passed. The National Association of Insurance Commissioners' (NAIC) model law requires the filing of an RBC Report by all domestic life insurers before March 15. While only a few states have actually passed the model law, the law does provide any foreign insurer must provide the report to the insurance commissioner upon request. In the simplest of terms, RBC requires insurers to keep minimum levels of capital based on a formula that takes into account the amount of risk each company faces on its products and investments.

Policy designs will be and have been impacted by RBC as well as new product offerings. Variable annuities and variable U.L. have experienced growth rates of grand proportions partly for tax deferral and partly because of potential increased returns in a low interest environment. Another cause is the planned marketing of these products by insurers because there are virtually no effects on RBC capital ratios. Since liabilities in the separate account exactly offset assets in the separate account, the only impact would be to the extent the company maintained surplus, which under normal circumstances is nominal. Fixed products would reduce the ratio by requiring higher capital levels.

V. WHICH TYPE OF POLICY

A. Permanent, Term, Blended, Load or No-Load

Once the decision is made on a stock or mutual company the selection of the right policy to use is next. With the myriad of products available today and the variety of client circumstances, what kind of policy should be purchased? Should the advisor use current assumption whole life, a convertible term policy with a disability waiver, variable (U.L. or whole life) or one of the no-load (no commission) products? The key to matching clients with policies is understanding the options, features, costs and benefits of each contract. Basic policy characteristics are outlined in this table:

	Least→Most		
Cost	Universal	Whole Life	Variable
Cash Value Risk	Whole Life	Universal	Variable
Death Benefits Risk	Whole Life	Universal	Variable
Client Involvement	Whole Life	Universal	Variable
Policy Modifications	Whole Life	Universal	Variable

1. Whole Life

These policies may be either participating or non-participating as well as interest sensitive or non-interest sensitive; that is, returns which are either directly tied to fluctuating interest rates (new money method) or not (portfolio average). The most popular today are interest sensitive par and stock company fixed premium. With a non-participating policy, the owner will receive no more than the guaranteed cash value specified in the contract. The participating policy generally requires higher premiums, the difference used purely for investment purposes. The annual dividends are considered a return of premium and a reduction of basis, for tax purposes. Par products set the dividend scale retrospectively at the end of the policy year, while stock company products set interest rate and risk charges prospectively for the upcoming year. The "EMI" factors are bundled in this type of policy and therefore impossible to determine separate costs.

2. Universal Life

U.L. policies are separated into the "EMI" elements with each easily measured and identified. This design allows the insured to vary the death benefit or premiums according to current needs. It is only necessary to pay enough premium to cover mortality and expense charges, if so desired. U.L. products have two death benefit alternatives — level

(Option A) or increasing (Option B). The Option B provides the cash value in addition to the face amount of the policy as a death benefit.

The policy has guaranteed death benefits and cash values so long as a minimum premium is paid. The guarantees are typically much shorter, such as 5 years, and are referred to as no lapse guarantees. Investments made within the portfolio for U.L. products are more short-term than under the portfolio average method. This is necessary because the policyholder may vary premium payments, skip, or even stop them. The insurance carrier then must keep a larger portion of its investments liquid to be prepared for an unpredictable premium stream. The advisor must remember this factor and review the advantages or disadvantages of the new money method of interest crediting in a proposal. In times of low interest rates, this method may illustrate lower cash values than the higher portfolio average return assumed in a whole life proposal.

3. Variable Life

In contrast to the other products discussed, where investment performance is a function of the company's general investment account, variable life allows the policyholder to choose from a menu of investments. The cash value is generally not guaranteed in that the values are tied to the performance of a particular investment fund which operates essentially as a mutual fund. They generally do offer some minimum guaranteed death benefit. Variable insurance can be Whole Life (either participating or non-participating) or Universal Life.

Changes in policy values are directly a result of the performance of the fund into which premiums are directed, therefore transferring risk from the carrier to the policyholder. Fund performance then will determine the amount of cash values and of the death benefit. Wide fluctuations in returns can result in early lapse of a policy if fund performance is inadequate or if a loss is sustained, especially in the early years. (See Exhibit 5 for VUL Analysis.)

4. Survivorship or Second to Die Policies

These contracts cover two insureds and mature at the death of the last survivor. They are most commonly used in estate planning situations where the proceeds are not needed until the later of the two deaths; are usually between a husband and wife, and used for payment of federal estate taxes. Survivorship policies place little to no emphasis on early cash values since the policy is intended to be held until the second death. The policies are usually less expensive than two individual policies as the expenses of the carrier are reduced by issuing only one contract. Mortality charges are often much less because of delaying the death claim until later. Some caution is urged in the assumption of mortality rates used by some companies. Second to die policies are generally larger policies, $1 million usually the starting point, and because of the purpose for which they are bought, have a low lapse rate.

In evaluating these contracts, some additional concerns are raised which must be addressed by the advisor. For instance, if the tax laws change — does the carrier allow or the contract permit the coverage to be split into two policies? Is there a charge for this option (rider) and is this charge reflected in the proposal? What if there is a divorce — can the policy be split? Is evidence of insurability required on a split for tax purposes, divorce or both? What is the chance of the client passing insurability standards at an advanced age? What is the carrier's history on this? Are there new commissions earned? Are mortality charges increased? Based on what table or assumption? What changes are assumed in the contract after the first death? Answers to many of these questions will disclose both interesting differences and additional issues for an advisor.

5. 10-20-30 Year Term

Originally, term policies were offered for a specified period of time, with annual renewable term the distinct leader in the sales mix. Convertible term policies were introduced which gave more flexibility and allowed for conversion to a permanent policy when desired or appropriate. Since then, the name "term" has become a bit of an anachronism with products that provide coverage to age 100. These products are usually term insurance in a Universal Life chassis, utilizing the same averaging of premium assumption of whole life, but paying only the mortality and expense charges. Because it eliminates the investment aspect, it results in lower costs.

This is soon to change as the long-anticipated "Triple X" regulations move closer to becoming reality. The National Association of Insurance Commissioners (NAIC) is expected to adopt Triple X and go into effect January 1, 1995. It changes the reserving requirements for term products with long-term guarantees and so-called "U.L. term." Products with premium guarantees of more than 5 years will have higher gross premium deficiency reserve requirements. Companies are preparing to redesign their products and 5 year guarantees will most likely become the norm for long-term policies.

6. Blended Policies

The cost of whole life can be reduced by using term insurance to make up part of the face amount. For example, a policy consisting of 80% Whole Life and 20% term insurance would be less than a "pure" Whole Life policy. The approach used with a blended policy is using the dividends from the Whole Life portion to buy paid-up additions to replace the term portion of the coverage. The larger the term amount or percentage, the longer this process takes.

The use of term insurance or term riders to increase the Whole Life face amount or reduce premiums for an equal face amount adds substantial risks to the policyholder. The entire concept is dependent upon the use of projected and non-guaranteed dividends. The larger the percentage mix of term insurance — the longer it takes to convert and the greater the risk of dividend reductions. The time involved also will affect the pricing of the paid up additions as the insured is getting older each year. The other major risk is non-guaranteed mortality charges. Any increase in mortality charges in the future may require additional premiums — which, in effect, negates the original purpose of this concept. Term riders should not be more than 20% of the face amount as the sensitivity to interest rate or dividend changes becomes problematic.

7. <u>No-Load or Low-Load Contracts</u>

The most dynamic change in insurance today is the development and marketing of "No Commission" life insurance, disability and annuity products. The term "low-load is generally used if at least 88% of premium goes toward cash value right away according to LIMRA. A "no-load" product has only a service fee and no separate charges for administrative or monthly fees.

No-load and low-load are both no commission products generally described as traditional products which have stripped out commissions and bonuses, home office and agency expenses, recruiting and training cots, as well as long surrender charges. These costs typically will make up 150%-200% of the first year premium. (See Exhibit 2). Since these products remove the traditional costs of cash value insurance policies, it results in immediate cash values of up to 97% of premiums. Some contracts even provide guaranteed cash surrender values equal to the sum of premiums paid.

These products are available in Kentucky only through Licensed Insurance Consultants (LIC) who charge a fee for their services. This fee must be included in the total cost for coverage, but virtually always represents substantially less than comparable commissions on a similar product. Several advantages to the buyer are presented by this approach; fees for this service can be deductible, insurance is bought directly from the insurance company and possible conflicts of interest are eliminated because commission scales of various products are not a consideration. The other advisors; attorney, trust officer or CPA can reduce or eliminate their liability exposure to either product selection or performance by transferring it to the independent LIC, who contracts directly with the client.

B. <u>Costs vs Benefits of Policy Selection</u>

1. <u>Guarantees</u>

We reviewed a situation where a carrier <u>guaranteed</u> the bonus rate in 10, 15 or 20 years but in reality, nothing prevented this company from dropping their credited rate to do so. Other situations exist similar to this which many agents, buyers and advisors <u>assume</u> to be guaranteed, but indeed are not. Today many mutual companies' dividend scales are higher than they will be next year, and yet many provide proposal illustrations assuming these larger dividends for 20 or 30 years.

Another assumption, which deceptively hides policy expenses, in a proposal includes a column referred to as the "Account Value." This account value cannot be borrowed, used as collateral or even obtained by surrendering the policy. This fictional account value shows the policy's value if there hadn't been any commissions paid to the agent and general agent. But there were. Therefore, the true value of a policy is the surrender value. For example, a proposal may indicate an annual premium of $10,000, first year account value of $8,000, and surrender value of 0. The $8,000 account value only exists as ink on the proposal.

It often is claimed that whole life has greater policy guarantees than universal life. This simply is not true. While it is true that whole life has guaranteed premiums, guaranteed cash values, and guaranteed death benefits, in order to be competitive these whole life policies depend on non-guaranteed dividends to enhance the policy values. The level of dividends enhancing the policy depends on the "EMI" factors discussed earlier. Therefore, whole life policies have the single mechanism (dividends) to adjust expense, mortality and investment experience. Universal life and interest sensitive whole life, on the other hand, have two mechanisms to adjust: mortality charges and interest rates. Whether a policy has only one mechanism (dividends) or two (mortality and interest) to adjust — they both depend on the same major pricing components. The element which U.L does not have is a guaranteed premium.

A very large drop in projected values due to a change in policy pricing factors occurred in 1988 with a participating whole life policy from a major Connecticut based life insurer. In 1988, this insurer had a dividend scale of 10.75%. By the end of the year the rate, without warning, dropped to 9.05%. This 170 basis point drop resulted in a projected decrease in death benefits of 29% and cash value decrease of 31%, after 20 years, compared to the proposal of just one year earlier. This case is illustrative for two reasons: first, it indicates that participating whole life is as vulnerable to projected price changes as Universal Life and, second, it is dramatic evidence that policy pricing assumptions (dividends) must be carefully scrutinized.

2. Flexibility or Liability

Circumstances and needs of a policyholder vary over time and often this is the reason for life insurance being purchased to begin with. Yet invariably individuals end up with a policy with higher costs and least flexibility — severely limiting the options available for the inevitable changes which will occur. When asked to evaluate or approve a policy for a client this factor is most often overlooked.

Whole life provides guaranteed premiums also meaning no flexibility to reduce or skip premiums. Whole life is also unable to reduce the face amount should this become a factor in the future, excepting a reduced paid-up policy option which also is fixed. These factors can pose dangers from a liability standpoint, especially to the trustee of a life insurance trust. On one hand, the guaranteed factors are attractive to the grantor — but the inability to change or alter many aspects of coverage presents a dilemma for the trust on the other hand. As owner of the policy, is there a fiduciary duty required of the trust for the future interests of beneficiaries?

Is the higher premium required by Whole Life worth the perceived benefits of the "guarantees" and to what extent is the fiduciary responsible for possible future needs? An interesting comparison is made between this choice and the investments a trustee would purchase for a client. Would it be prudent to invest 100% of a clients assets in guaranteed investments, i.e. government bonds, or is diversification and asset allocation of funds the fiduciary's primary responsibility?

At the other end of the spectrum is Variable U.L. which allows complete flexibility on the cash value, death benefits and premiums. For this flexibility, the policyholder gives up the guaranteed aspects and transfers these risks to him or herself. In this case, are the benefits of the flexibility, lack of guarantees and potential investment returns worth the risk? What are the upfront costs and expenses incurred in a Variable Universal Life? Exhibit 5 presents a diagram depicting the charges on a variable U.L. policy issued by one of the top three companies (in size) with the highest ratings. The costs break out as follows:

Premium Tax Deduction	3.25%
Mgt. Fees & Expenses	.65%
Mortality & Expense Risk	.90%
Sales Charge	6.00%
Admin., Risk & Premium Charges	.50%
TOTAL DEDUCTIONS	11.30%

The 11.30% is deducted from gross returns to determine the net rate illustrated in a proposal. In other words, a 20.30% gross annual return would be required in order to show a 9% net return in a proposal. It becomes apparent the need for detailed analysis of the prospectus to determine the feasibility of projected returns. With this example, a government bond fund selected as the investment vehicle earning 8.30% would actually net the policyholder a negative 3% return.

VI. DUE DILIGENCE PROCESS

A. Company Information and Sources

Research on the background of an insurance company should include an analytical methodology not unlike the due diligence performed in evaluating a limited partnership and includes some basic questions. How well has the company's portfolios performed in the past? How stable is the company? What are the expenses of the company in relation to other carriers or industry norms? Answers to these questions can be found through two A.M. Best Co. publications. Best Insurance Reports and the Trend Report. The first gives comprehensive statistical reports on the financial history and operating results of legal reserve life insurance companies. The Trend Report has 5 year results of profitability, leverage and liquidity tests. This may provide a better sense of where the company is going with past performance as a indication of future expectations.

Information may also be obtained by consulting the Convention Statements (or "blue books") which are the annual reports filed with the insurance commissioner by all companies doing business in the state. These provide very detailed analysis of assets, liabilities, surplus, cash flow, income, expenses, reserves, claims and operations by lines of business. Companies are also required to include Schedule M in these reports, which applies to interest sensitive policies and provides answers to a series of disclosure questions about dividends and illustrations. Advisors may want or need to consult as well with other professionals who have done this type of work or have knowledge about a particular company. When conducting due diligence on a company, remember that no one can guarantee a company's performance years from now. Other sources for determining the financial strength and claims paying abilities of a carrier are Moody's Investor Services, Standard & Poor's and Duff & Phelps.

B. <u>Product and Policy Comparison</u>

1. <u>Statistical Measures</u>

Although we live in the age of information we remain mired in the Stone Age when it comes to obtaining data about insurers' practices so that policies may be understood and compared. Because of the compelling need to improve this, a new policy-disclosure and cost-measurement approach has been submitted to the NAIC and the Society of Actuaries. A Society of Actuaries task force investigating illustrations confirmed the need for improved information and comparison standards. The industry's primary tool for policy information — interest adjusted index — is not only inadequate, but also regularly misused and misunderstood. For instance, comparisons of interest-adjusted indexes of dissimilar insurance plans are invalid and therefore a limited tool in today's times of policy diversity. This index is used as a comparison but is derived from illustrations that are not required to be reliable or even reasonable. As you have seen, there is little relevant information provided to facilitate an evaluation.

Internal rate of return (IRR) calculations have also been used as a measure to compare policies in situations where premiums differed from one proposal to another. The IRR is the interest rate which, if credited to the annual premiums, would yield the cash surrender value at various points in time. Sometimes it is also used to calculate the return on death benefits although this produces a figure with no particular meaning, it merely depicts the leveraged nature of life insurance where small premiums provide substantial amounts of coverage. Since IRR calculations are based upon the cash values <u>projected</u> in an illustration, the underlying assumptions again, must be evaluated. The IRR method of evaluating life insurance proposals can be compared to evaluating the yield of a one-year CD projected over 20, 30 or

40 years — hardly an accurate procedure and dependent entirely on the assumptions made in the annual interest rate.

Currently another approach, quite unique in many ways, is attempting to bring a new way to analyze proposals. Fungible present-value analysis begins with the observation that if the same stream of premium dollars invested in a life insurance policy were put into an investment vehicle earning the same annual compounding rate and tax advantages, the cash value in the alternative investment would exceed the policy's cash value because of the cost of life insurance components. Life insurance, after all, requires annual mortality charges to cover death claims, underwriting expenses and larger sales loads (commissions). Fungible present-value analysis states that these total costs are best understood by examining the difference between these future cash values — the policy's and the alternative investment — and expressing it as a present-value by using the compounding rate as a discount rate.

This approach is called fungible present-value analysis because the use of the same rate for both compounding and discounting preserves the interchangability or fungibility of dollars at different times within the "investment/cost system." This fungibility is critical to the accuracy and completeness of the approach. The system's compounding/discounting rate is defined as the rate of return on the insurer's net interest or dividend rate credited on cash values. In essence, these figures show the present sacrifice — the policy's internal economic opportunity cost — that a policyholder would make for the insurance protection in the illustration.

2. Sources for Proposal Information

There are firms which have sprung up across the country that provide specific policy analysis. This can be useful but rather late for many policyholders who find out after their purchase the value of the policy. The service is also available from a number of fee-based or fee-only insurance advisors although there are not many as this area is relatively new. It would be beneficial for this advisor to be a Licensed Insurance Consultant, a Registered Investment Advisor and not a captive or general agent of an insurance company. Actuarial firms will often perform an audit concerning a policy or proposal and the Society of Actuaries can provide names of firms in your area. Either of these sources will be somewhat expensive; plan on spending $500 or more. For smaller face amounts and an inexpensive review the National Insurance Consumer Organization will provide one for approximately $40. Beacon Co. in Michigan uses a policy's values to compare with "benchmark" industry values for approximately $100.

The American Bar Association - Real Property, Probate and Trust Law Section, publishes "The Life Insurance Counselor" and is an excellent source of information on life insurance products, illustrations and due diligence. Basic knowledge is provided as a guide to the elements of an insurance proposal and due diligence questions necessary for analyzing projections.

The American Society of CLU's and ChFC's has developed an Illustration Questionnaire (IQ) as an analytical tool for its members. The IQ has 25 questions which can be sent to an insurer requesting detailed information on the assumptions behind the illustrations. The questions cover five areas: general, expenses, mortality, interest rate and policy persistency assumptions. This provides an interesting approach and results in agents rating the relative effectiveness of illustrations and assumes their credibility and capability to do so. Interpreting company responses to the IQ can be difficult without an actuarial background or experience in pricing policies. Approximately half of the major life insurers have agreed to answer the questions, leaving many unanswered. Mass Mutual is one carrier refusing to comply with the request for additional information stating, among other concerns, "One important point to keep in mind about dividends is that the choice of a dividend schedule is strongly influenced by short-term considerations. There is no commitment or expectation that the given dividend schedule will remain in place indefinitely. The dividend schedule is not a prediction nor an estimation of future dividends. This is the major reason why illustrations should not be viewed as long-term projections." These considerations are, of course, not unique to Mass Mutual but apply to all companies.

Life Insurance Marketing and Research Association

(LIMRA) Study Of Whole Life Policies

Statistics Regarding Persistency

Year	Policies in Force
2	83%
3	64%
5	50%
10	27%
20	13%

"But to make their policies look as attractive as possible, some companies design them so that the cash surrender value by the 20th or 25th year will be immense. Agents sell life insurance on the basis of the 20th or 25th year numbers — which few policyholders will ever collect."

Consumer Reports
August 1993

Percentage of First Year's Premium Paid in Acquisition Cost for Traditional Cash Value Life Policies

	Range *From*	*To*
Agent Commission	55%	60%
General Agent Override	30%	40%
Bonus	10%	15%
Trips/Meetings/Gift	2%	4%
Fringe Benefits	5%	9%
Expense Allowance	10%	20%
Home Office:		
Recruiting, Training, Promotions/Advertising		
Advanced Sales Department, Underwriting		
Actuarial & Accounting Depts.	20%	30%
Other Home Office:		
Medical, Investment Mgt., Legal	18%	22%
Total	**150%**	**200%**

$500,000 Universal Life Policy

Male - 40 Nonsmoker $3400.00 Premium for 20 years

Projected Mortality Table

9.5%	$525,000	40 year cash value
8.5%	$300,000	40 year cash value

Current Mortality Table

9.5%	$150,000	40 year cash value
8.5%	$ 1,000	40 year cash value

This illustrates how powerful changes in just two of the variables (mortality and investment) can be on the policy-holders cash values overtime.

10 Companies With Largest Increase In Holdings Of Foreclosed Real Estate Sorted By Net $ Amount Change (12/31/92 - 9/30/93) (Data In Millions)

Company	R.E. Holdings Acquired By Foreclosure		9 Month	Net $ Amount Change For
	12/31/92	9/30/93	% Change	9 Months
Metropolitan Life NY	464	825	77.7%	361
Prudential Ins. Co.	539	768	42.6%	229
Principal Mutual	416	607	46.0%	191
Teachers Ins. And Ann.	423	564	33.3%	141
Equitable Life Assur.	483	623	28.9%	140
Connecticut General	555	686	23.6%	131
John Hancock Mutual	405	522	28.7%	116
Mutual Life Of NY	486	586	20.7%	100
Phoenix Home Life	168	217	28.7%	48
Northwestern Mutual	113	160	42.0%	47
130 Company Composite	10,660	11,865	11.3%	1,205

Premium Payment

- less charge for taxes attributable to premiums
- less $2 processing fee

Invested Premium Amount

- To be invested in one or a combination of:
    - The Investment Portfolios of the Series Fund described below
    - The Fixed-Rate Option
    - The Real Property Account

Daily Charges

- Management fees and expenses are deducted from the assets of the Series Fund.
- A daily charge equivalent to an annual rate of up to 0.9% is deducted from the assets of the variable investment options for mortality and expense risks.

Monthly Charges

- A sales charge is currently deducted from the Contract Fund in the amount of ½ of 1% of the primary annual premium.
- The Contract Fund is reduced by a guaranteed minimum death benefit risk charge of not more than $0.01 per $1,000 of the face amount of insurance.
- The Contract Fund is reduced by an administrative charge of up to $3 per Contract and $0.03 per $1,000 of face amount of insurance; if the face amount of the Contract is greater than $100,000, the charge is reduced.
- A charge for anticipated mortality is deducted, with the maximum charge based on the Non-Smoker/Smoker 1980 CSO Tables.
- If the Contract includes riders, a deduction from the Contract Fund will be made for charges applicable to those riders; a deduction will also be made if the rating class of the insured results in an extra charge.

Possible Additional Charges

- If the Contract lapses or is surrendered during the first 10 years, a contingent deferred sales charge is assessed; the maximum contingent deferred sales charge during the first 5 years is 50% of the first year's primary annual premium but this charge is both subject to other important limitations and reduced for Contracts that have been in force for more than 5 years.
- If the Contract lapses or is surrendered during the first 10 years, a contingent deferred administrative charge is assessed; during the first 5 years, this charge equals $5 per $1,000 of face amount and it begins to decline uniformly after the fifth Contract year so that it disappears on the tenth Contract anniversary.
- An administrative processing charge of up to $15 will be made in connection with each withdrawal of excess cash surrender value or a decrease in face amount.

ETHICAL CONSIDERATIONS IN ESTATE PLANNING

Wiley Dinsmore
Dinsmore & Shohl
Cincinnati, Ohio

SECTION J

ETHICAL CONSIDERATIONS IN ESTATE PLANNING

TABLE OF CONTENTS

ETHICAL CONSIDERATIONS
IN ESTATE PLANNING

Wiley Dinsmore

I. OVERVIEW OF ETHICS

A. History:

1. Canons - adopted by A.B.A. in 1908 - 47 Canons

2. Code of Professional Responsibility - A.B.A. approved 1970

   a. Lawyers in Kentucky formerly were governed by the Code. Lawyers in Ohio still are governed by the Code of Professional Responsibility.

   b. The Code has a three part format. First, there are nine canons. After each canon, there are ethical considerations and after ethical considerations ("ECs") for each canon are disciplinary rules ("DRs").

   c. ECs. Ethical Considerations are aspirational in character and represent the objectives toward which every member of the profession should strive. They constitute a body of principles upon which the lawyer can rely for guidance in many specific situations.

   d. DRs. Disciplinary Rules are mandatory in character. They state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action.

   e. In Ohio, "The code has the force of law . . ." Kirschbaum v. Dillon (1991) 58 Ohio St. 3d 58, 567 N.E. 2d 1291.

3. Rules of Professional Conduct - A.B.A. approved 1983.

   a. Adopted by Kentucky effective January 1, 1990 as S.C.R. 3.130.

   b. The Rules have a two-part format. First, there is a rule that usually begins with "a lawyer shall", "a lawyer may" or "a lawyer shall not." Each rule is followed by a commentary.

4. Restatement of the Law of Lawyering - Currently being written by ALI.

B. Relationship Between Code, Rules and Restatement

Professor Jeffrey N. Pennell has written:

> "A practioner in a state that embraces the Model Code standards will benefit from a consideration of the more recently developed Model Rules, which establish minimum standards rather than the "aspirational" goals of the Model Code. In this respect, the Model Rules should be regarded as a lesser obligation than the Model Code's Disciplinary Rules and Ethical Considerations, although many attorneys would like to believe it is otherwise. Moreover, as rules of ethics, the professional is subject to being judged in the harshest possible light consistent with preserving the profession's responsibility -- and opportunity -- to govern itself. More importantly, notwithstanding perceptions that self-governance has become ineffective, no responsible attorney will rely on the "audit lottery" of ethics enforcement."
>
> Hess Lecture, October, 1990, The Record of the Association of the Bar of the City of New York, Vol. 45, No. 6, pages 716 and 717.

II. REASONS TO COMPLY

A. To Avoid Liability for Malpractice

"While the failure to comply with general rules of conduct, like the rules of conduct involved in the case before us (DR 5-101(A), 5-104(A) and EC (5-5)), will not ordinarily constitute negligence <u>per se</u>, it is a circumstance that can be considered, along with other facts and circumstances, in determining whether the actor has acted with reasonable concern for the safety and welfare of others - that is with due care.

Because the norms of behavior expressed in the Code of Professional Responsibility are directly relevant to the issue of what a reasonable person in Dillon's (the attorney) position would have done, we conclude that they are relevant to the issue of whether Dillon brought undue influence to bear upon Krischbaum (a client for whom Dillon was preparing a will from which Dillon would receive one-half the residue)."

<u>Krischbaum v. Dillon</u>, 58 Ohio St. 3d 58, 567, N.E.2d 1291 (1991).

Comment: This case in the ethics and malpractice areas seems to stand for two important propositions.

1. Even though Ethical Consideration are merely aspirational, the jury may consider them in determining whether a lawyer acted with due care.

2. Undue influence by an attorney can be found from the failure by the attorney to comply with the Code of Professional Responsibility."

   But see Lazy Seven Coal States, Inc. v. Stone & Hinds, P.C. (1991) 813 S.W.2d 400 holding the Tennessee Code does not establish a standard of care.

B. To Avoid Disciplinary Action

C. To Avoid Loss of a Gift or Bequest

D. To Avoid Being Disqualified or Conflicted Out

III. COMPETENCE

A. Rules

1. A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

   See Canon 6 of the Code.

B. Comments

1. In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required on some circumstances.

C. Discussion

1. Attorneys' Liability Assurance Society, Inc. ("ALAS"), a malpractice insurance company that insures medium to large non-New York City law firms reported in the fall of 1991 that the trusts and estates area was the third most dangerous area for malpractice claims. It stated that their most common claim of negligence involved an estate tax issue.

2. Although every lawyer feels competent to prepare a will, the tax impact of the provisions of the will are often not considered or understood. As a result Estate Planning and probate administration may be a particular field of law requiring expertise and not just the proficiency of a general practitioner.

IV. DILIGENCE

A. Rule 1.3

1. A lawyer shall act with reasonable diligence and promptness in representing a client.

B. Comments

1. Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's trustworthiness.

C. Discussion

1. This rule really is self-explanatory, but the comment points out a problem with regard to estate planning documents. What is a reasonable time for the preparation of a set of estate planning of documents? Two weeks? One month?

V. COMMUNICATIONS

A. Rule 1.4

1. A lawyer should keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.

2. A lawyer should explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

B. Discussion

1. Again this Rule should not cause any substantial difficulty in the estate planning and probate areas.

VI. SECRETS AND CONFIDENCES

A. Rule 1.6

1. A lawyer shall not reveal information relating to the representation of a client.

B. Discussion

1. The commentary to the Rules makes it clear that the Rule relates to information whatever its source. The Code required the information to be acquired during representation.

2. The Rules require the information to "relate to the representation". The Code is broader.

3. Note that the information is did not come from the client.

4. The Rules state that the lawyer should not "disclose" the information but he can "use" the information unless its use is to the disadvantage of his client (see Rule 1.8(b)).

See discussions under conflict of interest below.

VII. CONFLICTS OF INTEREST

A. Rules of Professional Conduct.

1. Rule 1.7

a. The Rule

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

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

(b) each client consents after consultation.

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

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

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

b. Comments

i. Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined. If such a conflict arises after representation has been undertaken, the lawyer should withdraw from the representation. See Rule 1.16. Where more than one client is involved and the lawyer withdraws because a conflict arises after representation, whether the lawyer may continue to represent any of the clients is determined by Rule 1.9. See also Rule 2.2(c). As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.

ii. A lawyer may be paid from a source other than the client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty to the client. See Rule 1.8(f).

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

iv. A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.

2. DR5-107 provides in part:

a. Except with the consent of his client after full disclosure, a lawyer shall not:

i. Accept compensation for his legal services from one other than his client.

ii. Accept from one other than his client anything of value related to his representation of or his employment by his client.

3. Rule 1.8 provides in part that ---

4. Rule 1.10 disqualifies a firm, its partners, associates, shareholders or employees if one of its lawyers is conflicted out of a matter.

a. A lawyer shall not accept compensation for representing a client from one other than the client unless:

i. such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;

ii. there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

iii. information relating to representation of a client is protected as required by Rule 1.6.

b. Comments

Person Paying for Lawyer's Services

Paragraph (f) requires disclosure of the fact that the lawyer's services are being paid for by a third party unless such payment is provided for in an agreement between the client and the third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest. Where the client is a class, consent may be obtained on behalf of the court-supervised procedure.

B. Discussion

Kentucky seems to follow that in transactions between a lawyer and a client, the burden of proof as to the fairness of the transaction shifts to the lawyer. Morgan v. Hibbard (1944) 299 Ky. 57, 184 S.W.2d 218.

1. Rule 2.2.

a. A lawyer may only act as intermediary between clients if:

i. the lawyer consults with each client concerning the implications of the common representation, including the advantages and risks involved, and the effect on the attorney-client privileges, and obtains each client's consent to the common representation;

ii. the lawyer reasonably believes that the matter can be resolved on terms compatible with the clients' best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful; and

iii. the lawyer reasonably believes that the common representation can be undertaken impartially and without improper effect on other responsibilities the lawyer has to any of the clients.

b. While acting as intermediary, the lawyer shall consult with each client concerning the decisions to be made and the considerations relevant in making them, so that each client can make adequately informed decisions.

c. A lawyer shall withdraw as intermediary if any of the clients so requests, or if any of the conditions stated in paragraph (a) is no longer satisfied. Upon withdrawal, the lawyer shall not continue to represent any of the clients in the matter that was the subject of the intermediation.

C. Code of Professional Responsibility

1. Canon 5 requires a lawyer to exercise independent professional judgment solely for the benefit of a client, free of compromising influences and legalities. Neither his personal interest, interests of other clients, nor desires of third parties should be permitted to dilute his loyalty. EC5-1.

2. The ethical considerations are divided into three parts:

   a. Interests of a lawyer that may affect his judgment.

   b. Interests of multiple clients.

   c. Desires of third persons.

3. Interests of a lawyer that may affect his judgment. Interests that are particular to estate planning and probate lawyers are dealt with.

a. EC5-5 provides:

> "A lawyer should not suggest to his client that a gift be made to himself or for his benefit. If a lawyer accepts a gift from his client, he is peculiarly susceptible to the charge that he unduly influenced or overreached the client. If a client voluntarily offers to make a gift to his lawyer, the lawyer may accept the gift, but before doing so, he should urge that his client secure disinterested advice from an independent, competent person who is cognizant of all the circumstances. Other than in exceptional circumstances, a lawyer should insist that an instrument in which his client desires to name him beneficially be prepared by another lawyer selected by the client."

b. EC5-6 provides:

> A lawyer should not consciously influence a client to name him as executor, trustee, or lawyer in an instrument. In those cases where a client wishes to name his lawyer as such, care should be taken by the lawyer to avoid even the appearance of impropriety.

4. Interests of Multiple Clients:

a. Ethical Considerations

EC5-14 provides:

> Maintaining the independence of professional judgment required of a lawyer precludes his acceptance or continuation of employment that will adversely affect his judgment on behalf of or dilute his loyalty to a client. This problem arises whenever a lawyer is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or other discordant.

EC5-15 provides in part:

> If a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, he must weight carefully the possibility

> that his judgment may be impaired or his loyalty divided if he accepts or continues the employment. . . . If a lawyer accepted such employment and the interests did become actually differing, he would have to withdraw from employment with the likelihood of resulting hardship on the clients; and for this reason it is preferable that he refuse the employment initially. . . .

EC5-16 provides in part:

> In those instances in which a lawyer is justified in representing two or more clients having differing interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent.

b. Disciplinary Rules

DR5-105 provides:

> (A) A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, except to the extent permitted under DR5-105(C).
>
> (B) A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or likely to be adversely affected by his representation of another client, except to the extent permitted under DR5-105(C).
>
> (C) In the situations covered by DR5-105(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.

(D) If a lawyer is required to decline employment or to withdraw from employment under DR 5-105, no partner or associate of his or his firm may accept or continue such employment.

VIII. CANON 5 - INDEPENDENT JUDGMENT - CONFLICTS OF INTEREST

A. General

Canon 5 covers several areas. The first area is where the representation of a client is "directly adverse" to another client. The second area is where the lawyer's representation may be materially limited because of the lawyer's responsibility (1) to another client or (2) to a third party or (3) by the lawyer's own interest.

DR 5-105 provides:

(A) A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, except the extent permitted under DR 5-105(C).

(B) A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, except to the extent permitted under DR 5-105(C).

(C) 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.

(D) If a lawyer is required to decline employment or to withdraw from employment under DR 5-105, no partner or associate of his or his firm may accept or continue such employment.

B. Multiple Representations - Rules 1.7, 1.8 and 2.2, D.R. 5-105 and E.C. 5-2, E.C. 5-5

1. Husband and Wife Wills, Asset Transfers, Divorce and Marriage

See the New Section Recommendations of the Real Property, Probate and Trust Law Section, ABA published in Probate and Property, July-August, 1993, page 26.

These recommendations state that the representation of spouses without any agreement is a joint representation and that Rule 1.7 the Model Rule dealing with Conflicts of Interests does not apply until facts come to the attention of the lawyer that indicate to the lawyer a conflict is arising. If those facts do arise, the lawyer must obtain informed consent from both spouses. "Mere difference in objectives . . . are not necessarily conflicts that require a Rule 1.7(a) waiver." DR 5-105 of the Code also requires obtaining of such consent but such consent should not be required until the lawyers feels a conflict developing.

The Conference on Ethical Responsibilities of Serving Older Client held at Fordham University School of Law on December 3, 4 and 5, 1993 (The Fordham Conference") concluded differently.

"In order to undertake joint representation, the lawyer must reasonably believe that the husband and wife both understand the implications of joint representation. To accomplish this, the lawyer should review the terms and implications of the representation with the husband and wife, preferably in writing."

At the Fordham Conference seven of the ten members of the Committee that made the recommendations of the Real Property, Probate and Trust Law Section were present.

In October, 1993 the Board of Regents of the American College of Trust and Estate Counsel adopted ACTEC Commentaries on the Model Rules of Professional Conduct ("ACTEC Commentaries"). These ACTEC Commentaries are very similar in this area to the conclusions of the Fordham Conference.

The writer has great difficulty with the Committee's recommendations because it only focuses on when the joint representation is "directly adverse" as required by Rule 1.7(a). The recommendation does not deal with the representation being limited by "the lawyer's responsibility to another client" or to a "third party" or by the "lawyer's own interest" as required by Rule 1.7(b) and Canon 5. An opinion of the Allegheny County, Pennsylvania Bar Association Professional Ethics Committee dated March 1, 1983 is widely cited as permitting a lawyer to represent both husband and wife in estate planning.

The Real Property, Probate and Trust Laws Section of the A.B.A. has recently issued Comments and Recommendations on the lawyers' duties in representing husband and wives. 24 Real Property, Probate and Trust Journal 765 (Winter, 1994). These comments and recommendations are a prescriptive guide prepared by trusts and estates lawyers experienced in the area. The articles suggests that representation may be "joint" or "separate". (Separate means separate simultaneous representation.)

The comments state representation is joint unless made otherwise by the parties. There is no conflict until the lawyers discerns conflict. Once conflict is discerned, the lawyer consent should be obtained preferably in writing. The mere fact husband and wife want to distribute their assets differently is not a per se conflict. Confidences disclosed must be evaluated.

If a confidence is communicated by one spouse, the report suggests that the lawyer must determine "how best to handle the situation between two spouses at the time the confidence is imparted." Id. at 29. According to the report the lawyer must "inquire into the nature of the confidence to permit the lawyer to determine whether the couple's differences that caused the information to be secret constitutes either a material potential for conflict or a true adversity." Id. at 28. The report goes on to describe three broad types of confidences that may cause the lawyer to conclude that the differences between the spouses make the spouses' interests truly adverse: (1) Action-related confidences, in which the lawyer is asked to give advice or prepare documents without the knowledge of the other spouse, that would reduce or defeat the other spouse's interest in the confiding spouse's property or pass the confiding spouse's property to another person; (2) Prejudicial confidences, which seek no action by the lawyer, but nonetheless indicate a substantial potential of material harm to the interest of the other spouse; and (3) Factual confidences which indicate that the expectations of one spouse with respect to an estate plan, or the spouse's understanding of the plan, are not true. Because an unexpected letter of withdrawal may not protect a confidence from disclosure, the ABA Committee concluded that "the lawyer must balance the potential for material harm arising from an unexpected withdrawal against the potential for material harm arising from the failure to disclose the confidence to the other spouse." Id. at 30.

If lawyer withdraws he can convert the representation into a separate representation but only with full disclosure and the consent of both.

The Real Property, Probate and Trust Journal articles argues that separate simultaneous representation is permitted under the Rules. This representation must be by specific agreement. However, the article points out the "overriding ethics" duty to provide independent judgment and the difficulty separate representation causes in exercising independent. Most persons who have examined this issue carefully have concluded that separate representation while theoretically possible in practically impossible. Teresa Stanton Collett has argue that --

No lawyer can serve two masters, for the lawyer will either love the first (preserving the client's confidences), and hate the second (betraying the other client's trusts), or hate the fist (disclosing the client's confidences), and love the second (protecting the other client's ability to make informed decisions. This inherent conflict compels the rejection of separate simultaneous representation as a professional norm. As reflected by the initial recommendation of the Professional Standards Committee of the American College of Probate Counsel, this model of representation should be permitted only on the rare occasions when exceptional circumstances require the heroic effort of building and maintaining a Chinese Wall within the lawyer's mind.

Collett, "And the Two Shall Become One . . . Until the Lawyers Are Done" 7 Notre Dame Journal of Law, Ethics & Public Policy 101, 143.

The Fordham Conference concluded that in the initial conferences, the lawyer and the client should agree on the confidentiality of disclosures. The Conference set forth only two options: (1) the lawyer, in the lawyer's discretion, may disclose all information even if a client does not want it disclosed, or (2) the lawyer must disclose such information. The Conference felt the first option was preferred. The Conference rejected an option that the lawyer will hold the information to the lawyer alone .

2. Parent-Child - Intergenerational Representation.

   a. The Fordham Conference also discussed the ethical concerns in representing multiple generations, e.g., father-daughter or mother-son. The Conference could not agree that a lawyer may represent a family group if there was a clear identification of the persons who would become clients if there was a splintering of the group and the persons to whom the duties of loyalty and confidentiality were owed.

b. Haynes v. First National State Bank, 87 N.J. 163, 432, A, 2d 890 (1981). This case involved a will contest. The lawyer who prepared the will and trust of the decedent was also the attorney for the decedent's daughter who was the principal beneficiary of the estate. The court held that there was a presumption of undue influence by the daughter's attorney which could be rebutted by clear and convincing evidence. Did the daughter have a malpractice claim against the lawyer?

3. Corporation and Shareholder, Officer or Director

The law firm of Kirkland & Ellis sought attorneys fees in the Estate of George Halas. The beneficiaries objected. The firm represented the fiduciary as fiduciary, the fiduciary individually, the fiduciary as CEO of the Chicago Bears corporation, the corporation, the sister of the decedent, and her family. The court determined the firm's conduct representing so many interests showed an absence of good faith which resulted in a reduction in the fee. Estate of Halas, 159 Ill. App. 3d 818, 512 N.E.2d 1276 (1987). See also the ABA Informal Decision 564 (1962) in which the attorney who represented the estate of a decedent was conflicted out because he also represented the corporation.

4. Corporate Fiduciary & Client. An attorney who represents a bank should disclose this representation to a client thinking of naming the bank executor in the client's will. Ill. State Bar Association Opn. 90-2.

5. Insurance Agent & Client - Neb. St. Bar Assn. Opn. 81-10; Wisc. Prof. Ethics Com. 392-2. An attorney to whom clients are referred by an insurance agent should disclose that relationship to any clients who purchase insurance from the agent. Neb. State Bar Assn. 81-10.

6. Fiduciaries and Beneficiaries.

The Concept of Derivative Liability. The Fordham Conference was clear in its determination that the client of an attorney who represents a fiduciary is the fiduciary and not the beneficiaries of the estate or trust. Nevertheless, the Fordham Conference did decide that the lawyer for a fiduciary owes a derivative duty to the beneficiaries.

Case law supports this decision. Estate of Halas; Elam v. Hyatt Legal Services, 44 Ohio St. 3d 175, 541 N.E.2d 616 (1989); Fickett v. Sup. Ct., 27 Ariz. App. 793, 558 P.2d 988 (1976) (Guardianship)

The Fordham Conference concluded that the lawyer for a fiduciary may, but is not obligated to, disclose secrets and confidences of his fiduciary to the beneficiaries of the fiduciary relationship.

On May 9, 1994, the A.B.A. Standing Committee on Ethics issued Opinion 94-380 which clearly states that a lawyer who represents a fiduciary represents the fiduciary and has no obligation under Model Rule 1.6 to disclose to beneficiaries a breach of fiduciary obligations including fraud and other wrongdoing. But in Kentucky a lawyer may disclose confidential information to the extent necessary to prevent criminal conduct likely to result in imminent death or substantial bodily injury. K.B.A. Opinion E-360 (9/11/93). See Rule 1.6(b)(2)(3). (The crimes/fraud exception). This version of the Rules would seem to mean that a lawyer for a fiduciary who is stealing from an estate or trust should not disclose the information because the client's criminal conduct does not relate to death or injury. Under Ohio DR4-101(C)(3) the lawyer may realize the intention of his client to commit a crime and the information necessary to prevent the crime.

The opinion, however, does not address the other problem of the trust and estates lawyer. If the lawyer represents the trustee and the trustee is an individual, the other beneficiaries of the trust are likely to be related to the trustee and either present or past clients of the lawyer. As a result, Rule 1.6(a) on information may apply requiring present client consent or Rule 1.9(a) requiring former client consent.

7. Charity and Client

8. Dual Representation Letter

C. Pecuniary Interest

1. Rule 1.8(a) - Draftsperson as Beneficiary: Also EC 5-5

EC5-5 provides:

> "A lawyer should not suggest to his client that a gift be made to himself or for his benefit. If a lawyer accepts a gift from his client, he is peculiarly susceptible to the charge that he unduly influenced or overreached the client. If a client voluntarily offers to make a gift to his lawyer, the lawyer may accept the gift, but before doing so, he should urge that his client secure disinterested advice from an independent, competent person who is

cognizant of all the circumstances. Other than in exceptional circumstances, a lawyer should insist that an instrument in which his client desires to name him beneficially be prepared by another lawyer selected by the client."

But Rule 1.8(c) permits a lawyer to prepare giving the lawyer or a person related to the lawyer as a parent, child, sibling or spouse a substantial gift unless the client is related to the donee.

2. Designation of Attorney Draftsperson as Executor or Trustee; E.C. 5-6

EC5-6 provides:

> "A lawyer should not consciously influence a client to name his as executor, trustee, or lawyer in an instrument. In those cases where a client wishes to name his lawyer as such, care should be taken by the lawyer to avoid even the appearance of impropriety."

A lawyer should not consciously influence a client to name him executor or trustee. State v. Gulbankian, 196 N.W.2d 733 (1972).

Nevertheless, the Fordham Conference determined ...

a. A lawyer is not be precluded from serving as a fiduciary.

b. A lawyer may draft an instrument in which the client names the lawyer fiduciary. The client should be adequately informed by the lawyer. If the client is not adequately informed, the appointment will be denied. Estate of DeMarco, N.Y. L.J. 3/1/88.

c. If the lawyer fiduciary has represented another interested party in a substantially related matter, the lawyer can be forced to withdraw.

The ACTEC Commentaries have similar conclusions.

28 Real Property, Probate & Trust Journal (Winter 1994) contains a report on the "Preparation of Wills and Trusts that name Drafting Lawyer as Fiduciary." The report emphasizes Rule 11.8(a) requiring (1) that the transaction be fair and reasonable as fully disclosed in a

writing that is reasonably understandable, (2) the client is given reasonable opportunity to seek independent advice and (3) the client consents in writing. The report concludes that Rule 1.8 does not apply to the draftsman. The report also mentions Rul 2.1 requiring the lawyer to exercise independent professional judgment and render candid advice. The report continues by saying disclosure is a good idea and the lawyer disclose the role and function of the fiduciary, alternative persons or institutions who could act; conflicts, compensation issues and arguments of undue influence, conflicts with other clients and competency. Also, the lawyer should not limit the liability of the fiduciary.

3. Corporate Fiduciaries Policy of Using Draftsperson as Attorney for Estate - Rule 2.1 discussed above.

4. Naming Draftsperson in Will as Attorney for Estate

   This does not mean the lawyer does not need to withdraw, he must withdraw!

5. Clients of Diminished Capacity.

   The Fordham Conference concluded:

   > "Where a client has diminished capacity to make decisions and lawyer believes client is at risk of harm, lawyer may disclose confidential information obtained in the course of the representation without client consent with the goal of protecting the client from harm. In determining whether to make such disclosures, lawyer must consider the following factors:
   >
   > i. Harm to the client that is likely to result if the lawyer does not disclosure the confidences. Harm may include damage to the physical, mental or financial well being of the client, or to a clearly stated interest of the client, or to the client's dispositive plan or to the client.
   >
   > ii. The degree to which the lawyer has knowledge of the situation.
   >
   > iii. The potential for harm to third parties, in so far as the client's interests are adversely affected.

iv. The nature of the confidence and the potential for embarrassing or stigmatizing the client in light of the client's personal values.

RULES OF PROFESSIONAL CONDUCT

Kentucky Excerpts With Commentaries

RULE 1.3 DILIGENCE

A lawyer shall act with reasonable diligence and promptness in representing a client.

Comment

(1) A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and may take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer should act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. However, a lawyer is not bound to press for every advantage that might be realized for a client. A lawyer has a professional discretion in determining the means by which a matter should be pursued. See Rule 1.2. A lawyer's workload should be controlled so that each matter can be handled adequately.

(2) Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's trustworthiness.

(3) Unless the relationship is terminated as provided in Rule 1.16, a lawyer should carry through to conclusion all matters undertaken for a client. If a lawyer's employment is limited to a specific matter, the relationship terminates when the matter has been resolved. If a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal. Doubt about whether a client-lawyer relationship still exists should be clarified by the lawyer, preferably in writing, so that the client will not mistakenly suppose the lawyer is looking after the client's affairs when the lawyer has ceased to do so. For example, if a lawyer has handled a judicial or administrative proceeding that produced a result adverse to the client but has not been specifically instructed concerning pursuit of an appeal, the lawyer should advise the client of the possibility of appeal before relinquishing responsibility for the matter.

RULE 1.4 COMMUNICATION

(a) **A lawyer should keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.**

(b) **A lawyer should explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.**

Comment

(1) The client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued, to the extent the client is willing and able to do so. For example, a lawyer negotiating on behalf of a client should provide the client with facts relevant to the matter, inform the client of communications from another party and take other reasonable steps that permit the client to make a decision regarding a serious offer from another party. A lawyer who receives from opposing counsel an offer of settlement in a civil controversy or a proffered plea bargain in a criminal case should promptly inform the client of its substance unless prior discussions with the client have left it clear that the proposal will be unacceptable. See Rule 1.2(a). Even when a client delegates authority to the lawyer, the client should be kept advised of the status of the matter.

(2) Adequacy of communication depends in part on the kind of advice or assistance involved. For example, in negotiations where there is time to explain a proposal, the lawyer should review all important provisions with the client before proceeding to an agreement. In litigation a lawyer should explain the general strategy and prospects of success and ordinarily should consult the client on tactics that might injure or coerce others. On the other hand, a lawyer ordinarily cannot be expected to describe trial or negotiation strategy in detail. The guiding principle is that the lawyer should fulfill reasonable client expectations for information consistent with the duty to act in the client's best interests, and the client's overall requirements as to the character of representation.

(3) Ordinarily, the information to be provided is that appropriate for a client who is a comprehending and responsible adult. However, fully informing the client according to this standard may be impracticable, for example, where the client is a child or suffers from mental disability. See Rule 1.14. When the client is an organization or group, it is often impossible or inappropriate to inform every one of its members about its legal affairs; ordinarily, the lawyer should address communications to the appropriate officials of the organization. See Rule 1.13. Where many routine matters are involved, a system of limited or occasional reporting may be arranged with the client. Practical exigency may also require a lawyer to act for a client without prior consultation.

Withholding Information

(4) In some very unusual circumstances, a lawyer may be justified in delaying transmission of information when the client would be likely to react imprudently to an immediate communication. Thus, a lawyer might withhold a psychiatric diagnosis of a client when the examining psychiatrist indicates that disclosure would harm the client. A lawyer may not withhold information to serve the lawyer's own interest or convenience. Rules or court orders governing litigation may provide that information supplied to a lawyer may not be disclosed to the client. Rule 3.4(c) directs compliance with such rules or orders.

RULE 1.6 CONFIDENTIALITY OF INFORMATION

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

(b) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

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

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

(3) to comply with other law or court order.

Comment

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

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

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

(4) A fundamental principle in the client-lawyer relationship is that the lawyer maintain confidentiality of information relating to the representation. The client is thereby encouraged to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter.

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

(6) The requirement of maintaining confidentiality of information relating to representation applies to government lawyers who may disagree with the policy goals that their representation is designed to advance.

Authorized Disclosure

(7) A lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation, except to the extent that the client's instructions or special circumstances limit that authority. In litigation, for example, a lawyer may disclose information by admitting a fact that cannot properly be disputed, or in negotiation by making a disclosure that facilitates a satisfactory conclusion.

(8) Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

Disclosure Adverse to Client

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

(10) Several situations must be distinguished.

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

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

(13) Third, the lawyer may learn that a client intends prospective conduct that is criminal and likely to result in imminent death or substantial bodily harm. As stated in paragraph (b)(1), the lawyer has professional discretion to reveal information in order to prevent such consequences. The lawyer may make a disclosure in order to prevent homicide or serious bodily injury which the lawyer reasonably believes is intended by a client. It is very difficult for a lawyer to "know" when such a heinous purpose will actually be carried out, for the client may have a change of mind.

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

Withdrawal

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

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

(17) Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct in connection with this Rule, the lawyer may make inquiry within the organization as indicated in Rule 1.13(b).

Dispute Concerning Lawyer's Conduct

(18) Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct, or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonable believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(2) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend, of course, applies where a proceeding has been commenced. Where practicable and not prejudicial to the lawyer's ability to establish the defense, the lawyer should

advise the client of the third party's assertion and request that the client respond appropriately. In any event, disclosure should be no greater than the lawyer reasonably believes is necessary to vindicate innocence, the disclosure should be made in a manner which limits access to the information to the tribunal or other persons having a need to know it, and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

(19) If the lawyer is charged with wrongdoing in which the client's conduct is implicated, the rule of confidentiality should not prevent the lawyer from defending against the charge. Such a charge can arise in a civil, criminal or professional disciplinary proceeding, and can be based on a wrong allegedly committed by the lawyer against the client, or on a wrong alleged by a third person; for example, a person claiming to have been defrauded by the lawyer and client acting together. A lawyer entitled to a fee is permitted by paragraph (b)(2) to prove the services rendered in an action to collect it. This aspect of the rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary. As stated above, the lawyer must make every effort practicable to avoid unnecessary disclosure of information relating to a representation, to limit disclosure to those having the need to know it, and to obtain protective orders or make other arrangements minimizing the risk of disclosure.

Disclosures Otherwise Required or Authorized

(20) The attorney-client privilege is differently defined in various jurisdictions. If a lawyer is called as a witness to give testimony concerning a client, absent waiver by the client, paragraph (a) requires the lawyer to invoke the privilege when it is applicable. The lawyer must comply with the final orders of a court or other tribunal of competent jurisdiction requiring the lawyer to give information about the client.

(21) The Rules of Professional Conduct in various circumstances permit or require a lawyer to disclose information relating to the representation. <u>See Rules 2.2, 2.3, 3.3 and 4.1.</u> In addition to these provisions, a lawyer may be obligated or permitted by other provisions of law to give information about a client. Whether another provision of law supersedes Rule 1.6 is a matter of interpretation beyond the scope of these Rules, but a presumption should exist against such a supersession.

(22) Paragraph (b)(4) gives the lawyer professional discretion to reveal such information as the lawyer reasonably believes is necessary to comply with a court order.

Former Client

(23) The duty of confidentiality continues after the client-lawyer relationship has terminated.

RULE 1.7 CONFLICT OF INTEREST: GENERAL RULE

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless;

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

(2) each client consents after consultation.

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

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

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

Comment

Loyalty to a Client

(1) Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined. If such a conflict arises after representation has been undertaken, the lawyer should withdraw from the representation. See Rule 1.16. Where more than one client is involved and the lawyer withdraws because a conflict arises after representation, whether the lawyer may continue to represent any of the clients is determined by Rule 1.9. See also Rule 2.2(c). As to whether a client-lawyer relationship exists, or having once been established, is continuing, see Comment to Rule 1.3 and Scope.

(2) As a general proposition, loyalty to a client prohibits undertaking representation directly adverse to that client without that client's consent. Paragraph (a) expresses that general rule. Thus, a lawyer ordinarily may not act as advocate against a person the lawyer represents in some other matter, even if it is wholly unrelated. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not require consent of the respective clients. Paragraph (a) applies only when the representation of one client would be directly adverse to the other.

(3) Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client. Paragraph (b) addresses such situations. A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client. Consideration should be given to whether the client wishes to accommodate the other interest involved.

Consultation and Consent

(4) A client may consent to representation notwithstanding a conflict. However, as indicated in paragraph (a)(1) with respect to representation directly adverse to a client, and paragraph (b)(1) with respect to material limitations on representation of a client, when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved cannot properly ask for such agreement, or provide representation on the basis of the client's consent. When more than

one client is involved, the question of conflict must be resolved as to each client. Moreover, there may be circumstances where it is impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent.

Lawyer's Interests

(5) The lawyer's own interests should not be permitted to have adverse effect on representation of a client. For example, a lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee. See Rules 1.1 and 1.5. If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. A lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed interest.

Conflicts in Litigation

(6) Paragraph (a) prohibits representation of opposing partisan litigation. Simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (b). An impermissible conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests is proper if the risk of adverse effect is minimal and the requirements of paragraph (b) are met. Compare Rule 2.2 involving intermediation between clients.

(7) Ordinarily, a lawyer may not act as advocate against a client the lawyer represents in some other matter, even if the other matter is wholly unrelated. However, there are circumstances in which a lawyer may act as advocate against a client. For example, a lawyer representing an enterprise with diverse operations may accept employment as an advocate against the enterprise in an unrelated matter if doing so will not adversely affect the lawyer's relationship with the enterprise or conduct of the suit and if both clients consent upon consultation. By the same token, government lawyers in some circumstances may represent government employees in proceeding in which a government agency is the opposing party. The propriety of concurrent representation can depend on the nature of the litigation. For example, a suit charging fraud entails conflict to a degree not involved in a suit for a declaratory judgment concerning statutory interpretation.

(8) A lawyer may represent parties having antagonistic positions on a legal question that has arisen in different cases, unless representation of either client would be adversely affected. Thus, it is ordinarily not improper to assert such positions in cases pending in different trial courts, may it may be improper to do so in cases pending at the same time in an appellate court.

Interest of Person Paying for a Lawyer's Service

(9) A lawyer may be paid from a source other than the client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty to the client. See Rule 1.8(f). For example, when an insurer and its insured have conflicting interests in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's professional independence. So also, when a corporation and its directors or employees are involved in a controversy in which they have conflicting interests, the corporation may provide funds for separate legal representation of the directors or employees, if the clients consent after consultation and the arrangement ensures the lawyer's professional independence.

Other Conflict Situations

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

(11) For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.

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

(13) A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.

Conflict Charged by an Opposing Party

(14) Resolving questions of conflict of interest is primarily the responsibility of the lawyer undertaking the representation. In litigation, a court may raise the question when there is reason to infer that the lawyer has neglected the responsibility. In a criminal case, inquiry by the court is generally required when a lawyer represents multiple defendants. Where the conflict is such as clearly to call in question the fair or efficient administration of justice, opposing counsel may properly raise the question. Such an objection should be viewed with caution, however, for it can be misused as a technique of harassment. See Scope.

RULE 1.8 CONFLICT OF INTEREST: PROHIBITED TRANSACTIONS

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
   (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
   (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
   (3) the client consents in writing thereto.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation.

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

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:
   (1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
   (2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
   (1) such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;
   (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
   (3) information relating to representation of a client is protected as required by Rule 1.6

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client consents after consultation, including disclosure of the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement, or settle a claim for such liability with an unrepresented client or former

client without first advising that person in writing that independent representation is appropriate in connection therewith.

(i) **A lawyer related to another lawyer as parent, child, sibling or spouse shall not represent a client in a representation directly adverse to a person who the lawyer knows is represented by the other lawyer except upon consent by the client after consultation regarding the relationship.**

(j) **A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:**

(1) **acquire a lien granted by law to secure the lawyer's fee or expenses; and**

(2) **contract with a client for a reasonable contingent fee in a civil case.**

Comment

Transactions Between Client and Lawyer

(1) As a general principle, all transactions between client and lawyer should be fair and reasonable to the client. In such transactions a review by independent counsel on behalf of the client is often advisable. Furthermore, a lawyer may not exploit information relating to the representation to the client's disadvantage. For example, a lawyer who has learned that the client is investing in specific real estate may not, without the client's consent, seek to acquire nearby property where doing so would adversely affect the client's plan for investment. Paragraph (a) does not, however, apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

(2) A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If effectuation of a substantial gift requires preparing a legal instrument such as a will or other conveyance, however, the client should have the detached advice that another lawyer can provide. Paragraph (c) recognizes an exception where the client is a relative of the donee or the gift is not substantial.

Literary Rights

(3) An agreement by which a lawyer acquires literary or media rights concerning the conduct of the representation creates a conflict between the interests of the client and the personal interests of the lawyer. Measures suitable in the representation of the client may detract from the publication value of an account of the representation. Paragraph (d) does not prohibit a lawyer representing a client in a transaction concerning literary property from agreeing that the lawyer's fee shall consist of a share in ownership in the property, if the arrangement conforms to Rule 1.5 and paragraph (j).

Person Paying for Lawyer's Services

(4) Paragraph (f) requires disclosure of the fact that the lawyer's services are being paid for by a third party unless such payment is provided for in an

agreement between the client and the third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest. Where the client is a class, consent may be obtained on behalf of the class by court-supervised procedure.

Limiting Liability

(5) Paragraph (h) is not intended to apply to customary qualifications and limitations in legal opinions and memoranda.

Family Relationships Between Lawyers

(6) Paragraph (i) applies to related lawyers who are in different firms. Related lawyers in the same firm are governed by Rules 1.7, 1.9, and 1.10. The disqualification stated in paragraph (i) is personal and not imputed to members of firms with whom the lawyers are associated.

Acquisition of Interest in Litigation

(7) Paragraph (j) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. This general rule, which has its basis in common-law champerty and maintenance, is subject to specific exceptions developed in decisional law and continued in these Rules, such as the exception for reasonable contingent fees set forth in Rule 1.5 and the exception for certain advances of the costs of litigation set forth in paragraph (e).

RULE 1.10 IMPUTED DISQUALIFICATION: GENERAL RULE

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7, 1.8(c), 1.9 or 2.2.

(b) When a lawyer becomes associated with a firm, the firm may not knowingly represent a person in the same or a substantially related matter in which that lawyer, or a firm with which the lawyer was associated, had previously represented a client whose interests are materially adverse to that person and about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(b) that is material to the matter.

(c) When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer unless:

(1) the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

(2) any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(b) that is material to the matter.

(d) A disqualification prescribed by this rule may be waived by the affected client under the conditions stated in Rule 1.7

Comment

Definition of "Firm"

(1) For purposes of the Rules of Professional Conduct, the term "firm" includes lawyers in a private firm, and lawyers employed in the legal department of a corporation or other organization, or in a legal services organization. Whether two or more lawyers constitute a firm within this definition can depend on the specific facts. For example, two practitioners who share office space and occasionally consult or assist each other ordinarily would not be regarded as constituting a firm. However, if they present themselves to the public in a way suggesting that they are a firm or conduct themselves as a firm, they should be regarded as a firm for the purposes of the Rules. The terms of any formal agreement between associated lawyers are relevant in determining whether they are a firm, as is the fact that they have mutual

access to confidential information concerning the clients they serve. Furthermore, it is relevant in doubtful cases to consider the underlying purpose of the rule that is involved. A group of lawyers could be regarded as a firm for purposes of the rule that the same lawyer should not represent opposing parties in litigation, while it might not be so regarded for purposes of the rule that information acquired by one lawyer is attributed to another.

(2) With respect to the law department of an organization, there is ordinarily no question that the members of the department constitute a firm within the meaning of the Rules of Professional Conduct. However, there can be uncertainty as to the identity of the client. For example, it may not be clear whether the law department of a corporation represents a subsidiary or an affiliated corporation, as well as the corporation by which the members of the department are directly employed. A similar question can arise concerning an unincorporated association and its local affiliates.

(3) Similar questions can also arise with respect to lawyers in legal aid. Lawyers employed in the same unit of a legal service organization constitute a firm, but not necessarily those employed in separate units. As in the case of independent practitioners, whether the lawyers should be treated as associated with each other can depend on the particular rule that is involved, and on the specific facts of the situation.

(4) Where a lawyer has joined a private firm after having represented the government, the situation is governed by Rule 1.11(a) and (b); where a lawyer represents the government after having served private clients, the situation is governed by Rule 1.11(c)(1). The individual lawyer involved is bound by the Rules generally, including Rules 1.6, 1.7 and 1.9.

(5) Different provisions are thus made for movement of a lawyer from one private firm to another and for movement of a lawyer between a private firm and the government. The government is entitled to protection of its client confidences, and therefore to the protections provided in Rules 1.6, 1.9, and 1.11. However, if the more extensive disqualification in Rule 1.10 were applied to former government lawyers, the potential effect on the government would be unduly burdensome. The government deals with all private citizens and organizations, and thus has a much wider circle of adverse legal interests than does any private law firm. In these circumstances, the government's recruitment of lawyers would be seriously impaired if Rule 1.10 were applied to the government. On balance, therefore, the government is better served in the long run by the protections stated in Rule 1.11.

Principles of Imputed Disqualification

(6) The rule of imputed disqualification stated in paragraph (a) gives effect to the principle of loyalty to the client as it applies to lawyers who practice in a law firm. Such situations can be considered from the premise that a firm of lawyers is essentially one lawyer for purposes of the rules governing loyalty to the client, or from the premise that each lawyer is vicariously bound by the obligation of loyalty owed by each lawyer with whom the lawyer is associated. Paragraph (a) operates only among the lawyers currently associated in a firm. When a lawyer moves from one firm to another, the situation is governed by paragraphs (b) and (c).

Lawyers Moving Between Firms

(7) When lawyers have been associated in a firm but then end their association, however, the problem is more complicated. The fiction that the law firm is the same as a single lawyer is no longer wholly realistic. There are several competing considerations. First, the client previously represented must be reasonably assured that the principle of loyalty to the client is not compro-

mised. Second, the rule of disqualification should not be so broadly cast as to preclude other persons from having reasonable choice of legal counsel. Third, the rule of disqualification should not unreasonably hamper lawyers from forming new associations and taking on new clients after having left a previous association. In this connection, it should be recognized that today many lawyers practice in firms, that many to some degree limit their practice to one field or another, and that many move from one association to another several times in their careers. If the concept of imputed disqualification were defined with unqualified rigor, the result would be radical curtailment of the opportunity of lawyers to move from one practice setting to another and of the opportunity of clients to change counsel.

(8) Reconciliation of these competing principles in the past has been attempted under two rubrics. One approach has been to seek per se rules of disqualification. For example, it has been held that a partner in a law firm is conclusively presumed to have access to all confidences concerning all clients of the firm. Under this analysis, if a lawyer has been a partner in one law firm and then becomes a partner in another law firm, there is a presumption that all confidences known by a partner in the first firm are known to all partners in the second firm. This presumption might properly be applied in some circumstances, especially where the client has been extensively represented, but may be unrealistic where the client was represented only for limited purposes. Furthermore, such a rigid rule exaggerates the difference between a partner and an associate in modern law firms.

(9) The other rubric formerly used for dealing with vicarious disqualifications is the appearance of impropriety proscribed in Canon 9 of the ABA Model Code of Professional Responsibility. This rubric has a twofold problem. First, the appearance of impropriety can be taken to include any new client-lawyer relationship that might make a former client feel anxious. If that meaning were adopted, disqualification would become little more that a question of subjective judgment by the former client. Second, since "impropriety" is undefined, the term "appearance of impropriety" is question-begging. It therefore has to be recognized that the problem of imputed disqualification cannot be properly resolved either by simple analogy to a lawyer practicing alone or by the very general concept of appearance of impropriety.

(10) A rule based on a functional analysis is more appropriate for determining the question of vicarious disqualification. Two functions are involved: preserving confidentiality and avoiding positions adverse to a client.

Confidentiality

(11) Preserving confidentiality is a question of access to information. Access to information, in turn, is essentially a question of fact in particular circumstances, aided by inferences, deductions or working presumptions that reasonably may be made about the way in which lawyers work together. A lawyer may have general access to files of all clients of a law firm and may regularly participate in discussions of their affairs; it should be inferred that such a lawyer in fact is privy to all information about all the firm's clients. In contrast, another lawyer may have access to the files of only a limited number of clients and participate in discussion of the affairs of no other clients; in the absence of information to the contrary, it should be inferred that such a lawyer in fact is privy to information about the clients actually served but not those of other clients.

(12) Application of paragraphs (b) and (c) depends on a situation's particular facts. In any such inquiry, the burden of proof should rest upon the firm whose disqualification is sought.

(13) Paragraphs (b) and (c) operate to disqualify the firm only when the lawyer involved has actual knowledge of information protected by Rules 1.6 and 1.9(b). Thus, if a lawyer while with one firm acquired no knowledge of information relating to a particular client of the firm, and that lawyer later joined another firm, neither the lawyer individually nor the second firm is disqualified from representing another client in the same or a related matter even though the interests of the two clients conflict.

(14) Independent of the question of disqualification of a firm, a lawyer changing professional association has a continuing duty to preserve confidentiality of information about a client formerly represented. <u>See Rules 1.6 and 1.9.</u>

Adverse Positions

(15) The second aspect of loyalty to client is the lawyer's obligation to decline subsequent representations involving positions adverse to a former client arising in substantially related matters. This obligation requires abstention from adverse representation by the individual lawyer involved, but does not properly entail abstention of other lawyers through imputed disqualification. Hence, this aspect of the problem is governed by Rule 1.9(a). Thus, if a lawyer left one firm for another, the new affiliation would not preclude the firms involved from continuing to represent clients with adverse interests in the same or related matters, so long as the conditions of paragraphs (b) and (c) concerning confidentiality have been met.

RULE 2.2 INTERMEDIARY

(a) A lawyer may only act as intermediary between clients if:

(1) the lawyer consults with each client concerning the implications of the common representation, including the advantages and risks involved, and the effect on the attorney-client privileges, and obtains each client's consent to the common representation;

(2) the lawyer reasonably believes that the matter can be resolved on terms compatible with the clients' best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful; and

(3) the lawyer reasonably believes that the common representation can be undertaken impartially and without improper effect on other responsibilities the lawyer has to any of the clients.

(b) While acting as intermediary, the lawyer shall consult with each client concerning the decisions to be made and the considerations relevant in making them, so that each client can make adequately informed decisions.

(c) A lawyer shall withdraw as intermediary if any of the clients so requests, or if any of the conditions stated in paragraph (a) is no longer satisfied. Upon withdrawal, the lawyer shall not continue to represent any of the clients in the matter that was the subject of the intermediation.

Comment

This Rule explicitly recognizes the special role of the lawyer acting as an intermediary, to be distinguished from joint representation as an advocate.

(1) A lawyer acts as intermediary under this Rule when the lawyer represents two or more parties with potentially conflicting interests. A key factor in defining the relationship is whether the parties share responsibility for the lawyer's fee, but the common representation may be inferred from other circumstances. Because confusion can arise as to the lawyer's role where each party is not separately represented, it is important that the lawyer make clear the relationship, and obtain the client's consent, preferably in writing.

(2) This Rule does not apply to a lawyer acting as arbitrator or mediator between or among parties who are not clients of the lawyer, even where the lawyer has been appointed with the concurrence of the parties. In performing such a role the lawyer may be subject to applicable codes of ethics, such as the Code of Ethics for Arbitration in Commercial Disputes prepared by a joint

Committee of the American Bar Association and the American Arbitration Association.

(3) A lawyer acts as intermediary in seeking to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest, arranging a property distribution in settlement of an estate or a marital division or mediating a dispute between clients. The lawyer seeks to resolve potentially conflicting interests by developing the parties' mutual interests. The alternative can be that each party may have to obtain separate representation, with the possibility in some situations of incurring additional cost, complication or even litigation. Given these and other relevant factors, all the clients may prefer that the lawyer act as intermediary.

(4) In considering whether to act as intermediary between clients, a lawyer should be mindful that if the intermediation fails the result can be additional cost, embarrassment and recrimination. In some situations the risk of failure is so great that intermediation is plainly impossible. For example, a lawyer cannot undertake common representation of clients between whom contentious litigation is imminent or who contemplate contentious negotiations. More generally, if the relationship between the parties has already assumed definite antagonism, the possibility that the clients' interests can be adjusted by intermediation ordinarily is not very good.

(5) The appropriateness of intermediation can depend on its form. Forms of intermediation range from informal arbitration, where each client's case is presented by the respective client and the lawyer decides the outcome, to mediation, to common representation where the clients' interests are substantially though not entirely compatible. One form may be appropriate in circumstances where another would not. Other relevant factors are whether the lawyer subsequently will represent both parties on a continuing basis and whether the situation involves creating a relationship between the parties or terminating one.

(6) In some circumstances a lawyer will undertake representation of a party in litigation or negotiation, and be forced to deal with an unrepresented party. For example, the lawyer representing a spouse in a divorce case may deal with the unrepresented spouse within the limits of Rule 4.3. The fact that the lawyer negotiates with the unrepresented spouse does not make the lawyer an intermediary, or subject the lawyer to the special rule of disqualification contained in Rule 2.2(c).

Confidentiality and Privilege

(7) A particularly important factor in determining the appropriateness of intermediation is the effect on client-lawyer confidentiality and the attorney-client privilege. In a common representation, the lawyer is still required both to keep each client adequately informed and to maintain confidentiality of information relating to the representation. See Rules 1.4 and 1.6. Complying with both requirements while acting as intermediary requires a delicate balance. If the balance cannot be maintained, the common representation is improper. With regard to the attorney-client privilege, the prevailing rule is that as between commonly represented clients the privilege does not attach. Hence, it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

(8) Since the lawyer is required to be impartial between commonly represented clients, intermediation is improper when that impartiality cannot be

maintained. For example, a lawyer who has represented one of the clients for a long period and in a variety of matters might have difficulty being impartial between that client and one to whom the lawyer has only recently been introduced.

Consultation

(9) In acting as intermediary between clients, the lawyer is required to consult with the clients on the implications of doing so, and proceed only upon consent based on such a consultation. The consultation should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances.

(10) Paragraph (b) is an application of the principle expressed in Rule 1.4. Where the lawyer is intermediary, the clients ordinarily must assume greater responsibility for decisions than when each client is independently represented.

Withdrawal

(11) Common representation does not diminish the rights of each client in the client-lawyer relationship. Each has the right to loyal and diligent representation, the right to discharge the lawyer as stated in Rule 1.16, and the protection of Rule 1.9 concerning obligations to a former client.