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25th Annual Midwest/Midsouth Estate Planning Institute

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

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

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SECTION A

NOTABLE DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS, 1997-1998

A. **1997 - 1998 TAX RELATED ACTS**

1. **Taxpayer Relief Act of 1997**. The Taxpayer Relief Act of 1997 (the "Act") made a number of significant changes of interest to estate planners. Among them are the following:

a. Section 4980A, the excess retirement accumulation and distribution tax, is repealed for distributions received, and decedent's dying, after December 31, 1996.

b. The unified credit is renamed the applicable credit amount and the amount sheltered increases as follows:

1998	$ 625,000
1999	650,000
2000/01	675,000
2002/03	700,000
2004	850,000
2005	950,000
2006	1,000,000

What should be done with marital deduction/credit shelter formula provisions that refer to the unified credit? The term "applicable credit amount" is used in section 2010, the heading to which continues to refer to the unified credit. New documents should refer to the applicable credit amount, perhaps with a continued reference to the unified credit. For example, "applicable credit amount (unified credit)." There should be no need to revise existing documents.

Estate plans that have been created with reference to the $600,000 exemption may need to be revised. For example, in a second marriage the children of the first marriage may receive the exempt amount with the intent being for the children to receive $600,000. If the children's distribution is defined by the unified credit, or the maximum amount that can pass free of estate tax (other than to a spouse or to a charity), then the amount passing to the children will increase over the next eight years. A question may arise about the client's intent.

c. The $10,000 gift tax annual exclusion amount has been indexed for inflation (rounded to the next lowest $1,000) as has the GST exemption (rounded to the next lowest $10,000), for years after 1998. The $750,000 reduction under section 2032A is also indexed for years after 1998 (rounded to the next lowest $10,000).

d. The gift tax statute of limitations has been changed for gifts after August 5, 1997. Section 2001(f) has been added to provide that the value of gifts may not be changed for estate tax purposes once the gift tax statute of limitations has run. Normally the period is three years. In order for the limitation to run the gift must be "disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such gift." The disclosure which is sufficient to begin the statute running is unknown, although regulations can be expected soon. A new section 7477 allows the Tax Court to adjudicate gift valuation disputes.

The change is generally positive. If the IRS wants to increase the value of gifts it has three years from the date of the gift tax return to do so. Thus, if an increase results in gift tax the interest owed will be for a limited time. On the other hand, there is no statute of limitations for undisclosed transactions. If a taxpayer believes a sale has occurred -- to children, for instance -- the taxpayers can either disclose the transaction on the gift tax return (by having the sale be for a little less than fair market value), and create an audit risk, or not disclose and be subject to audit <u>at any time</u>. Similarly, gift tax audits for unreasonable compensation in a family business may occur at any time for any year after 1996.

e. Section 6166 interest is no longer deductible under section 2053. On the other hand, the interest rate is now 45% of the usual rate. Of importance is that all interest on unpaid estate tax is not deductible if a section 6166 election is in effect. If the IRS denies the section 6166 election to an estate the denial may be appealed to Tax Court under section 7479. Revenue

Procedure 98-15, I.R.B. 1998-4 sets forth the procedure for estates to elect the new section 6166 interest rate. In general, making such an election is undesirable.

f. Changes have been made in the predeceased child exception for GST purposes.

1. Pre-1998 Law. As originally enacted, section 2612(c)(2) created the so-called predeceased child exception. If, at the time of a GST transfer, a child of transferor (or transferor's spouse) had died, the child's children would be treated as having moved up a generation for purposes of determining whether or not a direct skip occurred. The child's children's descendants were also moved up a generation. The benefit existed only for direct skips not for taxable terminations or taxable distributions. Disclaimers could not be used to create a "predeceased" child; the disclaimer was ineffective to change the assignment of generations.

2. New Law -- For Transfers After January 1, 1998. The Act made significant changes to the predeceased child exception by repealing section 2612(c)(2) and replacing it with section 2651(e). Section 2651 generally sets forth the rules for making generation assignments.

i. Expansion of the Exception beyond Direct Skips. The most important effect of the change is to expand the application of the exemption beyond direct skips to include taxable terminations and taxable distributions. The effect of the change is to assign the children of a deceased child to the child's generation. The new provision provides:

> (1) IN GENERAL. For purposes of determining whether any transfer is a generation-skipping transfer, if --
>
> (A) an individual is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and
>
> (B) such individual's parent who is a lineal descendant of the parent of the transferor (or the transferor's spouse or former spouse) is dead at the time the transfer (from which an interest of such individual is established or derived) is subject to a tax imposed by chapter 11 or 12 upon

> the transferor (and if there shall be more than 1 such time, then at the earliest such time),

> such individual shall be treated as if such individual were a member of the generation which is 1 generation below the lower of the transferor's generation or the generation assignment of the youngest living ancestor of such individual who is also a descendant of the parent of the transferor (or the transferor's spouse or former spouse), and the generation assignment of any descendant of such individual shall be adjusted accordingly.

> (2) LIMITED APPLICATION OF SUBSECTION TO COLLATERAL HEIRS. This subsection shall not apply with respect to a transfer to any individual who is not a lineal descendant of the transferor (or the transferor's spouse or former spouse) if, at the time of the transfer, such transferor has any living lineal descendant.

The change will simplify planning in a number of ordinary situations. To illustrate, if a child has died and parent creates a trust for the parent's remaining children and lower descendants, under the new law transfers from the trust to the descendants of the deceased child will be exempt from the GST. Under the old law transfers from the trust would have been subject to the GST because the trust would not have been a skip person and thus the transfer into the trust would not have been a direct skip. Many Crummey trusts are established for the benefit of all of a parent's descendants; such trusts were undesirable if a child had predeceased, under the old law.

Under the old law, a grantor retained annuity trust (GRAT) or a qualified personal residence trust (QPRT) could result in a transfer subject to the GST if the grandchildren of a deceased child were beneficiaries of the trust after the termination of the grantor's interest. Because of the grantor's retained interest the trust would not be a skip person and thus the transfer into the trust would not be a direct skip. The result is different under the new law.

Similarly, if a child has predeceased parent, the parent may now create a charitable lead trust for the benefit of the child's children without such trust being subject to the GST. The grandchildren are assigned to the predeceased child's generation.

Section 2651(e)(1) provides that the child must be dead at the time of the transfer that is subject to a gift or estate tax "and if there shall be more than 1 such time, then at the earliest such time." Thus, planners must remember that the change applies only if the child predeceases the transfer. For example, if a child is living when a GRAT is created and dies during the term of the grantor's retained interest, any of the remaining GRAT assets that pass to the child's children will be subject to the GST. The result would be the same for a QPRT.

What if the GRAT or QPRT provided that the trust assets would be paid to the grantor's probate estate if the grantor died during the trust term? For example, if the grantor's Will provides that the deceased child's children inherit is that subject to the GST because the assets came from the GRAT or QPRT? The answer should be no because the grantor's probate estate intervened in the chain. The result should be the same if the grantor exercised a general power of appointment over the trust assets, even if the appointment did not change the beneficiaries. If the grantor retained a general power of appointment over the trust assets which was not exercised, would that be sufficient to cause the exception to apply?

The requirement that the child be dead at the time the transfer is made will affect reverse QTIP planning in certain situations. If the child dies during the surviving spouse's lifetime the predeceased child exception is unavailable; on the other hand, if no reverse QTIP election were made the surviving spouse would be treated as the transferor and the exception would be available. If the surviving spouse has a testamentary special power of appointment the reverse QTIP election can be made and the spouse can appoint the reverse QTIP property to a child and descendants and appoint an equal portion of the remaining QTIP property to the descendants of the deceased child.

ii. Expansion of the Exception to Include Some Grandnieces and Grandnephews. Section 2651(e)(2) expands the predeceased child exception to include a transferor's grandnieces and grandnephews where the transferor has no descendants and the parent of the grandnieces or grandnephews (the transferor's sibling) has died. The section also creates an ambiguity.

If the transferor had living descendants at the time the transferor transfers property into trust, but does not have living descendants at the time a transfer is to be made to a grandniece or grandnephew, will the exception apply? If the term "transfer" means a transfer that is subject to the GST then the exception should apply. However, the term in section 2651(e)(1) is modified to mean the first transfer of the property, whether or not subject to a GST.

Section 2702 allows a common law grantor retained income trust (GRIT) to be established for persons other than lineal descendants. The leverage provided by a GRIT is often substantial and thus the transaction is very desirable for persons who lack descendants and who desire to benefit other members of the family. The significance of the expansion of the exception is that grandnieces and grandnephews can be benefited through a GRIT if the applicable niece or nephew has predeceased.

The spouse of a transferor may have descendants. Thus, a married transferor may make transfers using this exception to the grandnieces and grandnephews of the transferor's spouse, assuming the spouse's niece or nephew has predeceased, <u>even if</u> the spouse has descendants.

g. Revocable trusts may be taxed as part of an estate for income tax purposes.

The Act enacted a new section 646 of the Internal Revenue Code which applies to the estates of decedents dying after August 5, 1997. Under section 646(a), the executor of an estate <u>and</u> the trustee of a qualified revocable trust" may elect to have the trust treated and taxed for income tax purposes as part of the decedent's estate and not as a separate trust for all taxable years of the estate ending after the decedent's date of death and before the applicable date.

For purposes of this election, a "qualified revocable trust" is defined as any trust (or a portion thereof) which was treated under section

676 as owned by the decedent by reason of a power in the grantor, but determined without regard to any powers granted under section 672(e). § 646(b)(1). The term "applicable date" means: (A) if no estate tax return is required to be filed, the date which is 2 years after the decedent's date of death; and (B) if an estate tax return is required to be filed, the date which is 6 months after the date of the final determination of estate tax liability (i.e., the running of the statute of limitations on the federal estate tax return). § 646(b)(2).

The election to treat the qualified revocable trust as part of the estate for income tax purposes must be made no later than the time prescribed for filing income tax return for the first taxable year of estate, including extensions. § 646(c). Once made, the election is irrevocable. § 646(c). Revenue Procedure 98-13 sets out the procedures and requirements for making an election under section 646.

To make the election, the executor must attach the required statement to the Form 1041 filed for the estate for its first taxable year. In addition, a copy of the statement must be attached to a Form 1041 filed for the trust for the taxable year ending after the decedent's date of death. The required statement must:

1. Identify the election as an election made under section 646;
2. Contain the name, address, date of death and taxpayer identification number of the decedent;
3. Contain the name, address, and taxpayer identification of the qualified revocable trust;
4. Contain the name, address, and taxpayer identification number of the estate;
5. Provide a representation that as of the decedent's date of death, the trust for which the election is being made was treated under section 676 as owned by the decedent by reason of a power in the decedent to revoke the trust (determined without regard to section 672(e)); and
6. Be signed and dated by both an executor of the estate and a trustee of the qualified revocable trust.

Note, however, the trust does not have to file a Form 1041 for the taxable year ending after the decedent's date of death if it satisfies the following requirements: (1) the Form 1041 for the estate's first taxable year is filed before the due date for filing a Form 1041 for the trust for the taxable year ending after the decedent's date of death; (2) the trust items attributable to the decedent are reported pursuant to Reg. § 1.671-4(b)(2)(i)(A) or (B); and (3) the entire trust is a qualified revocable trust.

Once the election is made, the items of income, deductions and credits attributable to the qualified revocable trust after the decedent's death must be reported on the estate's Form 1041, and not on a separate Form 1041 for the trust.

Because the trust will be taxed as part of the estate until the applicable date, it may be able to take advantage of several income tax provisions which, in the past, were only available to estates. For example:

1. The trust will be able to use the estate's fiscal year end for income tax purposes (§ 644(a)).

2. The trust will qualify, along with the estate, for a single $600 exemption instead of a $100 or $300 exemption (§ 642(b)).

3. The trust will be able to take a deduction for "income permanently set aside for charity" as opposed to a deduction for only amounts currently paid to charity (§ 642(c)).

4. The trust will qualify to hold stock in an S corporation (§ 1361(b)(1)(B)).

5. The trust may deduct on the decedent's final return medical expenses that it pays within one year of the decedent's death (§ 213(c)(1).

6. The trust may engage in sales and exchanges to satisfy pecuniary bequests (§ 267(b)(13)).

7. The trust may dispose of depreciable property to satisfy pecuniary bequests (§ 1239(b)(3)).

8. Along with the estate, the trust qualifies for the $25,000 exemption with respect to passive activity losses (§ 469(i)(4)(A)).

9. The trust is not required to pay estimated taxes for the first two years after the decedent's death (§ 6654(l)(2)(A)).

h. A new section 2031(c) has been added which allows up to 40% of the value of land subject to a qualified conservation easement to be deducted from the estate (up to $500,000, after year 2001).

i. Estate of Jalkut v. Commissioner, 95 T.C. 675 (1991) has been overruled by a revised section 2035(e) which provides that gifts made from revocable trusts are treated as gifts from the decedent directly. The trust must be taxed to the grantor by section 676 (ignoring section 672(e)).

j. Charitable remainder trusts may not have more than a 50% payout (whether a unitrust or an annuity trust) and the value of the income tax charitable deduction must be at least 10%. The latter requirement makes CRTs for young people, and for parents and children, impossible in many instances.

k. Section 6034A(c) has been added which requires a beneficiary's income tax return be consistent with an estate or trust return unless the IRS is notified. For instance, an estate cannot claim that an assets is worth $100 and a beneficiary, who intends to sell the assets, claim a basis of $150.

l. A new section 2033A was added. Subsequently, the IRS Restructuring Act repealed section 2033A and created a new provision, section 2057. See subsequent outline for details.

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

1. **Necessity of Appraisal**. The Tax Court denied an income tax charitable deduction for a contribution of closely-held stock in Hewitt, et ux v. Commissioner, 109 T.C. 258 (1997), because the taxpayers did not submit a qualified appraisal (as defined in Treas. Reg. §1.170A-13). The taxpayers argued for substantial compliance which the court discussed as follows:

> Petitioners rely on Bond v. Commissioner, 100 T.C. 32 (1993), to sustain their position that a qualified appraisal is not a requirement under the circumstances herein. In that case, respondent challenged a charitable deduction for failure to obtain a qualified appraisal prior to filing the return. The parties stipulated there was no valuation overstatement. We found that the taxpayers had had the subject property, two blimps, appraised by a qualified appraiser within the specified time frame, and that substantially all of the information required by respondent's regulations, section 1.170A-13(c)(3)(i), Income Tax Regs., was contained in an appraisal summary, signed by a qualified appraiser, set forth in the Form 8283 attached to their return. Accordingly, we held that the taxpayers had

substantially complied with the requirements of the statute and the regulations even though a separate appraisal had not been obtained and the qualifications of the appraiser were omitted from the appraisal summary attached to the return.

In so holding, we stated:

> the essence of section 170 is to allow certain taxpayers a charitable deduction for contributions made to certain organizations. * * * However, the reporting requirements (of section 1.170A-13, Income Tax Regs.,) do not relate to the substance or essence of whether or not a charitable contribution was actually made. * * * [Bond v. Commissioner, 100 T.C. at 41.]
>
> As a consequence, we concluded that the reporting requirements of section 1.170A-13, Income Tax Regs., were directory, not mandatory, and therefore, that these requirements could be met by substantial, rather than strict, compliance. Bond v. Commissioner, 100 T.C. at 41. In effect, we held that the appraisal summary itself constituted the required appraisal. In this connection, we note that the appraisal requirements may not be entirely procedural so as to justify the application of the substantial compliance rules under any and all circumstances. See Atlantic Veneer Corp. v. Commissioner, 812 F.2d 158, 160-161 (4th Cir. 1987), affg. 85 T.C. 1075 (1985).

We find nothing in Bond v. Commissioner, supra, which relieves petitioners of the requirement of obtaining a qualified appraisal. Such a requirement is statutorily imposed by section 155(a)(1)(A), and its impact is reflected in the legislative history of that provision. See H. Conf. Rept. 98-861, at 995-996 (1984), 1984-3 C.B. (Vol. 2) 1, 249-250, stating:

> pursuant to present law (sec. 170(a)(1)), which expressly allows a charitable deduction only if the contribution is verified in the manner specified by Treasury regulations, no deduction is allowed for a contribution of property for which an appraisal is required under the conference agreement unless the appraisal requirements are satisfied.
>
> * * * * * *
>
> For donations of property as to which the donor appraisal requirements apply, the donor must obtain and retain a qualified written appraisal by a qualified appraiser for the property contributed and must attach a signed appraisal summary to the return on which the deduction is

first claimed (with such other information as prescribed by regulations).

Petitioners herein furnished practically none of the information required by either the statute or the regulations. Given the statutory language and the thrust of the concerns about the need of respondent to be provided with appropriate information in order to alert respondent to potential overvaluations, see infra p. 12, petitioners simply do not fall within the permissible boundaries of Bond v. Commissioner, supra, where an appraisal summary, which was completed by a qualified appraiser, contained most of the required information and could therefore by treated as a written appraisal, was attached to the return. Cf. D'Arcangelo v. Commissioner, T.C. Memo. 1994-572 (respondent prevailed where no qualified appraisal was obtained.

2. **Transfer of Incentive Stock Options to Charity**. Incentive stock options have become increasingly popular. PLR 9737015 considers the tax consequences of transferring such options to an Intermediary which, at a stated date, would exercise the options and transfer the proceeds to charity. The employee could alter the date and the charities at any time prior to the date. The ruling described the exercise process as follows:

> Option A is subject to the terms and conditions of a Gift Administration Agreement ("Agreement"). Under that Agreement, Intermediary must exercise Option A on a specified date, which Employee has reserved the right to change. Under that Agreement, Employee retains the right to specify and subsequently change (until the exercise date) the maximum spread that may result from exercise of Option A and the amount of withholding taxes to be paid upon exercise.
>
> Under the Agreement, upon the exercise of Option A, Intermediary must immediately sell the Company shares received and deposit the net proceeds of the sale (gross proceeds less the exercise prices, withholding taxes, and costs relating to the exercise) into the Asset Account. In accordance with the Agreement, Employee will contemporaneously identify one or more charities (described in section 170(c)(2) of the Code) to receive a contributions, and Intermediary will make a wire transfer from the Asset Account of the amounts specified for contribution to the charities. Intermediary will not commingle any other payment or contribution to the charity (or charities) in that wire transfer.
>
> Under the Agreement, if Employee dies prior to the full exercise of Option A, Intermediary must transfer what remains of Option A to a previously designated charity (or charities), and the charity may exercise Option A without regard to the criteria for permissible exercise

dates. To the extent that Option A is not exercised before its expiration date, it will expire unexercised.

Intermediary, as the agent of Employee, will receive from each charity a contemporaneous written acknowledgment stating that a specified amount was received by the charity on a specified date by a specified wire transfer from a specified asset account maintained by Intermediary. The acknowledgment will also state the other information required by section 170(f)(i) of the Code. Intermediary will promptly furnish the charity's acknowledgment to Employee.

Intermediary will also furnish to Employee statements detailing the activities in the Asset Account during each month that a contribution is made to a charity. These statements will include the amount, number, date, and recipient of any wire transfer to a charity.

Upon exercise, income would be triggered:

(1) Employee did not recognize income or gain upon the transfer of Option A to Intermediary.

(2) If Option A is exercised while Employee is living,

(a) Employee will recognize compensation income equal to the excess of the fair market value of the optioned shares on the date of exercise over the exercise price of the option; and

(b) the compensation income recognized by Employee will constitute "wages," under section 3401 of the Code, that are subject to federal income tax withholding. See Revenue Ruling 67-257, 1967-2 C.B. 359.

(3) If Option A is exercised after Employee dies,
(b) the compensation income attributable to such exercise will not constitute "wages" under section 3401 of the Code. See Revenue Ruling 86-109, 1986-2 C.B. 196.

A charitable deduction would also be allowed if the exercise occurred during the employee's lifetime:

Although, on Date Y, Employee irrevocably transferred Option A to Intermediary with the proceeds to go to a charity (or charities) described in section 170(c)(2) of the Code, he also reserved rights that control whether, and the extent to which, Option A may be exercised. Thus, on Date Y, Employee did not make a contribution that was deductible under section 170. See section 1.170A-1(e) of the regulations.

If Option A is exercised while Employee is alive, Intermediary must sell the shares received and deposit the proceeds of the sale (net of any amounts needed to

> pay the exercise price, withholding taxes, and other costs relating to the transfer and exercise of the option) in the Asset Account. Afterwards, Intermediary will make a wire transfer from the Asset Account to each of those charities in the specified amount. At the time of such transfer(s), Employee A will be making a "charitable contribution," within the meaning of section 170(c), of money.
>
> If the charities to which the funds are transferred are organizations described in section 170(b)(1)(A) of the Code, the limitation on the deductions will be governed by that section. The charity's contemporaneous written acknowledgment (identifying the number, amount, and date of the wire transfer and containing the other information required by section 170(f)(8)) that Employee will receive through Intermediary along with the statement of account from Intermediary (detailing the activity in the Asset Account) will substantiate the contribution for purposes of section 170(f)(8)(A).

The gift is incomplete until the option is exercised. Therefore, if the exercise occurred after or within three years prior to the decedent's death, the option would be included in the decedent's estate and a charitable deduction would be allowed:

> Accordingly, based upon the facts submitted and the representation made, to the extent that Option A has not been exercised by Intermediary before Employee's death, the value of Option A will be includible in Employee's gross estate under section 2036 and/or section 2038. Furthermore, if the charity or charities are organizations described in section 2055(a) and the deductions are not disallowed under section 2055(e), Employee's estate will be eligible for federal estate tax charitable deductions, under section 2055(a), for the transfer of Option A to the charity or charities.
>
> Further, pursuant to sections 2035(d)(2) and 2036 (and/or section 2038), to the extent that Intermediary exercised an option for Employee and transfers the net proceeds to a charity during the three-year period ending on Employee's date of death, the value that Option A would have had on the date of this death will be includible in Employee's gross estate. If the charity is an organization described in section 2055(a) and the deduction is not disallowed under section 2055(e), Employee's estate will be eligible for a federal estate tax charitable deduction, under section 2055(a), for the amount included in the gross estate.

PLRs 9737014 and 9737016 consider substantially similar issues with the same result. See also the discussion at §2501-2524, dealing with gifts of options generally.

3. **Easement Valuation**. Before the Tax Court in Browning v. Commissioner, 109 T.C. 303 (1997) was the valuation of a charitable easement. Treas. Reg. §1.170A-14(h)(3)(i) states:

> The value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. See section 1.170A-7(c). If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the sales prices of such comparable easements. If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

The first issue was the meaning of the regulations. The taxpayer was paid by the county for the easement but claimed that there was a bargain sale. The IRS argued the county's purchase price was determinative of value. The court held:

> In the case of a perpetual conservation restriction, if the market for such restrictions is not well established, it is usually necessary to value the restriction by applying a "before and after" analysis; i.e., a comparison of the fair market value of the donor's property unencumbered by the restriction with the fair market value of the property after the conveyance of the restriction, with any diminution of value to be ascribed to the fair market value of the restrictions. See, e.g., Symington v. Commissioner, supra at 895 & n.5, which states as follows:
>
>> This method has been approved by the Internal Revenue Service, see Rev. Rul. 73-339, 1973-2 C.B. 68, as clarified by Rev. Rul. 76-376, 1976-2 C.B. 53, and endorsed by Congress in connection with the adoption of the Tax Treatment Extension Act of 1980, see S. Rept. 96-1007 (1980), 1980-2 C.B. 599, 606.
>>
>> Nothing in section 1.170A-14(h)(3)(i), Income Tax Regs. (the PCR valuation regulation), contradicts that analysis; indeed, the PCR valuation regulations adopts the serial approach described: "If no substantial record of market-place sales is available to use as a meaningful or valid

comparison," the general rule is a before and after approach.

Respondent, however, argues that the second substantive sentence of the PCR valuation regulation, see supra sec. II., which sets forth the marketplace sales analysis, is the beginning and end of the inquiry into the fair market value of the easement, notwithstanding evidence to support a finding that sales of development rights in Howard County occur in an inhibited market. Respondent, thus, seeks to preclude petitioners from using appraisal evidence to establish a greater value. We believe that respondent's interpretation of the regulation is misguided.

The first substantive sentence of the PCR valuation regulation, see supra sec. II., establishes the general rule that the value of the contribution under section 170 of a perpetual conservation restriction is the fair market value of the restriction at the time of contribution. When there is evidence to support a finding that marketplace sales of such restrictions are unreliable, blind application of the second substantive sentence, which provides a method for determining the amount required by the rule of the first substantive sentence, would ignore the purpose of the regulation. Essentially, respondent's interpretation of the PCR valuation regulation narrowly focuses on whether there exists a substantial record of sales of comparable easements, irrespective of whether a comparison of the sale of the subject easement to such sales of comparable easements would yield the proper amount of the deduction under section 170. That misguided approach fails to recognize that a substantial record of sales of comparable easements must provide a "meaningful or valid comparison" to be considered a record of comparable sales. Sec. 1.170A-14(h)(3)(i), Income Tax Regs. (third substantive sentence).

The meaningful or valid comparison standard serves the purpose of determining the proper amount of the deduction under section 170 by establishing the fair market value of the contributed property rights and does not serve the function of determining some market value of the subject easement as an independent objective. Indeed, other portions of the PCR valuation regulation support that assertion. In the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family, the amount of the deduction under section 170 is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction. Sec. 1.170A-14(h)(3)(i), Income Tax Regs. (fourth substantive sentence). Sales of easements comparable to the donated easement covering a portion of the contiguous property owned by the donor and the donor's family and, thus, the market value of such easements are irrelevant.

In conclusion, we must examine the applicability of the second substantive sentence of the PCR valuation regulation in light of its role in determining the proper amount of the deduction under section 170. Therefore, we are not required to accept the substantial record of sales of development rights to Howard County under the Program as determinative of the fair market value of the easement when there is evidence to support a finding that those sales occur in an inhibited market.

* * *

On brief, respondent recites:

> Petitioners contend that the cash paid by Howard County for the development rights to their property does not represent the fair market value of the development rights. This argument is largely based on two factors: 1. petitioners did not believe the cash payments represented the fair market value of the property conveyed; and 2. Howard County did not intend to pay them fair market value for their easement.

In response, respondent concedes that petitioners' evidence as to the subjective beliefs of the parties (petitioners and Howard County) is persuasive on the issue of donative intent. See supra sec. IV.A. We take that response as a concession by respondent that petitioners and the county intended a bargain sale; i.e., a part sale part gift. Certainly, that conclusion is supported by the testimony of petitioner Charles Browning (the $6,000 an acre received for the easement "couldn't possibly represent the fair market value of the easement") and Donna Mennitto, administrator of the Program ("It was never the intention of the County to pay the full easement value and we do not believe that we ever did with the information that he had available."), and, thus, we accept respondent's concession and so find. Moreover, we believe that the record supports a finding that, under the Program generally, at the time petitioners conveyed the easement to the county and before, participants in the Program intended to make a gift to the county by way of a bargain sale of development rights. We have the testimony of two participants in the Program as to that point, petitioner Charles Browning and his neighbor, Gene Mullinix. In addition, Mr. Mullinix, who was a chairman of the board that supervised the Program and served on that board for 10 years, testified that the board that ran the Program never paid "full" fair market value for any easement that it purchased under the Program. Ms. Mennitto's testimony as to the procedures followed to implement the Program, including publication of the Program, public hearings at which properties offered to the Program were presented for comment, the limitations on what the county would pay, and the appraisal process designed to insure that the county did not pay the full amount of the value of the development

> rights indicated by that appraisal, all convince us that participants in the Program generally intended to make a gift to the county by way of a bargain sale of development rights, and we so find.
>
> Of course, our finding that participants in the Program INTENDED a bargain sale is not determinative that there was a bargain sale. Nevertheless, it is determinative that the universe of sales to the county under the Program does not represent a universe populated with sellers all of whom (or, perhaps, even, ANY of whom) were looking for the best deal (highest price) possible. Sales data from that universe, thus, are not reflective of a market populated by buyers and sellers EACH trying to maximize profits by searching for the lowest (buyers) or highest (sellers) price possible. Any "market price" based on evidence from that market is not a market price fairly reflective of the price the easement would fetch in an uninhibited market. It is not a "fair" market price within the meaning of Heider v. Crosby, 24 F.2d at 193, nor are the sales "market-place" sales within the meaning of section 1.170A-14(h)(3)(i), Income Tax Regs., available to use as a "meaningful or valid" comparison to the sale of the easement.

The court then reviewed the experts' opinions to determine the "before and after" value.

4. Termination of Interest in Trust. PLR 9728026 deals with an interesting factual situation. The decedent's Will created a trust for the decedent's spouse followed by several charitable bequests. The trust would not be included in the spouse's estate. The trust's terms were as follows:

> My trustee shall pay to or apply for the benefit of my wife, [Spouse], for her lifetime, such amounts of income and principal up to the whole thereof, only for my beneficiary's special needs for health, safety and well being, when such requisites are not presently being provided by any public entity, office or department of the beneficiary's state of residence, or any other state, or of the United States. "Special needs" shall include, but not be limited to, medical and dental expenses; equipment; and programs of treatment; my trustee shall have no discretion in my trustee's distribution of income and principal for special needs, and shall refer to current applicable state administrative rules, procedure manuals, and corresponding federal statutory and administrative sources for current eligibility and reimbursement mandates. The express purpose of this trust shall be to provide for my beneficiary's extra and supplemental needs for health, safety and well being, in addition to and over and above the benefits provided for by any public entity, office or department of the United States. It is the express purpose of the trustor to use

> the trust estate only to supplement other benefits received by my wife, [Spouse].

Decedent's estate obtained an extension for filing the estate tax return. Spouse died a year after decedent. The estate claimed a charitable deduction for the remainder interests passing to charity.

The Service discussed the applicable portion of section 2055 as follows:

> Section 20.2055-2(c)(1) of the Estate Tax Regulations provides that in the case of a bequest, devise, or transfer made by a decedent dying after December 31, 1976, the amount of a bequest, devise or transfer for which a deduction is allowable under section 2055 includes an interest which falls into the bequest, devise or transfer as the result of either:
>
> > (i) A qualified disclaimer [described in section 2518], or
> >
> > (ii) The complete termination of a power to consume, invade, or appropriate property for the benefit of an individual by reason of the death of such individual or for any other reason, if the termination occurs within the period of time (including extensions) for filing the decedent's Federal estate tax return and before such power has been exercised.
>
> * * *
>
> In this case, the trustee's power to invade income and principal for Spouse's health, safety and well being, pursuant to the terms of the instrument, terminated on Spouse's death, prior to the due date (including extensions) for filing Decedent's estate tax return. Accordingly, under section 2055(a) and section 20.2055-2(c)(1)(i) an estate tax charitable deduction is allowed for the portion of the trust passing directly to Charities A, B, C, D and E as a result of the termination of Spouse's discretionary interest in the trust (assuming these entities are described in section 2055(a)).

5. **Gifts by Attorney-in-Fact**. The federal District Court for Vermont has refused to grant summary judgment in Estate of Smith v. United States, 979 F.Supp 279 (D. Vt. 1997). The facts reviewed by the court were straightforward:

> In 1952, Smith II bought a 291 acre farm located in Danby, Vermont, where he lived until his death in 1991. On January 25, 1989, he executed a durable power of attorney naming his son, Charles S. Smith, III, ("Smith III") as his attorney-in-fact. The instrument gave the son the power to "sell, purchase, lease, mortgage, and convey" any real property owned by the father. On

> September 24, 1990, Smith III executed a deed donating the development rights to the farm to the VLT. Smith II died on March 2, 1991. Smith III and Fleet Bank were named co-administrators of Smith II's estate.
>
> On January 5, 1992, the Estate filed its federal estate tax return. In its return, the Estate excluded $436,000 from the value of the gross estate as a charitable gift. The Estate claimed that this amount represented the fair market value of the development rights to the farm, based on a 1990 appraisal.
>
> The IRS audited the return, and disallowed the deduction. The IRS claimed that Smith III exceeded his authority as attorney-in-fact when he donated the development rights to the farm to the VLT.
>
> The IRS assessed an additional tax of $189,247.83, plus interest of $38,017.87, for a total of $227,265.70. The Estate paid this amount to the IRS in April and June, 1994. It thereafter filed a claim for refund of the tax and interest. On January 19, 1995, the IRS denied the Estate's claim for refund. On administrative appeal by the Estate, the denial was upheld. This action for refund followed.

The court determined that the power of attorney instrument was ambiguous and thus denied summary judgment for either the government or the estate. The instrument was discussed by the court:

> The Power of Attorney enumerated the following powers: to demand, receive and sue for all accounts, debts, moneys, legacies or other personal property to which I am now or hereafter may be entitled; to sign my name to checks on all banks and trust companies in which I have or may have deposits; to have access to all safe deposit boxes leased by any banking or trust companies; to endorse my name on all checks, drafts and other instruments in writing payable to me or to my order, to sell, assign, pledge and convey all stocks, bonds or other securities in my name or to my personal account, and for that purpose to sign, execute and deliver all assignments and other instruments in writing necessary to transfer said stocks, bonds and other securities to the purchaser thereof; TO SELL, PURCHASE, LEASE, MORTGAGE AND CONVEY ANY REAL PROPERTY OWNED BY ME OR TO BE ACQUIRED BY ME, AND FOR THIS PURPOSE, MAKE, EXECUTE, SIGN, SEAL, ACKNOWLEDGE AND DELIVER UNTO THE SELLER OR PURCHASER THEREOF, A PROPER AND SUFFICIENT DEED OF CONVEYANCE OF ALL MY RIGHT, TITLE AND INTEREST AND ESTATE IN SAID REAL ESTATE, OR ANY OTHER DOCUMENTS NECESSARY FOR THE COMPLETION OF SUCH TRANSACTIONS.
>
> Hereby giving and granting unto my said Attorney full power and authority to do and perform all and every act and thing whatever requisite and necessary to be done in and about the premises as fully and to all intents and

> purposes as I might do or could do if personally present, hereby ratifying and confirming all that said Attorney shall do or cause to be done by reason hereof, . . .

The court concluded:

> To date, no reported decision from a Vermont court has addressed the meaning of "convey" in the context of a general power of attorney. Other jurisdictions have frequently held that a general power of attorney authorizing a person to convey real property does not authorize conveyance as a gift. See King v. Bankerd, 492 A.2d 608, 612 (Md. 1985) (collecting cases). As the Court in King pointed out, the power to make a gift is a power that is potentially hazardous to the principal's interests, and will not lightly be inferred from broad, all-encompassing grants of power to the agent. Id. at 613. See also, Aiello M. Clark, 680 P.2d 1162, 1166 (Alaska 1984); Whitford v. Gaskill, 480 S.E.2d 690, 691-92 (N.C. 1997); Johnson v. Fraccacreta, 348 So. 2d 570, 572 (Fla. Dist. Ct. App. 1977); Honeycutt v. Farmers & Merchant Bank, 487 S.E.2d 166, 168 (N.C. App. July 15, 1997).
>
> The Supreme Court of Vermont has consistently used the term "convey" to refer to any transfer of an interest in land. In Colby v. Colby, 157 Vt. 233, 235, 596 A.2d 901, 902 (1991), for example, the Court discussed two transactions in which it described land as "conveyed," one for consideration, and the other as a gift. In Bills v. Wardsboro Sch. Dist., 150 Vt. 541, 542-43, 554 A.2d 673, 674-75 (1988), the Court referred to the gift of real property to build a school as a "conveyance." A parcel of-land was "conveyed" as a gift in Tokarski v. Gates, 138 Vt. 220, 221, 414 A.2d 1155, 1156 (1980). In Ball v. Hall, 129 Vt. 200, 274 A.2d 516 (1971), the term "conveyance" was used to describe a gift of land to the town of Bakersfield.
>
> None of these cases, however, addressed the nature of an agent's authority to "convey," when the term is preceded and followed by terms that suggest that the context is a transfer for consideration: "sell, purchase, lease, mortgage and convey . . . and for this purpose . . . deliver unto the Seller or Purchaser thereof General, all-embracing expressions, such as the second paragraph of the power of attorney at issue, granting "full power and authority to do and perform all and every act and thing whatever requisite and necessary . . . as fully and to all intents and purposes as I might or could do if personally present, hereby ratifying and confirming [the agent's actions]," add nothing to the attorney-in-fact's enumerated powers, and are disregarded, in the words of the Restatement, as "meaningless verbiage." Restatement, section 34, Comment on Clause (e). See also Estate of Casey v. Commissioner, 948 F.2d 895, 901 (4th Cir. 1991). These features of the power of attorney suggest that inclusion of the term

"convey" did not authorize a donative transfer of an interest in land. But see Estate of Neff v. Commissioner, 73 T.C.M. (CCH) 2606 (1997) (general language sufficient evidence of principal's intent to allow conveyance of property as gift); In re Estate of Augustine, 695 A.2d 836, 838 (Pa. Super. 1997) (same); Taylor v. Vernon, 652 A.2d 912, 916 (Pa. Super. 1995) (same).

The language of the power of attorney as a whole, however, does not clearly and unambiguously preclude the power to make a gift. In Casey, by contrast, the power of attorney authorized a son to "lease, sell, grant, convey, assign, transfer, mortgage and set over to any person, firm or corporation and for such consideration as he may deem advantageous, any and all of my property . . ." and to "accept and receive any and all consideration payable to me on account of any such lease, sale, conveyance, transfer or assignment and to invest and reinvest the proceeds derived therefrom." 948 F.2d at 896-97. The enumeration of general powers to grant, convey and transfer was qualified by the phrase "for such consideration as he may deem advantageous," and followed by an authorization to receive payment for any such transfer or conveyance. Here, the general power to convey was not qualified by a reference to consideration, or an authorization to accept payment.

The power of attorney at issue here, after authorizing Smith III to sell, purchase, lease, mortgage and convey real property, states that he may "for this purpose, make, execute, sign, seal, acknowledge and deliver unto the Seller or Purchaser thereof, a proper and sufficient deed of conveyance of all [the principal's] right, title and interest and estate" in the property. A literal reading of some of this language is impossible: it would authorize an attorney-in-fact to deliver to a seller a deed conveying the principal's right, title and interest to land he did not own Furthermore, if the conveyance is to be of all "right, title and interest and estate," an attorney-in-fact would be unable to lease or mortgage property on behalf of his principal, as authorized by the previous clause.

The two clauses are inconsistent with one another, and appear to be the result of careless drafting or inadvertent omission of additional terms. How the clauses may be construed to form a "harmonious whole" is far from clear at this stage of the proceedings. The second clause certainly cannot support the construction that the Government urges: that it unambiguously expresses that any conveyance of property would be to a "Purchaser." Given the absence of any explicit expression of intention in the document, the broad powers conveyed therein, the broad use of the term "convey" in Vermont law, and the internal inconsistencies of the clauses in the document, the Court finds as a matter of law that the term "convey" as used in the power of attorney is ambiguous. "Convey"

> could reasonably be interpreted either as authorizing gifts of real property or as a general term that did not expand the attorney-in- fact's powers beyond transfers for consideration.

The court also discussed the effect of the Dead Man's Statute:

> The dead man's statutes were created as exceptions to the broad common law rule that disqualified interested parties from testifying in their own favor, and are thus intended to allow the admission of otherwise inadmissible evidence rather than to create rules of disqualification. In re Estate of Farr, 150 Vt. 196, 199, 552 A.2d 387, 390 (1988) Section 1602 provides that "[a] party shall not be allowed to testify in his own favor where the other party to the contract or cause of action in issue and on trial is dead . . ." Section 1603 provides that "[w]hen an executor or administrator is a party, the other party shall not be permitted to testify in his own favor . . ." Both sections contain exceptions to this disqualification, none of which apply to the circumstances of this case.
>
> The dead man's statutes do not disqualify Smith III from testifying as to the nature and extent of his agency. An agent is a competent witness, either for or against a principal, to prove his acts done and contracts made as agent, and to prove his agency. Lytle v. Bond's Estate, 40 Vt. 618, 622 (1868); Gifford v. Thomas' Estate, 62 Vt. 34, 35, 19 A. 1088 (1889). The dead man's statutes provide that a survivor who is a party to the contract or cause of action in issue and on trial may not testify in his or her own favor. The agent in this case would not be testifying in his own favor, but on behalf of the estate of his principal. Furthermore, the estate and the agent in this case are parties on the same side of the controversy. The dead man's statutes were designed to protect decedents or estates from adverse parties, not to bar testimony presented on behalf of estates. See 3 Jack B. Weinstein, et al., Weinstein's Evidence, paragraph 601[03] (1996); McCormick on Evidence section 65 (Edward W. Cleary, ed., 3rd ed. 1984).

See also the discussion at §§ 2501-2524, dealing with gifts by a guardian.

6. **Payment to Charity in Settlement of a Claim**. The facts submitted to the IRS in PLR 9812014 were that an attorney in fact altered the residuary takers under the incompetent decedent's trust, replacing a charity with the decedent's niece. After death, the charity objected and a settlement was reached. The estate took a charitable deduction for the amounts payable to charity.

The ruling discusses the general rule and determines as follows:

> Thus, in the present case, a deduction is allowable under section 2055(a) to the Decedent's estate for the

amounts paid to Charity C pursuant to the Settlement Agreement if:

(1) the agreement was negotiated, and is in settlement of a bona fide will contest;

(2) Charity C has an enforceable right to the residue of the Decedent's estate and trust, and the payments are in recognition of that right;

(3) the payments do not exceed what Charity C would have received if it had pursued the right in litigation; and

(4) the form of the payments passing to Charity C under the Settlement Agreement resembles the form of the benefits that Charity C could have received under the terms of the Decedent's will and trust agreement.

For purposes of section 2055, a charitable deduction is allowable only for what is actually received by the charity. Ahmanson Foundation v. United States, at 772.

In Commissioner v. Estate of Bosch, supra, the Court held that where an issue involves the determination of property interests for federal tax purposes, and that determination is based on state law, the highest court of the state is the best authority on its own law. The Court held that, if there is no decision on the issue by the state's highest court, federal authorities must apply what they find to be state law after giving proper regard to the relevant rulings of other courts of the state.

* * *

Based on the facts submitted and the representations made and on an analysis of applicable local law, we believe that a court could have decided that the spouse did not have the authority under the durable power of attorney to change the beneficiary of the residue of the Decedent's trust and, thus, Charity C had an enforceable right to the residue.

The Settlement Agreement was negotiated in settlement of a bona fide contest relating to the residuary provision of the Decedent's Trust. Charity C has a legitimate claim that it possesses an enforceable right to the residue of the Decedent's Trust, and the payments are made in recognition of that right. Further, the payments totaling $750,000 are less than the $1,000,000 (plus) that Charity C would have obtained if Charity C had successfully pursued in litigation the right to the residue of the Decedent's Trust. Finally, the outright payments to Charity C under the Settlement Agreement have the same form as the outright payments under the terms of Decedent's Trust. Therefore, a deduction is allowable to the Decedent's estate under section 2055(a)

> for the payments received by Charity C under the Settlement Agreement.
>
> However, in computing the amount of the deduction, the total amount paid to Charity C must be reduced by the $46,000 income tax obligation that the charity must bear under the Settlement Agreement since the charity is, in effect, assuming an obligation otherwise fully payable from the residue to be received by the Niece. Fla. Stat. Ann. section 733.805 (West); section 20.2055-3(a); Ahmanson Foundation v. United States.

The state law was Florida, as to which the ruling states:

> Under State law, a principal may execute a durable power of attorney designating an attorney in fact. Fla. Stat. Ann. section 709.08 (West). A durable power of attorney creates the relationship of principal and agent between the one who gives the power and the one who holds it. It is the principal's intent that controls, not the agent's. A durable power of attorney grants only those powers specified, and the durable power is closely examined to ascertain the principal's intent. Kotsch v. Kotsch, 608 So.2d 879 (1992). If the agent exercises the durable power of attorney in a manner inconsistent with the principal's intent, the exercise is void. Kotsch v. Kotsch, at 880.

To avoid questions about an attorney in fact's authority over a revocable trust, the trust should provide either that an attorney in fact has no authority or that it does (in which case the power of attorney form should contain equivalent language).

7. **Ability of Donor to Enforce a Charitable Gift Restriction.** The Connecticut Supreme Court has determined that under neither the common law nor the Uniform Management of Institutional Funds Act - as in effect in Connecticut - does a donor, or the donor's family or heirs, have standing to sue to enforce the restrictions on a gift. The nature of the gift and the facts in Herzog Found. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997), were as follows:

> The plaintiff alleged in its revised complaint that prior to August 12, 1986, it made various grants to the defendant 'to provide need-based merit scholarship aid to disadvantaged students for medical related education.' On August 12, 1986, the plaintiff agreed, by letter, to participate in a matching grant program that would provide need-based merit scholarships to disadvantaged students for medical related education on a continuing basis. On September 9, 1986, the defendant wrote a letter accepting the offer of a matching grant of up to $250,000. Over a period of time, the defendant

raised the necessary $250,000, which the plaintiff matched in accordance with the agreement. The plaintiff transferred $144,000 on June 26, 1987, and $106,000 on June 28, 1988, to the defendant. The grants were used to provide scholarships to students in the defendant's nursing program. On November 21, 1991, however, the plaintiff was informed that the defendant had closed its nursing school on June 20, 1991.

The court summarized the common law:

> At common law, a donor who has made a completed charitable contribution, whether as an absolute gift or in trust, had no standing to bring an action to enforce the terms of his or her gift or trust unless he or she had expressly reserved the right to do so. "Where property is given to a charitable corporation and it is directed by the terms of the gift to devote the property to a particular one of its purposes, it is under a duty, enforceable at the suit of the [a]ttorney [g]eneral, to devote the property to that purpose." (Emphasis added.) 2 Restatement (Second), Trusts § 348, comment (f), p. 212 (1959); Attorney General v. First United Baptist Church of Lee, 601 A.2d 96, 98 (Me. 1992); see Sarkeys v. Independent School District No. 40, 592 P.2d 529, 533 (Okla. 1979)("[i]t has long been recognized at common law that the [a]ttorney [g]eneral has the duty of representing the public interest in securing the enforcement of charitable trusts"); Wilbur v. University of Vermont, 129 Vt. 33, 44, 270 A.2d 889 (1970)(where no provision in trust instrument for forfeiture or reverter, "the remedy for a breach of trust is by suit at the instance of the [a]ttorney [g]eneral of the state to compel compliance"). At common law, it was established that "[e]quity will afford protection to a donor to a charitable corporation in that the [a]ttorney [g]eneral may maintain a suit to compel the property to be held for the charitable purpose for which it was given to the corporation." (Emphasis added; internal quotation marks omitted.) Lefkowitz v. Lebensfeld, 68 App. Div. 488, 494-95, 417 N.Y.S.2d 715 (1979). "The general rule is that charitable trusts or gifts to charitable corporations for stated purposes are [enforceable] at the instance of the [a]ttorney [g]eneral. . . . It matters not whether the gift is absolute or in trust or whether a technical condition is attached to the gift." (Internal quotation marks omitted). Id., 495.
>
> "The theory underlying the power of the [a]ttorney [g]eneral to enforce gifts for a stated purpose is that a donor who attaches conditions to his gift has a right to have his intention enforced." Id., 495-96. The donor's right, however, is enforceable only at the instance of the attorney general; Wier v. Howard Hughes Medical Institute, 407 A.2d 1051, 1057 (Del. 1979)(attorney general "has the exclusive power to bring actions to enforce charitable trusts" [emphasis added]); Lopez v. Medford Community Center, Inc., 384 Mass.

163, 167, 424 N.E. 2d 229 (1981)(common law rule that "it is the exclusive function of the [a]ttorney [g]eneral to correct abuses in the administration of a public charity by the institution of proper proceedings" [emphasis added]); and the donor himself has no standing to enforce the terms of his gift when he has not retained a specific right to control the property, such as a right of reverter, after relinquishing physical possession of it. See, e.g., Marin Hospital District v. Dept. of Health, 92 Cal.App. 3d 442, 448, 154 Cal.Rptr. 838 (1979) (fact that charity is bound to use contributions for purposes for which they were given does not confer to donor standing to bring action to enforce terms of gift). As a matter of common law, when a settlor of a trust or a donor of property to a charity fails specifically to provide for a reservation of rights in the trust or gift instrument, "'neither the donor nor his heirs have any standing in court in a proceeding to compel the proper execution of the trust, except as relators.'" Smith v. Thompson, 266 Ill.App. 165, 169 (1932), quoting 2 J. Perry, Trusts and Trustees (7th Ed. 1929) § 732a, pp. 1255-56; see Wilbur v. University of Vermont, supra, 129 Vt. at 44, 270 A.2d 889 (breach of trust "creates no right in the donor's heirs to enforce a resulting trust"); Hagaman v. Board of Education, 117 N.J.Super. 446, 454, 285 A.2d 63 (1971)(heirs of settlor generally cannot enforce charitable trust). "There is no such thing as a resulting trust with respect to a charity. . . . Where the donor has effectually passed out of himself all interest in the fund devoted to a charity, neither he nor those claiming under him have any standing in a court of equity as to its disposition and control." (Internal quotation marks omitted.) Smith v. Thompson, supra, at 169; see Wier v. Howard Hughes Medical Institute, supra, at 1057; but see McGee v. Vandeventer, 326 Ill. 425, 441, 158 N.E. 127 (1927). On the basis of the weight of the foregoing authorities, we conclude that it is clear that the general rule at common law was that a donor had no standing to enforce the terms of a completed charitable gift unless the donor had expressly reserved a property interest in the gift.

The applicable provisions of the CUMIFA were:

"Release of restriction in gift instrument: Written consent, court order. Limitations. Doctrine of cy pres applicable. (a) With the written consent of the donor, the governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.

"(b) If written consent of the donor cannot be obtained by reason of his death, disability, unavailability or impossibility of identification, the governing board may apply, in the name of the institution, to the Superior Court for a judicial district in which the institution conducts its affairs for release of a restriction imposed by the applicable gift instrument on the use or

> investment of an institutional fund. The Attorney General shall be notified of the application and shall be given an opportunity to be heard. If the court finds that the restriction is obsolete, inappropriate or impracticable, it may by order release the restriction in whole or in part. A release under this subsection may not change an endowment fund to a fund that is not an endowment fund.
>
> "(c) A release under this section may not allow a fund to be used for purposes other than the educational, religious, charitable or other eleemosynary purposes of the institution affected.
>
> "(d) This section does not limit the application of the doctrine of cy pres or approximation."

The court reviewed the history of the statute and concluded:

> The specific area of relief to institutions focused upon by the Appellate Court and the plaintiff is that embodied in § 7, of UMIFA, entitled "Release of Restrictions on Use or Investment." The prefatory note to that section provides: "It is established law that the donor may place restrictions on his largesse which the donee institution must honor. Too often, the restrictions on use or investment become outmoded or wasteful or unworkable. There is a need for review of obsolete restrictions and a way of modifying or adjusting them. The Act authorizes the governing board to obtain the acquiescence of the donor to a release of restrictions and, in the absence of the donor, to petition the appropriate court for relief in appropriate cases." Id., 709. In the comment to § 7, the drafters of UMIFA expressly provided that the donor of a completed gift would not have standing to enforce the terms of the gift. "The donor has no right to enforce the restriction, no interest in the fund and no power to change the eleemosynary beneficiary of the fund. He may only acquiesce in a lessening of a restriction already in effect." (Emphasis added.) UMIFA, § 7, comment, 7A U.L.A. 724 (1985).
>
> These clear comments regarding the power of a donor to enforce restrictions on a charitable gift arose in the context of debate concerning the creation of potential adverse tax consequences for donors, if UMIFA was interpreted to provide donors with control over their gift property after the completion of the gift. Pursuant to § 170(a) of the Internal Revenue Code and § 1.170A-1(c) of the Treasury Regulations, an income tax deduction for a charitable contribution is disallowed unless the taxpayer has permanently surrendered "dominion and control" over the property or funds in question. Where there is a possibility not "so remote as to be negligible" that the charitable gift subject to a condition might fail, the tax deduction is disallowed. See also I.R.C. §2055; Treas. Reg. §20.2055-2(b)(similar provisions for estate tax deductions). The drafters of

UMIFA worked closely with an impressive group of professionals, including tax advisers, who were concerned with the federal tax implications of the proposed act. The drafters' principal concern in this regard was that the matter of donor restrictions not affect the donor's charitable contribution deduction for the purposes of federal income taxation. In other words, the concern was that the donor not be so tethered to the charitable gift through the control of restrictions in the gift that the donor would not be entitled to claim a federal charitable contribution exemption for the gift. See I.R.C. §170(a); Treas. Reg. § 1.170A-1(c).

In resolving these concerns, the drafters of UMIFA clearly stated their position in the commentary. "No federal tax problems for the donor are anticipated by permitting release of a restriction. The donor has no right to enforce the restriction, no interest in the fund and no power to change the eleemosynary beneficiary of the fund. He may only acquiesce in a lessening of a restriction already in effect." (Emphasis added.) UMIFA, § 7, comment, 7A U.L.A. 724 (1985). The Appellate Court dismissed this language, reasoning that it is limited to "tax implications when a donor does consent in writing to a release of a restriction" and does not answer the question of whether the sole right to speak to the donor's interest in the release of a restriction "lies with the attorney general, to the exclusion of a donor." Carl J. Herzog Foundation, Inc. v. University of Bridgeport, supra, 41 Conn.App. at 800, 677 A.2d 1378. We disagree. Although the comments and the prefatory note to UMIFA do recognize that a donor has an interest in a restriction, as analyzed herein, we find no support in any source for the proposition that the drafters of either UMIFA or CUMIFA intended that a donor or his heirs would supplant the attorney general as the designated enforcer of the terms of completed and absolute charitable gifts.

Indeed, it would have been anomalous for the drafters of UMIFA to strive to assist charitable institutions by creating smoother procedural avenues for the release of restrictions while simultaneously establishing standing for a new class of litigants, donors, who would defeat this very purpose by virtue of the potential of lengthy and complicated litigation.

8. **Charitable Lead Trust to Private Foundation**. Charitable lead trusts may benefit a private foundation so long as the donor does not participate in the governance of the foundation. PLR 9821030 allowed the donor's spouse and children to control the foundation. The ruling describes the income tax treatment of the trust:

> In the present case, the terms of Trust provide for a unitrust amount to be paid annually to Foundation that is represented to be described in sections 170(c), 2055(a) and 2522(a). In addition, in the event that the Trust's designated charitable beneficiary ceases to exist or is no longer a "Charitable Organization" as defined in Article VII, paragraph G, of Trust, the trustees shall pay any amount which would otherwise be payable to such a charitable beneficiary to such one or more organizations selected by the Trustees, each of which is a "Charitable Organization," as defined in Trust instrument, at the time of payment, in such proportions among such organizations as the Trustees, in their sole discretion, shall decide. Accordingly, except to the extent that Trust has unrelated business income within the meaning of section 681(a), we conclude that Trust will be allowed deductions in accordance with section 642(c)(1) for amounts of gross income paid during the taxable year or by the close of the following taxable year (if the trustees so elect in accordance with section 1.642(c)-1(b)) to charitable beneficiaries described in section 170(c). Because the deduction under section 642(c)(1) is limited to amounts of gross income of the trust, a deduction will be allowed for a distribution of trust principal only to the extent that the amount distributed has been included in Trust's gross income and has not been allowed as a deduction in any prior year.
>
> In addition, the ordering of the income distributions provided in Article III, paragraph A, of Trust will not be given effect for federal income tax purposes because the ordering provision has no economic effect on the distributions independent of tax consequences. Trust is required to pay annually a stated unitrust amount to an organization described in section 170(c), 2055(a) and 2522(a), regardless of the amount or character of income earned by Trust. Instead, income distributed to organizations described in sections 170(c), 2055(a) and 2522(a) shall consist of the same proportion of each class of items of income of Trust as the total of each class bears to the total of all classes. See section 1.642(c)- 3(b)(2).

9. **Rights Over a Charitable Lead Trust**. PLR 9737023 is an interesting ruling. The donor created a 6% charitable lead unitrust with a 40 year term; at the end of the term, the trust assets were payable to the donor's daughter (or, if deceased, as she appointed under a general power of appointment). With respect to the designation of the charities to receive the annual unitrust payments, the ruling stated:

> Donor, Daughter, the Daughter's husband, (Husband) are the initial trustees of Trust. At the time for payment of each installment of the unitrust amount, the trustees

> other than Donor, can designate one or more organizations described in section 170(c), 2055(a) and 2522(a) to receive the unitrust amount. The trustees shall not designate as a charitable beneficiary any organization in which Donor has an interest as a director, officer or employee. In addition, no trustee who has made a contribution to Trust can participate in the exercise of any power granted to the trustees involving the designation of the charitable beneficiaries, or any power to amend Trust to ensure qualification as a charitable lead unitrust, or any power to appoint or remove a corporate trustee.

The ruling determined:

> 1. The contribution of funds to Trust by Donor will constitute a completed gift under section 2511.
>
> 2. Trust will qualify as a charitable unitrust described in section 25.2522(c)-3(c)(2)(vii).
>
> 3. Donor will be entitled to a gift tax charitable deduction under section 2522(c)(2)(B) equal to the present value of the unitrust interest.
>
> 4. Upon the death of Donor, the remaining principal of Trust will not be included in the gross estate of the Donor under sections 2036 or 2038.

The Service also addressed the effect of the rights to designate the charitable beneficiaries:

> In this case, a trustee who also has made a contribution to Trust is precluded, under the terms of the trust instrument, from participating is any decision regarding the designation of the charitable beneficiaries of Trust. Accordingly, the power held by Daughter and Husband to designate charitable beneficiaries will not be exercisable with respect to any property they may transfer to Trust and accordingly will not cause inclusion of Trust corpus in their respective gross estates, for estate tax purposes. However, we note that Daughter possesses a testamentary general power to appoint Trust corpus. Accordingly, if Daughter possesses that power at the time of her death (and does not release the power prior to her death) the value of the interest subject to the power at the time of her death will be includible in Daughter's gross estate under section 2041. See section 20.2041-1(b)(3).

The designations would not be self-dealing either:

> Under section 4946(a)(1), Daughter and Husband are disqualified persons with respect to Trust since they are foundation managers. Daughter and Husband, as trustees, will designate the charitable beneficiary of the unitrust amount. Only organizations described in sections 170(c), 2055(a) and 2552(a) may be designated

> as recipients. Daughter and Husband may designate a charitable beneficiary of which either or both are officers, directors, and trustees. Any benefit to them from such designation will be incidental or tenuous. See section 53.4941(d)-2(f)(2).
>
> The designation of a charitable beneficiary is distinguishable from the transactions that are normally considered self-dealing under section 4941. Such transactions generally include the provision of personal services, sale or exchange of property, loans, leases, or payment of compensation. There is not inherent violation of the self-dealing rules under section 4941 in the transactions described above.

The same rationale explains why contributions to a depository account, like the Community Foundation of Louisville Depository, Inc., over which the donor retains the right to designate charitable beneficiaries does not cause the assets to be included in the donor's estate.

10. **CRT Reformations, Drafting Mistake**. The Service allowed a charitable remainder trust to be reformed -- it was intended to be a standard unitrust but was drafted as a net income with makeup trust -- in PLR 9804036. The ruling stated:

> Ordinarily, we would consider a charitable remainder trust's reformation of its payment provision to be an act of self-dealing under section 4941(d)(1)(E) of the Code. However, under the circumstances presented in this case, we find no act of self-dealing, since we are satisfied that the signatory parties to the Trust Instrument never intended to create a NIMCRUT payment method trust in the first place. A key fact in our consideration is that Trust has been consistently administered using the Fixed Percentage method. Another is that the payment provision error was discovered, and action to correct the error was taken, in a relatively short period of time after Trust was created. Another is E's sworn admission of a drafting mistake. Another is the lack of evidence that A or other income beneficiaries are reducing their own taxes or using the benefit of hindsight in making the change to the Fixed Percentage payment method.
>
> Consequently, the amendment ab initio of the Trust Instrument is not an act of self-dealing under section 4941 of the Code.

State law allowed the reformation upon court approval and the beneficiaries consent. PLR 9822041 approved changing, with court approval, a net income charitable remainder unitrust into a straight charitable remainder unitrust. The drafting attorney admitted using the wrong form.

A charitable trust may restrict the remainder beneficiary to organizations described in section 170(b)(1)(A), which excludes private foundations. A limitation only to section 170(c) organizations allows a private foundation to be a beneficiary, thus, the donor's income tax deduction is limited <u>even if</u> a public charity is the named beneficiary.

PLR 9818027 concerned the reformation of a CRT to allow private foundations as beneficiaries. The IRS allowed the reformation because of the grantor's original intent. The ruling describes the facts as follows:

> A states that the proposed reformation of the irrevocable trust is necessary due to a drafting error that makes it impossible for her to designate one or more private foundations, organizations described in section 170(c) but not in section 170(b)(1)(A) or in section 509(a)(3), as remainder beneficiaries as she originally intended. To establish her original intent, A has provided a comprehensive explanation of her overall estate plan, copies of documents evidencing that estate plan, and letters from her former representative who drafted the estate documents, including the unitrust. The documents indicate that A's estate plan involved leaving the bulk of her assets to one or more private foundations controlled by family members. The letters from her former representative, which were written contemporaneous with changes to the taxpayer's will and creation of one of the private foundations mentioned, contain language confirming that a primary concern of A was to allow her family to direct the ultimate charitable disposition of her assets after her death. The letters clearly focus on the family private foundations, which do not qualify as section 170(b)(1)(A) organizations. The documents submitted establish that A's original intent in creating Trust was to be able to designate one or more private foundations as remainder beneficiaries. As reformed, the trust agreement would allow A to designate one or more substitute charitable organizations as remainder beneficiaries provided that they qualify at the time of distribution as organizations described in sections 170(c), 2055(a), and 2522(a).

The reformation occurred by court order, with the attorney general as a party. The ruling states:

> After reviewing the facts and relevant documents submitted, we conclude that the proposed reformation will not violate sections 1.664-1(a), 1.664-3(a)(3)(ii)

> and 1.664-3(a)(4) or any provisions under section 664 and the remaining regulations thereunder. Because the proposed reformation is the correction of a drafting error, it will not be treated as violating the requirement that the remainder interest to charity must be irrevocable. Accordingly, we conclude that the proposed reformation of Trust will not adversely affect Trust's qualification as a charitable remainder unitrust if it otherwise meets the requirements of section 664 and the applicable regulations.

The ruling also considered the donor's income tax deduction:

> However, the proposed reformation of Trust will affect A's income tax deduction under section 170 allowable for the charitable contribution made to Trust. The deduction is subject to the provisions of section 170(e)(1)(B)(ii) because the exception provided in section 170(e)(5) for contributions of publicly traded stock was not in effect when A funded the trust. Under section 170(e)(1)(B)(ii) the value of the contribution will be determined using the taxpayer's adjusted basis, rather than the fair market value, in the contributed stock. In addition, under section 170(b)(1)(D)(i)(1)(I) the taxpayer's charitable contribution deduction will now be limited to 20% of the taxpayer's contribution base. Consequently, this ruling is conditioned on A's filing a timely amended return for the tax year that includes D1 reporting a reduced charitable deduction because of the limitation of the deduction to basis, rather than fair market value, and because of the 20% limitation.

11. **Recision of CRT**. PLR 9816030 considered unusual facts. Husband and wife, in their seventies, created a charitable remainder trust on July 20, 1993. The ruling states the couple's reason for creating the trust:

> At that time, X and Y were concerned that their income was not sufficient to cover their living expenses and maintain a level of principal consistent with inflation. having heard of the income benefits of a charitable remainder annuity trust, X, on July 20, 1993, executed trust T, a charitable remainder annuity trust requiring a payout of 6 percent annually for X's life, and at her death, to Y for his life, assuming that he survived her. X contributed the sum of $a to T to fund the trust. Z was named trustee of T.

At some time after creation of the CRT -- the ruling does not give the date -- husband suffered a "catastrophic illness" and the couple needed principal to meet their needs. Trustee resisted and litigation ensued. In 1997 the Court rescinded the trust ab initio. The ruling stated:

> The allegations asserted by the plaintiff, X, with respect to the litigation were disputed on the merits by the trustee of T. The court held for the plaintiff on the merits of the case. By order of court dated November 25, 1997, a final judgment was entered in favor of X for rescission of the trust, T, as void ab initio.

In the litigation, wife stated that she did not understand the restriction of a CRT.

The ruling determined:

> We find that the court case was litigated on the merits by both parties and was decided on the merits by the court. This is not the situation of a "friendly" law suit where the trustees consent to the plaintiff's action. The court declared the trust void ab initio. The trust is deemed not to have existed under state law. Accordingly, we find that no valid trust is deemed to have existed for federal income tax purposes by virtue of the fact that the court declared the trust void ab initio. We rule as follows:
>
> 1. The return of the assets possessed by T to X under the court order will not constitute an act of self-dealing and the Trustee, Z, will not be liable under section 4941 of the code for such action.
>
> 2. The return of the assets possessed by T to X under the terms of the court order will not constitute a taxable expenditure, and Z will not be liable under section 4945 of the Code for such actions.
>
> 3. The return of the assets possessed by T to X under the terms of the court order will not subject T to the tax on termination of the private foundation status imposed by section 507(c) of the Code and T will not be liable for the tax imposed by section 507 of the Code.

What of the income tax status of the trust during the year in which it was treated as a CRT? If the ordinary income of the trust were less than the annuity and no capital gains were realized income tax would be a wash -- husband and wife would have paid tax on all trust income. More likely, however, is that the exempt status of the trust sheltered some otherwise taxable income.

12. <u>**Trust as Creator of CRT**</u>. Suppose an individual has an inter vivos special power of appointment over a trust to appoint among his descendants and charitable organizations. May that power be exercised to create a CRT for a term of years with the trust as beneficiary? The IRS approved such a transaction in PLR 99821029, which states:

> Section 1.664-3(a)(3)(i) of the Income Tax Regulations provides that the unitrust amount must be payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). Section 1.664-3(a)(5)(i) provides that the period for which the unitrust amount is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual.
>
> Section 7701(a)(1) defines the term "person" to include an individual, trust, estate, association, company, corporation, and partnership.
>
> Qualification of Trust as Permissible Grantor for the CRUT
>
> There is nothing in section 664 or the applicable regulations that prohibits a trust from being a permissible donor to an otherwise qualified charitable remainder unitrust. Therefore, the Trust is a permissible donor for the CRUT.
>
> Trust as a Permissible Recipient of Unitrust Amount
>
> In the present situation, the unitrust amount from the CRUT is payable to Trust for a term of 20 years. Because the term of the CRUT does not exceed 20 years, the recipient of the unitrust amount may be any person or persons, including a trust, if at least one such person is not a charitable organization. Therefore, Trust is a permissible recipient of the unitrust amount from the CRUT.

The ruling does not address the income tax deduction under section 170, but presumably it was not available.

13. <u>Income Tax Consequences of Distributions from CRT</u>. Notice 98-20, 1998-13 IRB 1, sets forth the IRS ordering provisions for distributions from CRTs:

> Section 664(b) contains the ordering rule for determining the character of a CRT distribution in the hands of the recipient. The character of a CRT's income is determined at the time the income is realized by the trust. Under section 664(b), the following ordering rule applies for determining the character of a distribution in the hands of the recipient: (1) first, as ordinary income to the extent of the trust's ordinary income for the trust's taxable year and its undistributed ordinary income for prior years, (2) second, as capital gain to the extent of the trust's capital gain for the trust's taxable year and its

undistributed capital gain for prior years, (3) third, as other income to the extent of the trust's other income for the trust's taxable year and its undistributed other income for prior years, and (4) fourth, as a distribution of trust corpus.

The underlying policy in the ordering rule of section 664(b) and the existing regulations thereunder is that a CRT distribution is deemed to consist first of income that is subject to the highest federal income tax rate in effect at the time of the distribution and then of income that is subject to progressively lower (or no) federal income tax rates in effect at the time of distribution. The same policy applies in the regulations under section 664 when different income tax rates apply to different groups of income within a category of the items described in section 664(b), such as short-term and long-term capital gains. Therefore, income from a group that is subject to a higher federal income tax rate is deemed distributed before other income from a group, within the same category, that is subject to a lower federal income tax rate.

The following example illustrates how this principle applies to capital gain distributions after TRA 1997. Assume for the 1998 taxable year, a CRT has undistributed long-term capital gain in each of the three groups of long-term capital gain, i.e., the 28-percent group, the 25-percent group, and the 20-percent group, and also has undistributed short-term capital gain. To the extent capital gains are deemed distributed for the 1998 taxable year, the short-term capital gain is deemed distributed prior to any long-term capital gain. The long-term capital gain is deemed distributed in the following order: (1) the gain in the 28-percent group is deemed distributed prior to any other long-term capital gain; (2) the gain in the 25-percent group is deemed distributed prior to any gain in the 20-percent group; and (3) the gain in the 20-percent group is deemed distributed last of any long-term capital gain.

* * *

Pre-1997 long-term capital gains were characterized by the CRT based on the definitions of short-term and long-term capital gains applicable at the time the CRT sold a capital asset. CRTs have never been required to segregate these gains based upon the tax rate or holding period in effect at the time the gains were realized by the CRT. Thus, the undistributed pre-1997 long-term capital gains reflect gains realized when various tax rates and holding periods were in effect. Treasury will exercise its regulatory authority to treat undistributed CRT pre-1997 long-term capital gains as falling within the 20-percent group.

* * *

> Long-term capital gains properly taken into account from January 1, 1997, through May 6, 1997, are covered by the rules in section 1(h) regarding pre-effective date gains. Under section 1(h), for the taxable year that includes May 7, 1997, gains and losses properly taken into account by the CRT for the portion of the taxable year before May 7, 1997, must be taken into account in determining long-term capital gain in the 28-percent group. Because the taxable year for CRTs is the calendar year, long-term capital gains properly taken into account by a CRT from January 1, 1997, through May 6, 1997, are treated as long-term capital gains in the 28-percent group.

14. Partial Termination of CRT. PLR 9817010 discusses a method by which the partial termination of a CRT may be accomplished. The taxpayer intends to have a CRT segregate certain amounts into a new trust and then to assign taxpayer's interest to the charitable remainderman. The trust would then terminate because of an identity of interests with the assets of the new trust distributed to charity.

15. IRA Proceeds Paid to a Private Foundation. PLR 9818009 confirms that IRA and qualified plan benefits may be paid to a private foundation and the estate receive an estate tax charitable deduction. The ruling also holds that the estate will not recognize income from the benefits. The ruling states that being considered separately are (1) whether the Foundation will recognize income upon receipt of the benefits and (2) whether the Foundation will be subject to the section 4940(a) excise tax on net investment income.

16. Substitution of Supported Organizations. A section 509(a)(3) organization -- known as a supporting organization -- obtains public charity status, rather than being classified as a private foundation, by supporting one or more independent charities. A common example would be a perpetual charitable trust which distributes its income to one or more charitable organizations. In PLR 9739040 the Service determined that switching the supported charitable organizations in a charitable trust pursuant to a court order would not affect the status of the trust as a supporting organization.

17. **Charitable Match**. The Virginia Supreme Court applied basic contract law to a charitable pledge and determined it was not binding on the pledge's estate in Virginia School of the Arts, Inc. v. Eichelbaum, 493 S.E.2d 510 (Va. 1997). The facts were:

> The transaction in question took place in October 1993. At that time, the school was involved in soliciting prospective donors for the 1993-94 annual fund for the fiscal year July 1, 1993 to June 30, 1994. Because Mrs. Eichelbaum had been "a major donor to the school," the school's administrators decided to ask her to make a "challenge gift" in order to encourage other persons to contribute to the fund drive.
>
> Helen Burnette Harvey, who managed the school's internal operations, visited Mrs. Eichelbaum armed with fund-raising "materials" and a "request letter" dated October 5, 1993. The letter provided: "A gift of $100,000 as a challenge grant to the 1993-94 Annual Fund would ensure the School's place in this community as both a cultural and economic asset." The letter further provided: "With your permission we would like to promote your gift to encourage renewing and new donors to invest . . . We must raise $200,000 during this year's Annual Fund period; we believe a matching grant would make it possible for us to achieve this goal."
>
> Following the visit, Mrs. Eichelbaum consulted her financial adviser and signed a statement dated October 8, 1993 affixed to the end of the letter in which she "agree[d] to commit the sum of $100,000 . . . to The Virginia School of the Arts."
>
> The letter did not mention periodic payments of the "matching grant" or how the pledge would be paid, nor were those subjects discussed with Mrs. Eichelbaum or her financial adviser by any of the school's representatives.
>
> On October 18, 1993, Mrs. Harvey on behalf of the school wrote Mrs. Eichelbaum a letter of appreciation, stating her "recent generous gift . . . in the form of a $100,000 matching grant is exactly what we needed to ensure the success of the '93-'94 Annual Fund drive." On December 3, 1993, the school issued a press release announcing an anonymous "challenge gift" of $100,000, which "will encourage other individuals, business and industry sources, and private foundations in the community and beyond to contribute to the school's operations and programs." The press statement said the school "must match this challenge gift by the end of this fiscal year."
>
> The school then attempted to raise funds to match the pledge. In letters to prospects, the school called attention to the $100,000 challenge gift" and stated it

was "striving to meet this generous offering." In letters of appreciation to donors, the school stated that the particular gift "brings us closer to meeting our responsibility in relation to the $100,000 challenge grant that we received from a loyal supporter."

Mrs. Eichelbaum died testate on January 14, 1994. The school had not asked her to make any payments on the pledge and she had made none. Additionally, by that date, the school had not raised $100,000 to equal the decedent's matching grant. By the end of the 1993-94 fiscal year, the school had raised only $67,592.71.

The Court held:

A charitable subscription is governed by the law of contracts and must be supported by an offer, an acceptance, and consideration. Galt v. Swain, 50 Va. (9 Gratt.) 633, 635 (1853). And "a subscription, like any other promise or offer, may be conditional. If particular terms are prescribed, these terms in themselves are conditions which must be complied with before the subscription is binding." Id.

In the present case, there was valuable consideration to support a binding contract between the decedent and the school. The decedent's promise of a "matching" or "challenge" grant was relied on by school officials, who expended effort to solicit matching funds.

But the contract as expressed in the letter of October 5, 1993, and evidenced by the school's subsequent conduct and statements, clearly and unambiguously included a condition, that is, the school was obligated to raise $100,000 during the 1993-94 fiscal year ending June 30, 1994. This the school failed to do.

The October 5 "request letter" tied the request for a "challenge grant" specifically to the "1993-94 Annual Fund." The evidence plainly showed that the school operated on a fiscal year basis of July 1, 1993 to June 30, 1994, and that school officials considered the school had the "responsibility" to match the pledge during that period. The fact that the school raised $212,000 by June 1995 did not satisfy the condition.

Therefore, because the school failed to fulfill the condition, the contract is unenforceable, and the pledge is not binding on the decedent's estate.

18. Gaming Publication for Tax-Exempt Organizations. Publication 3079, Gaming Publication for Tax-Exempt Organizations, is now available for tax-exempt organizations conducting gaming. The publication provides general information regarding tax exemption, unrelated business tax, record keeping, filing requirements (income tax, withholding tax, excise, and employment tax), and provides examples of the type of records that should be maintained by tax-exempt organizations conducting bingo, pull-tabs, and other games of chance. The publication also provides information regarding related publications that contain additional information on the topics discussed in the publication.

Publication 3079 may be obtained by calling 1-800-TAX-FORM (1-800-829-3676).

19. **For-Profit Joint Ventures with Charitable Organization**. Rev. Rul. 98-15, 1998-12 IRB 6, sets forth IRS guidance on joint ventures between for-profit organizations and section 501(c)(3) hospitals. The Ruling must be considered in planning any significant joint venture arrangements.

20. **Supporting Organizations**. In TAM 9730002 the National Office refused to allow a charitable trust to qualify as a supporting organization under section 509. Thus the trust remained a private foundation.

The ruling discussed the Service's position:

> 1. The first alternative integral part test under section 1.509(a)-4(i)(3)(ii) of the regulations is met if X engages in activities to perform the functions of or to carry out the purposes of the City's Science Center, and, but for X's involvement, such activities would normally be engaged in by the City itself. Under the circumstances, X's mere investing of funds and granting of funds to the City does not perform the City's functions or carry out its purposes, even though such activity may benefit the City.
>
> 2. The second alternative integral part test described in section 1.509(a)-4(i)(3)(iii) of the regulations is met if (1) X makes payments of substantially all of its "income" to or for the use of the City's Science Center, and (2) the amount of the support is sufficient to assure the City's attentiveness to X's operations. X provides sufficient support to the Science Center to assure the City's attentiveness to X's operations. The main issue is whether X's "income" for such purposes includes its net short-term capital gains.
>
> The term "income" (or "annual net income") in section 1.509(a)-4(i)(3)(iii) of the regulations, like the term "substantially all," is not further defined in that section of the regulations, but is defined in section 4942 of the Code and the regulations thereunder. For the reasons expressed in Rev. Rul. 76-208, the term "adjusted net income" under section 4942(f)(1) of the Code should be used as the definition of "income" for

purposes of section 1.509(a)- 4(i)(3)(iii)(a) of the regulations. "Adjusted net income" under section 4942(f)(1) includes net short-term capital gain.

Therefore, under the facts described, X did not distribute substantially all of its "income" during 1991 through 1993. We caution, however, that the "substantially all" test is not an inflexible test that allows for no accumulation of income beyond the taxable year at issue. For example, an organization may meet the test if it accumulates its income for a limited period at the request of the publicly supported organization.

21. **<u>Charitable Trust Created By Conservator</u>**. PLR 9742006 dealt with a charitable income trust. The facts of the trust's creation were:

> Conservator is a bank that was appointed by court order as conservator of the estate of Grantor. Conservator assists Grantor in planning and carrying out her financial affairs, including her charitable objectives. Grantor desires to make additional charitable gifts and pledges. Accordingly, Conservator proposes to create an irrevocable trust (Trust).
>
> Under the terms of the trust agreement, Trustee must distribute all of the annual net income to one or more charitable beneficiaries designated by Conservator within 60 days following the end of each taxable year. The designated charitable beneficiaries must be organizations described in sections 170(c), 2055(a), and 2522(a)(qualified charitable organizations). If Conservator fails to designate one or more qualified charitable organizations within the specified time, Trustee is directed to distribute the trust income to such qualified charitable organizations as Trustee selects.
>
> Trust will terminate upon the death of Grantor. Upon termination of Trust, Trustee will make final payment of income to designated charitable income beneficiaries, and the trust property will then be distributed free of trust. Grantor has retained a testamentary power to appoint the trust corpus to and among the charitable and noncharitable beneficiaries listed in the trust agreement. If Grantor fails to exercise this testamentary power of appointment, trust property will be distributed to the noncharitable beneficiaries in the amount set forth in the trust agreement. However, the amounts distributed to these noncharitable beneficiaries will be reduced by amounts received by such beneficiaries under the last will and testament of Grantor. Any balance of the trust property will then be distributed to the named charitable beneficiaries in the percentages indicated in the trust agreement.

The Service concluded that the income interest was an incomplete gift:

> Rev. Rul. 77-275 concludes that the gift of the income interest was incomplete upon creation of the trust under section 25.2511-2(c). The termination of the settlor's power to designate income beneficiaries will constitute a completed gift of the income interest in the trust for the period covered by the termination. Under the terms of the trust agreement, the gift of the right to trust income for any year will always occur before the income for that year is earned. However, no charitable deduction is allowable for the present value of the future income because the income interest in the trust is not in the form of a guaranteed annuity or fixed percentage of the fair market value of the property as required by section 2522(c)(2)(B).
>
> Rev. Rul. 77-275 states different conclusions if the trust had provided for the settlor's designation to be made after the end of the year in which the income was earned. In that situation, the gift of the income would be complete by reason of such designation, or by the lapse of the right to designate, after the income was earned by the trust. The completed gift would be a gift of money, separate from the trust property itself. Thus, in those circumstances a charitable deduction would be allowable under section 2522 for the amount of income transferred to qualified charitable organizations.
>
> In the present situation, Conservator, acting on behalf of Grantor, has retained the power to designate the charitable organizations to receive the trust income. In addition, Grantor has retained the testamentary power to appoint the trust remainder. Thus, Grantor has retained dominion and control over the trust assets and pursuant to section 25.2511-2(c) has made no completed gift upon funding Trust.
>
> Conservator's power to designate the recipient of the trust income is exercisable during the 60-day period following the close of the taxable year in which the income is earned by Trust. A completed gift occurs when Conservator designates the charitable organization to receive the trust income during that period. If Conservator makes no designation in a particular year, the completed gift occurs upon the lapse of the power at the end of the 60-day period. Pursuant to Rev. Rul. 77-275, the completed gift is a gift of money that is separate from the trust property itself. Therefore, a charitable deduction is allowable under section 2522 for the amounts of trust income that are paid to qualified charitable organizations.

Further, the Grantor would not be taxed on the income of the trust, but would be the grantor with respect to the corpus portion:

> Our examination of the trust agreement reveals none of the circumstances that would cause administrative controls to be considered exercisable primarily for the

> benefit of Grantor under section 675. Thus, the circumstances attendant on the operation of Trust will determined [sic] whether Grantor will be treated as the owner of any portion of Trust under section 675. This is a question of fact, the determination of which must be made by the Office of the District Director with which the parties file their tax returns.
>
> * * *
>
> Under the terms of the trust agreement, Conservator, acting on behalf of Grantor, has the power, during Grantor's lifetime, to appoint the charitable beneficiaries of the net trust income. Pursuant to section 674(b)(4), however, Grantor will not be treated as the owner of the net trust income. Grantor also has a testamentary power of appointment over the remainder. Under local law, capital gains are added to corpus. Pursuant to section 1.674(b)-1(b)(3), Grantor will be treated as the owner of the portion of Trust that includes income allocable to corpus.

Finally, the trust would not be a private foundation under section 4947:

> Section 4947(a)(1) provides that for purposes of section 507-509 (other than section 508(a), (b), and (c)) and for purposes of this chapter, a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, . . . 652(c), 2055 . . ., or 2522 . . . shall be treated as an organization described in section 501(c)(3).
>
> Section 4947(a)(2) provides that in case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e)(relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditure) shall apply as if such trust were a private foundation.
>
> For purposes of section 4947(a)(1), Trust has noncharitable remainder beneficiaries whose interests will remain unexpired until the termination of Trust. Thus, all of its unexpired interests are not devoted to one or more of the purposes in section 170(c)(2)(3). Therefore, Trust is not a non-exempt charitable trust within the meaning of section 4947(a)(1).

> For purposes of section 4947(a)(2), the amounts for which a deduction will be allowed are not "amounts in trust." Therefore, Trust is not a split interest trust within the meaning of section 4947(a)(2).

The trust is, of course, not tax-exempt under section 501(a) because noncharitable remainder beneficiaries were potentially present.

22. Indeterminate Bequest. In Estate of Lockett v. Commissioner, 75 T.C.M. 1731 (1997), the decedent directed the trustee of her revocable trust to set aside her residence as a historical site. There was no requirement that the residence be distributed to a charitable organization thus no deduction was allowed under section 205. Even though the trustees did transfer the residence, the possibility that the residence would not be transferred to a charitable organization was not so remote as to be negligible.

23. Jeopardizing Investments. The IRS has revised Chapter 16 of the Private Foundations Handbook. The Handbook lists these as investments deserving close scrutiny:

> 16.2.3 (04/30/98)
> Close Scrutiny of Certain Investments
>
> (1) No category of investments is to be treated as a per se violation of IRC 4944. Thus, there are no specific investments that are treated as jeopardizing investments. There are, however, examples of types or methods of investments which require close scrutiny to determine whether foundation managers have met the requisite standard of ordinary business care and prudence. See Reg. 53.4944-1(a)(2)(i).
>
> (2) Examples of types or methods of transactions in the regulations which require close scrutiny are:
>
> o Trading in securities on margin
>
> o Trading in commodity futures
>
> o Investments in working interests in oil and gas wells
>
> o Purchase of puts, calls, and straddles
>
> o Purchase of warrants
>
> o Selling short
>
> (3) Other recent investment strategies that deserve close scrutiny are:

- o Investment in junk bonds
- o Risk arbitrage
- o Hedge funds
- o Derivatives
- o Distressed real estate
- o International equities in third world countries

(4) Guarantees or collateralizations are a type of a lending of money or an extension of credit and, thus, are forms of investment activity. Such investments also deserve close scrutiny. See Janpol v. Commissioner, 101 T.C. 518 (1993).

24. CRT Purchase of Deferred Annuities. TAM 9825001 allowed a CRT to purchase deferred annuities. The facts were:

> X is a charitable remainder unitrust which was intended to qualify under section 664 of the Internal Revenue Code. X was created by A by a trust instrument dated June 25, 1990. The trust instrument provides that the Trustee shall pay to A, and upon A's death, to A's wife, a unitrust amount equal to the lesser of (1) the trust income for the year or (2) eight percent of the aggregate fair market value of the trust assets for the year. The Trust instrument includes a make-up provisions so that for any year that the unitrust payment is less than eight percent, the shortfall for prior years may be made-up in subsequent years when trust income exceeds eight percent. B is the trustee of X and is also the nephew of A.
>
> Upon the death of the survivor of A or A's wife, the trust shall terminate and the balance of trust assets are to be distributed to designated charities.
>
> In December, 1991, X entered into a contract to purchase two deferred annuity contracts from R, a commercial life insurance company. In one policy A is named the annuitant and in the other policy A's wife is named the annuitant. In other respects the two policies are identical. X is the owner of the policy and is beneficiary of the policies should either annuitant fail to reach the maturity date of the policies which is age 80. As a result of the endorsement of the two policies in 1997, the Trust, X, became the annuitant. Additional information relating to the policies is discussed hereafter in greater detail.

The Service determined that the purchase was not self-dealing:

> In analyzing an issue of self-dealing under section 4941(d)(1)(E) of the Code, the Service has focused on three elements. Is a property right created? Is there

a transfer of such property right to a disqualified person? Does the disqualified person receive a benefit from the receipt of such property right?

It is the view of the Service that a valid contract right constitutes an enforceable property interest. Michtom v. United States, 573 F.2d 58, 63 (Ct. Cl., 1978). Thus, the donor's rights under the annuity contract constitute a property interest.

It has been the Service view that the prohibition against transferring or using foundation assets to disqualified persons was intended to be extremely broad. The range of transactions described under 4941(d)(1)(E) would also include transactions described under sections 4941(d)(1)(A), (B), (C), (D), or (F). Here, the property interest (the annuity right in the contract) was transferred to the donor and the donor's wife who are disqualified persons under section 4946 of the Code.

The final element for consideration is whether the receipt of the right to the annuity under the contract by the Donor or his wife confers a benefit on the Donor. Certainly there is a potential benefit to the donor. If the donor and his wife reach age 80 the contract will be annuitized and the donor and his wife have the potential to receive all the payments to be made under the contract. This would leave the charitable remainder interest with nothing.

However, the annuity rights in the contracts are contingent on several factors. The donor and his wife must survive to age 80 to receive annuity payments. Further, assuming that X is the owner of the policy, the right of the named annuitants can be defeated by the policy owner's rights to a partial withdrawal from the policy or the surrender of the policy in exchange for the cash value of the policy. Additionally, the owner may defeat the benefit to the named annuitants by changing the maturity date; the date when the annuity payments are to begin. The partial withdrawals and surrender of the policy are subject to some restrictions and penalties for early surrender. A change of the maturity date does require written notice to the company. Nevertheless, the owner of the policy does have the power to preempt the annuity by taking such actions.

The Service has found an act of self-dealing under section 4941(d)(1)(E) only in the case where the disqualified person has received a current benefit. In Rev. Rul. 74-600, 1974-2 C.B. 385, the Service held that self-dealing occurred under section 4941(d)(1)(E) when paintings owned by a private foundation were allowed to be placed in the residence of a disqualified person. In Rev. Rul. 77- 160, 1977-1 C.B. 351, the Service held that the dues paid to a church on behalf of a disqualified person in order to allow such person to

> retain his membership in the church was an act self-dealing.
>
> In summary, it is our position that the donor receives no present value from the contract right to receive annuity payments. We do not believe that the annuity right could be currently assigned by the donor and his wife to a third party for any significant value. The donor and his wife have recently assigned their interest in the policy as named annuitants to X. Thus, the problem is resolved for future years.

The Service also determined that the failure of the trustee to withdraw funds from an annuity is self-dealing:

> We have examined the transaction with the intention of ascertaining whether B, acting in concert with A on an ongoing basis, manipulated the assets of X for the personal benefit of A, by furthering his income, retirement and tax planning goals. There was a concern that the entire transaction taken as a whole; the purchase of a deferred annuity, the failure to make withdrawals from the annuity policies, and the intention to subsequently make unitrust payments to A under the "make-up" provision of the Trust; could be construed as an act of self-dealing under section 4941(d)(1)(E) of the Code by virtue of the authority provided by section 53.4941(d)-2(f)(1) of the Regulations.
>
> In as much as A, a disqualified person, is entitled to receive the income interest from the trust, it is difficult to argue that the disqualified person receives an inappropriate benefit by deferring the income interest, particularly where such deferral is permitted under section 664 of the Code. The underlying problem is that the income beneficiary interest is in itself a use for the benefit of the disqualified person of the assets of the trust. Inherently, any investment decision regarding the trust assets that increases or decreases the amount of payout of this income interest is a use for the benefit of the disqualified person (assuming the disqualified person does not object). Section 4947(a)(2)(A) provides that section 4941 will not apply to any amounts payable under the terms of the trust to the income beneficiary. The amounts of income deferred by the investment decision in this case were payable to the income beneficiary under the terms of Trust X. Accordingly, these uses must be permitted under the income exception of section 4947(a)(2)(A) unless the disqualified person controls the investment decision and uses this control to unreasonably affect the charitable remainder beneficiary's interest.
>
> While section 53.4941(d)-1(a) of the regulations provides that it is immaterial whether the transaction results in a benefit or a detriment to the private foundation, the regulation is incompatible with section 4947(a)(2)(A) because, as discussed above, any

> investment decision regarding trust assets that results in an increase or decrease in the unitrust amount will inescapably constitute an attempted use for the benefit of the disqualified person. Therefore, rather than focusing on whether the deferral of income is a use of trust assets, the relevant question is whether the deferral of income is a permitted use. Since charitable remainder trusts by their intrinsic nature provide for a continuous use by the disqualified person of the entire trust corpus, we conclude that the presence of an unreasonable affect on the charitable remainder interest distinguishes a permissible use of trust assets from an impermissible use.
>
> In addition to failing to show harm to the charitable remainder interest, the facts of this case do not clearly show control by the disqualified person. X represented that an independent attorney/trustee signed the contract to purchase the deferred annuity policies. Moreover, even if we conclude that B, as trustee, purchased the deferred annuity policies, the facts are insufficient to demonstrate that A usurped control from the trustee or that he could compel or influence the trustee to purchase the deferred annuity policies in question. Instead, the trustee merely took into consideration the particular financial needs of A before reinvesting the proceeds from the sale of the trust assets.

The final issue of importance was whether the funds from the annuity could be classified as income:

> The applicable state law, the Uniform Principal and Income Act of Tennessee, appears ambiguous on whether a trust's right to receive money is income to the trust, whether characterized as principal or income. The implication from the sections that define income and principal, however, is that a trust does not realize either until the trust actually receives possession of money or other property. See Tenn. Code Ann. section 35-6-102 and section 35-6-104 (1991). Therefore, the Trust's right to receive either the cash value or the surrender value of the contracts does not create trust accounting income under section 643(b) of the Code.

If the trustee were not independent not only could self-dealing occur but the trust would likely be a grantor trust not a charitable remainder trust because of the right of the trustee to allocate between income and principal in a net income with make-up unitrust.

25. **<u>Charitable Lead Trust as Grantor Trust</u>**. Typically, charitable lead trusts are not grantor trusts because such status creates an income tax deduction upon funding but causes the trust income to be taxable to the grantor, with no offsetting deduction, thereafter. PLR 9810019 is a contrary example and worth reviewing if a grantor lead trust is desirable.

26. **Protection From Creditors**. The Bankruptcy Code has been amended to protect from creditors contributions not in excess of 15% of the debtor's gross income for the year of the contribution. Contributions in excess of 15% may be protected if such were consistent with the practices of the debtor. The contribution must be of cash or financial instruments and must be to an organization described in sections 170(C)(1) or (2), which includes private foundations. The contributions may continue while the debtor is in bankruptcy.

C. **SECTION 408 -- IRAs**

1. **General Discussion (Thanks to Sharon A. Mattingly, Ogden Newell & Welch)**. The Taxpayer Relief Act of 1997 made changes to existing IRAs and also creates two new types of IRAs -- the Roth IRA and the Education IRA. The changes to the traditional IRA and the highlights of the new ones include:

Traditional IRAs

- If you are an active participant in an employer-sponsored retirement plan, whether or not you can make a deductible IRA contribution depends upon your adjusted gross income ("AGI"). If your AGI is below the phase out range, you will get a full deduction; if your AGI is above the phase out range, you are not entitled to any deduction. Under prior law, the $2,000 IRA deduction limit was phased out between $40,000 and $50,000 of AGI for married taxpayers filing jointly and between $25,000 and $35,000 of AGI for single taxpayers. The phase out limits have now been increased as follows:

Tax Years Beginning:	Single Taxpayers	Married Taxpayers Filing Jointly
1998	$30,000 to $40,000	$50,000 to $60,000
1999	$31,000 to $41,000	$51,000 to $61,000
2000	$32,000 to $42,000	$52,000 to $62,000
2001	$33,000 to $43,000	$53,000 to $63,000
2002	$34,000 to $44,000	$54,000 to $64,000
2003	$40,000 to $50,000	$60,000 to $70,000
2004	$45,000 to $55,000	$65,000 to $75,000
2005	$50,000 to $60,000	$70,000 to $80,000
2006	$50,000 to $60,000	$75,000 to $85,000
2007 and thereafter	$50,000 to $60,000	$80,000 to $100,000

- You will no longer be considered an active participant in an employer-sponsored plan merely because your spouse is an active participant in such a plan. However, if your spouse is an active plan participant, the deductibility of your $2,000 IRA contribution will be phased out if you have AGI between $150,000 and $160,000.

- The 10-percent tax on early withdrawals will not apply to IRA distributions used to pay qualified educational expenses for the IRA owner, the owner's spouse, or any child or grandchild of the owner or the owner's spouse. Qualified higher education expenses include tuition, fees, books, supplies, and equipment for post-secondary education.

- The 10-percent early withdrawal tax does not apply to a distribution for "first-time home buyer expenses." You will now be allowed to withdraw $10,000 during your lifetime which will not be subject to the penalty, but will still be subject to income taxes. The money must be used within 120 days to buy, build, or re-build a "first" home that is a principal residence of the IRA holder, the holder's spouse, or the child, grandchild, or ancestor of the holder or the holder's spouse. To be considered a "first-time home buyer," you (and your spouse, if married) must not have had an ownership interest in a principal residence during the two-year period ending on the date the new home is acquired.

Roth IRAs

The Taxpayer Relief Act established a new type of "backloaded" IRA. The contribution itself will not be deductible, but the earnings will accumulate tax-free and, if the distributions meet certain requirements, the earnings will not be taxed upon distribution. The laws governing Roth IRAs provide that:

- The maximum yearly contribution to a Roth IRA is phased out for single taxpayers with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

- You can make contributions to a Roth IRA after age 70½, and there is no required minimum distribution from the IRA after reaching age 70½.

- Qualified distributions are not included in your gross income and are not subject to the additional 10-percent early withdrawal penalty. To be a "qualified distribution," the contributions must have been held for a five-year period **AND** the distribution meet one of the following four requirements:

  - made on or after the date you reach age 59½;
  - made to your beneficiary after your death;
  - made to you because you are disabled; or
  - made to you to pay for "qualified first-time homebuyer expenses."
- You may convert a regular IRA to a Roth IRA if your AGI for the tax year does not exceed $100,000 and you are not married filing separate returns. If the conversion is made prior to January 1, 1999, the amount that would have been included in gross income if you had taken a distribution can be included in gross income over a four-year period. After that date, the portion of the rollover from the ordinary IRA which would have been included in gross income if you had taken a distribution will be included in your income the year of the rollover.

If you have an ordinary IRA, should you roll it into a Roth IRA? Preliminary analysis by consultants in the field indicates that conversion may not be a good idea if you will be dropping from a high tax bracket to a lower tax bracket when you retire. Also, if you do not have other funds to pay the income taxes on conversion and must pay those out of the IRA monies, it may take you more years to earn that tax money back than any benefit you gain in the conversion.

Education IRAs

Another new type of IRA may help low and middle-income taxpayers save for education expenses. The education IRA will be available January 1, 1998. If you fall within the AGI limits, you can contribute up to $500 per beneficiary (child) per year to an education individual retirement account. The contribution itself is not deductible, but the earnings on the contributions will be distributed tax-free as long as they are used to pay the beneficiary's post-secondary education expenses. Some features of the education IRA are:

- The contribution to an education IRA is limited if your modified AGI exceeds $150,000 for joint filers and $95,000 for single filers. If your modified AGI is at or above $160,000 (joint) or $110,000 (single), you cannot make contributions to an education IRA on behalf of any individual.
- Contributions must be made in cash and must be made before the beneficiary reaches age 18.
- The IRA funds must be distributed by the time the beneficiary reaches age 30. Any balance remaining at that time must be distributed to the beneficiary and the portion attributable to earnings will be includable in the beneficiary's gross income.
- Education IRAs can be rolled over to another family member of the beneficiary. "Family member" is defined to include the beneficiary's child, brother, sister, nephew, niece, certain in-laws, and the spouses of those relatives.
- Distributions can be taken tax-free as long as the distributions are for the payment of "qualified higher education expenses." "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible education institution. Expenses for room and board will be considered higher education costs only if the beneficiary is enrolled in a degree or certificate program on at least a half-time basis.

plan participant, the deductibility of your $2,000 IRA contribution

The Taxpayer Relief Act also contained provisions for new tax credits which can be elected by certain individuals for college tuition expenses. These credits are referred to as the "HOPE scholarship credit" and the "lifetime learning credit." If a taxpayer claims either of these credits, then the exclusion for the education IRA is not available. Also, you cannot make a contribution to an education IRA on behalf of a beneficiary during any tax year in which contributions are made to a qualified state tuition program by anyone on behalf of the same beneficiary.

In the November, 1996 issue of the Ogden Newell & Welch Client Update, we reported to you the changes to retirement plans as a result of the Small Business Job Protection Act passed in August, 1996. Once again, Congress has made changes in the laws relating to retirement plans. What should you know? A brief summary of the major pension-related provisions of The Taxpayer Relief Act of 1997 is set out below. Whether you are the sponsor of a retirement plan or a participant in a retirement plan, some of these changes will apply to you.

2. **Revocable Trust as Designated Beneficiary**. If a participant in a retirement plan or the owner of an IRA dies without providing for a "designated beneficiary," the remaining assets of the plan or IRA must be paid out within 5 years thus losing the benefit of tax-free investment. In many instances it is desirable to name a trust as designated beneficiary.

Proposed regulations under section 401 issued in 1987 required, among others, that a trust must be irrevocable on the earlier of the participant's death or required beginning date (normally April 1 of the year after the year in which the participant became 70½). In other words, a named trust had to be irrevocable at the time the participant began receiving distributions. This requirement was widely criticized because, for example, there was no necessity to make the beneficiary designation irrevocable, and testamentary trusts cannot be irrevcoable until the testator's death.

The Service has now amended the proposed regulations, Reg- 209463-82. The rationale for the change is described as follows:

Section 401(a)(9)(A) provides that, in order for a plan to be qualified under section 401(a), distributions of each employee's interest in the plan must commence no later than the "required beginning date" for the employee and must be distributed over a period not to exceed the joint lives or joint life expectancy of the employee and the employee's designated beneficiary. Section 401(a)(9)(B) provides that if distribution does not commence prior to death in accordance with section 401(a)(9)(A), distributions of the employee's interest must be made within 5 years of the employee's death, or, generally, commence within one year of the employee's death and be made over the life or life expectancy of the designated beneficiary.

Section 401(a)(9)(E) defines the term "designated beneficiary" as an individual designated as a beneficiary by the employee. The Existing Proposed Regulations provide that, for purposes of section 401(a)(9), only individuals may be designated beneficiaries. A beneficiary who is not an individual, such as the employee's estate, may not be a designated beneficiary for purposes of determining the minimum required distribution, but nevertheless may be designated as the employee's beneficiary under the plan. If a beneficiary who is not an individual is designated to receive an employee's benefit after death, the employee is treated as having no designated beneficiary when determining the required minimum distribution. In that case, under section 401(a)(9), distributions commencing before death must be made over the employee's single life or life expectancy and distributions commencing after death must be made within 5 years of the employee's death.

However, the Existing Proposed Regulations provide that if a trust is named as a beneficiary of an employee's benefit under the plan, the underlying beneficiaries of the trust may be treated as designated beneficiaries for purposes of section 401(1)(9) if certain requirements are satisfied. In response to comments, these proposed regulations modify these trust beneficiary requirements as explained below by:

> Permitting the designated beneficiary of a revocable trust to be treated as the designated beneficiary for purposes of determining the minimum distribution under section 401(a)(9), provided that the trust becomes irrevocable upon the death of the employee.
>
> Providing relief from the requirement that the plan be provided with a copy of the trust document if certain certification requirements are met.

Irrevocability of trust

> The Existing Proposed Regulations generally provide that a trust must be irrevocable as of the employee's required beginning date in order for the beneficiaries of the trust to be treated as designated beneficiaries under the plan for purposes of determining the distribution period under section 401(a)(9)(A). Commentators have indicated that most trusts established for estate planning purposes and designated as the beneficiary of an employee's plan benefits are revocable instruments prior to the death of the employee. In response to those comments, these proposed regulations provide that a trust named as beneficiary of an employee's interest in a retirement plan be permitted to be revocable while the employee is alive, provided that it becomes irrevocable, by its terms, upon the death of the employee. The requirements in the Existing Proposed Regulations that the trust be valid under state law (or would be but for the fact that there is no corpus) and that the beneficiaries be identifiable from the trust instrument are retained.

In order for a trust to qualify it must (1) be valid under state law, (2) be irrevocable or become so no later than the participant's death, and (3) have ascertainable beneficiaries. In addition, the plan administrator must be furnished with certain documentation:

> (a) Required distributions commencing before death. In order to satisfy the requirement of paragraph (b)(4) of D-5A of this section for distributions required under section 401(a)(9) to commence before the death of an employee, the employee must comply with either paragraph (a)(1) or (2) of this D-7A:
>
> (1) The employee provides to the plan administrator a copy of the trust instrument and agrees that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each such amendment, or
>
> (2) The employee --
>
> (i) Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remainderman beneficiaries with a description of the conditions on their entitlement);
>
> (ii) Certifies that, to the best of the employee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of D-5A of this section are satisfied;
>
> (iii) Agrees to provide corrected certifications to the extent that an amendment changes any information previously certified; and

(iv) Agrees to provide a copy of the trust instrument to the plan administrator upon demand.

(b) Required distributions after death. In order to satisfy the documentation requirement of this D-7 for required distributions after death, by the end of the ninth month beginning after the death of the employee, the trustee of the trust must either

(1) Provide the plan administrator with a final list of all of the beneficiaries of the trust (including contingent and remainderman beneficiaries with a description of the conditions on their entitlement) as of the date of death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of D-5A of this section are satisfied as of the date of death; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

The amended regulations also provide relief for discrepancies between the trust and the information the plan administrator has:

Relief for discrepancy between trust instrument and employee certifications or earlier trust instruments. (1) If required distributions are determined based on the information provided to the plan administrator in certifications or trust instruments described in paragraph (a)(1), (a)(2) or (b) of this D-7A, a plan will not fail to satisfy section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in those certifications or trust instruments previously provided to the plan administrator, but only if the plan administrator reasonably relied on the information provided and the minimum required distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument. For purposes of determining whether the plan satisfies section 401(a)(9) for calendar years after the calendar year in which the discrepancy is discovered, if the actual beneficiaries under the trust instrument are different from the beneficiaries previously certified or listed in the trust instrument previously provided to the plan administrator, or the trust instrument specifying the actual beneficiaries does not satisfy the other requirements of paragraph (b) of D-5A of this section, the minimum required distribution will be determined by treating the beneficiaries of the employee as having been changed in the calendar year in which the discrepancy was discovered to conform to the corrected information and by applying the change in beneficiary provisions of E-5 of this section.

3. **IRA Trust Rollover**. PLR 9744024 is another ruling from the IRS confirming that if the surviving spouse has sole control over the distribution of IRA proceeds then proceeds which are distributed to the surviving spouse will be treated as having passed from the decedent such that the surviving spouse can roll them over into the surviving spouse's own IRA. There have been over a dozen thus far in 1998. The facts of PLR 9744024 were:

> Individual B established Trust M on * * * which became irrevocable upon his death. Individual B died on * * *, at the age of * * *. His surviving spouse is Individual A. Individual B was the trustee of Trust M.
>
> Article VIII of Trust M provides that, upon the death of Individual B, the largest pecuniary amount which would not result in or increase the federal estate tax payable by reason of Individual B's death be held as a separate trust, Trust N, for the benefit of Individual A during her lifetime.
>
> Article IX of Trust M provides that the remainder of Trust M will be distributed outright to Individual A.
>
> Individual B named Trust M as the beneficiary of IRA G. The only other assets of Trust M were life insurance proceeds having an approximate value of $125,000. Upon Individual B's death, Individual A became the sole successor trustee of Trust M. As sole successor trustee the allocation of assets between Trust N and the residue of Trust M was in the sole discretion and control of Individual A. Approximately $475,000 of IRA G has been allocated to Trust N. The remainder of IRA G has been allocated to the residue of Trust M which will be distributed outright to Individual A. The residue is made up solely of IRA G assets. Individual A intends to rollover the residue of Trust M directly into an IRA maintained for her benefit. This rollover will take place within 60 days of the date of the distribution from Trust M.

The rulings were:

> 1. That the portion of the IRA G allocated to the residue of Trust M ("residuary amount") and which will be distributed, outright, to Individual A, does not represent an inherited IRA within the meaning of section 408(d)(3)(C) of the Code; and
>
> 2. That pursuant to section 408(d) of the Code, Individual A is not required to include any of the residuary amount in income for federal income tax purposes, for the year in which such amount will be

distributed to her, when the amount is contributed to a rollover IRA for her benefit.

D. SECTIONS 671-678 -- GRANTOR TRUST RULES

1. **Effect of Withdrawal Right**. The National Office ruling policy is that the holder of a Crummey withdrawal right is the owner for income tax purposes of the portion of the trust over which the powerholder has the withdrawal rights. PLR 9739026 is an example. The ruling considers 10 separate trusts:

> Because contributions to Trusts 1 through 10 will be subject to the withdrawal power of beneficiaries B through K, in amounts permitted under section 7 of each Trust, respectively, B through K will be treated as having a power to vest such amounts of each contribution in himself or herself within the meaning of section 678(a)(1) of the Code. If any of B through K fail to exercise the withdrawal power, they will be treated as having released the power, while retaining a right to have all trust income allocable to the portion of the contributions subject to the power to withdraw (ordinary income and income allocable to corpus), in the sole discretion of the trustee, distributed to them or accumulated for future distribution, for purposes of sections 678(a)(2) and 677(a). Therefore, B through K will be treated as the owners of those portions of Trusts 1 through 10 over which they have the power to withdraw, respectively, under section 678(a) of the Code.
>
> If, but only if, B through K have the power to withdraw all of each contribution to each Trust, under the provisions of section 7 of each respective Trust, B through K will be considered the owners of the entirety of Trusts 1 through 10, respectively, for purposes of section 671 of the Code, and the Trusts will be permitted S corporation shareholders as described in section 1361(c)(2)(A)(i).

In PLRs 9810006, 9810007, and 9810008 the IRS ruled similarly.

Of interest are the items expressly reserved by the Service in those rulings:

> Specifically, no opinion is expressed concerning whether X meets the requirements of a "small business corporation" under section 1361(b), whether the non-voting stock to be transferred to Trust is a second class of stock under section 1361(b)(1)(D), or whether future trusts meet the requirements to be a QSST.

Why the reservation is unknown.

Transferring S corp stock to a _Crummey_ trust or to a trust over which a beneficiary has a 5x5 power presents problems because the trust will be partially a grantor trust and partially something else (e.g., a QSST or ESBT). Ensuring that a _Crummey_ trust is a grantor trust with respect to the true donor is beneficial (care should be taken in dealing with the trust during the period after the donor's death but before all _Crummey_ rights have lapsed), as is limiting 5x5 withdrawal rights where S-corp stock is involved. The issue of whether a Crummey trust can co-exist as a grantor and an ESBT has not been decided.

E. SECTION 1361 - S CORPORATIONS

1. **ESBTs**. Notice 97-49, 1997-31 IRB 1, clarifies some rules relating to ESBTs.

> Section 1361(e)(1)(A)(i) provides that an ESBT may not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), which holds a contingent interest and is not a potential current beneficiary. For tax years beginning after December 31, 1997, the clause "which holds a contingent interest and is not a potential current beneficiary" is deleted. Section 1361(e) does not provide a specific definition of the term "beneficiary."

There are three rules for determining a beneficiary:

> 1. The term "beneficiary" does not include a distributee trust (other than a trust described in paragraphs (2) or (3) of section 170(c)), but does include those persons who have a beneficial interest in the property held by the distributee trust. For example, an intended ESBT's governing instrument provides for discretionary distributions of income or principal to A for life, and upon A's death the division of the remainder into separate trusts for the benefit of A's children. For purposes of section 1361(e)(1)(A)(i), the beneficiaries of the intended ESBT are A and A's children, and not the separate trusts for the benefit of A's children. Therefore, because all the beneficiaries of the intended ESBT are individuals, the intended ESBT meets the requirements of section 1361(e)(1)(A)(i).
>
> 2. The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the holder of the power of appointment actually

exercises the power of appointment in such person's favor.

3. The term "beneficiary" does not include a person whose contingent interest is so remote as to be negligible. For example, except in unusual circumstances, the contingent interest a State has under its laws pertaining to escheat would be considered negligible, and the State would not be considered a beneficiary of the intended ESBT.

Rules are also created for determining who is a potential current beneficiary:

1. If a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intended ESBT, then the S corporation election will terminate unless the distributee trust is a trust described in section 1361(c)(2)(A) (e.g., ESBT, qualified subchapter S trust, etc.). In addition, if the distributee trust is a trust described in section 1361(c)(2)(A), the persons described in section 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the shareholder restrictions under section 1361(b)(1) are met. In the above example involving the distributee trusts for A's children, the distributee trusts for A's children will become entitled to receive distributions from the ESBT upon A's death. At such time, the S corporation election will terminate unless (i) the distributee trusts are trusts described in section 1361(c)(2)(A), and (ii) the persons described in section 1361(c)(2)(B), with respect to the distributee trusts, satisfy the shareholder restrictions in section 1361(b)(1). If, for example, the distributee trusts are qualified subchapter S trusts, and A's children are the current income beneficiaries, A's children are treated as shareholders of the corporation for purposes of satisfying the shareholder restrictions under section 1361(b)(1).

2. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of the power of appointment) is not a potential current beneficiary until such time or the occurrence of such event. Whether a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary is currently under study.

The notice contains these other comments:

Section 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations ("S portion") is taxed as a separate trust. Section 641(d)(2)(C) specifies that the only items of income, loss, deduction, or credit to be taken into account by the S portion ("S portion items") are (i) the items required to be taken into account under section 1366; (ii) any gain or loss from the disposition of stock in an S corporation; and (iii) to the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

Section 641(d)(3) provides that the S portion items are excluded for purposes of determining the amount of tax on the portion of the trust that is not treated as a separate trust under section 641(d)(1)("non-S portion") and are excluded in determining the distributable net income (DNI) of the entire trust. Section 641(d)(3) also provides that, except as otherwise provided, section 641(d) does not affect the taxation of any distribution from the trust.

Guidance has been requested on the treatment of distributions from an ESBT when the trust has fiduciary accounting income in both the S portion and the non-S portion of the trust. Section 641(d)(3) specifically provides that, except as otherwise specified, section 641(d) does not change the taxation of any distribution from the trust. Because the S portion items are not included in the computation of the ESBTs DNI, they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into the DNI computation (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has $40 of DNI from the non-S portion and $70 of net fiduciary accounting income from the S portion. If the ESBT makes a distribution of $100, the distribution includes $40 of DNI.

F. SECTIONS 2031 and 2512 -- VALUATION

1. Valuation of One-Half Community Property Interest in Closely-Held Stock. In Estate of Fleming, 74 T.C.M. 1049 (1997), the Tax Court determined the value of a one-half community property interest in shares of B & W Financial Corporation of Longview. The court largely rejected the appraisers of both the Estate and the IRS. The court stated:

> Each of the parties' experts agree that, under the transaction method that each applied under the market approach to valuation, the starting point for determining the fair market value of the stock interest in question should be the book value of B&W Longview on the valuation date plus a 23-percent premium on the gross amount of the trade notes receivable that that corporation held on that date. We accept that starting point under the transaction method as reasonable. According to the expert reports, market conditions on

the valuation date, like market conditions in 1991 at the time of the FNFS transaction in which a 23-percent premium was applied to the trade notes receivable there involved, were more favorable than they were in 1989 at the time the B&W El Paso transaction occurred in which a 15-percent premium was applied to the trade notes receivable involved in that transaction.

A major difference between the parties' experts in valuing the stock interest in question relates to the discounts that each applied. Respondent's expert applied only a 10-percent minority discount, and petitioner's expert applied a 35-percent combined minority and lack-of-marketability discount. Discounts for a minority interest and for lack of marketability are conceptually distinct. Estate of Newhouse v. Commissioner, supra at 249. A minority discount reflects the minority shareholder's inability to compel liquidation and thereby realize a pro rata share of the corporation's net asset value. A discount for lack of marketability reflects the fact that there is no ready market for the stock of a closely held corporation. Id. The appropriate amount of a minority discount and/or a lack-of-marketability discount is a question of fact. Id.

We agree with both parties' experts that a minority discount should be applied in valuing decedent's 50-percent stock interest in B&W Longview. Although Mr. Harrell specified that he would apply a 10-percent discount, Mr. Bernstein did not specify how much of the 35-percent combined discount that he applied was attributable to the fact that decedent did not own a controlling stock interest in B&W Longview on the valuation date. On brief, petitioner, who has the burden of proof, does not insist that a minority discount in excess of 10 percent be applied in this case.

Respondent contends, and petitioner disputes, that, because the precedent transactions on which both experts, inter alia, relied involved stock for which there was no ready market, the respective prices paid for the stock sold in those transactions reflected some lack of marketability discount. While we generally agree with respondent, it is significant that the stock interests acquired in the precedent transactions were different from decedent's 50-percent stock interest in B&W Longview in that (1) the respective purchasers in the transactions involving (a) B&W El Paso and (b) B&W Brownsville, B&W Harlington, B&W Mission, B&W Austin, and B&W Finance acquired 100 percent of the stock of each of those corporations; and (2) although decedent purchased only 50 percent of the stock of TA&T Finance in the Young transaction, after that purchase, decedent owned 100 percent of the stock of that corporation. On the record before us, we find that there was even less of a ready market for decedent's 50-percent stock interest in B&W Longview than there was for the stock

> interests sold in the precedent transactions. Consequently, we conclude that, in addition to a minority discount, some amount of lack-of-marketability discount should be applied in determining the fair market value on the valuation date of decedent's 50-percent stock interest in B&W Longview.
>
> Based on our consideration of the entire record before us, and using our best judgment, we find that the fair market value on the valuation date of decedent's 50-percent stock interest in B&W Longview was $875,000.

2. **Valuation of Common Stock**. In Estate of Mitchell v. Commissioner, 74 T.C.M. 872 (1997), the Tax Court valued 49.04% of John Paul Mitchell Systems common stock as of April 21, 1989, Mr. Mitchell's date of death. The formation of the company was described by the court:

> Messrs. Mitchell and DeJoria first met in the early 1970's. They eventually developed a close friendship. In 1979, they joined forces to market Mr. Mitchell's hair care products (particularly the sculpting lotion) through professional-only hair salons. Mr. DeJoria believed he could successfully market the line. Initially, Messrs. Mitchell and DeJoria were unable to find anyone willing to provide financial assistance; thus, they pooled their resources of $700 to purchase an answering machine, bottles, and caps and hire an artist to design a logo for their labels. Mr. DeJoria persuaded a cosmetics laboratory to manufacture the first batch of products on credit. Instead of the orange and white bottles Mr. Mitchell had previously used, these products were packaged in white bottles with Paul Mitchell's name displayed in black lettering down the side.
>
> At all relevant times, Paul Mitchell products were sold to the public only through professional hair salons.
>
> 1. STRUCTURE AND OWNERSHIP
>
> On March 31, 1980, Messrs. Mitchell and DeJoria formed Paul Mitchell Systems, Inc. On May 9, 1985, the corporation changed its name to John Paul Mitchell System (JPMS). Messrs. Mitchell and DeJoria granted JPMS all proprietary and distribution rights to the hair and skin products that Mr. Mitchell developed (or had developed under his direction), including the products' trademark, service mark, or other intellectual property rights.
>
> JPMS' articles of incorporation authorized the issuance of 10,000 shares of common stock. Between March 3, 1980, and April 21, 1989 (the date of Mr. Mitchell's death), JPMS had 2,500 shares issued and outstanding. Article VII of JPMS' bylaws provided that any transfer of JPMS stock was subject to a right of first refusal,

exercisable first by the corporation, then by each nontransferring shareholder.

Initially, Mr. DeJoria owned 1,250 shares of JPMS common stock and Paul Mitchell Associates, Ltd. (PMA), owned 1,250 shares. Mr. Mitchell owned all of PMA. On February 20, 1982, PMA assigned its JPMS shares to Mr. Mitchell. On November 20, 1984, Mr. Mitchell assigned his JPMS shares to the Trust. On August 1, 1987, Mr. Mitchell, acting as trustee of the Trust, assigned 16 shares of JPMS common stock to Jeanne Braa, his long-time stage partner in hair shows, and 8 shares of JPMS common stock to Angus Mitchell, his son. Mr. DeJoria and JPMS executed written waivers of the right of first refusal with respect to all of these transfers.

As of April 21, 1989, the common stock of JPMS was owned as follows:

	Number of Shares	Percent
Mr. DeJoria	1,250	50.00
The Trust	1,226	49.04
Ms. Braa	16	0.64
Angus Mitchell	8	0.32
Total	2,500	100.00

In valuing the stock, the court began with purchase discussions and offers, one from Gillette and another described as follows:

> Another suitor of JPMS was Minnetonka Corp. (Minnetonka), a publicly traded company. Robert Taylor was Minnetonka's president and chief executive officer. Mr. Taylor co-founded Minnetonka in 1961 and took the company public in 1968.
>
> Minnetonka was involved in consumer product brands, primarily those that were sold through the department store, gift, or beauty trade. Minnetonka was the licensee for Calvin Klein and created Obsession and Eternity women's fragrances. In addition, Minnetonka created Foltene, a treatment used in the beauty salon business for fine and thinning hair, a product line for home fragrance, and a gift soap product line for department stores.
>
> In 1990, Mr. Taylor started a salon-only hair products company, Graham Webb International, which grew to $25 million in sales in 5 years. From 1992 or 1993 to approximately 1995, Mr. Taylor was on the board of directors of Banker's Trust Venture Capital Fund in New York (Bankers Trust), which specializes in providing funds for small businesses or recapitalization funds.
>
> As chairman, Mr. Taylor was responsible for Minnetonka's strategic acquisitions. In 1985, when JPMS' sales approximated $10 million, a financial adviser to JPMS

solicited Mr. Taylor's interest in acquiring JPMS. However, Minnetonka determined that JPMS was too small and that the Paul Mitchell brand name was not strong enough to stand on its own; accordingly, Mr. Taylor declined to enter discussions at that time.

Two years later, Minnetonka targeted the salon industry for acquisition candidates, and Mr. Taylor contacted Redken, Sebastian, and JPMS. During this time, the annual sales of these companies were approximately $120 million, $60 million, and $50 million, respectively. Although Minnetonka agreed to acquire Sebastian for $100 million in late 1987, the sale was not consummated.

Mr. Taylor initiated discussions with Mr. DeJoria in the fall of 1987 (JPMS' 1988 fiscal year) when JPMS' sales were approximately $50 million. Mr. Taylor informed Mr. DeJoria that Minnetonka was willing to pay $100 million to acquire all of the JPMS stock, assuming officers' salaries were revised. Mr. DeJoria insisted on a $125 million acquisition price. Mr. Taylor refused to raise Minnetonka's bid, and the negotiations were terminated.

In the fall of 1988, Mr. Taylor again approached Messrs. DeJoria and Mitchell. (At the time, JPMS' sales were in the $65 million range.) Mr. Taylor offered $125 million to acquire all of the JPMS stock. (At this time, Mr. Taylor was unaware that Mr. Mitchell was seriously ill.) The proposed acquisition price assumed that: (1) Mr. DeJoria would continue managing JPMS; (2) Mr. Mitchell would continue promoting the products for at least 18 months to 2 years as a transition period; and (3) both Messrs. Mitchell and DeJoria would be compensated in salary and stock at a level paid to officers of other Minnetonka subsidiaries, such as Calvin Klein.

Mr. DeJoria did not accept Minnetoka's $125 million offer; he believed that Minnetonka was "just a little short every time." (Mr. DeJoria represented to Mr. Taylor that he had received from Gillette a $150 million offer plus a royalty of 2 percent of sales for lifetime. Mr. Taylor informed Mr. DeJoria that he could not match Gillette's offer.) Sales discussions with Minnetonka thus ended.

The court held:

We have considered all of the testimony before us, as well as the expert witness reports, and have weighed all other relevant factors. As articulated by the parties, each expert witness report is susceptible to criticism. We are unable to accept the moment-of-death valuations given to the 1,226 shares of JPMS common stock by any of the expert witnesses. Instead, we rely on our own analysis, based on all the evidence in the record.

We begin our analysis by placing a $150 million value on JPMS at the moment immediately prior to Mr. Mitchell's death. In determining this value, we considered all the evidence but gave the greatest consideration to Minnetonka's "real world" $125 million offer in the fall of 1988 (which Mr. DeJoria found "a little short") and Mr. DeJoria's representation to Mr. Taylor that he had received from Gillette a $150 million offer PLUS a royalty of 2 percent of sales for a lifetime (which Mr. Taylor found to be an offer he could not match).

We next consider the impact of Mr. Mitchell's death on JPMS. Mr. Mitchell embodied JPMS to distributors, hair stylists, and salon owners. he was vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry. It is clear that the loss of Mr. Mitchell, along with the structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death.

In particular, a hypothetical buyer or seller would have to consider the following factors in valuing the 1,226 shares of JPMS common stock at the moment of Mr. Mitchell's death: (1) Whether it would be necessary to increase JPMS' advertising and marketing expenses; (2) whether litigation concerning Mr. DeJoria's compensation would ensue; (3) whether the lack of a ready or available market for the stock would affect its fair market value; (4) whether and how JPMS would continue its history of successful product development and styling leadership; (5) whether rumors concerning JPMS' "going retail" would adversely affect its relationships with salons; (6) whether JPMS' history of unreliable suppliers would continue; (7) whether JPMS would solve its inventory control and financial information reporting problems; and (8) whether JPMS' thin management and total reliance on Mr. DeJoria would hinder its performance.

Nonetheless, Mr. DeJoria stepped in to single-handedly run JPMS upon Mr. Mitchell's death. Mr. DeJoria had always overseen JPMS' marketing. Indeed, despite his reputation for creativity, Mr. Mitchell had not succeeded in marketing his product line in the late 1970's. Although there is no doubt that Mr. Mitchell's fame was an important component in launching JPMS in the early 1980's, Mr. DeJoria's salesmanship, marketing savvy, and construction of the distribution network were also vitally important.

In addition, Mr. Taylor, whom we found extremely credible, testified that Mr. Mitchell was not as essential to Minnetonka's interest in JPMS as Mr. DeJoria. Mr. Taylor also observed that the deaths of fashion designers Perry Ellis and Anne Klein did not affect their ongoing businesses to any significant degree "because the consumer somehow is so far removed from the actual * * * involvement of that designer * * * they're still buying the product.

> In our opinion, the $150 million value for JPMS at the moment immediately prior to Mr. Mitchell's death should be discounted by 10 percent to reflect the loss of Mr. Mitchell to JPMS. Thus, we believe that at the moment of Mr. Mitchell's death, JPMS had a value of $135 million.
>
> We further believe: (1) A total 35-percent discount is appropriate, reflecting combined discounts for lack of marketability and minority interest; and (2) a $1.5 million discount, reflecting the possibility of a lawsuit over Mr. DeJoria's compensation, should be applied. Taking these factors into consideration, we find, and thus hold, that the value of decedent's interest was $41,532,600 as of the moment of his death.

Footnote 25 contains this calculation:

Value of JPMS at the moment immediately prior to Mr. Mitchell's death	$150,000,000
Less: Discount to reflect the loss of Mr. Mitchell to JPMS	(15,000,000)
Value of JPMS at the moment of Mr. Mitchell's death	$135,000,000
Percent of Trust's interest in JPMS	x 49.04
Value of Trust's interest in JPMS prior to discounts	$ 66,204,000
Discount for lack of marketability and minority interest (35%)	(23,171,400)
	$ 43,032,600
Discount for possibility of lawsuit	(1,500,000)
Value of Trust's interest in JPMS after discounts	$ 41,532,600

3. **Appraisal Quality**. All appraisals are not created equal. A federal district court had occasion to dismiss taxpayer's expert because of "fundamental errors" in Estate of Hagerman v. United States, 81 AFTR2d Par. 98-771 No. 96-2032. The court's discussion of the taxpayer's appraiser is worth quoting:

> Plaintiffs relied upon the appraisal of John Trapp. Mr. Trapp graduated from the University of Illinois in 1939 with a B.S. degree. He obtained a real estate broker's license in 1965 and at that time, started selling and appraising real estate. He holds no certification but has done appraisals in connection with partitions, estates, condemnations, and divorces, as well as

appraisals related to bank loans. Approximately sixty percent (60%) of his appraisal work has been done in connection with federal estate tax returns. He has prepared appraisals exclusively for estates and never the Internal Revenue Service. Mr. Trapp limits his work to Vermilion, Edgar, Champaign, and Douglas Counties. In 1991, he did approximately 20 farm appraisals. Although Mr. Trapp has attended as many seminars as he could find, he has admitted that he has not researched Internal Revenue Service rulings and regulations as part of his process. He did obtain some materials of a summary nature approximately 20 years ago from an attorney in Paris, Illinois, but has not kept abreast of the changes since.

While Mr. Trapp was able to appraise closer in time to the valuation date, and was certainly more thorough in his on-site inspection of the premises, including inspection when growing crops were not obstructing his view, the major errors he made in his appraisals dealt a fatal blow to Plaintiff's case.

In assigning a total value of $158,170 for Farm 3, Mr. Trapp determined a land value of $1,075 per acre. In reaching this conclusion, he relied upon four comparable sales. One, listed as Sale 2, was reported as a July 24, 1990, sale of 60 acres with a sale price per acre of $866.66. In reality, the sale was a 1971 transaction making the price used by Mr. Trapp of no value. Further, he referenced Sale 3, an October 17, 1990, sale of 40 acres at a sale price of $1,075. However, only 20 acres were involved in that particular sale so the per acre price was actually twice that used by Mr. Trapp. The remaining comparables had sale prices of $2,175 and $1,775. The Court concludes that the per acre valuation assigned by Mr. Trapp is contrary to his own supporting evidence, thus rendering his valuation of Farm 3 unreliable.

Mr. Trapp determined the value of Farm 4 to be $866.66 per acre for a total of $121,330. He relied upon the same four comparables used in connection with Farm 3. In fact, according to his narrative, he relied particularly on Sale 2 finding the subject farm was of the same value. Unfortunately for Plaintiffs, the sale price for Sale 2 was as previously indicated 20 years outdated. Clearly, Mr. Trapp's valuation of Farm 4 is seriously flawed.

Mr. Trapp's assigned a value of $1,575 per acre to Farm 2 for a total of $196,955. He included eight sales from Vermilion County, Illinois, and four sales from Champaign County, Illinois, on his written appraisal. However, in his narrative, Mr. Trapp declared a November 30, 1990, sale of 248 acres from Lo to Prudential Insurance Company (Sale 1) to be "indicative" of the subject farm's market value. He re-ported a sale price of $1,674.19 per acre and reduced the subject tract $100 per acre because it was inferior to Sale 1. Mrs. Lo

> testified at trial that two separate tracts comprised the transaction used by Mr. Trapp. She and her husband sold several tracts to Prudential, negotiating individual prices for each but Prudential grouped them together and paid three lump sums. Specifically, the transaction used by Mr. Trapp involved a 168 acre parcel sold for $1,400 per acre and an 80 acre parcel sold for $2,250 per acre. The latter farm is in Jamaica Township as is Farm 2. By co-mingling the tracts, Mr. Trapp significantly diluted the per acre figure for that farm resulting in an unreliably low value for Farm 2.
>
> Although no such fundamental errors were noted regarding the Mr. Trapp's appraisal of Farm 1, the errors noted above, coupled with the Court's observation of Mr. Trapp while testifying have led the court to conclude that the valuation offered by Mr. Trapp is not reliable.

The IRS expert, well-liked by the court, was described as follows:

> Perhaps the discussion could simply stop here. However, the court had the additional benefit of testimony from defense expert, John T. Scott, Ph.D. Dr. Scott has lived in Champaign County, Illinois, since 1965. He grew up on a farm in Ford County where he helped his father. After graduating from high school, he continued to work on the farm until he entered the University of Illinois from which he obtained his B.S. in agriculture in 1951. He also obtained a M.S. in agronomy and stayed in graduate school until leaving to enter the Army prior to completing his doctoral work. Upon his return, he farmed with his parents until leaving to work as a fieldman advising farmers. Dr. Scott starting [sic] doing appraisal work in 1958. He returned to graduate school and obtained his Ph.D. in economics in 1965. Thereafter, he started with the University of Illinois in August of 1965 as an Associate Professor in farm management and production economics. He became a full professor in 1971. During the decade of the 80's, Dr. Scott started doing approximately eight to ten appraisals per year. He taught courses in farm appraisal. In connection with that, he required the students to do a demonstration appraisal. He had to gather data and appraise farms in the Champaign County area in connection with this course. In order to grade student appraisals, Dr. Scott did his own appraisal. He is the chairman of the Federal Farmland Assessment Technical Advisory Committee of the Illinois Department of Revenue.
>
> Dr. Scott is a member of the Appraisal Institute (M.A.I.) which designation required course work, presentation of a demonstration appraisal, and successful passage of a comprehensive examination. He is a state certified general real estate appraiser, a status necessary in order to appraise property that has a mortgage guaranteed by the government or one that will ultimately be sold to the government. Dr. Scott has authored or co-authored over 300 publications, many in

real estate value and management. In sum, he has studied, taught, engaged in, and written about farm appraisals. He was a far superior witness and his credentials are far superior to Plaintiff's expert, Mr. Trapp. The difference between the two, both in terms of credentials and the Court's observation in trial was scientist versus knowledgeable layman.

The Court does recognize that Dr. Scott's appraisal work was done well after the valuation date. The Court has previously noted that the field work undertaken by Mr. Trapp was more thorough. However, Dr. Scott did take into consideration the relevant characteristics, both attributes and deficiencies, which had been noted by Mr. Trapp. Consequently, the Court does not feel the quality of the appraisal has suffered in any way. For example, Dr. Scott discounted the value of Farm 1 for subsidence and coal mine sinks, a permanent pasture, high tension wires, and the proximity of a slag pile. Further, regarding Farm 2, Dr. Scott recognized the irregular shape of the farm, as well as the presence of a drainage district that runs through and thus divides the farm.

One comparison regarding methodology is important to note. Dr. Scott rejected the notion that an appraiser could form an impression regarding what the value of a tract should be and then find comparables to support that value. The Court was left with the conclusion that Mr. Trapp followed such an approach. The Court agrees with Dr. Scott that an appraiser must inspect the land, find appropriate comparables, analyze those comparables, and then, comparing the comparables to the subject property, determine the value of the land.

4. IRS Valuation Course Book. A May, 1997 Valuation Course Book designed to train appeals officers, has been obtained from the IRS. The Course Book discusses Murphy in this way:

Transactions Structured for Tax Benefits

Where the evidence shows that a transaction was structured to attain a minority discount solely for the tax benefits, the Courts generally have not allowed a minority discount. In other words, the courts are inclined to look for economic substance (or business purpose aside from the tax consequences).

In Murphy, the decedent's accountant periodically advised decedent to reduce her stock ownership below 50 percent. Eighteen days before her death, she made gifts of .88 percent of the stock to each of her two children, resulting in her ownership of 49.65 percent at her death.

EXTRACT

Murphy, 60 T.C.M. 645, page 658

* * * * *

> [T]he facts in this case are extreme. Briefly, control was kept in and exercised continuously by the Murphy family, including decedent, followed by her children. Decedent implemented a plan 18 days before her death with the sole and explicit purpose to obtain a minority discount. We are aware of no case where a court has allowed a minority discount in this situation."

* * * * *

> Because the facts are extreme, the Murphy case does not have general application in many minority discount cases. But, if the facts do indicate a transfer was made solely to achieve a NUMERICAL minority without relinquishing any ACTUAL control, a minority discount would not be allowable.

This discussion seems somewhat at odds with the National Office position in partnerships that transfers of control should be disregarded.

The Course Book discusses the discount for built-in capital gains:

> HIDDEN DISCOUNTS
>
> Liquidation Expenses
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> The courts have never recognized components of liquidation expenses.
>
> Capital Gains Tax
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> The taxpayer might take a deduction for prospective income tax liability, such as capital gains tax on unsold, but appreciated property, held by the corporation. This hidden discount might appear either in the calculation of the corporation's income stream or as a liability in the corporation's computation of adjusted book value.
>
> The case law has indicated prospective capital gains tax and liquidation expenses are speculative and not includible in the valuation.
>
> However, since the General Utilities doctrine has been revoked by statute, (Tax Reform of 1986), a tax liability upon liquidation is not necessarily speculative.
>
> General Utilities Doctrine
>
> For 51 years, acquiring corporations could revalue the target corporation's assets to current fair market values, without paying a capital gains tax on the increase in the tax basis of target corporation assets

(target corporation did pay ordinary tax on recapture of depreciation, ITC, etc.) under the General Utilities doctrine. The doctrine is based on a federal court case, General Utilities and Operating Co. v. Helvering. Congress endorsed this doctrine by writing it into IRC sections 311, 336 and 337.

The Tax Reform Act of 1986 repealed the General Utilities doctrine for liquidations after 1986, generally. This has the effect of increasing the tax on the sale of a corporation. If the election is made under IRC section 338 to assign cost to underlying assets, the target corporation has an immediate tax liability, due to recognizing current fair market value gain on the deemed sale of all assets. The only way to avoid this immediate tax is to forgo the tax basis reorganization and to continue the target corporation on its old basis rather than on a new basis, that is, to continue the business of the target as a wholly owned subsidiary, rather than to liquidate it and merge it.

While, as noted above, since the repeal of the General Utilities doctrine, a tax liability upon liquidation is not necessarily speculative, in many instances, liquidation of the corporation cannot be contemplated. In a very typical circumstances, such as the valuation of a minority interest in a personal holding or real estate investment company, the holder of the minority interest cannot force the company into liquidation. As such, unless there is a reason to believe that the corporation cannot be contemplated and the deduction for capital gains tax should not be taken. In addition, the prospective capital gains tax expenses are considered speculative because unless liquidation of the taxes or their occurrence at all cannot be known with certainty because of the likelihood of changes in future tax laws. (See TAM 9150001.)

5. **Discounted Cash Flow Method**. The tax court used the discounted cash flow method of taxpayer's expert in Estate of Lehmann v. Commissioner, 74 T.C.M. 415 (1997), to value real estate subject to a 99 year lease owned by a limited partnership. Discounts were not at issue because the decedent owned a 1% general partnership interest.

The opinion summarized taxpayer's expert's report as follows:

Petitioner relies upon the report and testimony of its expert, P. Richard Zitelman. Zitelman is the president of The Zitelman Group, a firm providing investment advisory and investment services.

Zitelman also considered two methods of evaluating the fair market value of decedent's interest: (1) The liquidation method, and (2) the DCF method. Ultimately, Zitelman selected the DCF method because, in his view, a 'potential buyer' of decedent's interest would be an individual or entity seeking long-term cash-flows but having no expectation of receiving the return of its invested capital.

Under the DCF method, Zitelman estimated the fair market value of decedent's interest by calculating the present value of decedent's pro rata share of the partnerships' expected net cash-flows. He calculated the net income due pursuant to the lease and the net reversionary interest in the land.

For purposes of calculating the annual rent, Zitelman assumed that the fair market value of the unencumbered land, as of the valuation date and as of January 1, 1993, was $5,479,883. Thereafter, Zitelman assumed the value increased annually at a rate of 2.6 percent. He also assumed the rental rate for the lease period of January 1, 2013, through March 31, 2062, was 7.05 percent.

In estimating all of the expenses for 1992 except for the management fees and the franchise tax, Zitelman averaged the deductions reported upon the partnership's Federal income tax returns for taxable years 1989 through 1991. See appendix A. Thereafter, he treated the expenses as increasing at a rate of 2.6 percent per year.

Zitelman estimated the management fee as equal to 5 percent of the gross rental income and the franchise tax expense as equal to the product of the estimated net income and the tax rates in effect as of the valuation date.

Zitelman made several assumptions regarding the rate of return a hypothetical buyer would demand. He initially noted that, as of the valuation date, the rate of return of 30-year Treasury bonds was 7.9 percent and assumed that the applicable discount rate would have to be at least between 9.9 percent and 11.9 percent. Zitelman assumed that the discount rate necessary to achieve an acceptable rate of return required that such a discount rate should be increased for each of the following perceived risks: (1) The partnership agreement permits the general partners to make loans at (a) the prime rate to the partners for estate taxes, estate administrative expenses, and medical expenses or (b) the rate at which petitioner borrowed the funds; (2) there is a likelihood of a disagreement between the lessee and the partnership as to the future renal rates or the value of the property; (3) a potential buyer would have to invest substantial time, energy, aggravation, and cost to evaluate decedent's interest; (4) the partnership agreement granted the other partners a right of first refusal; and (5) the potential buyer did not have control over the partnership's management. Zitelman concluded that a hypothetical buyer would demand a purchase price based upon a discount rate between 15.3

percent and 22.6 percent. Ultimately, Zitelman averaged the present values calculated based upon these rates and assigned a fair market value to decedent's interest in the partnership of $399,000.

The court criticized the report as well:

> Although we accept that the DCF method is an appropriate approach in the instant case, we have found weaknesses in Zitelman's analysis. The DCF method generally requires assumptions regarding the future revenue, operating costs, and trends, see generally Estate of Cartwright v. Commissioner, T.C. Memo, 1996-286, but some of Zitelman's assumptions are unreasonable.
>
> We are not convinced that the perceived risks cited by Zitelman would depress the hypothetical purchase price as significantly as petitioner would have us believe. Zitelman correctly notes that the partnership agreement permits the general partners to lend money to the estate of a deceased partner, and obviously, in making such loans, the general partners would be motivated in part by their family ties to the deceased partner, but the partnership agreement also provides that the deceased partner's interest in the partnership must secure such a loan, and the loan must be at the prime rate or the rate at which the partnership borrows the funds. Accordingly, we do not see such lending as particularly jeopardizing the partnership's cash-flow.
>
> Nor do we find that the risk of future litigation over determining the rental rates or the fair market values of the unencumbered land substantially affected decedent's potential share of the cash-flows. To a large extent, the ground lease and the amendments eliminated these risks by setting forth a mechanism for settling such disputes through the use of appraisers.
>
> Similarly, we disagree with Zitelman's view that the hypothetical buyer would demand a higher rate of return because of the 'substantial amount of time, energy, aggravation, and cost' required to value decedent's interest. Although such an interest is not as easy to value as other investments, such as a 30-year Treasury bond or annuity, the present value of the cash-flows is, nevertheless, not so difficult or inconvenient to calculate as to justify a significant increase in such a rate of return. The partnership principally owns only one income-producing asset. Zitelman's own analysis evidences the relative ease by which decedent's interest may be valued.
>
> We are not convinced that the right of first refusal significantly affected the value of decedent's interest. The partnership agreement does not provide a price or a formula for determining the fair market value of the transferred partnership interest. The absence of a fixed price clearly has a less dramatic effect than fixed-price restrictions, see, e.g., Worcester County

> Trust Co. v. Commissioner, 134 F.2d 578, 581-582 (1st Cir. 1943), revg. Estate of Smith v. Commissioner, 46 B.T.A. 337 (1942); Estate of Reynolds v. Commissioner, 55 T.C. 172, 188-190 (1970); Mandelbaum v. Commissioner, T.C. Memo. 1995-255, affd. without published opinion 91 F.3d 124 (1996). Indeed, a right of first refusal without a fixed price does not limit the buyers to whom a seller could see the interest or the price for the interest, but merely governs the order in which prospective buyers must stand in line to purchase. Mandelbaum v. Commissioner, supra. Given the fact that such a right actually protects and benefits the other partners, the depressant effect (if any) upon the value of a privately held partnership interest subject to a right of first refusal is not necessarily substantial.
>
> Overall, from our perspective, Zitelman's report lacks a wholly objective analysis of the willing buyer/willing seller standard. Consequently, we do not find the report as compelling as petitioner suggests. Rather, Zitelman focuses exclusively upon the hypothetical willing buyer. Zitelman failed to consider whether a hypothetical seller would sell his or her interest in the partnership for $399,000. The test of fair market value rests upon the concept of a hypothetical willing buyer and hypothetical willing seller. We find incredible the proposition that any partner, limited or general, would be wiling to see his or her interest for such a low amount as to generate an internal rate of return of approximately 15 percent to 22 percent. Ignoring the views of a willing seller is contrary to this well-established rule. Id. In this regard, Zitelman's failure to consider a hypothetical willing seller of an interest in the partnership weakens his analysis.

The IRS had claimed a value of $1,100,000; Zitelman, $399,000; the court settled on $699,900. The opinion's comments about the willing seller are especially interesting. Saying that a willing seller would not sell at such a low value as to provide an internal return of 15% to 22% appears to be only another way of saying that the investment is not so risky as to require a 15% to 22% return.

6. **Effect of Buy-Sell Agreement**. At issue in Bommer Revocable Trust v. Commissioner, 74 T.C. M. 346 (1997), was the effect of a restrictive stock agreement on the value of shares included in the decedent's estate. Through a revocable trust the decedent had an interest in 86% of the stock of CamVic Corp. The decedent's wife owned 1.9%, and other members of the decedent's family owned the remaining shares.

In 1975 the shareholders entered into an agreement giving the other shareholders the option to purchase the decedent's stock at the decedent's death for $11,333 per share. The decedent died on September 10, 1990 and the estate valued the shares at $11,333 per share.

The Court used an analysis based on the Lauder case:

> In Estate of Lauder v. Commissioner, supra, we summarized these requirements:
>
> It is axiomatic that the offering price must be fixed and determinable under the agreement. In addition, the agreement must be binding on the parties both during life and after death. Finally, the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition. [Citations omitted.]

The analysis is similar to that of section 2703, in effect today.

The first issue was whether the decedent was bound by the Agreement:

> The original Buy-Sell Agreement, executed in May 1975, expressly provided that "This Agreement may be amended or altered by the written consent of the holder of at least seventy-five percent (75%) of the issued and outstanding shares of the Corporation." Decedent owned a beneficial interest (via the CWB Trust) in 86 percent of CamVic's outstanding stock on the date the Buy-Sell Agreement was executed and for the remainder of his life. This beneficial interest included the right to vote the shares. Thus, the plain wording of the Buy-Sell Agreement leaves no question as to the unilateral authority that decedent possessed. Decedent singlehandedly could have altered the price-per-share clause, as well as any other terms of the agreement.
>
> Ronald [the decedent's son] testified that the parties to the original agreement never intended that decedent should have the unilateral right to amend and that, in 1981 (6 years later), Ronald discovered this "error" in the agreement. We cannot accept this explanation. The evidence indicates that decedent was a man who liked to control his affairs. In 1975, he was 62 years old and in good health. The language of the agreement is clear. It was signed in 1975 by decedent, Ronald, and Kenneth Hughes. Mr. Hughes prepared the agreement and was also the trustee of the CWB Trust. We have no doubt that decedent, Ronald, and the attorneys at Santen, Santen Hughes recognized that the agreement gave decedent the authority to amend the agreement. Under these circumstances, we need not, and do not, accept Ronald's self-serving and uncorroborated testimony that the 1981 change was simply a correction of a scrivener's error in the 1975 Buy-Sell Agreement.

* * *

The next issue is whether the terms of the Revised Agreement executed in 1981 were binding on decedent. Pursuant to the Revised Agreement, the holders of at least 87.5 percent of CamVic stock could alter the terms of the agreement. While decedent held a beneficial interest in only 86 percent of the corporation's stock, his wife Marcella owned an additional 1.9 percent. Marcella did not actively participate in the affairs of the corporation. With Marcella's interest, decedent would have held the requisite amount of stock ownership to alter the agreement. Decedent also could have gained the required percentage if Marcella had predeceased him. We note that decedent's son, Ronald, and Ronald's three children, i.e., those shareholders with interests presumably adverse to the interests of an older majority shareholder, never had the ability by themselves to prevent decedent from amending the Revised Agreement. We view the Revised Agreement as an attempt to remedy an estate tax problem, while at the same time allowing decedent to retain the effective ability to alter the terms of the Revised Agreement.

For the foregoing reasons, we hold that neither the original Buy-Sell Agreement nor the Revised Agreement was binding on decedent during his lifetime. Nevertheless, even assuming that either agreement is construed as binding, petitioners still would not prevail because, as explained later, we believe that the Buy-Sell Agreement and Revised Agreement were testamentary devices to transfer decedent's interest in CamVic's stock to the natural objects of his bounty.

The Court also considered whether the agreements served a business purpose:

Petitioners raise several business purposes which they contend were furthered by the Buy-Sell Agreement. First, they maintain that the agreement was intended to preserve family control within the group consisting of the CamVic shareholders. The preservation of family ownership and control of a corporation has been recognized in certain cases as a legitimate business purpose. See <u>Estate of Bischoff v. Commissioner</u>, 69 T.C. at 39-40; <u>Estate of Littick v. Commissioner</u>, 31 T.C. 181, 187 (1958); <u>Estate of Lauder v. Commissioner</u>, supra.

Petitioners also assert that the Buy-Sell Agreement was intended to prevent Ronald from leaving CamVic. Respondent contends that the evidence fails to demonstrate that Ronald was uniquely qualified for any of his responsibilities at CamVic such that there was a bona fide business need to retain him.

Ronald began working for CamVic in 1959. Ronald testified that he supervised the construction of Dina Terrace, and he drew the plans for and supervised the construction of Dina Tower. When these apartments were completed, Ronald managed the properties for CamVic.

> Moreover, Ronald testified that he and decedent had conflicting business philosophies. Ronald stated that he believed CamVic should build and manage properties, whereas decedent had a build and sell philosophy. Ronald further testified that decedent had previously made impulsive business decisions which Ronald believed were to the detriment of CamVic. For instance, Ronald testified that decedent had constructed a golf course on land unsuitable for that purpose, purchased a mobile home park in a flood plain at a price above the land's appraised value, and insisted on purchasing nearly 4 acres of land for a car wash when a half acre was sufficient. Ronald stated that these concerns prompted him to approach Mr. Hughes, who, in turn, suggested the efficacy of a restrictive stock agreement.
>
> Following our review of the record, we find that Ronald's retention played some part in the creation of the Buy-Sell Agreement. At the time the agreement was created, Ronald was relatively young and had already worked at CamVic for over 20 years. During that time, he had gained solid experience through his work with CamVic's properties. Ronald also had concerns with respect to his security in the business. Under these circumstances, we conclude that it was reasonable for Ronald to attempt to solidify his future at CamVic through the creation of a restrictive stock agreement. We find that there was some business purpose for entering into the Buy-Sell Agreement and the Revised Agreement.

However, the Court concluded the agreements were a testamentary device:

> First, the purchase price set forth in the agreements was fixed at $11,333.30 per share. It was not subject to any periodic reevaluation in order to account for an increase in CamVic's value. We find it unrealistic to assume that decedent, as the majority shareholder, would have negotiated a fixed price for the agreements if he had been bargaining with unrelated parties.
>
> Petitioners argue that the Buy-Sell Agreement was not a testamentary device because real estate values fluctuate and decedent had personally experienced these fluctuations in his own business. We fail to see how concern about the fluctuation in the value of real estate or CamVic's shares could have been a nontestamentary purpose for decedent to have agreed to a fixed price per share. The Buy-Sell Agreement granted a purchase option; it did not require CamVic or the other shareholders to buy the shares if tendered. If the value of the shares declined, below $11,333.30, the rights to buy shares pursuant to the agreement would not be exercised. Therefore, neither decedent nor his estate was protected in the event of declining values. On the other hand, if the value of real estate in general, and CamVic in particular, rose, neither decedent nor his estate could sell the controlling interest in CamVic for more than $11,333.30. The only beneficiaries of an

increase in the value of CamVic's stock were the natural objects of decedent's bounty.

In addition to the fixed price per share, the generous payment terms of the Buy-Sell Agreement and the Revised Agreement are a further indication of their testamentary nature. Under the agreements, payments could be made pursuant to the following terms: A 10-percent cash downpayment and a promissory note to pay 10 annual installments with the unpaid balance accruing interest at a 5-percent annual rate. Petitioners' own expert witness stated that in the first half of 1975 banks were not granting loans to borrowers who had less than an AAA credit history, and the interest rate on business loans in excess of $1 million during this period was 11.81 percent. He also stated that in 1981 the prime interest rate exceeded 21 percent. Based on these figures, purchasers of CamVic under the agreements enjoyed the benefit of an interest rate that was less than one-half of the rate for 1975 and less than one-fourth of the rate for 1981.

We are also unpersuaded that decedent was anticipating a decline in value. There is no credible evidence suggesting that CamVic's value was declining at the time the original Buy-Sell Agreement was executed in 1975 or in 1981. Indeed, valuations of CamVic stock made between 1969 and 1974 indicate that CamVic's value was actually increasing during this time. On a gift tax return filed January 8, 1969, decedent reported the value of 9 shares of CamVic stock that he had gifted to Ronald at $7,091.07 per share. When CamVic later merged on June 21, 1971, with two other corporations owned by the Bommer family, the value of CamVic's stock for purposes of computing the exchange ratio for the merger was $14,192.45 per share. In addition, between 1972 and 1974, decedent made several gifts of CamVic stock to Ronald and his grandchildren. Each gift was valued for gift tax purposes at $15,105.74 per share.

Second, an inference of testamentary device can be drawn from the manner in which the parties elected the $11,333.30 price per share for the purchase of CamVic stock. Decedent was an experienced businessman, yet he failed to obtain a professional appraisal of CamVic, its subsidiaries, or its real properties. Instead, decedent did nothing more than consult with his attorney Mr. Hughes. Decedent and Ronald had one meeting with Mr. Hughes, who completed his computation, upon which the above price per share was based, in 1 day. No bona fide negotiations occurred with respect to the stock price, as Mr. Hughes and his law firm represented all parties to the Buy-Sell Agreement. Instead, the parties selected a value of $11,333.30 per share, a price which was approximately $4,000 less than the value decedent had reported for every gift of CamVic stock he made between 1972 and 1974.

The Court also determined that $11,333 was not the fair value of a share either when the agreements were entered into or at death.

7. **Valuation of Family Limited Partnerships**. The National Office continues to assert the inapplicability of discounts for a family limited partnership which owned farmland, where the partnership was formed when the decedent was terminally ill and about two months before his death. TAM 9730004.

8. **Valuation Where Securities Restriction Disappears at Death**. The Ninth Circuit has addressed an interesting fact pattern in Estate of McClatchy v. Commissioner, 81 AFTR 2d ¶98-5001. The decedent was subject to Rule 144 securities restrictions; the estate was not. What effect had the restrictions on the value of the stock?

The Ninth Circuit reversed the Tax Court and held that the stock should be valued pursuant to the restriction:

> The federal estate tax is a tax on "the transfer of the taxable estate of . . . decedent." 26 U.S.C. section 2001(a); see also United States Trust Co. v. Helvering, 307 U.S. 57, 60 (1939) ("[A]n estate tax is not levied upon the property of which an estate is composed. It is an excise imposed upon the transfer of or shifting in relationships to property at death."); Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) ("The tax is on the act of the testator not on the receipt of property by the legatees."); Young Men's Christian Ass'n v. Davis, 264 U.S. 47, 50 (1924)("YMCA")("What this law taxes is not the interest to which the legatees and devisees succeeded on death, but the interest which ceased by reason of the death."). The value of the estate includes "the value of all property to the extent of the interest therein of the decedent at the time of his death." 26 U.S.C. section 2033. At issue is whether the stock is to be valued in the hands of the decedent or the estate for estate tax purposes.
>
> There is no question that the estate tax is on the transfer of property at death and that, therefore, the property to be valued is the interest transferred at death, "rather than the interest held by the decedent before death or that held by the legatee after death." Propstra v. United States, 680 F.2d 1248, 1250 (9th Cir. 1982) (citing Estate of Bright v. United States, 658 F.2d 999, 1001 (Former 5th Cir. 1981)(en banc)). However, the Commissioner argues that, because the stock was transferred to a non-affiliate estate upon McClatchy's death, this is one of those rare cases in which death itself alters the value of the property. See

McClatchy, 106 T.C. at 214 (reasoning that the stock transferred "at the moment of death and passed to the decedent's estate," causing the securities laws restrictions to "evaporate[ ] at the moment of death"). According to the Commissioner, then, the stock is to be valued at its higher value in the hands of the non-affiliate estate because the property was transformed prior to distribution to the estate.

The Commissioner relies on Ahmanson Found. v. United States, 674 F.2d 761, 767-68 (9th Cir. 1981), and similar cases where death itself alters the value of the decedent's property. In Ahmanson, the decedent held, through a revocable trust, a controlling interest (600 shares) in voting common stock of HFA, a holding company which owned 81 percent of the stock of Home Savings & Loan Association. Also in the trust were all 100 shares (99 nonvoting and one voting share) of Ahmanco, a corporate shell with no assets prior to the decedent's death. At the moment of death, Ahmanco became unconditionally entitled to the 600 shares of voting HFA common stock, pursuant to declarations of trust. Under the same declarations, Ahmanson Foundation, a charitable organization, became entitled to the 99 nonvoting shares of Ahmanco, and the voting share remained in the control of Ahmanson's family. The court stated that valuation must "take into account any transformations of the property that are logically prior to its distribution to the beneficiaries," and so the Ahmanco shares were to be valued based on the 600 shares of HFA that passed at death. Id. at 767. The court noted that, although death itself does not usually alter the value of property owned by the decedent, in some instances, such as in the death of a key partner, death might change the value. Id. at 768 (citing United States v. Land, 303 F.2d 170, 172 (5th Cir. 1962)).

The Foundation argued that the Ahmanco shares should be split into two blocks for valuation, with its 99 nonvoting Ahmanco shares valued separately from the voting share. Id. The court declined to value the nonvoting shares separately from the voting share, reasoning that "'predistribution' transformations and changes in value brought about by the testator's death [must be distinguished] from changes in value resulting from the fact that under the decedent's estate plan the assets in the gross estate ultimately come to rest in the hands of different beneficiaries." Id. The court therefore concluded that the 100 shares should be "viewed in the hands of the testator," not as two separate assets, because "nothing in the statutes or in the case law . . . suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one." Id. at 768-69.

In Land, a partnership interest was restricted to two-thirds of its value during the partner's lifetime, but upon death, the surviving partners had to pay full value in order to purchase the interest. Because death "sealed the fact" that the interests would be purchased at full value, the court ruled that the full value controlled for estate tax purposes. 303 F.2d at 175. In Goodman v. Granger, 243 F.2d 264 (3d Cir. 1957), another case on which the Commissioner relies, an employment contract provided for the payment of benefits after the termination of employment, dependent upon contingencies which could cause forfeiture of the payments. Upon the employee's death, however, the possibility of any of the contingencies occurring was extinguished. The court reasoned that "[d]eath ripened the interest in the deferred payments into an absolute one;" consequently, the estate tax was measured by "the value of that absolute interest in property." 243 F.2d at 269.

In these cases, death clearly is the precipitating event and is the only event required to fix the value of the property. Similarly, the death of a key partner can instantly decrease the value of a business. See Ahmanson, 674 F.2d at 768. But in the instant case, death alone did not effect the transformation in the stock's value. The value of the stock was transformed only because the estate was a non-affiliate. Thus, contrary to the Commissioner's assertion, the property was not transformed prior to distribution to the estate. If the estate had been an affiliate, the securities law restrictions still would have applied. See 17 C.F.R. section 230.144(e)(3)(v) (setting forth restrictions on sale of securities by an affiliate estate but providing no limitation for a non-affiliate estate).

The affiliate or non-affiliate status of an estate depends on the status of the executor or other person who serves "in any similar capacity." 17 C.F.R. section 230.144 (a)(2)(ii). The personal representatives for the estate were not issued letters testamentary until 25 days after McClatchy's death. The restrictions therefore did not evaporate at the moment of death.

Making the amount of estate tax dependent on the affiliate or non-affiliate status of the executor contradicts the principle that valuation should not depend on the status of the recipient. See Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996) (the fact that decedent held a partial interest in property whose remaining interest was held in a trust that was included in decedent's estate did not allow the interests to be merged for 100% ownership of the assets by the estate); Ahmanson, 674 F.2d at 768 ("To take into account for valuation purposes the fact that the testator's unitary holding has become divided in the hands of two or more beneficiaries, would invite abuse."); Bright, 658 F.2d at 1006 ("It would be strange indeed if the estate tax value of a block of stock would vary depending upon the legatee to whom it was devised.").

The dissent stated:

> Applying the logic and language of Ahmanson to the instant case, McClatchy's death altered the value of his property by causing the shares to be passed to his non-affiliate estate, thereby voiding the restrictions that had previously attached on account of McClatchy's affiliate status. As in Ahmanson, the transformation at issue here -- the lapse of the securities restrictions -- went into effect prior to the distribution of McClatchy's property to his beneficiaries. Under Ahmanson, this pre-distribution transformation must be considered in determining McClatchy's estate tax liability.
>
> The hypotheticals offered by the Ahmanson court to illustrate the difference between pre-distribution and post-distribution transformations in a decedent's property fully support the Tax Court's decision. For example, the Ahmanson court posed the following scenario: "[I]f a public figure ordered his executor to shred and burn his papers, and then to turn the ashes over to a newspaper, the value to be counted would be the value of the ashes, rather than the papers." Id. Here, McClatchy's estate plan ordered that the stock be transferred to his executors prior to being distributed to his beneficiaries. Like the papers in the Ahmanson example, the stock should be valued in the aftermath of the pre-distribution transformation, free of the restrictions that attached while the stock was still in McClatchy's possession.
>
> The majority reasons that whereas the property transformation in the Ahmanson "ashes" example was occasioned by "death alone," the property transformation in the case at bar was occasioned by the non-affiliate status of decedent's estate. Given that the papers in the Ahmanson hypothetical were not burned and shred as a direct result of the decedent's death, but rather as the result of an order contained within the estate plan, I find the majority's distinction unconvincing.
>
> Moreover, I believe that the Fifth Circuit's opinion in United States v. Land, 303 F.2d 170 (5th Cir. 1962), which the majority cites in support of its decision, only bolsters the Tax Court's reasoning. The Land court held that in determining the federal estate tax, restrictions applicable by virtue of the decedent's status in life must be disregarded:
>
>> To find the fair market value of a property interest at the decedent's death we put ourselves in the position of a potential purchaser of the interest at that time. Such a person would not be influenced in his calculations by past risks that had failed to materialize or by restrictions that had ended. Death tolls the bell for risks, contingencies, or restrictions which exist only during the life of the decedent.

> Id. at 173. Here, McClatchy's death "tolled the bell" for the securities law restrictions that existed only during his lifetime. In the words of the Tax Court, the restrictions "evaporated at the moment of death."
>
> McClatchy attempts to confuse the issue by obscuring the difference between the transfer to his estate and the subsequent transfer to his beneficiaries or legatees. McClatchy maintains, for example, that "[c]hanges in the value of an asset which occur by reason of the identity and status of the recipient, not death, must be ignored for estate tax purposes." McClatchy's use of the generic term "recipient" blurs the line between the estate and the ultimate beneficiary of the decedent's property interest. Of course, it is well-established that changes in value resulting from distribution to beneficiaries or legatees are not accounted for in determining the federal estate tax. See, e.g., Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929). However, this court held in Ahmanson that there is a sharp distinction for estate tax purposes between pre- and post-distribution changes in the value of a decedent's property.

9. **Discount Levels**. In Dockery v. Commissioner, 75 T.C.M. 2032 (1998) the court allowed a 40% discount for a minority interest and for a lack of marketability. KPMG Peat Marwick did the appraisal for the taxpayer. The examining agent was Ray Wise who allowed a 35% discount.

In Estate of Furman v. Commissioner, 75 T.C.M. 2206 (1998) the court allowed a 40% cumulative minority interest and lack of marketability discount, plus a 10% key person discount. The court accepted the taxpayer appraiser's methods:

> Petitioners rely on the expert report of Francis X. Burns (Mr. Burns) and Brian R. Oliver (Mr. Oliver) of IPC Group, LLC (IPC). Messrs. Burns and Oliver are both experienced in business valuation and, in addition to their undergraduate degrees, hold master's degrees in finance from Northwestern University's Kellogg School of Management. Although Messrs. Burns and Oliver are not formally accredited as appraisers, we are satisfied that they are qualified to perform a business valuation. Fed. R. Evid. 702; see Martin Ice Cream Co. v. Commissioner, 110 T.C. ___, ___ (1998) (slip op. at 52).
>
> IPC valued the FIC shares using two approaches: A capitalized income method (income method) and a multiple of EBITDA method (EBITDA multiple method).
>
> Applying the income method, IPC determined per-share values for the stock transferred in the 1980 Gifts and the 1981 Recapitalization of $7,388 and $4,273,

respectively. Value was determined under the income method by capitalizing a measure of normalized earnings, adding the fair market value of nonoperating assets, and then applying a marketability discount to the per-share value. IPC determined normalized earnings using net operating cash-flow available to equity holders (NCF), adjusted to reflect noncash charges. In valuing the 1980 Gifts, IPC used the NCF for FY 1979, a 10-month fiscal year. A weighted average of the net operating cash- flows for the previous 3 years was used to compute the August 1981 fair market value of the stock.

IPC applied CAPM principles to determine the rate of return an investor would expect in February 1980 and August 1981. IPC used market data from Ibbotson Associates and determined that the expected rate of return an investor in FIC stock would demand would be equal to the sum of the applicable risk-free rate, risk premium, and small-stock premium, as well as an additional premium to account for the risk specific to FIC. To reflect the effect of nominal long-term earnings growth, IPC subtracted a growth factor from the expected rate of return and determined a capitalization rate of 21.38 percent for valuing the 1980 Gifts and a 25.50 percent capitalization rate for valuing the stock transferred in the Recapitalization.

After capitalizing normalized earnings to determine enterprise value from operations, IPC added the market value of FIC's nonoperating assets to determine total equity value. IPC computed a per-share equity value of $11,366 for the 1980 Gifts and $6,574 per share for the Recapitalization. IPC then determined that a marketability discount of 35 percent should be applied because of the following factors: (1) The transactions at issue involved minority interests, which are harder to sell; (2) the size of FIC precluded the possibility of a public offering; and (3), as of the relevant dates, no dividends had ever been paid by FIC on its common stock. After applying the marketability discount, IPC determined that the fair market value of the stock, per share, was $7,388 in 1980 and $4,273 in 1981. In comparison, book value per share after applying a 30-percent minority interest discount and a 35-percent marketability discount was determined to be $4,703 in 1980 and $5,048 in 1981. Applying book value as a floor in the valuation, IPC determined that use of the income method resulted in an undervaluation.

Petitioners have relied upon IPC's second method of valuation, the EBITDA multiple method. Under this method, a multiple of net earnings before interest, taxes, depreciation, and amortization (EBITDA) was used to determine total enterprise value. IPC determined the EBITDA of FIC for the FY 1979 through FY 1981. In valuing the 1980 Gifts, IPC used a multiple of FY 1979 EBITDA; a multiple of the weighted average of EBITDA for FY 1979 through FY 1981 was used to value the stock transferred in the Recapitalization. The parties have stipulated FIC's EBITDA for FY 1979 through FY 1981, using the figures determined by IPC.

> IPC determined that a multiple of 4 to 6 times EBITDA was a commonly used valuation guideline that should be applied in this case. IPC determined that high interest rates, a sluggish economy, and the high returns required by investors in small companies were factors that would depress the value of FIC stock, leading to a multiple in the order of 4.0 to 4.5, while the modestly successful sales growth of FIC between 1979 and 1981 suggested a multiple of 5.0 to 5.5. IPC concluded that FIC should be valued using an EBITDA multiple of 5.0 for both 1980 and 1981.
>
> After determining total enterprise value, IPC made various adjustments, such as subtracting the value of outstanding debt, to determine total equity value, which was then converted to equity value per share. Equity value per share was determined to be $20,842 in February 1980 and $26,245 in August 1981. After applying a 30-percent minority discount, a 35-percent marketability discount, and a 10-percent key-person discount, or a total of 59.05 percent in discounts, IPC determined a fair market value per share of $8,535 in February 1980 and $10,747 in August 1981; following these conclusions would result in an overstatement of $10,806 for Royal and Maude's 1980 taxable gifts, and zero taxable gifts for their transfers in 1981.
>
> We found Messrs. Burns and Oliver to be qualified, experienced, and credible expert witnesses. We agree with them that valuing FIC using the income method would not be appropriate inasmuch as the income method produces a value less than book value for August 1981. While it is odd that the use of an accepted method like this one would produce a value lower than book value, this oddity is explained by IPC's incorrect computation of book value for August 1981, and, we suspect, an overstated capitalization rate.

With respect to the appropriate discounts, the opinion states:

> Because the blocks of stock transferred in the 1980 Gifts and in the 1981 Recapitalization were minority interests, it is appropriate to apply a minority interest discount in their valuation. Since the willing buyer-willing seller test is an objective test, requiring that potential transactions be analyzed from the viewpoint of a hypothetical seller, whether a block of stock is a minority interest must be determined without regard to the identity and holdings of the transferee. See Estate of Watts v. Commissioner, 823 F.2d 483, 486-487 (11th Cir. 1987), affg. T.C. Memo. 1985-595; Estate of Bright v. United States, 658 F.2d at 1005-1006. Consequently, the fact that the 1980 Gifts enabled Robert Furman to gain control of FIC can not be considered.

Both parties agree that a minority discount should be applied in valuing both the 1980 Gifts and 1981 transfers by decedents in the Recapitalization, although we do not understand how respondent's expert determined that both a minority discount and a control premium should be applied, since the two are essentially opposites. We recognize that a hypothetical investor would not be willing to purchase a minority interest in FIC without a significant discount; no matter how successful the corporation, a minority interest in a corporation that does not pay dividends and whose stock does not have a ready market is of limited value.

Petitioners' expert cited three articles on minority discounts. The first, Bolten, "Discounts for Stocks of Closely Held Corporations", 129 Tr. & Est. 47 (Dec. 1990), summarized nine studies regarding discounts for minority interests that indicated a mean discount of 29.63 percent. The second article, "Survey Shows Trend Towards Larger Minority Discounts", 10 Est. Planning 281 (Sept. 1983), summarized the results of a study conducted by H. Calvin Coolidge that compared the actual sales of minority interests in closely held corporations to the reported book value of those corporations. The Coolidge study found an average discount of 39.9 percent and a median discount of 39 percent against book value. The third article cited by IPC, Pratt, "Discounts and Premia", in Valuation of Closely Held Companies and Inactively Traded Securities 38 (Dec. 5, 1989) (on file with The Institute of Chartered Financial Analysts), summarized several empirical studies regarding both minority and marketability discounts. By analyzing control premium data, Pratt found an implied minority discount of approximately 33 percent for 1980 and 1981 in the studied transactions. Based on the cited articles, IPC determined that a 30-percent minority interest discount was appropriate.

We do not believe that any control premium is warranted. We reject respondent's argument that a swing vote potential existed, since we have found that the transferred shares did not have swing vote potential. We are required to value the shares as if they were transferred to a hypothetical buyer and are not permitted to take into account the circumstances of the actual transferee in valuing the shares.

* * *

The factors limiting the marketability of stock in FIC in February 1980 and August 1981 included the following: (1) FIC had never paid dividends on its common stock; (2) the corporation was managed and controlled by one individual; (3) the blocks of stock to be transferred were minority interests; (4) a long holding period was required to realize a return; (5) FIC had no custom or policy of redeeming common stock; (6) because FIC's annual sales were only in the $7 million range, it was not likely to go public; and (7) there was no secondary market for FIC stock. While FIC had significant potential for controlled growth, a healthy balance sheet, and robust earnings growth, we find the factors limiting marketability to be significant.

In concluding that a 35-percent marketability discount should be applied, petitioners' expert cited four articles, including three studies on the sale of restricted stock that have been frequently brought to the attention of this Court. See, e.g., Estate of Jung v. Commissioner, 101 T.C. 412, 435-436 (1993); Mandelbaum v. Commissioner, T.C. Memo. 1995-255 (1995), affd. without published opinion 91 F.3d 124 (3d Cir. 1996); Estate of Lauder v. Commissioner, T.C. Memo. 1992-736; Estate of Friedberg v. Commissioner, T.C. Memo. 1992-310; Estate of Berg v. Commissioner, T.C. Memo. 1991-279, affd. in part and revd. and remanded in part 976 F.2d 1163 (8th Cir. 1992); Estate of O'Connell v. Commissioner, T.C. Memo. 1978-191, affd. in part and revd. in part 640 F.2d 249 (9th Cir. 1981). The first restricted stock study, Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-Held Company", 36 J. Taxn. 353 (June 1972), studied the transactions of four large, closed-end publicly traded investment companies that specialized in restricted securities. The study found mean marketability discounts of 33 percent after analyzing 89 restricted stock investments by the four investment companies. The second study, Moroney, "Most Courts Overvalue Closely Held Stocks", 51 Taxes 144 (Mar. 1973), is based on 10 registered investment companies that held a total of 146 blocks of restricted equity securities.

The Moroney study found an average discount on the restricted stock transactions of 35.6 percent. The third study, Maher, "Discounts for Lack of Marketability for Closely Held Business Interests", 54 Taxes 562 (Sept. 1976), is based on reports filed with the Securities and Exchange Commission by four mutual fund companies reporting their restricted stock transactions. The Maher study found a mean discount of 34.73 percent. The final study cited was an IPO study, Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock February 1992 through July 1993", Bus. Valuation Rev. 3 (Mar. 1994). The Emory study found an average marketability discount of 46 percent after comparing the share price in private transactions that occurred within 5 months of an IPO by the same corporation. We find petitioners' reliance on the restricted stock studies to be misplaced, since those studies analyzed only restricted stock that had a holding period of 2 years. Inasmuch as we expect the investment time horizon of an investor in the stock of a closely held corporation like FIC to be long term, we do not believe that marketability concerns rise to the same level as a security with a short-term holding period like restricted stock. In light of the foregoing, we find no persuasive evidence in the record

> to support our reliance on the restricted stock studies in determining an appropriate marketability discount.

The court allowed a key person discount:

> Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform services for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee. See Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976); Estate of Mitchell v. Commissioner, supra; Estate of Feldmar v. Commissioner, T.C. Memo. 1988-429; Estate of Yeager v. Commissioner, T.C. Memo. 1986-448. Although FIC could have purchased key-person life insurance on Robert's life, a minority shareholder could not compel FIC to purchase such insurance, and FIC had no such insurance in effect.
>
> We have found as facts that Robert was a key person in the management of FIC, that FIC had no second layer of management, and that Robert's contacts, experience, and managerial expertise were critically important to the success of FIC. While the operation of a franchised Burger King restaurant might appear to be formulaic, FIC was a growing organization, and Robert's responsibilities extended well beyond the operation of existing restaurants. Moreover, since BKC had considerable control over FIC's costs, expansion opportunities, competition, and ultimately profits, Robert's personal relationships with the founders of BKC were very helpful to the success of FIC. We therefore agree with petitioners and find that a key-person discount of 10 percent was appropriate in determining the value of FIC stock as of February 1980 and August 1981.

The total discount was 46%.

10. Market Absorption Discount. Estate of Auker v. Commissioner, 75 T.C.M. 2321 (1998) involved the calculation of a market absorption discount in apartment complexes owned by the decedent. With respect to the factors to consider, the opinion stats:

> Finding none of the experts dispositive to our decision in this case, we address the issue on the basis of the record before us, which is abundant with data on the subject properties and their marketability. In passing on whether a market absorption discount applies in the instant setting, and the amount of such a discount if it does apply, we utilize a five-part analysis. First, we examine the assets to be valued and categorize these assets by type. Second, we ascertain the market value (i.e., the fair market value without consideration of a

> discount for market absorption) of each asset in each category, assuming that each asset will be marketed separately. Third, we compare the number of assets in each category to the number of assets of that type which are traded in the market over a reasonable period of time. Fourth, we ascertain how much longer than this reasonable time period it would take to sell at market value (as defined above) each asset that could not be sold in this reasonable time period. Fifth, we discount the value of each asset in the category of assets that cannot be sold within a reasonable time period, taking into account the time value of money and the period of time that the category of assets would have to be marketed in order to sell each asset therein.

The court concluded:

> We must discount the value of each apartment complex that cannot be sold within a reasonable time, taking into account the time value of money and the time that each complex must be marketed in order to be sold. For purposes of our analysis, we use the following formula to calculate the applicable present value rates: 1--(1 +- i/n) -ny; i equals the discount rate, n equals the number of months over which the discount rate is compounded, and y equals the number of years involved. We round percentages to the third decimal point, and we round dollar amounts to the nearest dollar.
>
> The appraisers factored an 18-month marketing period into their market value of each apartment complex. Thus, we do not take the 18-month period after the applicable valuation date into account to arrive at the market absorption discount that applies herein. We have concluded that it would take a total of 42 months to sell all three complexes, or, in other words, 18 months after the end of the 6-month reasonable period of time starting 18 months after the applicable valuation date. Thus, one complex would sell within the reasonable time and the other two would not; of the two that would sell outside this time, one would sell 6 months after the end of it and the other would sell 18 months after the end of it.
>
> The appraisers applied 9.738-percent capitalization rates to Stonehenge and Fox Hill and a 10.238-percent capitalization rate to The Landings in order to ascertain their values. We believe that this capitalization rate reflects the time value of money, and that a weighted average of the rates (i.e., 9.905 percent) is the appropriate annual rate to use to determine the complexes' market absorption discount. As to the base to which this rate is applied, we use the average market value of the three complexes. We must determine how much lower than the market value a hypothetical seller will have to drop his or her price for each complex in order to sell all three within a reasonable time after the applicable valuation date. It would be inappropriate to apply the full discount to all

> three complexes because only two must be discounted in order to sell them within the reasonable time. However, if we were to discount two complexes, but not the other one, the discounted complexes, which are essentially similar to the remaining complex, but for the discount, would sell and the complex that was not discounted would not. To overcome this dilemma, we determine the discount on each complex that will not sell within the reasonable of time and apportion one-third of the aggregate discount to each complex so that a hypothetical buyer will buy all three complexes within the reasonable time. Because we are unsure which complexes will not sell within the reasonable time, we determine the discount on the basis of the complexes' average market value.

A discount of 6.189% was allowed.

11. **Undivided Interest in Realty**. Folklore says that a 15% - 20% discount for an undivided interest in real property is sustainable. Estate of Williams v. Commissioner, 75 T.C.M. 1758 (1998) allowed a 44% discount. The IRS would have allowed only a 5% discount, which corresponded roughly to the costs of partition. The court rejected this approach and relied on the taxpayer's expert. The opinion is worth reviewing in detail:

> The applicability and extent of a discount for a fractional interest is a question of fact to be decided based on the entire record. Estate of Fawcett v. Commissioner, 64 T.C. 889, 898 (1975); Estate of Campanari v. Commissioner, 5 T.C. 488, 492 (1945). Courts have held that the sum of all fractional interests can be less than the whole and have used fractional interest discounts to value undivided interests. Estate of Bonner v. United States, 84 F.3d 196, 197 (5th Cir. 1996); Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); see, e.g., Estate of Wildman v. Commissioner, T.C. Memo. 1989-667 (40-percent discount); Estate of van Loben Sels v. Commissioner, T.C. Memo. 1986-501 (60-percent discount).
>
> Respondent offered no evidence relating to the size of the discount that should apply, and concedes that a 5-percent discount should apply. Petitioners' expert, Wiggins, testified that the value of petitioner's undivided one-half interests in timberland should be discounted by 44 percent.
>
> a. WHETHER PETITIONERS' PROPERTY INTERESTS SHOULD BE DISCOUNTED ABSENT EVIDENCE OF ACTUAL SALES OF FRACTIONAL INTERESTS IN REAL PROPERTY
>
> Respondent contends that no discount larger than 5 percent should apply because petitioner offered no evidence of actual sales of fractional interests in real

property. We disagree. Pitts credibly testified that banks generally will not lend money to the owner of a fractional interest in real property without the consent of the coowner. We believe that Moses' and Pitts' inability to find sales of fractional interests in comparable real property in Florida shows that there was no market for fractional interests in such real property.

Respondent points out that neither Moses nor Elmore applied a discount for a fractional interest in real estate. We give little weight to the fact that Moses did not discount the property interests at issue here because petitioner retained him to value the fee simple interests in the properties, not petitioner's or decedent's undivided one-half interests in the properties.

b. WHETHER THE DISCOUNT SHOULD BE LIMITED TO SCRUBY'S ESTIMATE OF THE COST OF PARTITIONING THE PROPERTY INTERESTS

Respondent points out that respondent's 5-percent discount equals $41,300 (2,360 acres x $350 x .05) for the 1980 gift and $52,087.50 (2,315 acres x $450 x .05) for the 1983 gift. Respondent argues that we should not apply a discount greater than 5 percent because the 5-percent discount is greater than petitioners' expert's, Scruby's, estimate of the costs of partitioning the properties. We disagree. First, Wiggins estimated that partition costs here would be substantially more than respondent's 5-percent discount, that is, $164,400 for the Putnam County property, $172,500 for the Clay County property, and $76,500 for the estate property. Second, respondent's 5-percent discount does not give adequate weight to other reasons for discounting a fractional interest in real property, such as lack of control and the historic difficulty of selling an undivided fractional interest in real property, discussed below.

c. DISCOUNTS FOR LACK OF MARKETABILITY AND LACK OF CONTROL

Petitioners' expert, Wiggins, testified that the fractional interests at issue here should be discounted by 20 percent due to lack of marketability and by 30 percent for lack of control and the necessity of resorting to partition and related costs to liquidate one's interest, for a total discount of 44 percent. He concluded that a marketability discount is appropriate because of the 9-month marketing time and 10-percent real estate commission cost involved in selling real property in that particular market. He said that the holder of a fractional interest in real estate lacks control because he or she cannot unilaterally decide how to manage it. Wiggins noted that a partition action can take a considerable amount of time and expense. He estimated that partition costs would be $164,400 for the

1980 transfer, $172,500 for the 1983 transfer, and $76,500 for the estate property because the properties are irregularly shaped parcels and contain pineland, swampland, and riverfront acreage. Respondent did not cross-examine Wiggins or offer any evidence to rebut Wiggins, testimony. Respondent offered no evidence regarding the size of the discount that should apply here. See Hess v. Commissioner, 24 B.T.A. 475, 478 (1931) (Court adopted the taxpayer's contention of value where the Commissioner introduced no evidence to rebut the taxpayer's expert's testimony).

Respondent argues that Wiggins was not qualified to value real property because he is a business appraiser and not a real estate appraiser. Respondent contends that Wiggins provided no factual basis for his conclusions that a 20-percent discount for lack of marketability should apply. Respondent points out that Wiggins included in his report as evidence of the appropriate amount for marketability discounts a discussion of the illiquidity of privately held companies and discounts relating to sales of their stock. Respondent argues that we should give no weight to Wiggins' opinion because he did not consider the marketability of real property. Respondent argues that Wiggins, use of a 30-percent discount for lack of control for the cost of partitioning the properties was not supported by any verifiable data in his reports and far exceeds Scruby's estimated costs of partition.

We disagree that we should disregard Wiggins report because he is not a real estate appraiser. Wiggins is an experienced business appraiser who has given expert opinions in valuing fractional interests in partnerships, businesses, and real property. We believe that he correctly considered various factors affecting the potential costs of partitioning the properties in issue. He considered the time and expense of selling real property in that particular market. Wiggins appropriately considered all relevant facts and gave a reasonable explanation for the discount he applied to the property interests at issue here.

Respondent's expert, Elmore, applied no discount to petitioner's and decedent's property interests. He admitted, however, that an undivided one-half interest in real property has a limited market and that a fractional interest may be discounted, although he did not quantify the amount of the discount. This generally supports petitioner's claim that the Putnam and Clay County properties and the estate property should be discounted because they are undivided one- half interests.

G. SECTION 2032A -- SPECIAL USE VALUATION

1. **Easement as Disposition**. In Estate of Gibbs v. U.S., 81 A.F.T.R.2d 98-901 (D. N.J.) the court in an unpublished opinion held that under New Jersey law the granting of a conservation easement was not a disposition of the property under section 2032A.

> The question with which this Court is confronted is whether the Conservation Servitude as identified in the Deed of Easement constituted the disposition of an interest in plaintiff's specially valued farmland. To answer this question, the Court must determine how New Jersey law construes conservation or equitable servitude. The Conservation Servitude burdened the land in question here by imposing certain restrictions on its use and development, namely, that the land must be used as a farm in perpetuity. As a result of the Conservation Servitude, the land is considered part of a farmland preservation program, encompassed by New Jersey's Right to Farm Act. The land use restrictions imposed upon land in that program are covenants that run with the land. Such restrictions on the use of land owned by another are generally referred to as "equitable servitudes." They are enforceable only in equity. See Homann v. Torchinsky, 296 N.J. Super. 326, 333 (App. Div.), certif. denied, 149 N.J. 141 (1997).
>
> New Jersey adheres to the minority view which treats an equitable servitude as a contract right, not a property right. Thus, in New Jersey, an equitable servitude creates no possessory interest in the burdened land. The burden imposed is enforceable only as a contract right. See McComb v. Hanly, 132 N.J. Eq. 182 (1942)(cited with approval in Homann, 296 N.J. Super. at 334).
>
> Thus, it appears that under New Jersey law, a conservation or equitable servitude is not an interest in land, but is, as plaintiff argues, a contractual burdening of it. Defendant argues that the phrase "interest in land" should be read more broadly. Defendant contends that what plaintiff gave up was an "unqualified right to develop the farm property which is an interest in the real property." (See Br. at 11). Defendant cites no cases to support this contention. They rely on the language in the Deed of Easement which states that the Deed "transfer[s] and conveys to [the State] all of the nonagricultural development rights and development credits appurtenant to the lands and premises described herein." This argument, however, ignores the treatment of such language in New Jersey as a contractual burdening and not as a transfer of property rights. Moreover, as a practical matter, the State of New Jersey acquired no right to use or direct the use of the land, and no rights which can be sold or conveyed to a third party.

The Court's holding was narrow:

> The Court also notes that while the restrictions imposed on the land at issue here unquestionably further the purpose of the special use valuation provision of section 2032A, the Court's decision neither turns nor depends on that fact. In other words, the Court's decision should not be construed as carving out an exception for the particular land use restrictions imposed here, just by virtue of the fact that they have the effect of giving the United States "more than it originally bargained for -- farmland in perpetuity rather than being limited to a ten-year period." (See Plaintiff's Br. at 2). Rather, the Court determines, simply, that plaintiff did not dispose of any interest in the land in question. The estate tax recapture provision at issue here only triggers the recapture tax if there is a disposition of an interest in the specially valued property. Under New Jersey law, the burdening of this farmland with a conservation servitude was not a disposition of an interest in land; therefore, it did not trigger the recapture of estate tax. Accordingly, judgment must be awarded in favor of plaintiff.

H. SECTIONS 2035-2038 -- RETAINED INTERESTS

1. **Termination of Old GRIT**. In 1941 a taxpayer created a trust retaining the income for life with remainder to descendants, per stirpes. PLR 9815023 approves the termination of the trust and distribution of the assets among the beneficiaries on an actuarial basis as not being a gift by any of the beneficiaries. A gift of the entire remainder interest had been made when the trust was created. The ruling specifically does not consider whether the trust would be included in the taxpayer's estate if taxpayer died within three years of the termination.

2. **Rights Over Trust**. In PLR 9809032 the IRS determined that grantor's retained right to set trustee's compensation was not a retained right under section 2036. The facts of the ruling were:

> On May 7, 1982, Decedent created an irrevocable trust (Trust) and transferred certain life insurance policies to the trust. Individual and Corporation were appointed trustees of the Trust and continue to serve as trustees.
>
> Paragraph C of Article FIRST of Trust provides that the trustees are vested with all right, title, and interest in and to the policies of insurance that were transferred to the trust and any additional policies of insurance assigned to the trust by any person. Paragraph C also authorizes the trustees to exercise all

> options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance.
>
> Paragraph E of Article FIRST authorizes the trustees to receive all payments on insurance policies.
>
> Paragraph (4) of Article SECOND provides that, at the death of Decedent and if his wife predeceases him, the trustees shall pay $1,000,000 to Individual, if he survives decedent or, if not, to Individual's issue that survive Decedent. If the $1,000,000 amount is more than five percent of the Decedent's gross estate including the principal held by the Trustees, the amount shall be reduced so that it is no greater than five percent of Decedent's gross estate. The balance of the remaining principal shall be paid to the issue of the Decedent.
>
> Article THIRD provides that Trust's principal shall be divided into equal shares, one for each of Decedent's children who is then living and each of his children who has died leaving issue.
>
> Article THIRTEENTH provides that, during Decedent's life, the trustees shall receive compensation for their services as fiduciaries as is determined by Decedent. Individual is granted the authority to name a successor trustee provided any such successor trustee is a partner of Individual's law firm.

With respect to whether the decedent had an incident of ownership in the insurance policies, the ruling stated:

> Section 20.2042-1(c)(2) provides that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.
>
> In this case, Decedent transferred insurance policies to Trust during his life. Trust was irrevocable and authorized the trustees to exercise all options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance. The trustees were Individual and Corporation. Under these circumstances, Decedent did not have the incidents

of ownership in the policies as that term is defined in section 20.2042-1(c)(2).

3. **Inclusion of Gift Tax Paid Within Three Years of Death**. In TAM 9729005 the Service considered whether gift tax paid by a decedent's spouse should be included in the decedent's estate. In a community property state a couple created an irrevocable trust in which to make gifts. Husband wrote checks to wife from his separate property, and wife in turn made gifts to the trust. Wife did not have separate assets with which to make the gifts. The same procedure was followed to enable wife to pay the gift tax. Husband died within six months.

The Service applied a substance over form theory:

> It is a well established legal principle that the form of a transaction will be recognized for federal tax purposes only if it comports with the substance of the transaction. In Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149, for example, the donor in form made gifts of stock to his son and the son's wife. These gifts were designed to use the donor's annual exclusions. The son's wife immediately transferred the stock to the donor's son. Concerning this activity, the court stated:
>
> > The purported gift to John Cidulka's wife Charlesa is clearly a gift to John. For a number of years decedent had given shares to Charlesa, who had immediately transferred them to John. Our inference from this record is that the shares were given to Charlesa to be passed on to John, and were, in fact, a gift to John.
>
> Supra, at 1098. See also, Estate of Murphy v. Commissioner, T.C. Memo. 1990-472.
>
> In the present situation, the Decedent transferred to the Spouse the exact amount of cash needed to pay the gift taxes due on the Decedent's and the Spouse's returns. The only discernable purpose for this transaction was to reduce the Decedent's gross estate by the amount of the gift taxes paid. Thus, by running the payment through the Spouse's bank account, the Decedent attempted to do indirectly what he could not do directly. In substance, the Decedent paid gift taxes in the amount of $1,415,732 on gifts made by the Decedent and the Spouse during the three-year period ending on the date of the Decedent's death. The Decedent's gross estate, therefore, is increased by the amount of these gift taxes under section 2035(c).

I. SECTION 2040

1. Pre-1977 Property; Gallenstein Followed. The Tax Court has followed Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992), in Hahn v. Commissioner, 110 T.C. No. 14, (1998) holding that section 2040(b)(1) does not apply to spousal joint interests created before January 1, 1977. The opinion summarizes the statutory history as follows:

> Section 1001 governs the determination of gains and losses on the disposition of property. Commissioner v. Tufts, 461 U.S. 300, 304 (1983). Generally, gain or loss from the disposition of property is measured by the amount realized less the adjusted basis of the property. Sec. 1001(a). Section 1014 generally provides that the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death or on the alternate valuation date. Sec. 1014(a). A surviving joint tenant, however, is considered to have acquired property from the decedent only to the extent that the property was required to be included in the estate of the deceased joint tenant. Sec. 1014(b)(9). Correspondingly, the portion of the property not included in the decedent's estate retains the survivor's adjusted basis. Thus, determination of petitioner's basis in the CPW shares hinges on the portion of the property required to be included in her husband's estate.
>
> Section 2040 governs the value of jointly-owned property to be included in a decedent's estate. Before 1977, section 2040 provided that the gross estate includes the value of all property held at the time of a decedent's death by the decedent and another person in a joint tenancy or tenancy by the entirety, except such part of the entire value that is attributable to the amount of consideration in money or money's worth furnished by such other person. Thus, the rule established a "contribution test," whereby the estate of the deceased joint tenant must generally include the value of the entire property less the portion of the property attributable to the consideration furnished by the surviving joint tenant. The statute creates a rebuttable presumption that the value of the entire property is includable in the deceased joint tenant's estate, and the burden of showing original ownership or contribution to the purchase price by the surviving joint tenant falls upon the estate. Estate of Heidt v. Commissioner, 8 T.C. 969 (1947), affd. per curiam 170 F.2d 1021 (9th Cir. 1948); Estate of Balazs v. Commissioner, T.C. Memo. 1981-423, affd. without published opinion 693 F.2d 134 (11th Cir. 1982).
>
> In 1976, subsection (b) of section 2040 was added to the Code by section 2002(c)(1) of the Tax Reform Act of 1976

> (TRA 76), Pub. L. 94-455, 90 Stat. 1520, 1855. The 1976 amendment created a special rule where the joint tenants were husband and wife. If the interest was a "qualified joint interest," only one-half of the value of the property owned in joint tenancy was includable in the decedent's gross estate, without regard to which spouse furnished the consideration to acquire the jointly held property. TRA 76 sec. 2002(d)(3), 90 Stat. 1856, provided an effective date for the new 50- percent inclusion rule of section 2040(b), making it applicable to "joint interests created after December 31, 1976."
>
> Congress amended section 2040 again in 1978, with the addition of subsections (c), (d), and (3). Revenue Act of 1978, Pub. L. 95-600, secs. 511(a) and 702(k)(2), 92 Stat. 2763, 2881, 2932. Essentially, these subsections provided a mechanism whereby an election could be made to treat joint interests created prior to 1977 as "qualified joint interests" subject to the 50-percent inclusion rule of section 2040(b).
>
> The final relevant amendment to section 2040 took place in 1981. Subsections (c), (d), and (e), which had been adopted in 1978, were repealed. Economic Recovery Tax Act of 1982 (ERTA), sec. 403(c)(3), Pub. L. 97-34, 95 Stat. 172, 302. The definition of a "qualified joint interest" in section 2040(b)(2) was redefined to eliminate the requirement that the creation (or re-creation), of the joint interest be treated as a gift. ERTA Sec. 403(c)(1), 95 Stat. 301-302. However, the operational provision of section 2040(b)(1), providing for 50 percent inclusion, was not changed. The effective date provision of the 1981 amendment made these changes applicable "to the estates of decedents dying after December 31, 1981." ERTA sec. 403(e)(1), 95 Stat. 305.

In Baszto v. United States, 80 A.F.T.R.2d 97-7740 (M.D. Fla. 1997) the court followed Patten v. United States, 116 F.3d 1029 (4th Cir. 1997):

> The government argues that the effective date of the Economic Recovery Tax Act of 1981 controls application of 26 U.S.C. Section 2040(b) for determining, pursuant to 26 U.S.C. Section 1014, the basis of property acquired from a decedent. However, Congress did not expressly repeal the effective date of Section 2040(b)(1). Furthermore, the provisions are capable of coexistence and, consequently, preclude implied repeal. Radzanower v. Touche Ross & Co., 426 U.S. 148, 154, 96 S. Ct. 1989, 1993, 48 L. Ed. 540 (1976).
>
> The government invites the Court to disregard the unanimous authority supporting the plaintiff's position. The Court declines this suspect invitation from the IRS to embrace its uniformly rejected theory, and adopts the holdings of Patten v. United States, 116 F.3d 1029 (4th Cir. 1997), and Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992). Accordingly the plaintiff's motion

> is GRANTED and the defendant's motion is DENIED. The Clerk is directed to (1) enter judgment in favor of the plaintiff in the amount of $54,952.00, plus interest, for overpayment of federal income taxes for the 1989 tax year and (2) close this file.

2. Valuation of Joint Interests. Should real estate owned by spouses joint with right of survivorship be valued as the entire interest multiplied by one-half, or as a one-half interest in the property taking into consideration any appropriate discounts for partial interests? That issue was addressed by the Tax Court in Estate of Young v. Commissioner, 110 T.C. No. 24 (1998). The case involved a California decedent and the court first determined that the real estate involved was held joint with right of survivorship rather than as community property.

The opinion discusses the operation of section 2040:

> Petitioner argues that section 2040 is an includability section, determining the interest in the gross estate, not a valuation section. Petitioner notes that section 2040, like section 2033, contains the language "to the extent of the interest therein". After determining the inclusion of property under section 2033 or 2040, petitioner argues that sections 2031, 2032, and 2032A determine the value. Therefore, with the same goal in sections 2033 and 2040, petitioner argues that the language of section 2040 cannot be construed to prohibit fractional interest discounts and lack of marketability discounts, while such valuation discounts have been allowed under section 2033.
>
> In cases dealing with section 2033, the rationale for a fractional interest discount is based on the rights of the tenants in common under local law, arising from the unity of interest and unity of possession. A fractional interest discount may be appropriate when a partial interest in property would sell for less than its proportionate share. Estate of Iacono v. Commissioner, T.C. Memo. 1980-520. For example, decedent owns Real Property A with X as tenants in common. While decedent has an undivided one-half interest in the property, a willing buyer may discount the value of decedent's interest in Property A due to the fact that a buyer of such interest would own the property concurrently with the other tenant in common, and as such, there is the inconvenience of dealing with several owners, partition suits, and potential disagreements among the owners. See Estate of Barclay v. Commissioner, 2 B.T.A. 696 (1925); Estate of Youle v. Commissioner, T.C. Memo. 1989-138. Discounts for lack of marketability arise from the inherent difficulty in the sale of the asset.

In arguing for the application of fractional interest discounts and/or lack of marketability discounts in the context of section 2040, petitioner primarily relies on the Court of Appeals for the Ninth Circuit's decision in Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), where a fractional interest discount was allowed for community property under section 2033.

In Propstra, the Ninth Circuit upheld a 15-percent discount in the value of the decedent's undivided one-half interest in real property held as community property. Id. at 1253. The court noted that the Federal estate tax is an excise tax, levied on the privilege of transferring property at death. Id. at 1250 (citing Estate of Bright, 658 F.2d 999, 1001 (5th Cir. 1981)). The amount to be taxed is valued by the property actually transferred, rather than what is owned by the decedent before death, or the interest held by the legatee after death. Id. The Government argued that under a unity of ownership theory, a fractional interest discount was inapplicable because "one can reasonably assume that the interest held by the estate will ultimately be sold with the other undivided interest and that interest's proportionate share of the market value of the whole will thereby be realized." Id. at 1251. After considering the language of section 2031 and section 2033, the court was unwilling to impute "unity of ownership" principles for valuation purposes. Id. Further, the court looked at the "willing seller" as a hypothetical seller, rather than the estate or any of decedent's beneficiaries. Id. at 1251-1252.

In Propstra, the court allowed a fractional interest discount for community property. Contrary to petitioner's arguments, we find the situation presented in Propstra is not analogous to the current situation involving joint tenancy.

First, Propstra dealt with section 2033, which provides that the value of the gross estate shall include the value of all property to the extent of the interest therein held by the decedent at the time of his death, and not section 2040, the relevant provision in our case. Section 2033 looks to the interest held by the decedent at his death. With community property, each spouse owns a present vested one-half interest in the community property. Their respective interests in such property are individually wholly owned (that is, separate property), so that the decedent has no interest, title or ownership, marital or otherwise, in the other's interest in the community property. As a result under section 2033, one-half of the value of property held as community property (that being the decedent's interest in the property) is includable in a decedent's gross estate, and the surviving spouse's one-half of the value is excluded from decedent's gross estate. In light of this, Propstra v. United States, supra, looked at the undivided one-half interest held by the decedent at his death.

On the other hand, joint tenancy is a distinct property interest from tenancy in common and community property. The right of survivorship is the chief characteristic that distinguishes a joint tenancy from other interests in property. United States v. Jacobs, 306 U.S. 363, 370 (1939); Zeigler v. Bonnell, 126 P.2d 118, 120 (Cal. Dist. Ct. App. 1942). While a joint tenancy may be severed by mutual agreement or by a conveyance by one of the joint tenants during the lives of the joint tenants, the decedent cannot devise property held by the decedent and another in joint tenancy. Estate of Sullivan v. Commissioner, 175 F.2d 657 (9th Cir. 1949), rev'g 10 T.C. 961 (1948). Joint tenancy has been characterized as a specialized form of a life estate, with what amounts to a contingent remainder in the fee, the contingency being dependent upon which joint tenant survives. Id. The surviving joint tenant does not secure that right from the deceased joint tenant, but from the devise or conveyance by which the joint tenancy was first created. At the time of decedent's death, decedent's interest in the property is extinguished, with the joint tenancy automatically passing to the surviving joint tenant by the operation of law, avoiding the need for probate.

* * *

In arguing that section 2040 is a mere includability section, petitioner focuses on the language in "to the extent of the interest therein." According to petitioner, section 2040 merely determines the interest to be included in decedent's gross estate. In light of similar language in section 2033, petitioner argues that discounts should be available to joint tenancy under the valuation provision of section 2031.

We think petitioner's focus is incomplete. In addition to the cited language, section 2040(a) also provides the following introductory language: "The VALUE of the gross estate shall include the VALUE OF ALL PROPERTY to the extent of the interest therein held as joint tenants with right of survivorship BY THE DECEDENT AND OTHER PERSON". (Emphasis added.) While petitioner categorizes section 2031 as the only section to determine value and section 2040 as a mere inclusion section, we conclude that determining value is dependent on examining both section 2031 and section 2040.

Section 2031 provides the starting point, but it is very broad. In section 2031's accompanying regulations, we learn that value is determined by looking at the willing buyer and the willing seller, which then needs to be considered in conjunction with sections 2033 through 2044. Sec. 20.2031-1(b), Estate Tax Regs.

* * *

Under the scheme of section 2040(a), the amount includable in a decedent's gross estate does not depend on a valuation of property rights actually transferred at death, or on a valuation of the actual interest held by the decedent (legal title); instead, decedent's gross estate includes the entire value of property held in a joint tenancy by him and any other person, except to the extent the consideration for the property was furnished by such other person. See Estate of Peters v. Commissioner, 386 F.2d 404, 407 (4th Cir. 1967), affg. 46 T.C. 407 (1966). Contrary to petitioner's argument, the statute does not inquire how much a willing buyer would pay to purchase the decedent's interest in the joint tenancy at the date of his death, because, at the moment of death, decedent no longer holds any interest in the property. The property passes by right of survivorship, unlike property governed by section 2033 which passes under a decedent's will or by intestate succession. Even if prior to death, decedent sold his interest in the joint tenancy (and by doing so severed the joint tenancy with right of survivorship), the value that a willing buyer would pay does not necessarily compare to the approach taken by Congress in section 2040. Section 2040(a) provides an artificial inclusion of the joint tenancy property: the entire value of the property less any contribution by the surviving joint tenant. Except for the statutory exclusions in section 2040(a), there is no further allowance to account for the fact that less than the entire interest is being included.

As a result of this artificial inclusion, we conclude that section 2040 is not concerned with quantifying the value of the fractional interest held by the decedent (as would be the case under section 2033). The fractional interest discount, as applied in section 2033, is based on the notion that the interest is worth less than its proportionate share, due in part to the problems of concurrent ownership. These problems are created by the unity of interest and unity of possession. However, at the moment of death, the co-ownership in joint tenancy is severed, thus alleviating the problems associated with co-ownership. We conclude that the Young Property is not entitled to a fractional interest discount.

Similarly, a lack of marketability discount arises from an inherent difficulty in the sale of the asset. It has been applied in determining the value of works of art and the value of restricted securities. See, e.g., Estate of O'Keeffe v. Commissioner, T.C. Memo. 1992-210. In regard to the Young Property, there is no inherent difficulty in its sale. We conclude that a lack of marketability discount is not applicable to the Young Property.

Petitioner argues that respondent's position is based on the unity of ownership theory; i.e., the theory that because the surviving joint tenant succeeds to the interest of the deceased joint tenant, there can be nothing to apply a fractional interest discount against. We note that the unity of ownership theory has been

> rejected by the courts, as in Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), but we do not characterize respondent's position as relying on the unity of ownership theory. Instead, we are looking at the inherent property characteristics of joint tenancy and the approach taken by Congress to value the property under section 2040 and section 2031.
>
> We conclude that a fractional interest discount and a lack of marketability discount are inapplicable to the Young Property.

The opinion points out the tax-problem with owning property as joint tenants, namely no discount. An additional problem is that such property passes outside whatever estate planning documents have been prepared.

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

1. **Release of Non-General Power of Appointment**. PLR 9739006 considered the effect of the release of the right to receive income for ascertainable standards. The ruling discussed the issue:

> Under Items 3(iii) and 3(iv) of Trust, the trustee is required to distribute among the issue of Child all of the income from the equal part of Trust set aside for Child and Child's issue, unless Child has made a written request for any of that income and the trustee has determined that the requested income would be used for Child's support and maintenance in keeping with the standard of living enjoyed by Child on the date Trust was executed and medical, surgical, and hospital services reasonably necessary to maintain Child in good health. Further, the trustee cannot distribute income to Child without a written request by Child and without determining that the distribution would satisfy the purpose provided in Item 3(iii).
>
> Consequently, based on the trustee's representations, Item 3(iii) creates in Child a power to appoint to Child income from an equal part. This power is exercisable by Child in conjunction with the trustee, who is not a person with a substantial and adverse interest under section 2514(c)(3)(B). See, Estate of Towle v. Commissioner, 54 T.C. 368 (1970). However, Child's power of appointment under Item 3(iii) of Trust is limited by an ascertainable standard related to Child's support, maintenance, and health. Therefore, Child's power is a non-general power of appointment.
>
> This case is similar to section 25.2514-3(e), Example 2. In that example, income is accumulated unless L appoints it to L. Here, income must be paid to Child's issue, unless Child (with the consent of the trustee) appoints it to Child. Thus, because we conclude that

> Child's power is limited by an ascertainable standard, the release of the power will not be a transfer of property for gift tax purposes.

2. **Renunciation of Trust Interest**. PLR 9738016 addressed whether a beneficiary's renunciation of interests in a trust was the lapse of a general power of appointment. The beneficiary's interests in the trust were set forth:

> Trust is an inter vivos trust created by Decedent in 1961. Under the terms of Trust, A, Decedent's former spouse, had the right to receive all of the net income from Trust. In addition, the trustee had the discretion to distribute to A such amounts of principal as the trustee determined to enable A to meet the expenses of specified emergencies, and to provide for her support and maintenance.
>
> After A's death, under Item 3 of Trust, Trust income is to be distributed at four specified times each year, until the death of the last surviving child of Decedent and A. Under Item 3(i), on each distribution date, Trust income must be divided into as many equal parts as there are then living children of Decedent and A as well as deceased children of Decedent and A with then living issue. Under Item 3(ii), the trustee must distribute one equal part to a child with no then living children.
>
> With respect to a child that has living issue, under Item 3(iii), the trustee is given the power, in its sole discretion, upon written request from the child, to distribute any amount of income from an equal part to the requesting child for support and maintenance in keeping with the standard of living enjoyed by that child on the date Trust was executed and for medical, surgical, and hospital services reasonably necessary to maintain the child in good health.
>
> Under Item 3(iv), to the extent that income from an equal part is not distributed under Item 3(iii) to a child, the trustee is required to distribute that income equally among the issue of that child.
>
> On the death of the last survivor of the children of Decedent and A, Trust is to be distributed equally among the grandchildren of Decedent and A.

At issue was the power under section 3(iii):

> Consequently, based on the trustee's representations, Item 3(iii) creates in Child a power to appoint to Child income from an equal part. This power is exercisable by Child in conjunction with the trustee, who is not a person with a substantial and adverse interest under section 2514(c)(3)(B). See, Estate of Towel v. Commissioner, 54 T.C. 368 (1970). However, Child's power of appointment under Item 3(iii) of Trust is limited by an ascertainable standard related to Child's

> support, maintenance, and health. Therefore, Child's power is a non-general power of appointment.
>
> This case is similar to section 25.2514-3(e), Example 2. In that example, income is accumulated unless L appoints it to L. Here, income must be paid to Child's issue, unless Child (with the consent of the trustee) appoints it to Child. Thus, because we conclude that Child's power if limited by an ascertainable standard, the release of the power will not be a transfer of property for gift tax purposes.

PLR 9738019 reaches the same result in very similar circumstances.

3. **Veto Power**. At issue in PLR 9741009 was whether the following power was a general power of appointment:

> Article X appointed Spouse and Attorney 1 as the original trustees. Article X further provides that as each son attains the age of twenty-five, he will become a trustee of his trust. However, under Article XIII the son or other issue of Grantor, who is serving as a trustee, is prohibited from participating in any decision relating to discretionary distributions of income or principal. Each son is currently serving as a co-trustee of his own trust with Spouse, Attorney 1, and Attorney 2.
>
> Trusts 1 and 2 both provide that on the death, resignation, or inability of attorney 1 to serve as co-trustee, the vacancy will be filled by:
>
>> . . . such member of the firm of . . . as [Attorney 1] may designate in his Will or in any other written instrument delivered to his co-Trustees during his lifetime, but in the event he fails so to designate, or if his designee dies, resigns or is unable to serve, the said vacancy shall be filled, and shall continue to be filled, by such member of the firm of . . . as shall be designated by that firm, from time to time.
>
> It is proposed that Firm now will agree to a letter of understanding regarding the appointment of successor co-trustees from Firm after both Attorney 1 and Attorney 2 are no longer serving as a trustee. At such time as neither Attorney 1 nor Attorney 2 is serving as a co-trustee, Firm will appoint a successor co-trustee as provided under the terms of the trust instruments. However, the proposed agreement provides that if Firm's designee as successor co-trustee does not meet with the approval of Spouse (or if she is unable to indicate her approval, then the majority of the sons), Firm will make another designation from among the members of Firm. This procedure will continue each time a vacancy occurs. The power of disapproval is referred to as a "veto power."

> In addition, the proposed agreement provides that if no proposed designee is approved, Firm will decline to name a successor trustee. A petition will then be filed with the court having jurisdiction over the trusts to appoint a substitute co-trustee who is not related or subordinate to any of the beneficiaries, as defined in section 672(c). Firm will agree to assist in connection with the filing of the petition.

The Service determined there was no general power:

> In this case, Spouse (or sons if Spouse is incapable of acting) will have the power to veto any trustee that is appointed by Firm. If no member of Firm is acceptable to Spouse (or sons), a court will appoint an independent trustee who is not related or subordinate to any trust beneficiary (within the meaning of section 672(c)). Although Spouse and sons serve as co-trustees, they are prohibited by the trust instrument from participating in any discretionary decisions to distribute income or principal to the trust beneficiaries. Thus, the independent trustee's discretion is the sole standard for distribution. Consequently, neither Spouse's and sons' retained power to veto a replacement trustee selected by Firm nor their right to petition the court to select an independent trustee that is not related or subordinate to any beneficiary of the trust constitutes a general power of appointment under sections 2041 and 2514.
>
> Based on the facts submitted and representations made, we conclude that Spouse and sons will not be deemed, under sections 2041 and 2514, to have a general power of appointment over the income and principal of any of the trusts by virtue of their power to veto a replacement trustee and their right to petition the court to select an independent replacement trustee. Accordingly, the assets of the trusts will not be included in the gross estate of Spouse or sons and will not be deemed transferred by Spouse or sons for gift tax purposes.

4. **Power Not Limited By Ascertainable Standard But Exercisable With Consent of Adverse Party**. PLR 9809037 considered the application of section 2041 to a trust the dispositive provisions of which were stated as follows:

> Under the terms of Trust, the trustees are authorized to distribute to Daughter A and her descendants such amounts of income and principal as the trustees in their discretion may deem for the best interest of the distributees as a class, considering the age and condition of health of each of them from time to time, the income and means of support available to them and each of them from other sources known to the trustees, and the reasonable cost of support, maintenance and education of each beneficiary according to his or her station in life. The trust will terminate on the later

> of the death of Daughter A or when Daughter A's children all have attained age 21 (or die before attaining such age). Upon termination, the Trust estate is to be distributed outright to Daughter A's then living children or their descendants, per stirpes, if a child predeceases termination. On Daughter A's death, if Daughter A has no living descendants, then the trust property will pass to the beneficiaries of another trust.

Daughter A, Child A, and Child B were to become the sole trustees of the trust, replacing 5 other trustees. The ruling states:

> The proposed reduction of the board of trustees from five members to three members will not affect the exempt status of the Trust under section 2601. However, we note that it is proposed that Child A, Child B, and Daughter A will act as trustees, and as trustees, will have the power (by majority vote) to distribute trust property to themselves as provided in the trust instrument. Under the proposed arrangement, Daughter A does not have a general power of appointment because the power to distribute trust property will require the consent of a remainderman (child A or Child B), a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of Daughter A. See section 20.2041-3(c)(2), example 1. Likewise, Child A and Child B will not have a general power of appointment, because the exercise will require the consent of a person having a substantial interest adverse to either child. We express no opinion as to whether Daughter A, Child A, or Child B will have a general power of appointment if any of the proposed trustees is replaced at some point in time by a new trustee.

5. **Beneficiary's Powers**. PLR 9818054 considered a trust which gave two powers to the beneficiary. The first was the right to withdraw principal with the consent of the trustees:

> Paragraph (c) of article IV provides the terms of the Taxpayer's separate trust. Until the Taxpayer reaches age 25, the trustees have discretion to distribute any or all of the net income to the Taxpayer as in the opinion of the trustees is reasonably necessary for her welfare, support, comfort and happiness. When the Taxpayer reaches age 25, the trustees must distribute all of the trust income to her. In addition, after reaching age 30, the Taxpayer may withdraw up to one-fourth of the principal of her trust "with the consent and approval of the trustees" and after reaching age 35, she may withdraw up to one-third of the remaining principal "with the consent and approval of the trustees." Further, under paragraph (h) of article IV, the trustees may distribute to the Taxpayer any amounts of principal from her trust as the trustees "in their

> uncontrolled discretion may deem advisable." The Taxpayer is over age 35.

Such a power would be taxable under sections 2041, unless the trustees were adverse (§2041(b)(1)(C)(ii)). This power, however, had been created prior to October 21, 1942:

> Under section 2041(b)(1)(B), a power of appointment created on or before October 21, 1942 (a "pre-1942 power") which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.
>
> Under section 2041(b)(3), a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will died before July 1, 1949, without having republished such will, by codicil or otherwise, after October 21, 1942.

The second power was the right to remove the trustee:

> The individual trustees or trustee at any time acting hereunder shall have the power at any time and from time to time, by a written instrument signed by such trustees or trustee, to remove the corporate Trustee then acting hereunder. In the event of the resignation, removal, refusal, or inability to act of the corporate Trustee at any time, the individual Trustees or Trustee then acting hereunder must, by written instrument signed by them, appoint as successor corporate Trustee hereunder, any bank or trust company, wherever situated, having a capital and surplus of not less then One Million Dollars ($1,000,000), as evidenced by its last authentic published statement.
>
> It is represented that this removal and replacement power has never been exercised. The current co-trustees of the Taxpayer's trust are the Taxpayer, the Taxpayer's brother, and Bank.
>
> As authorized under paragraph (c) of article V, the Taxpayer and the Taxpayer's brother plan to remove Bank as their co-trustee and replace Bank with another corporate trustee. It is represented that any successor corporate trustee will not be related or subordinate to the Taxpayer.

The IRS discussed the effects of this power:

> Under paragraph (c) of article V, the Taxpayer has the power to remove and replace the acting corporate trustee with another corporate trustee. Paragraph (c) of article V expressly requires that the Taxpayer replace the corporate trustee with another corporate trustee. Further, because the Decedent's will requires that there must always be a corporate trustee, the Taxpayer cannot

> appoint herself in lieu of a corporate trustee, under any provision of the will, and the Taxpayer can never be the sole trustee. Thus, for purposes of sections 20.2041-1(b)(1), 25.2514-1(b)(1), 20.2036-1(b)(3), and section 20.2038-1(a)(3), the Taxpayer does not have the power to remove a corporate trustee and appoint herself. Instead, the Taxpayer's removal and replacement power is similar to that under Rev. Rul. 77-182, in which the decedent grantor retained the power to replace the corporate trustee with another corporate trustee. Consequently, we conclude that the Taxpayer's power under paragraph (c) of article V is not a power of appointment under section 2041 and 2514.

Revenue Ruling 77-182 was summarized in this way:

> Under Rev. Rul. 77-182, 1977-1 C.B. 273, the value of the trust estate is not includible in a decedent grantor's gross estate under section 2036, where a corporate trustee determines distributions of income among the grantor's children and the decedent retained the right to appoint a successor corporate trustee if the designated trustee resigned or was removed by judicial process.

6. **Amendment to Delaware Asset Protection Trust Statute**. Section 3573 of the Delaware Statutes has been amended. Alimony creditors can reach the assets of a properly created asset protection trust, as can tort creditors but only if the damage occurs before the date of a qualified disposition to the trust.

A qualified disposition is a gift to a trustee. Other key definitions under the statute are:

> "Trustee" means a person who:
>
> a. In the case of a natural person, is a resident of this State or, in all other cases, is authorized by the law of this State to act as a trustee and whose activities are subject to supervision by the Bank Commissioner of the State, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision or any successor thereto; and
>
> b. Maintains or arranges for custody in this State of some or all of the property transferred to the trustee, maintains records for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of fiduciary income tax returns for the trust, or otherwise materially participates in the administration of the trust.

> "Trust instrument" means an instrument appointing a trustee for the property that is the subject of a disposition, which instrument:
>
> a. Expressly incorporates the law of this State to govern the validity, construction and administration of the trust;
>
> b. Is irrevocable, but a trust instrument shall not be deemed revocable on account of its inclusion of 1 or more of the following: A transferor's power to veto a distribution from a trust, a testamentary special power of appointment or similar power vested in the transferor, or the transferor's potential or actual receipt of a distribution of income, principal or both, in the sole discretion of a trustee who is neither the transferor not a related or subordinate party of the transferor within the meaning of 26 U.S.C. § 672(c); and
>
> c. Provides that the interest of a beneficiary in the trust property or the income therefrom may not be transferred or assigned, whether voluntarily or involuntarily, before the trustee distributes the property or income to the beneficiary.

The beneficiary should not be able to receive distributions under an ascertainable standard and neither the beneficiary, nor a person related or subordinate to the beneficiary under section 672(c) of the Code, may be trustee.

Of interest in connection with the Alaska and Delaware asset protection trust statutes is Matter of Shurley, 115 F.3d 333 (5th Cir. 1997), in which the court reversed a Bankruptcy Court decision that the entire trust of a Texas debtor was a part of the debtor's bankruptcy estate. The trust had been created by the debtor's parent and sister, and by the debtor. The trust contained a spendthrift clause; income from the debtor's part of the trust was distributed to the debtor, and principal could be distributed to the debtor or the debtor's descendants for their maintenance and support in their accustomed manner of living. Under Texas law, only the debtor's portion of the trust could be reached by the creditors.

Mississippi has created a public policy exception for tort claimants to the general rule that spendthrift trusts are unreachable by creditors. Sligh v. First National Bank of Holmes County, 704 So. 2d 1020 (Miss. 1997). The spendthrift doctrine is judicial in Mississippi, created by Leigh v. Harrison, 11 So. 604 (1892) and Calhoun V. Markow, 151 So. 547 (1933). The opinion states:

> Upon examination of the two Mississippi cases, Leigh and Calhoun, one can identify three public policy considerations observed by this Court when enforcing spendthrift trust provisions: (1) the right of donors to dispose of their property as they wish; (2) the public interest in protecting spendthrift individuals from personal pauperism, so that they do not become public burdens; and (3) the responsibility of creditors to make themselves aware of their debtors' spendthrift trust protections. Upon consideration of these public policy concerns in the present context, we find that they do not weigh in favor of enforcing spendthrift trust provisions as against the claims of tort creditors or those found liable for gross negligence.

With respect to the second and third policies, the court found that protection from tort creditors was not the purpose:

> Regarding the responsibility of creditors when entering into transactions with spendthrift trust beneficiaries, Austin W. Scott stated in The Law of Trusts:
>
> > In many of the cases in which it has been held that by the terms of the trust the interest of a beneficiary may be put beyond the reach of his creditors, the courts have laid some stress on the fact that the creditors had only themselves to blame for extending credit to a person whose interest under the trust had been put beyond their reach. The courts have said that before extending credit they could have ascertained the extent and character of the debtor's resources. Certainly, the situation of a tort creditor is quite different from that of a contract creditor. A man who is about to be knocked down by an automobile has no opportunity to investigate the credit of the driver of the automobile and has no opportunity to avoid being injured no matter what the resources of the driver may be.
>
> Scott, supra. Likewise, George T. Bogert reasoned in Trusts and Trustees:
>
> > It is true that a tort creditor has had no chance to choose his debtor and cannot be said to have assumed the risk of the collectibility of his claim. The argument for the validity of spendthrift trusts based on notice to the business world of the limited interest of the beneficiary does not apply. It may be argued that the beneficiary should not be permitted to circumvent the case and statute law as to liability for wrongs by taking advantage of the spendthrift clause.

> George T. Bogert, Trusts and Trustees S 224 (2d ed. Rev.1992). As these scholars point out, it is plain to see that one of the main reasons for enforcing spendthrift trust provisions--the responsibility of creditors to be aware of the law and of the substance of such provisions--simply does not apply in the case of tort judgment creditors.
>
> As for the public interest in protecting spendthrift individuals from personal pauperism, we believe that this interest is not as strong in the case of tort judgment creditors, where the inability to collect on their claims may well result in their own personal pauperism. While it is true that most contract creditors do not risk becoming insolvent if they do not collect on a particular claim, such is often not the case with tort judgment creditors, particularly those who have suffered such devastating and expensive injuries as did the Slighs. The public interest against individuals becoming public burdens would not be served by protecting a spendthrift tortfeasor from personal pauperism where such protection would result merely in the pauperism of his victim. If one must choose whom to reduce to personal pauperism in such a case, the spendthrift tortfeasor or the innocent tort judgment creditor, we are inclined to choose the party at fault, especially where that fault rises to the level of gross negligence or intentional conduct.

The court had more difficulty with the right of persons to bequeath property as desired:

> Clearly, the right of donors to place restrictions on the disposition of their property is not absolute, for as discussed above, there are several generally recognized exceptions to the spendthrift trust doctrine. Rather, a donor may dispose of his property as he sees fit so long as such disposition does not violate the law or public policy. We find that it is indeed against public policy to dispose of property in such a way that the beneficiary may enjoy the income from such property without fear that his interest may be attached to satisfy the claims of his gross negligence or intentional torts.
>
> Our tort doctrine has evolved into two types of torts, ordinary torts and intentional torts. Public policy deems it so important to deter the commission of intentional torts or acts of gross negligence, that we allow victims of gross negligence or intentional torts to recover damages above and beyond what is necessary to compensate them for their injuries, i.e., punitive damages. However, the intended deterrent effect would be completely lost upon individuals whose interests are immune from the satisfaction of such claims.
>
> The Slighs have alleged facts to the effect that Lorance's mother intended that her son should be able to

> commit acts of gross negligence or intentional torts without fear that his beneficial interests would be attached as a result thereof. However, in cases such as this where the donor has died, such facts may often be difficult, if not impossible, to prove. We hold that plaintiffs need not prove such facts but that such intent shall be presumed where a party has obtained a judgment based upon facts evidencing gross negligence or an intentional tort against the beneficiary of a spendthrift trust. Furthermore, we state the natural corollary that when assessing punitive damages against a tortfeasor found to have committed gross negligence or an intentional tort who is a spendthrift trust beneficiary, the beneficiary's interest should be taken into account as a factor in determining his monetary worth. However, in order to uphold spendthrift trust provisions so much as is reasonably possible, we hold that the beneficiary's interest in a spendthrift trust should not be attached in satisfaction of a claim until all of his other available assets have first been exhausted.

The dissenting justices expressed concern:

> I must respectfully dissent to the limitations placed by the majority on the exempt status of spendthrift trust benefits. The majority acknowledges that Louisiana is the only other State to place such limitations on spendthrift trust benefits for tort creditors, and said limitations were implemented by the Louisiana legislature rather than the courts of said state. This Court is thus, apparently, the first to so limit the exempt status of spendthrift trust benefits. I am aware of the public policy considerations which motivated the majority's decision, but, in my view, the general rule favoring the exempt status of spendthrift trusts benefits is a sound one which is in no need of revision.
>
> Spendthrift trusts provide a means for a parent or other concerned party to provide for the basic needs of a beneficiary, and the largely exempt status of the trust benefits has given comfort and support to countless settlors and beneficiaries. The facts of the present case are tragic, but this Court should, in my view, avoid changing longstanding precedent based on the fact pattern of a particular case. Creditors in this state have at their disposal a number of means of collecting judgments, and I fear that the majority opinion signals the start of a gradual decline of the spendthrift trust in this state. I would affirm the ruling of the trial court, and I must accordingly dissent.

A petition for rehearing was denied.

K. SECTION 2042 - LIFE INSURANCE

1. **Private Split-Dollar**. In PLR 9745019, the IRS ruled favorably on a private split-dollar life insurance arrangement. Husband and Wife entered into the arrangement with an irrevocable trust and a second to die policy. The ruling describes the arrangement:

> The taxpayers initially funded the primary trust with a cash gift. With this initial contribution the trustee purchased, and paid the first premium on, a second-to-die life insurance policy covering the lives of the taxpayers. The irrevocable trust was named the owner and beneficiary of the policy. The taxpayers and the trustee propose to enter into a collateral assignment split-dollar agreement with respect to any policies held by the trust.
>
> Under the collateral assignment split-dollar agreement, the trustee is designated the owner of the policy. During the joint lives of the taxpayers, the trustee will pay that portion of the annual policy premiums equal to the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first taxpayer to die, the trustee will pay that portion of the annual policy premiums equal to the lesser of 1) the applicable amount provided in the P.S. 58 tables set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, or 2) the insurer's current published premium rate for annually renewable term insurance general available for standard risks. The taxpayers will pay the remaining portion of the annual premium. The entire premium may be remitted by the taxpayers, and, if the taxpayers remit the total premium, the trustee is obligated to reimburse the taxpayers within 30 days for the trustee's portion of the premium.
>
> The split-dollar agreement may be terminated at will by either the trustee or the taxpayers if the value of the assets held by the trust, excluding the value of the insurance policy, but including the loan value of the policy, equal or exceed the amount that is to be paid to the taxpayers upon termination as set forth below. In all other cases, the split-dollar agreement may be terminated only through the mutual consent of the trustee and the taxpayers. The agreement will also terminate upon the bankruptcy of the taxpayers, the failure of the trustee to timely reimburse the taxpayers, the failure of the taxpayers to pay the premiums, or the death of the survivor of the taxpayers.
>
> If the agreement is terminated prior to the death of the survivor of the taxpayers, the survivor of the taxpayers will be entitled to receive an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). For a 60-day period after the date of termination the owner has the option of obtaining a release from the collateral

assignment by returning to the insureds (taxpayers) or the survivor an amount equal to the then cash surrender value of the policy less the cash surrender value at the end of the initial policy year. If the owner fails to exercise this option, the insureds or the survivor have the right to surrender the policy and obtain the cash surrender value less the cash surrender value at the end of the initial policy year.

If the agreement is terminated as a result of the death of the survivor of the taxpayers, the estate of the survivor of the taxpayers (or its designated beneficiaries) will be entitled to receive an amount equal to the cash surrender value of the policy immediately prior to the death of the survivor of the taxpayers less the cash surrender value at the end of the initial policy year.

In order to secure the taxpayers' interest (or the interest of the estate of the survivor) in the policy, the trustee will assign to the taxpayers, under a collateral assignment agreement, certain rights in the policy. Under the agreement, the following rights are assigned to the taxpayers: 1) the right to receive a portion of the proceeds payable on the survivor's death equal to the taxpayers' interest under the split-dollar agreement; and 2) the right to receive the cash value of the policy if the policy is surrendered by the trustee, less the cash surrender value amount at the end of the initial policy year. All other rights with respect to the policy are reserved to the trustee and all such rights may be exercised solely by the trustee subject to the taxpayer's security interest.

With respect to the income tax consequences of the arrangement, the ruling stated:

The arrangement in Rev. Rul. 78-420 arises out of the employer-employee relationship between the employee and the corporation. The arrangement is of the type contemplated by Rev. Rul. 64-328, and, consequently, the premium payments by the corporation are deemed to be compensatory in nature and income to the employee. The employee is then deemed to make a gift of this income to his spouse.

Unlike the relationships contemplated in the above mentioned revenue rulings, the premium payments by the trustee of the trust, in the present case, are not compensatory in nature. The taxpayers have no employer-employee relationship with the trustee of the trust. The taxpayers made a taxable transfer to the trust at its inception and they receive nothing else of value, compensatory or otherwise, when the premium payments are made.

Under the terms of the split-dollar agreement, the taxpayers will pay the portion of the premiums in excess

> of that paid by the trustee. If the agreement is terminated prior to the death of both taxpayers, the surviving taxpayer or taxpayers will receive, as reimbursement for their premium payments, an amount equal to the cash surrender value of the policy, less the cash surrender value at the end of the initial policy year. The death of the last taxpayer to die, the estate of that taxpayer will receive, as reimbursement for the premium payments, an amount equal to the cash value of the policy immediately prior to the taxpayer's death, less the cash surrender value at the end of the initial policy year. Since the taxpayer (if living) or the estate of the last taxpayer to die will be reimbursed by the trust for the portion of the premium payments made by the taxpayers, the portion of the premium payments made by the taxpayers will not constitute gifts to the trust for gift tax purposes. We note that, if the taxpayers make additional contributions to the trust in order to provide funds for the trustee's portion of the premium payments, these latter contributions will be taxable for gift tax purposes.
>
> We conclude that the payment by the taxpayers of the portion of the premiums for which they are responsible under the split-dollar agreement, will not result in a gift to the trust by the taxpayers or a deemed gift to the trust by the taxpayers under section 2511.

The Service determined that neither spouse retained an incident of ownership:

> In the present case, the taxpayers have retained no incidents of ownership in the second-to-die life insurance policy on their lives. In the event that the trust includes assets (other than the insurance policy) such that these assets when added to the loan value of the policy would allow the trustee to pay the specified amount upon termination and the taxpayer(s) elects to cancel the agreement, the trustee could pay the taxpayer(s) an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). The taxpayer(s) cannot, thus, force the cancellation of the policy.
>
> We conclude that the insurance proceeds payable to the trust pursuant to the split-dollar agreement from the second-to-die life insurance policy held by the irrevocable trust will not be includible in the gross estate of the last taxpayer to die under section 2042.

The Service also specifically declined to rule on the application of section 7872 or 2503.

2. Change of Beneficiary. In Engelman v. Connecticut General Life Insurance Company, 690 A.2d 882 (Conn. 1997), the Connecticut Supreme Court expanded the substantial compliance doctrine to encompass a situation in which the insured sent the company a letter which referred specifically to the policy by number and was signed, dated, and witnessed.

L. SECTION 2053 and 2054 - DEBTS AND ADMINISTRATION EXPENSES

1. **Allowance of Expenses; Effect of Probate Decree**. The Sixth Circuit has overruled Estate of Park v. Commissioner, 475 F.2d 673 (6th Cir. 1973), in Estate of Millikin v. Commissioner, 125 F.3d 339 (6th Cir. 1997), heard en banc. The issue was the deductibility of administration expenses. Park held that section 2053 refers only to state probate law. The opinion described the issue:

> The Commissioner relies on Treasury Regulation § 20.2053-3(a), which provides, in part: "The amounts deductible from a decedent's gross estate as 'administration expenses' . . . 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, payments of debts, and distribution of property to the persons entitled to it." 26 C.F.R. § 20.2053-3(a). The Commissioner asserts that this regulation imposes a separate, federal requirement that expenses must be "actually and necessarily incurred" in order to be deductible, and claims that this requirement is in addition to the statutory requirement that the expenses must be "allowable by the laws of the jurisdiction." The Commissioner argues that this additional requirement does not conflict with the statutory standard. Instead, the regulation merely defines the allegedly ambiguous term "administration expenses" in the statute.
>
> Over twenty years ago, a panel of this Court considered a similar question in Estate of Park v. Commissioner, 475 F.2d 673 (6th Cir. 1973), and ruled that deductibility of administration expenses is determined solely under state probate law. The Tax Court properly considered itself bound by Estate of Park, as did the panel of our Court that heard the estate's initial appeal. In this en banc review, however, the Commissioner has asked us to reconsider Estate of Park. In light of developments in the law since Estate of Park was decided -- particularly the Supreme Court's decision in Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984), and opinions from other circuits -- we find that Estate of Park is no longer good law, and we therefore overturn that decision.

The Court cited Chevron as follows:

In Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., the Supreme Court held:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

467 U.S. 837, 842-43, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984)(citations omitted).

The Court held:

> The structure of 26 U.S.C. § 2053(a) compels a two-part test for deductibility of expenses under that statute. First, an expense must be one of the four types of expenses specifically enumerated in the statute. If an expense qualifies as one of those four types, it must further be "allowable by the laws of the jurisdiction . . . under which the estate is being administered." 26 U.S.C. § 2053(a). We agree with the Commissioner that the phrase "administration expenses" is neither self-defining nor unambiguous. Moreover we find that the Treasury Regulation's construction of that phrase to include only those expenses "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." 26 C.F.R. § 20.2053-3(a), is a permissible construction of the statute. We are therefore bound by that construction.

The opinion noted that the Second, Fourth, Fifth, Ninth, and Eleventh Circuits have similarly held. The opinion also discussed the rule in the Seventh Circuit:

> Estate of Jenner v. Commissioner, 577 F.2d 1100 (7th Cir. 1978), can be read to hold that deductibility of administration expenses is governed solely by state law. Indeed, at least one other circuit appears to have read Estate of Jenner in that manner. See Estate of Love v. Commissioner, 923 F.2d 335, 337 n. 6 (4th Cir. 1991). That is not the only possible reading of that case,

> however. In fact, the Estate of Jenner court quoted the Treasury Regulation restriction on administration expenses with apparent approval, Estate of Jenner, 577 F.2d at 1105, but concluded that "[b]ecause Illinois laws . . . only permit executors to sell estate assets when it is necessary for the proper administration of the estate, . . . the probate court's approval of the account constitutes an implicit finding of the 'necessity' of the sale," id. at 1106 (internal quotation marks omitted). Only when it turned to the separate issue of whether state court determinations of the reasonableness of claimed expenses are binding on the Commissioner did the Estate of Jenner court cite Estate of Park with approval and provide the analysis which could be viewed as an endorsement of the Estate of Park holding. Id.

In Kentucky this may mean a significant change in the way the IRS reviews estates.

2. **Amounts Payable to Children as a Result of Divorce**. The deductibility under section 2053 of amounts payable to children as a result of a divorce was at issue in Estate of Edwards, 74 T.C.M. 748 (1997). The taxpayer argued that the payments to the children were payable under a divorce decree; the Internal Revenue Service argued that the amounts were payable pursuant to a property settlement agreement. The Court summarized the facts as follows:

> Decedent, at the time of the divorce, desired to maintain control of the Company. Ann Goss was not opposed to decedent's desire to run the Company, because she recognized that the Company has prospered under his stewardship. However, in return, Ann Goss demanded certain property rights that she may not have otherwise received in a dissolution proceeding, such as alimony that would continue after her remarriage. On March 6, 1970, in order to meet these goals, decedent and Ann Goss entered into a written property settlement agreement (the 1970 PSA) incident to the divorce proceedings. Pursuant to the 1970 PSA, Ann Goss received one-half of the jointly owned stock. In addition, she agreed to place her shares of stock in trust (the voting trust), and then execute a voting trust agreement in favor of decedent. Pursuant to the terms of the voting trust, decedent would be entitled to vote her shares of stock in the Company and Highland Properties for 21 years or until his death, if sooner. In return, decedent agreed to pay alimony that would not terminate upon her remarriage. Further, decedent and Ann Goss agreed to maintain their reciprocal will provisions. At that time, each of their wills provided that the stock in the Company and Highland Properties would pass, in trust, to the surviving spouse for life, with the remainder to the three children.

On March 10, 1970, decedent's marriage to Ann Goss was dissolved by a Los Angeles County Superior Court interlocutory order. The Los Angeles County Superior Court entered a final judgment of dissolution of marriage on March 12, 1970 (the final judgment). The 1970 PSA was incorporated into the final judgment. At the time the final judgment was entered, each of the Edwards children was over 21 years old.

A disagreement between Ann Goss and decedent arose concerning some of the terms of the 1970 PSA. In order to resolve the disagreement, decedent, Ann Goss, their three children, and the Company entered into a second property settlement agreement on January 20, 1984 (the 1984 PSA). On June 6, 1984, a stipulation for modification of judgment and order thereon was entered by the California Superior Court (the 1984 court order). The 1984 court order incorporated the 1984 PSA into the final judgment in place of paragraph 14 of the 1970 PSA. Paragraph 14 had dealt with the reciprocal will provisions of petitioner and Ann Goss. In the 1984 court order, decedent was prohibited from modifying, without prior approval of the court, the Arthur C. Edwards settlement trust (settlement trust), a revocable living trust that he had created in 1981. Under the terms of the settlement trust, decedent was to receive the income from his stock in the Company and Highland Properties during his life; at his death, Ann Goss was to receive such income for life; and, at her death, the trust property was to be distributed to the three children.

On November 6, 1988, the date of decedent's death, the fair market values of decedent's interests in the Company and Highland Properties, respectively, were $18,113,960 and $106,184. Pursuant to the terms of the settlement trust, outlined supra, Ann Goss possessed an income interest in this property for her life. The parties have agreed that the fair market value of that income interest was $6,741,453.

After decedent's death, a Federal estate tax return was filed by the executor of decedent's estate. In the return, the executors claimed deductions for the value of Ann Goss' life interest in decedent's stock and the value of the Edwards children's remainder interest. Respondent, in the notice of deficiency, disallowed both deductions. Respondent has subsequently conceded that the claim of Ann Goss is deductible. The deductibility of the remainder interest of the Edwards children, however, is still in dispute.

The requirements of section 2053 were reviewed by the Court:

Section 2053(a)(3) provides that the value of the gross estate is determined by deducting the amount of claims against the estate. Section 2053(c)(1)(A) limits the deduction for claims founded on a promise or agreement to the amount of claims that were contracted for full and adequate consideration. One purpose of this consideration requirement is to prevent decedents from reducing their gross estate through contractually arranged transfers that serve a "donative or testamentary intent." Estate of Huntington v. Commissioner, 100 T.C. 313, 316 (1993), affd. 16 F.3d 462 (1st Cir. 1994); see also United States v. Stapf, 375 U.S. 118, 130-133 (1963). However, liabilities imposed by law and not founded on a promise or agreement are deductible from the gross estate regardless of the ability to show consideration. Sec. 20.2053-4, Estate Tax Regs.

A claim founded on a divorce decree is a liability imposed by law and deductible without regard to the limitations of section 2053(c)(1)(A). See Harris v. Commissioner, 340 U.S. 106 (1950); Estate of Robinson v. Commissioner, 63 T.C. 717 (1975). Petitioner asserts that the claim of the Edwards children is founded on the divorce decree and is therefore deductible as a claim imposed by law. Respondent disagrees, arguing that the claim is founded on the 1970 PSA, not the divorce decree.

In order for the claim to be imposed at law, the divorce decree, rather than the agreement between the parties, must be the "operative element" of a claim. Estate of Satz v. Commissioner, 78 T.C. 1172, 1179 (1982). Whether the divorce decree is the "operative element" depends upon whether the divorce court has the power to vary the terms of the agreement between the parties -- here the rights of the Edwards children vis-a-vis the stock. Harris v. Commissioner, supra at 109-110; Estate of Fenton v. Commissioner, 70 T.C. 263, 271-2724 (1978). If the divorce court has the power to prescribe a property settlement with terms different from those agreed to by the spouses, then it is the decree that fixes the right of the spouses, and, under the rationale of Harris v. Commissioner, supra, any subsequent claim by a Spouse is founded on that decree. Estate of Fenton v. Commissioner, supra at 272. The fact that a property settlement agreement is incorporated into the divorce decree is not determinative in ascertaining whether the decree is the operative element of a claim. Id.

The Court held for the IRS:

In this regard, our examination of California law indicates that, absent exceptional circumstances, a California divorce court lacks the power to modify a property settlement agreement before incorporating it into a divorce decree. See Flynn v. Flynn, 265 P.2d 865 (Cal. 1954); Adams v. Adams, 177 P.2d 265 (Cal. 1947). The Court of Appeals for the Ninth Circuit has addressed this question in Gray v United States, 541 F.2d 228 (9th Cir. 1976). In Gray, the decedent husband and his wife had entered into a property settlement agreement, whereby the husband agreed to maintain an insurance policy on his life, designating his wife as the beneficiary. Id. at 230. The husband died in a plane crash shortly after the divorce court had entered a divorce decree, wherein the court approved the property settlement agreement and ordered the parties to carry out its provisions. Id. The proceeds of the policy were paid directly to the wife; the executor included the proceeds in the gross estate and claimed a deduction for that same amount. Id. at 231. The District Court held that the claim was founded on a divorce decree and thereby deductible under section 2053, and the Government appealed. Id.

The Court of Appeals for the Ninth Circuit reversed the District Court. The Court of Appeals for the Ninth Circuit agreed with the Government's position that a claim is founded on the court decree only where "the court entering the decree had the power to modify or alter the terms of the agreement." Id. at 231. The Court of Appeals, in concluding that the wife's claim was founded on the marriage settlement agreement, observed that "under California law a California court entering a divorce decree, in the absence of fraud, has no power to modify or alter the property agreement." Id. at 232. According to the Ninth Circuit, the fact that the divorce court ordered the parties to carry out the terms of the agreement only imposed an additional method for enforcing its terms and did not change the conclusion that the wife's claim was founded on the agreement.

Petitioner attempts to distinguish the present case by noting that the law relating to property settlement agreements has changed since the Ninth Circuit decided Gray v. United States, supra, and cites a number of cases where the divorce court altered the terms of a marriage settlement agreement. See Adkins v. Adkins, 186 Cal. Rptr. 818 (Ct. App. 1983); Brennan v. Brennan, 177 Cl. Rptr. 520 (Ct. App. 1981); Moore v. Moore, 169 Cal. Rptr. 619 (Ct. App. 1980). Petitioner's attempts to distinguish the case at bar from Gray v. United States, supra, fall short.

In each of the above cases, the presence of exceptional circumstances, such as fraud or overreaching, gave the court grounds to set aside the agreements. See Adkins v. Adkins, supra at 822 (sufficient showing of extrinsic fraud for the court to set aside a marital settlement agreement where the husband, unable to read or write, signed the agreement based on his wife's misleading representations); Brennan v. Brennan, supra at 525 (sufficient showing of extrinsic fraud for the court to set aside a marriage settlement agreement where the wife, unrepresented by counsel, relied to her detriment on the advice of her husband and his attorney); Moore v. Moore, supra at 624 (wife's waiver of her interest in the community property set aside where she was not represented by counsel and spoke only limited English). Moreover, in each of these cases, the court set aside a property settlement agreement after a divorce decree had

> been previously entered. None of the cases involves a court's power to modify an agreement PRIOR TO entering the decree.

3. **Theft Loss**. In an unusual case described under Pennsylvania law an estate was allowed to take a theft deduction where the attorney for the estate had been paid, the Orphans' court refused to approve payment, and the attorney was bankrupt and could not pay. The executor was not required to reimburse the estate because the executor had been removed and a prior settlement reached with her. Estate of Meriano v. Commissioner, 81 A.F.T.R.2d ¶98-640 (3d Cir. 1998).

M. SECTIONS 2056 AND 2056A - MARITAL DEDUCTION

1. **QTIP; Condition**. In Estate of Rinaldi v. United States, 38 Fed. Cl. 341 (1997) the Court of Federal Claims denied the QTIP election for a trust which contained an unusual provision. The provision was described as follows:

> The son was nominated as trustee of the Trust, but his authority to manage the Trust was made subject to several conditions. As long as the son continued in the day-to-day management of the company, the voting rights of the stock were to be vested in him. But if, for any reason, the son became unwilling or unable to continue active management of the company, the voting rights were to be vested in Rinaldi's wife, or, if she was no longer living, in the fiduciary of the Trust. Additionally, as soon as practicable after the son gave up day-to-day management, the fiduciary of the Trust was to offer to sell the Trust's stock to the son at book value. If the sale to the son was not effectuated, then the fiduciary was to select other potential buyers and offer reasonable terms for the stock's sale. The will went on to provide that:
>
> > I hereby authorize but do not direct my Personal Representative to elect that the property (Rinaldi Printing Company capital stock) constituting the principal of this Trust be treated as qualified terminable interest property for the purpose of qualifying for the marital deduction allowed in determining the federal estate tax upon my estate.

The Court held that the marital deduction must be determined as of the date of death. In this instance, the stock was actually redeemed by the company before the estate tax return was filed and the QTIP election made. The reason for the redemption was to enable the company to make an S election; it was represented that an S election could not have been made if the trust were a shareholder.

The estate analogized the facts to the contingent QTIP cases (Estate of Spencer v. Commissioner, 43 F.3d 226, 231 (6th Cir. 1995); Estate of Clayton v. Commissioner, 976 F.2d 1486, (5th Cir. 1992); Estate of Robertson v. Commissioner, 15 F.3d 779, (8th Cir. 1994)). The Court rejected the analogy:

> The difficulty with accepting plaintiff's characterization stems from the means by which the trust's defect was allegedly remedied. The trust may indeed have rid itself of the troublesome stock in question; what remains unchanged, however, are the terms of the will that rendered the trust ineligible for QTIP treatment in the first place. There exists no legal impediment to the trust's ownership of the printing company's stock. Rather, it is only the company's desire to continue as an S corporation that led to the shares' redemption. And it is only the maintenance of that desire which keeps the trust's defect from again rising to the surface. For example, if a change in tax law were to diminish the disparity between "S" corporations' and "C" corporations' relative tax burdens, thereby making the company's continued operation as an S corporation significantly less desirable, there is nothing to prevent the trust from reacquiring shares of the company. In the event of such a reacquisition, the terms of Rinaldi's will presumably would still govern. Under those terms, the shares potentially would be subject once again to a bargain sale to Rinaldi's son or a third party, thereby diminishing the corpus of the trust. The portion of the trust's corpus lost in the bargain sale would have escaped taxation in both Rinaldi's and his surviving spouse's estates -- the very potentiality which the statutory QTIP requirements were implemented to avoid.
>
> Granted, the likelihood that Rinaldi's trust will reacquire the company's stock, and that his son will quit the company's management -- thereby spurring the bargain sale -- may be remote. but when it comes to judging QTIP eligibility, "it is the possibility, not the probability, that an interest will terminate or fail that will determine whether the surviving spouse's interest is a 'qualifying income interest for life.'" Estate of Kyle v. Commissioner, 94 T.C. 829, 845 (1990). Because deductions, whether from income or estate taxes, are "a matter of legislative grace,'" the taxpayer must meet every condition of eligibility set forth by Congress:
>
> > It is not enough that such conditions are nearly met, or that a potentiality inconsistent with the legislative mandate is unlikely to actually become operative. The taxpayer may not haggle

> with Congress; he either fits squarely within the statute in every particular or the deduction is unavailable.
>
> Estate of Weisberger v. Commissioner, 29 T.C. 217, 220 (1957). This mindset has led courts to take consistently firm stances against QTIP treatment for trusts failing to meet one of section 2056's requirements. See Estate of Doherty v. Commissioner, 95 T.C. 446, 460-61 (1990)(rejecting QTIP treatment for trust where surviving spouse had discretion as trustee to accumulate all or part of trust income for distribution to others upon his death), rev'd on other grounds, 982 F.2d 450 (10th Cir. 1992); Estate of Bowling v. Commissioner, 93 T.C. 286, 296 (1989)(rejecting QTIP treatment for trust where trustee was authorized to invade trust corpus during life of surviving spouse to provide for emergency needs not only of surviving spouse, but also of decedent's surviving son and brother).

The Court's holding is correct. The representations involving the S election are curious because it would appear that the trust could have qualified as a qualified subchapter S trust. What would the result have been if the restriction had been in a stock agreement?

2. **Requirement That Spouse Receive All Income**. PLRs 9739015 - 9739018 deal with substantially similar facts, and address the appropriateness of allocating liquidating payments from a partnership between income and principal. The marital deduction was allowed. The language to be included in the trust was:

> It is anticipated that the trustee will be receiving from the remaining partners of [Partnership], a [State] limited partnership (the "Partnership") presently located at [---] as partial purchase price for my entire interest in the Partnership, an amount equal to a specified percentage of the net profits, if any, of the Partnership for a specified period of time, pursuant to the terms of that certain Restated Partnership Agreement of Limited Partnership dated as of ________, (or pursuant to any successor partnership agreements)(such purchase price payments being hereinafter referred to as the "Contingent Payments"). In this regard, for all purposes of this instrument, a portion of each contingent payment will be treated as a payment of interest and the remainder as a payment of principal. The principal amount of each contingent payment will equal the present value of the payment, discounted at the appropriate Applicable Federal Rate (as published in the Internal Revenue Bulletin) from the date the payment is made to the date of the sale or exchange. Such

> amount of each payment shall be allocated to and considered principal of the trust. The excess of the amount of the contingent payment over the amount treated as principal will be treated as interest and shall be allocated to and considered principal of the trust. The excess of the amount of the contingent payment over the amount treated as principal will be treated as interest and shall be allocated to and considered income of the trust. However, if a contingent payment is made not more than six months after the date of the sale or exchange, no portion of the payment will be treated as interest and such payment shall be treated as principal.

3. **Rollover to QDOT**. PLR 9746049 discusses the rollover of IRA proceeds, received annually, into a qualified domestic trust ("QDOT") under section 2056A.

4. **Termination of Rights Upon Incompetency**. In Estate of Walsh v. Commissioner, 110 T.C. No. 29 (1998) the court denied a marital deduction to a trust with the following provisions:

> 1. During the life of the surviving spouse who remains competent as set forth in Article XXIII * * *
>
> a. The net income, beginning as of the date of the first to die, may be paid to said spouse in quarterly or other convenient installments during the life of said spouse.
>
> b. The Trustee may pay to said spouse or apply for the benefit of said spouse such amounts of principal as the Trustee deems necessary or advisable for the proper care, comfort, support, maintenance, and welfare of said spouse, including reasonable luxuries.
>
> c. Said spouse shall withdraw any amount or all of this Trust by written request to the Trustee.
>
> d. If said spouse should at any time be determined as incompetent * * *, said spouse shall take no benefits hereunder and this Trust shall be treated and distributed as if said spouse had died.
>
> 2. After the death of the surviving spouse or after the incompetency of the surviving spouse * * *
>
> a. All property in TRUST A, including income, shall be distributed to such appointee or appointees in the manner and proportions as the surviving spouse may designate by Will expressly referring to this general power of appointment, including the power in said spouse to appoint all thereof to said spouse's estate, free of any Trust hereunder. Such general power of appointment shall exist immediately upon the death of the first one

> of us to die and shall be exercisable by the surviving spouse exclusively and in all events.

The issues were summarized in the opinion:

> Respondent determined and argues that the property passing to Trust A does not qualify for the marital deduction because the property is a terminable interest. Respondent reaches this result mainly because, in respondent's view, the Agreement revokes the surviving spouses's right to receive income from the Trust, or to appoint the Trust's property, upon incompetency. The estate argues primarily that the property is not a terminable interest because the surviving spouse has a general power of appointment over the Trust's assets that allows the surviving spouse to dispose of these assets any time before the Trust terminates on account of the surviving spouse's death or incompetency. The estate asserts that the Agreement states clearly that the intent of the Trust's settlors was to qualify Trust A for the marital deduction. If the property is a terminable interest, the estate argues alternatively, the decedent's estate tax liability must be computed as if no completed gift of property was made to the Trust before the decedent died. The estate asserts that the Trust fails because its settlors never relinquished control over the property transferred to it. The estate asserts that the Trust is revoked if the settlors' intent to qualify Trust A for the marital deduction is thwarted.

The applicable Treasury Regulations relating to section 2056(b)(5) were noted by the court, which then held:

> Section 20.2056(b)-5(g)(1) and (3), Estate Tax Regs., provides:
>
> (g) Power of appointment in surviving spouse. -- (1) The conditions * * * that the surviving spouse must have a power of appointment exercisable in favor of herself or her estate and exercisable alone and in all events, are not met unless the power of the surviving spouse to appoint the entire interest or a specific portion of it falls within one of the following categories:
>
> (i) A power so to appoint fully exercisable in her own favor at any time following the decedent's death (as, for example, an unlimited power to invade); or
>
> (ii) A power so to appoint exercisable in favor of her estate. Such a power, if exercisable during life, must be fully exercisable at any time during life, or, if exercisable by will, must be fully exercisable irrespective of the time of her death * * *; or
>
> (iii) A combination of the powers described under subparagraphs (i) and (ii) of this subparagraph. * * * However, the condition that the spouse's power must be

> exercisable in all events is not satisfied unless irrespective of when the surviving spouse may die the entire interest or a specific portion of it will at the time of her death be subject to one power or the other * * *.
>
> * * * * *
>
> (3) A power is not considered to be a power exercisable by a surviving spouse alone and in all events * * * if the exercise of the power in the surviving spouse to appoint the entire interest or a specific portion of it to herself or to her estate requires the joinder or consent of any other person. The power is not "exercisable in all events", if it can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of it. * * *

(Ellipses in opinion).

> From this text, we discern that the surviving spouse must have the ability during life to exercise or release the power of appointment in all events. A power of appointment that may terminate upon the happening of an event does not meet this requirement, unless the event is the voluntary exercise or release of the power by the surviving spouse. See Eckel v. United States, 259 F. Supp. 184 (S.D.N.Y. 1966) (surviving spouse not entitled to income for life when spouse's right to income is terminated upon remarriage); see also Starrett v. Commissioner, 223 F.2d at 166. A power of appointment that lapses on the happening of a contingent event such as incompetency is outside the reach of section 2056(b)(5). This is especially true in the instant case where applicable State law requires that an exercise or release of a power of appointment must adhere to the same formalities as those that must be followed to create a power of appointment or to transfer property in general, e.g., by a written instrument. Minn. Stat. Ann. sec. 502.64, 502.79 Subd. 2 (West 1990).

The opinion discusses Estate of Tingley as follows:

> The incompetency provisions in Article VII of the Agreement take the property passing to Trust A outside the statutory and regulatory requirements for the marital deduction. In Estate of Tingley v. Commissioner, 22 T.C. 402 (1954), the surviving spouse received an income interest and an inter vivos right to withdraw corpus. Under the terms of the trust, this right terminated upon the surviving spouse's legal incapacity or upon the appointment of a guardian; upon legal incapacity or the appointment of a guardian, the trustee was given the discretion to use and apply this part of the net income and corpus for the surviving spouse's benefit. The Court in Estate of Tingley held that the estate was not entitled to the marital deduction mainly because the income interest and power

of appointment were outside the scope of the predecessor to section 2056(b)(5). This was so even though the surviving spouse could invade corpus and actually did so shortly after the decedent died. The Court noted that the surviving spouse could not invade corpus in all events because the trust would terminate that right upon legal incapacity or upon the appointment of a guardian. The Court noted that the surviving spouse's right to receive income would terminate at the same time.

The estate argues that the facts of Estate of Tingley are distinguishable from the facts at hand. The estate contends that the power of appointment in Estate of Tingley, which terminated upon the surviving spouse's legal incapacity or the appointment of a guardian, is different from the power of appointment in this case, which, the estate asserts, is activated by incompetency. The estate claims that the surviving spouse in Estate of Tingley could lose the power to appoint the property for reasons other than legal incapacity, whereas the Agreement here terminates the Trust only on death or incompetency. The estate concludes that these differences in fact warrant a result in the instant case different from the result in Estate of Tingley.

We disagree with the estate that Estate of Tingley is inapposite to our decision herein. Although there may be differences between the facts of Estate of Tingley and the facts of this case, the critical fact that appears in both cases is that the surviving spouse could lose power over the corpus upon the happening of a contingent event; namely, incompetency (in the instant case) and incapacity or the appointment of a guardian (in the case of Estate of Tingley). In Estate of Tingley, the surviving spouse would lose any power over the corpus if the contingent event occurred before the surviving spouse withdrew the corpus. Although the surviving spouse in Estate of Tingley did actually withdraw the corpus before the happening of this contingent event, the Court held that, when viewed at the time of the decedent's death, the surviving spouse's power was not exercisable in all events. Estate of Tingley v. Commissioner, 22 T.C. at 404, 406. The same is true here. When viewed at the time of the decedent's death, the surviving spouse would lose power over the corpus if the contingent event occurred before the surviving spouse either withdrew the corpus or provided in his will for the corpus' disposition. Given this possible loss of power, we are unable to conclude that the surviving spouse's power of appointment was exercisable by the surviving spouse alone, see sec. 20.2056(b)-5(g)(1), Estate Tax Regs., and that it was exercisable by the surviving spouse in all events, see sec. 20.2056(b)-5(g)(3), Estate Tax Regs.; see also S. Rept. 1013, 80th Cong., 2d Sess. 17 (1948), 1948-1 C.B. 285, 343 ("An example of a power which * * * [is not exercisable alone and in all events] is a power which (unless sooner exercised or released) will terminate on

> * * * [a given date] or on the date of death of the surviving spouse, whichever occurs first.").

Oddly, footnote 6 would appear dispositive without the foregoing analysis or the court's struggle with it:

> We are also unable to conclude that the Trust meets the requirements of sec. 2056(b)(5) in that the Agreement provides that the surviving spouse is not entitled to any trust income upon incompetency.

5. **Reformation**. The Ninth Circuit has upheld the Tax Court in Estate of Rapp v. Commissioner, 140 F.3d 1211 (1998), finding that the post-mortem reformation by a California probate court of a trust that authorized distribution of income and principal among the surviving spouse and children to create a QTIP trust was not effective for marital deduction purposes. The court discussed the U.S. Supreme Court decision in Bosch and Rev. Rul. 73-142. Because the latter is not often used when it could be to good effect, the opinion is worth reviewing in detail:

> The IRS argues, and the tax court agreed, that the probate court's reformation of Mr. Rapp's will is without binding effect for the purpose of determining federal estate taxes owed, unless California's highest court has affirmed the result. Both rely on Commissioner of Internal Revenue v. Estate of Bosch, 387 U.S. 456 (1967). We agree that Bosch is controlling.
>
> A.
>
> In Bosch, the respondent, Mrs. Bosch, filed a federal estate tax return in which she claimed a marital deduction. Id. at 458. The IRS denied the deduction. Mr. Bosch's will had created a trust from which Mrs. Bosch was to receive all income and in which Mrs. Bosch had a general power of appointment. If she declined that appointment, however, half of the corpus of the trust was to go to Mr. Bosch's heirs.
>
> The entire trust would qualify as tax exempt only if Mrs. Bosch retained the general power of appointment. Before Mr. Bosch died, Mrs. Bosch executed a release of her general power of appointment. Thus, whether or not the entire value of the trust was to be taxed depended upon the validity of the release. Before the tax court, Mrs. Bosch claimed that the release was invalid. While those proceedings were pending, Mrs. Bosch sought and received a determination from a New York state court that the release was a nullity under state law. The result was that a larger estate was to go to Mrs. Bosch as the surviving spouse, a diminished inheritance was to

go to other beneficiaries, and a larger marital deduction could be claimed.

The issue before the Supreme Court was what effect was to be given to the state court's determination regarding the validity of the release. The Court first noted that neither res judicata nor collateral estoppel applied. Id. at 463. The Court then reviewed the legislative history of the marital deduction statute, and concluded that Congress did not intend state court actions to have a determinative effect on federal tax questions.

It noted:

> [Congress] said that "proper regard," not finality "should be given to interpretations of the will" by state courts and then only when entered by a court "in a bona fide adversary proceeding." We cannot say that the authors of this directive intended that the decrees of state trial courts were to be conclusive and binding on the computation of the federal estate tax as levied by the Congress. If the Congress had intended state trial court determinations to have that effect on the federal actions, it certainly would have said so -- which it did not do.

Id. at 464 (citations omitted). Relying on <u>Erie R.R. Co. v. Tompkins</u>, 304 U.S. 64 (1938), the Court stated:

> when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should a fortiori not be controlling. . . . If there be no decision by [the State's highest court] then federal authorities must apply what they find to be the state law after giving the "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court.

Id. at 465 (citation omitted).

This rule remains valid today. See, e.g., <u>Ahmanson Found. v. U.S.</u>, 674 F.2d 761, 774 (9th Cir. 1981) (holding that neither a lower state court decision following a good faith adversary proceeding nor a private good faith settlement is binding on federal courts when determining federal estate tax consequences); <u>Estate of Kraus v. Commissioner of Internal Revenue</u>, 875 F.2d 597, 600-01 (7th Cir. 1989) (holding that state court's reformation of a will is not binding on federal courts because "only the state's highest court can make a ruling on state law that binds the federal courts"); <u>Estate of Selby v. U.S.</u>, 726 F.2d 643, 646 (10th Cir. 1984) (holding that the federal court is obligated to review state probate court proceeding to determine whether proper state law was applied where highest state court has not spoken, and where issue of federal tax liability is involved).

In this case, Mrs. Rapp sought modification in the probate proceeding for the sole purpose of reforming her husband's will so that the trust would qualify as a QTIP trust. As in Bosch, the state court proceedings were "brought for the purpose of directly affecting federal estate tax liability," and, as in Bosch, the issue before the state court was "determinative of federal estate tax consequences." Bosch, 387 U.S. at 462-63. Accordingly, the principle of Bosch applies here. The tax court correctly held that it was not bound by the California probate court's reformation of Mr. Rapp's will.

B.

The executor does not argue that the tax court improperly applied California law. In fact, the executor concedes that the probate court's decision to reform Mr. Rapp's will was erroneous. Instead, the executor argues that the tax court was without power to ignore the California probate court decision to reform Mr. Rapp's will, i.e., that Bosch is inapplicable to the instant case. He argues that the tax court only needed to determine whether Mrs. Rapp had a QTIP trust as of the proper "measuring date." According to the executor, the proper measuring date is the date on which the executor elected a QTIP deduction, and as of that date, Mrs. Rapp had a QTIP trust because the probate court's order had become final. Bosch, he argues, cannot be read to stand for the proposition that a state court order affixing the property rights of a taxpayer may be ignored where the order becomes final and unappealable as of the relevant measuring date for federal tax purposes. The executor argues that Rev. Rul. 73-142, 1973-1 C.B. 405 (hereinafter Revenue Ruling 73- 142), supports his position, and is binding on the IRS Commissioner.

Regardless of the proper measuring date, however, the executor's argument fails because, contrary to the executor's assertion, Bosch does stand for the proposition that a probate court decision may be ignored when determining federal tax consequences, even when that order is final, if the decision is contrary to state law.

The executor's argument that Bosch is inapplicable is unavailing. The executor argues that Bosch does not permit the tax court to ignore the import of a state court decision that has become final and unappealable, i.e., one that cannot be directly challenged. There is no language in Bosch or subsequent decisions, however, that would support this position. That the California Supreme Court itself can no longer overrule the probate court's decision is irrelevant. Bosch stands only for the proposition that the federal court is not bound by the state court proceedings for determining federal estate taxes; to this end, the tax court decision does nothing to upset the actual outcome of the probate court proceedings. Mrs. Rapp will still enjoy the benefits of the reformation for which she petitioned in probate court. The estate simply will not receive the federal tax benefits of a QTIP.

Revenue Ruling 73-142, cited by the executor, does not support his position. As the executor correctly notes, revenue rulings are not binding as to the taxpayer, but may limit the IRS' ability to assert a position that is contrary to that asserted in the ruling if the ruling is published, to the extent that the ruling addresses a similar issue. See Beneficial Found., Inc. v. U.S., 8 Cl. Ct. 639, 644-45 (Cl. Ct. 1985); cf. Estate of Kosow v. Commissioner of Internal Revenue, 45 F.3d 1524, 1528 n.4 (11th Cir. 1995) (noting that taxpayers may assert revenue rulings as a shield, although they do not have the effect of law and are not binding on the courts). However, Revenue Ruling 73-142 is not analogous to the instant case.

The decedent in Revenue Ruling 73-142 created a trust during his lifetime for the benefit of his wife and children. Under the terms of the trust instrument, the decedent reserved to himself the power to appoint or discharge a trustee at any time. The trustee had the unreserved power to distribute income from the trust. Before his death, the decedent, in a non-adversary action before the state court, asked the state court to interpret the trust instrument. The state court held that the trust the decedent created gave the decedent the power to remove and appoint a trustee only once. This decision was contrary to the law of the state. Subsequent to this order, the decedent removed the original trustee and appointed another. Thus, under the state court order, the decedent no longer had a right to remove the trustee as of the date of his death.

The question before the IRS was the effect to be given to the state order in determining the estate tax consequences of the trust created by the decedent. Under the tax law at the time, if the decedent had retained the unfettered right during his life to designate the trustee, the value of the trust was to be included in his estate for tax purposes; if not, the value of the trust was to be excluded.

In its ruling, the IRS held that the grantor did not have the unlimited power to appoint a trustee because the state court decree had become final and unappealable, and was "conclusive as to those parties," despite the fact that the decision was contrary to state law. Revenue Ruling 73-142 (emphasis added). The value of the trust, therefore, could not be included in the decedent's federal estate taxes. The IRS noted:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, regardless of how erroneous the court's application of the state law may have been. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of the [tax code] were thus effectively cut off before his death.
>
> Unlike the situation in Bosch, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power.
>
> Revenue Ruling 73-142. That is not this case. The state court proceeding at issue in Revenue Ruling 73-142 bound the testator himself before his death. After the decree became final and the testator exercised his power once, the testator no longer retained the type of power necessary for the trust to be considered under his control during his lifetime and thus was not part of his estate upon his death. By contrast, here the state court proceedings took place after Mr. Rapp's death. The executor argues that this distinction is irrelevant. We disagree. Before death, the testator is free to create estate plans and execute documents for the express purpose of minimizing taxes. In this case, however, persons other than the testator sought to modify his will after death. They did so not to effect his intent, but to avoid taxes. This is precisely the situation addressed by the Court in Bosch.

Unavailable but perhaps more effective would have been an argument based on "scrivener's error." Footnote 7 to the opinion discusses the role of Mr. Clark, decedent's attorney who prepared the Will:

> Mr. Clark initially was retained as counsel for the estate but was subsequently replaced. Although Mr. Clark did not testify at the reformation hearing, he did testify before the tax court at the behest of the government. He indicated that Mr. Rapp specifically intended to create a trust for his children's benefit, and did not wish to leave outright his money to Mrs. Rapp.

6. **Disclaimer to Create QTIP**. Attempted reformation of trusts to create trusts that qualify for the QTIP election are an on-going issue. PLR 9818005 considered the following language:

> (b) [the] Trustee . . . shall use such part of the income and/or principal . . . as it may deem necessary to provide for the support in reasonable comfort of my wife, and to provide for the support and education of my children and the descendants of any deceased child of mine.
>
> (c) My wife shall have the power at any time and from time to time by instrument in writing signed by her and delivered to the Trustee, to direct the Trustee to turn over any part of the property in this trust to or among such of my descendants, or spouses of such descendants, and in such manner, in trust or otherwise, as my said wife may in such instrument direct or appoint, provided that she shall have no power to appoint said property to herself, to her estate, to her creditors or to the creditors of her estate.
>
> (d) On the death of my said wife, the property then remaining in this trust shall be distributed to or among such of my descendants, and in such manner, in trust or otherwise as my said wife may by her Last Will and Testament direct or appoint, provided that she shall have no power to appoint said property to herself, to her creditors, to her estate or to the creditors of her estate.
>
> (e) Should my said wife fail to exercise her power of appointment as to all of the property in this trust . . . the property of this trust as to which she fails to exercise such power of appointment shall be divided into as many separate and equal shares as I have children then living and deceased children with descendants then living.

A series of disclaimers were undertaken. The IRS accepted those by the beneficiaries of the trust other than wife:

> The disclaimers executed by A's adult children, A's minor child, and the unborn and unascertained descendants of A, as well as the disclaimer executed by B in her individual capacity, purport to disclaim any right or interest to have income withheld from the income beneficiary or accumulated during the lifetime of B and any right or interest to cause the trustee to so withhold or accumulate income. These rights and interests were not granted to the beneficiaries under the terms of A's will. Whether income is to be distributed or accumulated is determined by the terms of the governing instrument, not by the trust beneficiaries. For these reasons, we do not believe these portions of the disclaimers have any force or

> effect. However, to the extent that the disclaimers by the children and unborn and unascertained descendants renounce the right to receive principal and income of the Residuary Trust during the life of B, we conclude that they are effective under State law and are qualified disclaimers under section 2518. The result of these disclaimers is that B is the only permissible distributee of income of the Residuary Trust during her lifetime.

Wife, as trustee, also disclaimed certain trustee powers:

> . . . the Trustee, on behalf of herself and all successors and assigns, in accordance with [State statute] Section 53-2-115, having neither exercised nor accepted any of the above-described powers as trustee, hereby (i) affirms that under both [State] law and the terms of the Residuary Trust the Trustee has no directive, power or authority to withhold from the income beneficiary or accumulate income under the Residuary Trust; (ii) irrevocably and unqualifiedly disclaims, renounces and refuses such Trustee Power to Distribute to Decedent's Descendants; (iii) irrevocably and unqualifiedly disclaims, renounces and refuses any directive, power or authority that may be said to exist to withhold from the income beneficiary or accumulate income as Trustee under the Residuary Trust during the lifetime of the surviving spouse; (iv) irrevocably and unqualifiedly disclaims, renounces and refuses any directive, power or authority that may be said to exist to acquire or retain unproductive property during the lifetime of the surviving spouse without the surviving spouse's consent; and (v) irrevocably and unqualifiedly disclaims, renounces and refuses any directive, power or authority that may be said to exist to treat any receipt or other item as principal which is properly treated under applicable law as income.

One of the trustee's powers was fatal to qualification of the trust under section 2056:

> Generally, a trustee cannot accept a trust in part and disclaim in part. This is true whether he purports to accept the trust only as to a part of the trust property, or only as to some of the duties. Also, generally, a disclaimer by a trustee does not extinguish a power except with respect to the disclaiming fiduciary. See Restatement (Second) of Trusts sections 35 and 102 (1959); Scott on Trusts sections 102.3 and 102.4 (1987).
>
> In Rev. Rul. 90-110, 1990-2 C.B. 209, the surviving spouse disclaimed her power as trustee to invade corpus during the life of the surviving spouse for the benefit of a grandchild of decedent. The grandchild neither disclaimed his interest in the trust nor consented to the trustee's disclaimer of the power.

The decedent's will did not authorize the trustee to make such a disclaimer. Under applicable state law, the trustee's attempt to disclaim this type of power was ineffective without the written consent of the beneficiary or an express grant of authority to make such a disclaimer in the governing instrument. The revenue ruling holds that because neither local law nor the governing instrument authorized the trustee to make a unilateral disclaimer of a fiduciary power, the trustee's attempted renunciation of the power to invade corpus was not qualified under local law and was not, therefore, a qualified disclaimer under section 2518.

In the present case, the governing instrument (A's will) did not authorize the trustee to disclaim any powers or duties; on the contrary, the will provides that "the provisions of each and every subparagraph of this Item [Item XII, which lists the trustee's powers] are intended to apply to each fiduciary named in this will. . . ."

State statute allows a fiduciary, ACTING ON BEHALF OF ANOTHER PERSON, to renounce property or an interest in property which was transferred TO THAT OTHER PERSON. We cannot read this statute as authorizing a trustee to disclaim certain powers and duties given to the office of the trustee by the governing instrument, with or without the consent of the trust beneficiaries. In attempting to disclaim these powers, B was not renouncing an interest in property on behalf of another person to whom that property was transferred; rather, she was attempting to renounce her own powers and duties which she possessed by virtue of being the trustee. We therefore conclude that B's attempted disclaimer of certain trustee powers and duties was not a valid disclaimer under local law and, therefore, is not a qualified disclaimer under section 2518.

In reaching this conclusion we have taken into consideration the state statute which prohibits a trustee from disclaiming a trusteeship after acceptance of the trusteeship. B petitioned the court for appointment as trustee. The court appointed B as trustee more than one month prior to B's filing of the document in which she states that she has "neither exercised nor accepted" the powers she wished to disclaim. The statute does not address a partial disclaimer by a trustee of only certain powers or duties. We interpret the omission as meaning that once a trusteeship has been accepted, it cannot be partially disclaimed. This would be in keeping with the general rule cited previously with respect to partial disclaimers by trustees.

We also note that for federal tax purposes, in determining the effect of state law on a question of property rights , where there has been no decision by the highest court of the state, the Service must determine what it finds to be state law from the

> viewpoint of the state's highest court. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). It is our determination that, based on state statutes and the facts of the present case, the Supreme Court of State would find the attempted disclaimer of the trustee powers to be ineffective under local law.

Thus, the trust did not qualify for QTIP:

> In the present case, the powers given to the trustee which B has attempted to disclaim are expressly and unconditionally granted by A in his will. The terms of the Residuary Trust, in their entirety, provide no reason to believe that A intended these powers to be circumscribed in order that B may be deemed to be entitled to that degree of beneficial enjoyment of the trust property during her life which is necessary for the allowance of a marital deduction under section 2056(b)(7). B is not empowered by the will to demand that the trust be made fully productive; nor may she challenge the good faith determinations regarding items of income and principal made by the trustee in its discretion. In sum, the trustee's powers to allocate income to principal and to invest in unproductive property disqualify B's interest in the Residuary Trust for the marital deduction. See Estate of Bennett, 100 T.C. at 58, 59.

N. SECTIONS 2501 TO 2524 - GIFTS

1. **Reduction for Built-In Capital Gains**. In Eisenberg v. Commissioner, 74 T.C.M. 1046 (1997), the issue was the effect of built-in capital gains on gift tax valuation. Avenue N Realty Corp. was a C corporation which owned cash and a building which was leased. The court reviewed these transactions.

> On December 23, 1991, the first transfer date, petitioner made gifts of 668 shares of stock in the corporation as follows: (1) 334 shares to her son, Joseph Eisenberg; (2) 167 shares to her granddaughter, Joanne B. Bayer; and (3) 167 shares to her grandson, David Blum. Subsequently on September 20, 1997, the second transfer date, and on February 23, 1993, the third transfer date, petitioner gave as gifts 275 shares and 57 shares of stock in the corporation, respectively, to her son Joseph Eisenberg.
>
> The fair market value of the stock, after a 25-percent minority discount, was $517.20 per share on the first transfer date, $356.71 per share on the second transfer date, and $341.77 per share on the third transfer date.
>
> On the first, second, and third transfer dates, the property's adjusted basis was $69,500, $67,906, and $67,108, respectively. At the time of the first transfer, the fair market value of the property was

> $600,000. At the time of the second and third transfers, the fair market value of the property was $470,000. The corporation, however, did not possess a plan to liquidate, sell, or distribute the property in conjunction with the stock transfers.
>
> On or about October 16, 1992, April 16, 1993, and April 12, 1994, respondent received petitioner's timely filed Federal gift tax returns, Form 709, for the taxable years 1991, 1992 and 1993, respectively. Respondent issued a statutory notice of deficiency to petitioner on July 18, 1995.

The only issue before the court was the effect of the built-in capital gains:

> Here, the parties have agreed that the net asset value method is appropriate for the value of the stock of the corporation. They are also in agreement as to the fair market value of the property in question and the valuation of the shares as reported on petitioner's Federal gift tax returns. The parties further agree that the corporation would have recognized capital gains in the amount of $530,500, $402,094, and $402,892 for the taxable years 1991, 1992, and 1993, respectively, if the property had been disposed of in a taxable disposition (built-in capital gain). However, the parties diverge on whether, in arriving at the corporation's net asset value, adjustments should be made to reflect costs that would, potentially, be incurred if its assets were liquidated.
>
> Petitioner contends that, for gift tax purposes, she is entitled to take into account the full amount of capital gain taxes to reduce the fair market value of the stock of the corporation. Simply put, petitioner argues that a willing purchaser of the corporate stock would have discounted the otherwise applicable fair market value because of the income tax liability inherent in the aforementioned property. The parties have stipulated the amounts that would have been realized in the years under consideration if a sale of the property had actually taken place. In that regard, petitioner computed the capital gain tax reductions as though the corporation had sold the property in a taxable disposition on the transfer dates.
>
> Respondent, on the other hand, argues that petitioner is not entitled to reduce the fair market value of the corporate stock to account for potential capital gain taxes since there was no liquidation, distribution, or sale of the stock at the transfer dates.

A number of previous Tax Court cases disallowed a discount for built-in capital gains. The court disagreed with the taxpayer's attempt to distinguish those cases:

This Court has repeatedly held that no reduction in the value of closely held stock to reflect potential capital gains is warranted where the evidence fails to establish that a liquidation of the corporation or sale of the corporation's assets is likely to occur. Ward v. Commissioner, 87 T.C. 78, 103-104 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938, 942 (1982); Estate of Piper v. Commissioner, 72 T.C. 1062, 1087 (1979); Estate of Robinson v. Commissioner, 69 T.C. 222, 226 (1977); Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947). Moreover, we have also held that a discount to asset values for the "lost use of money" is inappropriate because it fails to recognize that the underlying assets will themselves appreciate, most likely, at a rate similar to that applied as a discount. Estate of Andrews v. Commissioner, supra at 950.

* * *

Petitioner contents that Estate of Piper v. Commissioner, supra at 1087, and Estate of Luton v. Commissioner, T.C. Memo. 1994-539, among other cases, represent the denial of a discount for potential capital gain taxes was based, in part, on the possibility that the taxes could be avoided by liquidating the corporation.

In that regard, petitioner argues that those cases have lost their vitality as a result of the October 22, 1986, enactment of the Tax Reform Act of 1986 (TRA), Pub. L. 99-514, sec. 631, 100 Stat. 2269. Specifically, petitioner contends that the amendments made by the TRA to sections 336 and 337 repealed the General Utilities doctrine. Petitioner states that prior to the effective date of TRA, the corporation could have liquidated completely and distributed the property and cash to her, or to any other individual or entity, without recognizing the built-in gain. Further, petitioner asserts that, subsequent to the effective date of TRA, she does not possess the ability to completely liquidate the corporation without the recognition of the built-in gain. Further, petitioner asserts that, subsequent to the effective date of TRA, she does not possess the ability to completely liquidate the corporation without the recognition of the built-in gain. See e.g., secs. 336(a) and 337. As a result, petitioner argues that it is now a virtual certainty that if the corporation is liquidated, capital gain taxes will be imposed at the corporate level. Moreover, petitioner states that any "willing buyer" of the corporate stock, having "reasonable knowledge" of the applicability of the capital gain taxes, would reduce the price paid for the stock by the full amount of the tax. Sec. 25.2512-1, Gift Tax Regs. Thus, petitioner argues that this change in the law justifies the allowance of a discount for potential taxes.

In contrast, respondent counters that a hypothetical buyer possesses the option of avoiding the imposition of

> any capital gain taxes through the purchase of corporate stock and the continuation of the business of leasing the property in question through the corporate form. Thus, respondent asserts that any individual or entity may indefinitely defer taxes. Additionally, respondent argues that there are several transactions in which the corporation may transfer the property to a new corporation in exchange for the new corporation's stock and thus avoid the recognition of gain. See e.g., secs. 351 and 355.
>
> We agree with respondent that a discount for capital gain taxes does not apply here. As noted, we have held that a discount for potential costs of sale or liquidation, whether in the nature of selling expenses or income taxes that might be incurred, is inappropriate where the sale or liquidation is itself speculative.
>
> In this instance, both parties have stipulatd that there was no plan of liquidation. Accordingly, it is inapposite to apply a discount for potential capital gain taxes when the recognition event itself is purely speculative.

Similarly is the Estate of Welch v. Commissioner, T.C. Memo 1998-167. The valuation was performed by Mercer Capital Management, of Memphis, Tennessee, which has an office in Louisville. The opinion states:

> The parties agree that the fair market value of decedent's interest in ESI and ISC as of the applicable valuation date, absent a discount for built-in capital gains, is $328,294 and $365,419, respectively. The estate argues that a willing seller and a willing buyer of the corporate stock would have discounted the value of ESI's and ISC's stock to reflect the income tax liability due upon sale of the condemned properties. In support thereof, the estate contends: At the time of decedent's death, the real property owned by ESI and ISC was under threat of condemnation by the Housing Authority; that the real property was in fact sold to the Housing Authority; and that a portion of the nonvoting common stock owned by the decedent at her death was sold on March 4, 1994, at a per share price equal to the per share price shown on the estate's Federal estate tax return. As to the March 4, 1994, stock sale, the estate is, in essence, arguing that the sale is indicative of what a willing buyer would have paid for the stock on the valuation date given the income tax liability inherent in the aforementioned property.
>
> Respondent makes several arguments for disallowing a built-in capital gains discount. First, respondent argues that the estate has not established that a liquidation of the corporations or the sale of the corporations' assets was likely to occur. Among other things, respondent contends that the estate has failed

to show that the condemnation of the subject properties was foreseeable on the valuation date, and that the evidence establishes that legislative action to condemn the property was not taken until August 12, 1993, more than 5 months after the valuation date. Second, respondent argues that the discount is not warranted where only the real estate, and not the corporations, was subject to condemnation. Third, respondent argues that the discount is not warranted where both corporations could avoid, and did indeed avoid, the recognition of gain under section 1033.

As previously stated, ordinarily a [stricken work] sale within a reasonable time before or after the valuation date is the best criteria of market value. See Estate of Scanlan v. Commissioner, T.C. Memo. 1996-331, affd. without published opinion 116 F.3d 1476 (5th Cir. 1997). However, in this case, we do not assign any weight to the March 4, 1994, stock sale which included the sale of nonvoting common shares in ESI and ISC. The sale was between related parties, the coexecutors (decedent's son and daughter). Moreover, the coexecutors appear to have determined the sales price of the stock solely by referencing its fair market value as reported on decedent's Federal estate tax return, even though the sale occurred approximately 12 months after decedent's death. We therefore focus our attention on the issue of whether the value of decedent's interest in ESI and ISC includes a discount for built-in capital gains tax liability. The estate must prove error in respondent's determination of value as set forth in respondent's notice of deficiency. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933).

This Court has repeatedly rejected reductions in value of closely held stock to reflect built-in capital gains tax liability where the evidence fails to establish that a liquidation of the corporation or sale of the corporation's assets is likely to occur. See Ward v. Commissioner, 87 T.C. 78, 103-104 (1986); Estate of Andrews v. Commissioner, supra at 942; Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947); Estate of Thalheimer v. Commissioner, T.C. Memo. 1974-203, affd. on this issue and remanded without published opinion 532 F.2d 751 (4th Cir. 1976). Recently, in Eisenberg v. Commissioner, T.C. Memo. 1997-483, the Court stated:

> taxpayers may not obtain a valuation discount for estate and gift tax purposes based on an event that may not transpire. Hence, "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." [Estate of Andrews v. Commissioner, supra at 942; emphasis added.]

In sum, the primary reason for disallowing a discount for capital gain taxes in this situation is that the tax liability itself is deemed to be speculative. [In prior cases] * * * there was a failure to show the requisite likelihood that the beneficiaries would liquidate the corporation or sell the underlying assets and incur the tax and other expenses. Further, there was no showing that a hypothetical willing buyer would desire to purchase the stock with the view toward liquidating the corporation or selling the assets, such that the potential tax liability would be of material and significant concern.

We find that in this case the potential for capital gains tax recognition was too speculative to warrant application of the capital gains discount. As suggested in Eisenberg v. Commissioner, supra, and other cases cited above, the estate must show the requisite likelihood that the corporation would sell the assets and incur the tax. Assuming that the condemnation of the subject properties was foreseeable as of the valuation date, see Ithaca Trust Co. v. United States, 279 U.S. 151 (1929) (subsequent events are not considered in determining fair market value, except to the extent that they were reasonably foreseeable at the date of valuation); Estate of Scanlan v. Commissioner, supra, and consequently there was the requisite likelihood that the corporations would sell the properties, the estate has failed to show that it was likely that either of the corporations would pay built-in capital gains tax upon sale.

As a general rule, gain realized from the sale or other disposition of property must be recognized. See sec. 1001(c). Section 1033 provides an exception to this general rule by allowing gain realized from certain involuntary conversions to be deferred. Realized gain can be deferred in its entirety under section 1033 if: (1) nonrecognition treatment is elected; (2) qualified replacement property is purchased within the time limits specified; and (3) the cost of the qualified replacement property equals or exceeds the amount realized on the conversion. Sec. 1033(a)(2)(A). Among other things, an involuntary conversion results when property is condemned by the government. Sec. 1033(a). The aforementioned exception to the general rule that gain is recognized casts doubt on whether or when a taxpayer would have to recognize gain as a result of an involuntary conversion.

A section 1033 election was available to the estate on the applicable valuation date. The estate presented no evidence that on or near the valuation date either corporation considered recognizing the built-in capital gain and foregoing the election under section 1033. Additionally, ESI and ISC manifested their intent to find replacement properties by filing the section 1033 elections with each corporation's 1994 Federal income tax returns. The principal shareholder, and now sole shareholder, Newton covenanted to find replacement property when he acquired the shares of the other

> shareholders. Given these facts, no reduction in value should be allowed for the corporations' built-in capital gains, and we therefore uphold respondent's determination on this issue.

The Tax Court has handed down an extremely important case in Estate of Davis v. Commissioner, 110 T.C. No. 35 (1998). The opinion of Judge Chiechi was not reviewed but was a regular opinion. The court allowed a reduction for built-in capital gains as part of a lack of marketability discount.

The stock to be valued was of a personal holding company which owned considerable Winn-Dixie stock:

> Decedent, who was one of the founders of Winn-Dixie Stores, Inc. (Winn-Dixie), died testate on June 11, 1995, while he was a legal resident of Florida. Robert Davis, the personal representative of decedent's estate, resided in Jacksonville, Florida, at the time the petition was filed.
>
> On or about November 2, 1992 (the valuation date), ADDI&C, a closely held Florida corporation that was incorporated on December 22, 1947, had a total of 97 shares of common stock issued and outstanding, all of which were owned by a trust (Davis trust) for the benefit of decedent and none of which was subject to any restrictive sale provisions or buy-sell agreements. On the valuation date, decedent transferred 25 shares of such stock to his son Robert Davis and 25 shares of such stock to his son Lee Davis. On that date, each of those two blocks of ADDI&C common stock constituted 25.77 percent of the issued and outstanding common stock of ADDI&C.
>
> As of the valuation date, ADDI&C was primarily a holding company for various assets of decedent, although ADDI&C also had certain cattle operations (both feeder and breeding cattle) as of that date. Specifically, on the valuation date, ADDI&C owned 1,020,666 shares, or 1.328 percent, of the issued and outstanding common stock of Winn-Dixie, which was at all relevant times traded on the New York Stock Exchange (NYSE); 3,456 shares, or .0737 percent, of the issued and outstanding common stock of D.D.I., Inc. (DDI), which was a holding company for various assets of decedent and his family and the stock of which was at all relevant times not publicly traded; various feeder and breeding cattle; certain equipment; and certain other unidentified assets.

On the valuation date, the net asset value of the company was a little over $80,000,000 with a tax basis of about $7,600,000. A number of discounts were at issue:

	Petitioner's Expert Mr. Howard	Petitioner's Expert Mr. Pratt	Respondent's Expert Mr. Thomson
Blockage and/or SEC rule 144 discount	4.9 percent or $3,432,117	10 percent or $7,004,320	-$0-
Discount or adjustment attributable to ADDI&C's built-in capital gains tax	25,395,109	Factored in as part of lack-of-marketability discount	Factored in as part of lack-of-marketability discount
Net asset value of ADDI&C	51,313,043	73,135,976	80,140,269
Minority discount	15 percent or 7,696,956	20 percent or 14,627,195	12 percent or 9,616,832
Lack-of-marketability discount	35 percent or 15,265,630	50 percent or 29,254,391	38 percent or 26,798,906
Portion of lack-of-marketability discount attributable to ADDI&C's built-in capital gains tax	-0-	15 percent or 8,776,317	15 percent or 10,578,516
Total dollar amount of discounts or adjustments	51,789,812	50,885,906	36,415,738
Fair market value of each 25-share block of ADDI&C common stock	7,306,825	7,539,800	11,250,000
Fair market value of each share of each 25-share	292,273	301,592	450,000

	Petitioner	Respondent
Blockage and/or SEC rule 144 discount	10 percent or $7,004,320	-$0-
Discount or adjustment attributable to ADDI&C's built-in capital gains tax	24,645,525	-0-
Net asset value of ADDI&C	49,490,424	80,140,269

Minority discount	15 percent or 7,273,564	15 percent or 12,021,040
Lack-of-marketability discount	35 percent or 14,425,901	23 percent or 15,667,423
Portion of lack-of-marketability discount attributable to ADDI&C's built-in capital gains tax	-0-	-0-
Total dollar amount of discounts or adjustments	53,349,310	27,688,463
Fair market value of each 25-share block of ADDI&C common stock	6,904,886	13,518,500
Fair market value of each share of each 25-share block of ADDI&C common stock	276,195	540,740

With respect to the built-in gains issue, the opinion states:

> We are convinced on the record in this case, and we find, that, even though no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of ADDI&C's built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of ADDI&C stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no ADDI&C's built-in capital gains tax as of that date. Respondent's position to the contrary is inconsistent with the record in this case. We have found nothing in the following cases on which respondent relies that requires us, as a matter of law, to alter our view: Ward v. Commissioner, 87 T.C. 78 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Piker v. Commissioner, 72 T.C. 1062 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162 (1947); Estate of Luton v. Commissioner, T.C. Memo. 1994-539, supplemented by T.C. Memo. 1996-181; Estate of Ford v. Commissioner, T.C. Memo. 1993-580, affd. 53 F.3d 924 (8th Cir. 1995); Estate of Bennett v. Commissioner, T.C. Memo. 1993-34.
>
> We note initially that one of the cases on which respondent relies, Estate of Bennett v. Commissioner, supra, involved a valuation date that preceded the repeal of the General Utilities doctrine and did not

involve a request by the taxpayer for a reduction in valuing the stock interest in question for the capital gains tax that would have been due upon liquidation of the corporation whose stock was at issue, absent tax planning to avoid that tax which was permissible as of the valuation date in that case. Instead, the taxpayer in the Estate of Bennett case asked the Court to reduce the value of the stock interest in question there by the "estimated costs of liquidation" which consisted of a "discount for commissions", a "discount for losses on liquidation", and a "discount for the costs of overhead and sales costs". Estate of Bennett v. Commissioner, supra.

Turning to the remaining cases on which respondent relies, it is significant to us that, except for Estate of Luton v. Commissioner, supra, none of the cases on which respondent relies indicates that any of the expert witnesses who testified in those cases considered corporate built-in capital gains tax as a factor in appraising the respective stock interests at issue in those cases. In the Estate of Luton case, one of the taxpayer's experts, but not respondent's expert, reduced the asset value of each of the corporations at issue by liquidation costs that included, inter alia, Federal and State capital gains taxes that would have been incurred on liquidation of those corporations. Estate of Luton v. Commissioner, supra. In contrast, in the present case, all of the experts for both parties are of the view that ADDI&C's built-in capital gains tax must be taken into account as a factor in ascertaining the fair market value of each of the two blocks of ADDI&C stock in question.

Except for Estate of Luton v. Commissioner, supra, and Estate of Ford v. Commissioner, supra, the other cases on which respondent relies (like Estate of Bennett v. Commissioner, supra) involved valuation dates that preceded the repeal of the General Utilities doctrine. As we read all of those cases, including Estate of Luton and Estate of Ford, the taxpayers requested the Court for a reduction in valuing the respective stock interests in question equal to the full amount of capital gains taxes that would have been due upon liquidation of the respective corporations whose stock was at issue in those cases, absent tax planning to avoid those taxes which was permissible as of the respective valuation dates in those cases. The Court denied each of those requests for a reduction for the full amount of such capital gains taxes where there was no evidence as of those respective valuation dates that a liquidation of the corporation in question or sale of corporate assets was planned or contemplated or that the full amount of such taxes could not have been avoided.

In the present case, petitioner and all of the experts, including respondent's expert, believe, and we have found, that, in determining the fair market value on the valuation date of each of the blocks of stock at issue,

> it is necessary to apply a discount or adjustment attributable to ADDI&C's built-in capital gains tax because that is what a hypothetical willing seller and a hypothetical willing buyer would have done under the facts and circumstances existing on that date. Petitioner adopts the view of petitioner's expert Mr. Howard and argues that the full amount of such tax should reduce ADDI&C's net asset value in making that determination. On the record before us, we reject petitioner's position and Mr. Howard's opinion. On that record, we find that, where no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, the full amount of ADDI&C's built-in capital gains tax may not be taken as a discount or adjustment in determining the fair market value on that date of each of the two blocks of stock in question, even though we have found that as of that date it was unlikely that ADDI&C could have avoided all of ADDI&C's built-in capital gains tax, and the record does not show that there was any other way as of that date by which ADDI&C could have avoided all of such tax. See Ward v. Commissioner, 87 T.C. 78 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Piper v. Commissioner, 72 T.C. 1062 (1979).

Footnote 17 discusses two cases decided recently:

> See Estate of Welch v. Commissioner, T.C. Memo. 1998-167, and Eisenberg v. Commissioner, T.C. Memo. 1997-483, which were decided after the parties filed their briefs in this case and which involved valuation dates that occurred after the repeal of the General Utilities doctrine. In neither of those cases was a liquidation of the corporation in question or a sale of its assets planned or contemplated as of the respective valuation dates. In valuing the respective stock interests at issue in those cases, the taxpayers asked the Court for a reduction equal to the full amount of capital gains taxes that would have been due upon liquidation of the respective corporations involved there, absent tax planning to avoid those taxes which was permissible as of the respective valuation dates. In neither of those cases does the Court indicate that any expert believed that such a reduction was warranted. The Court denied the taxpayers' requests.

Two lessons are apparent. One, valuation experts must consider built-in gains explicitly as part of a discount analysis. Two, valuation cases should be approached either on a going concern basis -- with free cash-flow as the key criterion of value -- or on a liquidation basis in which built-in gains are a key component.

2. **Gift by Trustee**. The Second Circuit has reversed the Tax Court in Saltzman v. Commissioner, 131 F.3d 87 (2nd Cir. 1997). The primary issue before

the court was whether the Trustee made a gift to his son when the trust exchanged common stock for preferred stock of a lesser value, thus increasing the value of the son's stock. The court determined that no gift was made.

> Section 288 of the Restatement (Second) of Trusts provides:
>
> > If the trustee in breach of trust transfers trust property to a person who takes with notice of the breach of trust, the transferee does not hold the property free of the trust, although he paid value for the transfer.
>
> Comment (a) thereunder elaborates on the scope of the rule as follows:
>
> > The interest of the beneficiary in the trust property is not cut off by a transfer by the trustee in breach of trust to a third person who at the time of the transfer has notice that the transfer is in breach of trust, although he paid value for the transfer; and the beneficiary can in equity compel the third person to restore the property to the trust. The third person holds the interest which he acquires by the transfer upon a constructive trust for the beneficiary of the trust.
>
> The is the law of New York. See Renz v. Beeman, 589 F.2d 735, 744 (2d Cir. 1978); see also Albright v. Jefferson County Nat'l Bank, 292 N.Y. 31, 40 (1944); Wendt v. Fisher, supra, 243 N.Y. at 444. The alleged gift from Arnold to Eric was imperfect or inchoate rather than consummate.
>
> In Burnet v. Guggenheim, 288 U.S. 280 (1933), the Court held that the gift statute "is aimed at transfers of the title that have the quality of a gift, and a gift is not consummate until put beyond recall." Id. at 286. That holding has been followed consistently. See, e.g., Smith v. Shaughnessy, 318 U.S. 176, 181 (1943)("The separable interests transferred are not gifts to the extent that power remains to revoke the trust or recapture the property represented by any of them[.]"(citing Burnet); Rev. Ruling 74-365.
>
> Moreover, Burnet is applicable not only where the grantor has expressly reserved the right to revoke the conveyance but also where a right arises by indirection or operation of law. 5 Bittker, Federal Taxation of Income, Estates and Gifts Para(s) 122.3.1 (1984); Dodge v. United States, 413 F.2d 1239, 1242-43 (5th Cir. 1969). Commissioner v. Allen, 108 F.2d 961, 963 (3d Cir. 1939), cert. denied, 309 U.S. 680 (1940); Berger v. United States, 487 F.Supp. 49, 52 (W.D. Pa. 1980).

> One who receives property as a result of a breach of trust holds the property in constructive trust. This does make him a trustee as that term generally is used. "In the case of a constructive trust, the duty is merely to surrender the property." V Scott on Trusts section 462.1 at 3415 (3d ed. 1967), see also Coco v. Coco, 107 A.D.2d 21, 24-27, appeal dismissed, 65 N.Y.2d 637 (1985). In the face of this duty, the transfer of property by a trustee in violation of his fiduciary obligations cannot be said to be final or consummate. It therefore is not taxable as a gift.

3. **Gift Upon Trust Termination**. In PLR 9802031 the Service ruled that a gift is made when the beneficiary of a trust allows the trust to be terminated. The ruling states:

> In the present case, the terms of the Decedent's testamentary trust grant Spouse an interest in trust income and principal. Distributions of income and principal are to be made at the discretion of the trustee based on an ascertainable standard relating to Spouse's needs for health, education, support, and maintenance. The trust is to terminate at the death of Spouse.
>
> In the present case, the trustee and beneficiaries of Trust have petitioned the court to terminate the trust prior to the Spouse's death. Section *** of the *** Trust Code provides that, upon petition by the trustee or beneficiary of a trust, a court may order that a trust be terminated if the purposes of the trust have been fulfilled.
>
> Spouse holds an interest in the trust even though distributions to Spouse are at the discretion of the trustee. The relinquishment of this interest through the proposed early termination of the trust, will constitute a transfer by Spouse for federal gift tax purposes to the trust remaindermen. See, Rev. Rul. 67-370. The value of the gift is the fair market value of the interest relinquished by Spouse. The value is determined based on all relevant factors, such as the projected needs of Spouse for health, education, support, and maintenance for the remainder of his life.

The cited revenue ruling was summarized as follows:

> In Rev. Rul. 67-730, 1967-2 C.B. 324, the decedent's estate was entitled to receive the principal of an inter vivos trust upon the death of the settlor, provided the settlor, who survived the decedent, did not revoke the trust, or otherwise amend the trust during the settlor's lifetime. The ruling concludes that the fair market value of the decedent's interest in the trust is includible in the decedent's gross estate, notwithstanding that the estate's interest could be divested at the discretion of the settlor subsequent to

> the decedent's death. The ruling also holds that the value of the interest would not necessarily be nominal.

4. **Gift Created By Renouncing Interest in Trust**. PLR 9811044 considered the effects of a child giving up rights to income and principal from a trust. The trust terms were:

> Under the terms of the Residual Trust, as amended, the trustees have the sole discretion to pay the net income to Child during her life and, with Child's express consent, to or for the benefit of Child's issue without any requirement that distributions be equal or made at the same time. The trustees also have sole discretion to distribute all or any part of trust corpus to or for the benefit of Child for any worthy purpose, including but not limited to, the purchase of a house, investment in a business, hospital and other medical expenses, and any emergency or disaster affecting Child. Upon Child's death, the trust corpus will be distributed outright by right of representation to Child's then surviving issue. If there are none, the corpus will be distributed to any surviving issue of the Settlor. During the term of the Residual Trust, the trustees may make distributions to or for the benefit of Settlor's spouse of all or any part of trust corpus to maintain her in her accustomed standard of living; to meet any expenses of illness, hospitalization, nursing care, or surgery; or to care for her in any other type of emergency reasonably requiring the use of funds.

The ruling determined that there would be a gift although of an amount that must be determined by the district director:

> Rev. Rul. 67-370, 1967-1 C.B. 324, holds that a defeasible remainder interest in trust which is subject to termination at the will of another is an interest in property within the meaning of section 2033. The ruling notes that the fair market value of the interest would be affected by its possible divestment and would be determined in accordance with the general rules for valuation of property for estate tax purposes contained in section 20.2031-1(b) of the Estate Tax Regulations. The ruling also notes that the mere presence of the possibility of divestment does not warrant the assignment of a merely nominal value to the defeasible interest.
>
> Similarly, in the instant case, Child has an interest in the trust property although her right to receive any distribution, either of income or corpus, is solely within the discretion of the independent corporate trustee.
>
> The proposed renunciation by Child of her interest will not satisfy the requirements for a qualified disclaimer since it will not have been made within 9 months of the

death of Settlor. Therefore, such renunciation will constitute a gift from Child to the remainder beneficiaries of the Residual Trust.

The value of the gift is a question of fact. However, since the gift is not an absolute right to distributions of income or principal, it cannot be valued by use of the tables contained in section 2512. See Deal v. Commissioner, 29 T.C. 730 (1958). Rather, the value of the gift should be determined in accordance with the general valuation principles contained in section 25.2512-1.

Section 3.01(42) of Rev. Proc. 97-3, 1997-1 I.R.B. 85, provides that the Service will not rule on actuarial factors for valuing prospective or hypothetical gifts of a donor under section 2512. Such matters are solely within the jurisdiction of the District Director upon audit of the return.

5. **Purchase of Remainder Interest in QTIP**. Revenue Ruling 98-8 has held that the purchase of a remainder interest in a QTIP trust by the surviving spouse will constitute a gift of the property in the trust. The IRS rationale is that the purchase is a disposition.

The facts of the Ruling were these:

The decedent, D, died in 1993 survived by S, D's spouse. Under the terms of D's will, a trust (the QTIP trust) was established under which S was to receive all of the trust income, payable at least annually, for S's life. On S's death, the remainder was to be distributed outright to C, D's adult child.

S was not given a general power of appointment over the trust property.

On the federal estate tax return filed for D's estate, the executor made an election under section 2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to D's estate for the value of the property passing from D to the QTIP Trust.

Subsequently, S, C, and the trustee of the QTIP Trust entered into the following transaction: (1) S acquired C's remainder interest in the QTIP Trust; (2) S gave C a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest; (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to S; and (4) S thereupon paid x dollars from those assets to C in satisfaction of the promissory note.

At the conclusion of the transaction, the QTIP Trust was terminated; S held QTIP Trust assets having a value of y dollars (which was equal to the value of S's life

> interest in the trust); and C held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). S contended that the transaction was not subject to gift tax because S received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by S to C.

The Ruling discussed the disposition argument as follows:

> Under section 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (i.e., all interests in the property other than the income interest). Correspondingly, under section 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.
>
> The term "disposition," as used in section 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:
>
> The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.
>
> A commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under section 2519 of the value of the remainder interest. The commutation of the spouse's income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the income interest. Sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations. Section 25.2519-1(g), Example 2 (illustrating that the sale by the spouse of the spouse's income interest to the trust remaindermen is a disposition of the income interest); section 25.2519-1(f) providing that "[T]he sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee-spouse's income interest, is considered a disposition of the qualifying income interest." See also, <u>Estate of Novotny v. Commissioner</u>, 93 T.C. 12 (1989), in which the surviving spouse and remainderman divided the sale proceeds of QTIP property proportionately on the basis of the respective values of

> their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of section 2519 and was thus subject to gift tax.
>
> There is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where S acquired the remainder interest. In both cases, after the transaction the spouse's income interest in the trust is terminated and the spouse receives outright ownership of property having a net value equal to the value of the spouse's income interest. Similarly, the remainderman receives ownership of property equal in value to the remainder interest. Thus, the transaction in the instant case essentially effectuates a commutation of S's income interest in the trust, a transaction that is a disposition of S's income interest under section 2519. Therefore, under section 2519, S is regarded as making a gift of x dollars, the value of the remainder interest in the QTIP Trust. Section 25.2519-1(f).

The Ruling also stated that because spouse received something which was already included in spouse's estate there could be no full and adequate consideration.

> This conclusion that S has made a gift is also supported by an additional analysis. S acquired an asset (the remainder interest in the QTIP Trust) that is already subject to inclusion in S's transfer tax bases under section 2044. In analogous situations, the courts have recognized that the receipt of an asset that does not effectively increase the value of the recipient's gross estate does not constitute adequate consideration for purposes of the gift and estate tax. See Commissioner v. Wemyss, 324 U.S. 303, 307 (1945), 1945 C.B. 416, ("The section taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate.")
>
> A companion case to Commissioner v. Wemyss, Merrill v. Fahs, 324 U.S. 308 (1945), 1945 C.B. 418, and the cases that preceded it, involved situations where A, an individual, transferred property to B, A's spouse (or future spouse), in exchange for B's relinquishment of marital rights in A's property. The Court held that B's relinquishment of the marital rights did not constitute adequate and full consideration for A's transfer because the assets subject to the marital rights were already includible in A's taxable estate. The property subject to dower and marital rights were already included in the gross estate of the property owner. Thus, to conclude that the relinquishment of dower and marital rights by the spouse of the property owner constituted adequate and full consideration for a transfer by the property

> owner for gift tax purposes would effectively subvert the legislative intent and statutory scheme of the gift tax provisions. Merrill v. Fahs, at 311-312. See also, Commissioner v. Bristol, 121 F.2d 129, 136 (1st Cir. 1941).
>
> Likewise, in the present situation, property subject to the QTIP election was intended to be subject to either gift or estate tax. S's receipt of the remainder interest does not increase the value of S's taxable estate because that property is already subject to inclusion in S's taxable estate under section 2044. Rather, S's issuance of the note results in a depletion of S's taxable estate that is not offset by S's receipt of the remainder interest. Thus, for estate and gift tax purposes, S's receipt of the remainder interest cannot constitute adequate and full consideration under section 2512 for the promissory note transferred by S to C. As was the case in Merrill v. Fahs, any other result would subvert the legislative intent and statutory scheme underlying section 2056(b)(7). Therefore, under section 2511, S has made a gift to C equal to the value of the promissory note S gave to C.

The result would be the same if cash were used for the purchase or if only part of the remainder interest were purchased:

> In addition, a gift tax would be imposed under the above alternative rationales even if S acquired only a portion of C's remainder interest; e.g., S acquired 60 percent of C's remainder interest. If, under applicable state law, such a transaction results in a partial termination of the trust, S would be treated as disposing of part of S's income interest in the trust, and the commutation analysis would apply. See, e.g., Restatement (Second) of Trusts section 340(2) (1959). See also, section 25.2519-1(g), Example 4, (illustrating the estate and gift tax consequences of the disposition of a portion of the spouse's income interest). If the trust does not terminate, S could nonetheless be treated as making a transfer under sections 2511 and 2512 for less than adequate and full consideration to the extent of the value of the property or cash S transfers in exchange for the partial remainder interest.
>
> Further, the conclusion of this revenue ruling would be the same if S transferred to C property or cash rather than the promissory note. The economic effect of the transaction is identical, regardless whether S uses S's own funds to finance the transaction or gives a promissory note and discharge the note using some of the QTIP Trust assets received in the transaction. Thus, the result is the same for transfer tax purposes.

6. **Gifts of Stock Options**. Rev. Rul. 98-21, 1998-18 I.R.B.1, discusses the transfer of stock options and concludes that a transfer will not be a

completed gift until the exercise is no longer conditional on the performance of services. The stock option plan outlined in the Ruling is perhaps not typical.

> A is employed by Company. Company has one class of stock. Company has a stock option plan under which employees can be awarded nonstatutory stock options to purchase shares of Company's stock. These stock options are not traded on an established market. The shares acquired on the exercise of an option are freely transferable, subject only to generally applicable securities laws, and subject to no other restrictions or limitations. Company grants to A, in consideration for services to be performed by A, a nonstatutory stock option to purchase shares of Company common stock. Company's stock option plan provides that the stock option is exercisable by A only after A performs additional services.
>
> All options granted under Company's stock option plan expire 10 years from the grant date. The exercise price per share of A's option is the fair market value of one share of Company's common stock on the grant date. Company's stock option plan permits the transfer of nonstatutory stock options to a member of an optionee's immediate family or to a trust for the benefit of those individuals. The effect of such a transfer is that the transferee (after the required service is completed and before the option's expiration date) will determine whether and when to exercise the stock option and will also be obligated to pay the exercise price.
>
> Before A performs the additional services necessary to allow A's option to be exercised, A transfers A's option to B, one of A's children, for no consideration.

The Ruling concludes:

> The gift tax applies to a transfer of property by way of gift, whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible and intangible. Section 25.2511-1(a). For this purpose, the term property is used in its broadest and most comprehensive sense and reaches "every species of right or interest protected by law and having an exchangeable value." H.R. Reg. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Reg. No. 665, 72d Cong., 1st Sess., 39, (1932); both reprinted in 1939-1 (Part 2) C.B. 476, 524. Some rights, however, are not property. See e.g., Estate of Howell v. Commissioner, 15 T.C. 224 (1950)(nonvested pension rights were not property rights includible in gross estate under section 811(c) of the 1939 Code); Estate of Barr v. Commissioner, 40 T.C. 227 (1963) acq., 1964-1 C.B. 4 (death benefits payable at discretion of board of directors who usually but not always, agreed to payment, were in the nature of hope or expectancy and not property rights includible in gross estate for estate tax purposes).

> Generally, a gift is complete when the donor has so parted with dominion and control over the property as to leave the donor no power to change its disposition, whether for the donor's own benefit or for the benefit of another. Section 25.2511-2(b).
>
> In Estate of Copley v. Commissioner, 15 T.C. 17 (1950), aff'd, 194 F.2d 364 (7th Cir. 1952), acq., 1965-2 C.B. 4, the petitioner entered into an antenuptial agreement in which the petitioner promised to give the future spouse a sum of money in consideration of the marriage and in lieu of all the spouse's marital rights in the petitioner's property. The agreement became legally enforceable under state law on the date of the marriage in 1931. The petitioner transferred part of the sum of money in 1936 and the rest in 1944. The court concluded that a gift tax would have been due in 1931 if there had been a gift tax law in effect at that time.
>
> In Rev. Rul. 79-384, 1979-2 C.B. 344, a parent promised to pay a child $10,000 if the child graduated form college. Rev. Rul. 79-384 holds that the parent made a gift on the day the child graduated from college, the date when the parent's promise became enforceable and determinable in value.
>
> In Rev. Rul. 80-186, 1980-2 C.B. 280, a parent transferred to a child, for nominal consideration, an option to purchase real property for a specified period of time at a price below fair value. Rev. Rul. 80-186 holds that the transfer is a completed gift at the time the option is transferred provided the option is binding and enforceable under state law on the date of the transfer.

The Ruling's position is questionable. Continued employment has been determined in other contexts to be an act of independent significance. See Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986). The Ruling cites this authority:

> In the present case, Company grants to A a nonstatutory stock option conditioned on the performance of additional services by A. If A fails to perform the services, the option cannot be exercised. Therefore, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, such portion of the option that becomes exercisable at a different time is treated as a separate option for the purposes of

> applying this analysis. In the event that B is a skip person (within the meaning of section 2613(a)), the generation-skipping transfer tax would apply at the same time as the gift tax. See Rev. Proc. 98-34, 1998-18, which sets forth a methodology to value certain compensatory stock options for gift, estate, and generation-skipping transfer tax purposes.

Rev. Proc. 98-34, 1998-17 I.R.B.1, sets forth the proper method of valuing stock options. The standard method is referred to as the Black-Scholes method, which is approved subject to certain parameters:

> Taxpayers may determine the value of Compensatory Stock Options for transfer tax purposes by using a generally recognized option price model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account as of the valuation date the following factors: (1) the exercise price of the option; (2) the expected life of the option; (3) the current trading price of the underlying stock; (4) the expected volatility of the underlying stock; (5) the expected dividends on the underlying stock; and (6) the risk-free interest rate over the remaining option term.
>
> In order to rely on this revenue procedure: (1) the taxpayer must use the factors determined in section 4.03 through 4.07 of this revenue procedure; (2) each of the factors used in applying the option pricing model must be reasonable (for this purpose, the use of the factors in section 4.03 through 4.07 of this revenue procedure will be deemed reasonable); (3) the option pricing model must be properly applied; (4) the company that granted the option must be subject to FAS 123 in preparing its financial statements for the fiscal year of the company that includes the valuation date; (5) the underlying stock must be common stock and must be the same stock for which the expected volatility and expected dividends were estimated by the company for purposes of FAS 123; and (6) no discount can be applied to the valuation produced by the option pricing model (for example, no discount can be taken due to lack of transferability or due to the termination of the option within a specified number of days following termination of employment).

7. **Crummey Gifts**. The IRS has again disallowed certain gifts in the context of a Crummey trust, in TAM 9731004. Of interest is the following statement by the National Office:

> The Service generally does not contest gift tax annual exclusions for transfers subject to withdrawal powers that are held by current income beneficiaries and persons with vested remainder interests. These individuals have current or long term economic interests in the trust and in the value of the corpus. It is understandable that in weighing these interests, they

decide not to exercise their withdrawal rights. However, where nominal beneficiaries enjoy only discretionary income interests, contingent rights to the remainder, or no rights whatsoever in the income or remainder, their non-exercise of the withdrawal rights indicates that there was some kind of prearranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both.

The facts which bothered the Service were these:

Trust #1 was established on December 28, 1981, with a transfer of an interest in real property. Under the terms of Trust #1, B, the primary beneficiary and daughter of the Donor, was to receive the income realized by the trust on an annual basis during the life of Donor. In the event that B died during the Donor's life, the income of the trust was to pass equally to B's surviving children, per stirpes, if any, or if none to Donor's remaining children, per stirpes.

Each of the 16 individuals named in Exhibit B (a group consisting of the Donor's children and their spouses, and the Donor's grandchildren) had the non-cumulative power to withdraw an amount specified at all times during a one-year period commencing on the date of a contribution to the trust.

Upon Donor's death, subject to the withdrawal powers, the trustee was to distribute the trust property to B. In the event B predeceased D , the trust property was to pass equally to B's surviving children, per stirpes. In the event B had no children surviving her, the trust property was to pass equally to the Donor's remaining children, per stirpes.

Because B's sons were entitled to income of Trust #1 only in the event that they survived B while the Donor lived they had a contingent income interest in Trust #1. Because B's sons were entitled to receive the corpus of Trust #1 only in the event that the Donor died, predeceased by B, the sons had a contingent remainder interest in Trust #1.

Donor's other children, A, C, and D, had only remote contingent income and remote contingent remainder interests in Trust #1. In the event that B and all B's children died, while the Donor survived, the Donor's children were entitled to the income from Trust #1. In the event that at the time the Donor died neither B nor any of B's children survived, the trust corpus would pass to the Donor's remaining children.

The children of A, C, and D had even more remote contingent income and remainder interests in Trust #1 because they would receive income or corpus only if B, all of B's children, and their own parent died before the Donor. For example, A's children would receive income from the trust only if B, all of B's children, and A died before the Donor. Similarly, the trust corpus would pass to A's children only if at the time the Donor died B, all of B's children, and A were deceased.

Neither the spouse of B nor the spouses of B's siblings, (A C and D) had any interest in Trust #1 aside from his or her withdrawal right.

The ruling concluded:

The substantive effect of all these trusts and all these transfers was to carry out the Donor [sic] intention that upon her death the farm property comprising the corpus of the eight trusts would be transferred outright in four approximately equal shares to the Donor's four children. Such a purpose could not be accomplished if any of the 15 or 16 individuals (other than the primary beneficiary) had exercised his or her withdrawal right to remove property from the trust.

In fact, none of the individuals ever exercised a withdrawal right with respect to any of the ten transfers to the trusts. The individuals (other than the primary beneficiary of the trust) had only a contingent interest, a remotely contingent interest, or no possible interest in any property left in the trust upon the expiration of the withdrawal rights. The children of the primary beneficiary would receive trust property only if their parent died before their grandmother. The siblings of the primary beneficiary would receive trust property only if the primary beneficiary and all the primary beneficiary's children died before the siblings' mother. The grandchildren of the Donor, other than those who are children of the primary beneficiary, would receive trust property only if the primary beneficiary, all the children of the primary beneficiary, and the grandchildren's parent died before their grandmother. The spouses of the donor's children would never receive any interest in the trust property.

The fact that none of the withdrawal rights was ever exercised, even by those who had no other interests in the trusts, leads to the conclusion that as part of a prearranged understanding, all of the individuals (other than the primary beneficiary) knew that their rights were paper rights only, or that exercising them would result in unfavorable consequences. There is no other logical reason why these individuals would choose not to withdraw the amount specified in each trust as a gift which would neither be includible in their income nor subject the Donor to the gift tax.

Having considered the facts and circumstances surrounding the creation, funding, and purpose of each trust, we conclude that Donor did not intend to make bona fide gifts of present interests to any of the trusts' beneficiaries other than the primary beneficiary of each trust.

8. **Gifts by Guardian Under Court Order**. The National Office in TAM 9731003 has disallowed certain gifts made under court order by the guardians for an incompetent. The facts described were as follows:

> In February 1992, Nephew A and Nephew B (sons of Sibling A) were appointed temporary guardians of the Decedent's person and property. The appointment became permanent in March 1992. In October 1992, the guardians filed a "Motion to Implement Estate Planning" with the local court. The principle purpose of the Motion was to authorize the guardians to make gifts during the Decedent's life in order to (1) reduce the potential estate liability, and (2) increase the amount available for the ultimate distributees. The guardians represented in the motion that the Decedent had an estimated 1992 annual income of approximately $700,000 from annuities, pensions and assets, including stocks, bonds, cash, and cash equivalents. They also estimated that the Decedent's annual expenses for care, support and welfare, including federal and state income taxes, was approximately $200,000.
>
> The Motion sought authorization for the guardians to make the following noncharitable gifts from the Decedent's assets: (1) $200,000 each to Sibling A and Sibling B, (2) $75,000 to each of the children of Sibling A and Sibling B (totaling $600,000), (3) $10,000 to each of Sibling A and Sibling B's first line lineal descendants and their spouses, if any, and their children, if any, (totaling $310,000), and (4) tuition payments for any lineal descendant of Sibling A and Sibling B (total not to exceed $125,000).
>
> An independent counsel appointed by the court reviewed the motion and in a submission to the court on November 10, 1992, recommended that certain gifts be made. The counsel confirmed that neither Sibling A nor Sibling B, or any of their descendants, was in need of support and that the sole reason for the gifts proposed by the guardians was to reduce federal estate tax and state inheritance tax liabilities.
>
> The court issued an order on November 17, 1992, authorizing the guardians to make the gifts recommended by the independent counsel including the direct tuition payments to lineal descendants of Sibling A and Sibling B, not to exceed $125,000 annually. In addition, the court authorized a one-time gift of $200,000 each to Sibling A and Sibling B.

The issue was whether the gifts were proper under the substitution of judgment doctrine under Maryland law. The Service discussed the doctrine:

> This doctrine, which has evolved over several hundred years, essentially evokes the principle that a court can substitute its judgment for that of an incompetent and

do for the incompetent that which he probably would have done for himself, if he was able. On this basis, the court can order distributions from the incompetent's estate for the benefit of others.

In general, courts have been willing to apply substituted judgment only if there is a state statute authorizing the court to make distributions for the benefit of others. See Mazaroff, Comment, Substitution of Judgment For Mentally Incompetent, 24 Md. L. Rev. 332, 335 (1964). Assuming such statutory authority exists, then the question becomes whether the reason for the transfers (e.g., support for those in need, estate planning, etc.) is such that the court can authorize the distribution under the statute.

New York appears to be one of the first states to extend the application of the substitution of judgment doctrine to allow the guardian to use "principal" in the same way that the incompetent probably would have done, if competent. In re Fleming's Estate, 173 Misc. 851, 19 N.Y.S.2d 234 (1940); In re Bond, 198 Misc. 256, 98 N.Y.S.2d 81 (1950). Several New York courts, in addressing the issue of authority to allow distributions of principal to reduce death taxes, took into consideration the relationship of the distributees to the incompetent, the incompetent's testamentary plan, prior distributions by the incompetent, and the future needs of the incompetent. See In re Carson, 39 Misc.2d 544, 241 N.Y.S.2d 288 (1962); In re Myles' Estate, 57 Misc.2d 101, 291 N.Y.S.2d 71 (1968). In In re Turner, 61 Misc.2d 153, 305 N.Y.S.2d 387 (1969), the court refused to allow gifts of principal distribution to the incompetent's children because the guardian failed to establish that, despite the tax advantages, the incompetent would have made the gifts if he was of sound mind.

In California, the courts, pursuant to the state probate code, have authorized transfers of property of the incompetent for the purpose of avoiding estate or inheritance tax. It must appear from all the circumstances that the ward, if competent, acting as a reasonably prudent person, would so plan his estate, and there can be no substantial evidence of a contrary intent. In re Guardianship of Christiansen, 56 Cal. Rptr. 505, 522 (1967). In determining what a reasonably prudent person would do, the court took into account the following factors: (1) the permanency of the ward's condition; (2) the needs of the ward; (3) the ward's testamentary plan; and (4) whether the donees were the natural objects of the ward's bounty. See also, In re Trott, 118 N.J.Super. 436, 288 A.2d 303 (1972), where the New Jersey court adopted the reasoning of Christiansen. In both Christiansen and Trott, the gifts were made to the persons who would take the incompetent's property, either under the terms of the incompetent's will or through intestacy.

In In re Dupont, 194 A.2d 309 (Del. Ch. 1963), the Delaware Chancery court held that it did have the power to authorize estate planning gifts. The court concluded that, while the Delaware statute conferred on the court considerable latitude in managing the affairs of an incompetent for his benefit, the court's power to authorize distributions for the purpose of reducing death tax liability was not unrestrained. The power must be exercised in the incompetent's interest, taking into account the ward's testamentary plan, the sufficiency of the assets, and the prior actions of the ward, while competent.

In some states, however, the courts have refused to approve the gifts for the purpose of reducing death tax liability. In In re Guardianship of Estate of Neal, 406 S.W.2d 496 (Tex. Civ. App. 1966), the court addressed the "prudent man" rule in the Texas statute, which provided that "It is the duty of the guardian of the estate to take care of and manage such estate as a prudent man would manage his own property." The court concluded that the "prudent man" rule authorized the court to enter an order that would result in protecting and preserving the estate, rather than giving away or depleting it and, thus, held that, under Texas law, the court had no power to authorize gifts from principal for the purpose of reducing death tax liability.

A Florida court addressed this issue in In re Guardianship of Bohac, 380 So.2d 550 (Fla. App. 1980). In that case, the Florida statute specifically allowed the guardian to make gifts to members of the ward's family for estate planning. The court stated that gifts provided for under the statute were predicated on the court's determination that the ward would make the gifts if she were competent. Since the donees were not close relatives and the ward had never made gifts to them while she was competent, the court concluded that the requisite donative intent didn't exist and that the trial court's refusal to authorize the gifts was valid.

With respect to Maryland, the ruling stated:

The Substitution of Judgment Doctrine has only been addressed by a Maryland court in one case, Kelly v. Scott, 215 Md. 530, 137 A.2d 704 (1958). The court found that there was no statutory authority in Maryland that would allow a payment for support to an incompetent's granddaughter, who was not a dependent of the incompetent. Accordingly, the court concluded that a court of equity lacked jurisdiction to apply the doctrine to allow distributions for the support of persons not in the incompetent's household. As a result of Kelly, Art. 16, section 135A was enacted adopting the doctrine to a limited extent. That statute was subsequently replaced. As noted above, the current statute (Md. Est. & Trusts Code Ann., section 13-203) grants the court "all power over the property" of the ward "that he could exercise if not disabled . . ."

See also the discussion at M-2.

9. **Use of Actuarial Tables**. The Fifth Circuit has again reversed the Tax court in McLendon v. Commissioner, 135 F.3d 1017 (5th Cir. 1998), this time requiring the application of Rev. Rul. 80-80 to the private annuity transaction entered into by McClendon some months before his death. The IRS had attempted to ignore Rev. Rul. 80-80, which provided that the actuarial tables under section 2512 must be used unless the change that the individual will live a year is so remote as to be negligible. The IRS conceded that when the private annuity was entered into McClendon had a 10% change of surviving for one year. The Fifth Circuit held that 10% is clearly not so remote as to be negligible. As to IRS contention that it could ignore its own Revenue Ruling, the opinion states:

> We note at the outset that the Tax Court has long been fighting a losing battle with the various courts of appeals over the proper deference to which revenue rulings are due. Whereas virtually every circuit recognizes some form of deference, the Tax Court stands firm in its own position that revenue rulings are nothing more than the legal contentions of a frequent litigant, undeserving of any more or less consideration than the conclusory statements in a party's brief. Although the Supreme Court has not spoken definitively on the subject, its recent jurisprudence tends to support the view that the courts owe revenue rulings a bit more deference than the Tax Court would have us believe. Still, revenue rulings are odd creatures unconducive to precise categorization in the hierarchy of legal authorities. They are clearly less binding on the courts than treasury regulations or Code provisions, but probably (and in this circuit certainly) more so than the mere legal conclusions of the parties. Apart from that, little can be said with any certainty, and in the absence of a definitive statement from on high, the Tax Court continues its crusade to ignore them in toto. This bit of background explains a great deal with regard to the posture of this case. In support of its general position on deference, the Tax Court went to great lengths to avoid applying Rev. Rul. 80-80 to McLendon's situation. The earlier panel of this court noticed this slight, and asked the Tax Court if it really wanted an open confrontation on the issue. Sticking to its guns, the Tax Court replied that it did. The result was the instant appeal.
>
> As it turns out, however, this case does not require us to step squarely into the fray. Most questions of deference to a revenue ruling involve an argument by the taxpayer that a particular ruling is contrary to law. Here, however, the argument to ignore or minimize the

effect of Rev. Rul. 80-80 comes from the Commissioner, the very party who issued the ruling in the first place. In such a situation, this circuit has a well established rule that is sufficient to resolve this case without probing the penumbrae of the general deference question.

In Silco, Inc. v. United States, 779 F.2d 282, 286 (5th Cir. 1986), we held that a taxpayer was entitled to rely on the legal standard implied by two revenue rulings extant at the time of his transaction, even though they had been subsequently abrogated. In reaching this conclusion, we noted that: Treas. Reg. section 601.601(e) provides that taxpayers may generally rely on published revenue rulings in determining the tax treatment of their own transactions, if the facts and circumstances of their transactions are substantially the same as those that prompted the ruling. Id. at 286. Because the statute, regulations, and case law were less than clear at the time of the taxpayer's transaction, we found that the rulings "provide[d] the only insight available to [the] taxpayer at the time of [his] transaction as to the conceptual approach the [Commissioner] would use," and that the Commissioner acted improperly in subsequently applying a different test to that taxpayer. Id. at 287.

Silco stands for the proposition that the Commissioner will be held to his published rulings in areas where the law is unclear, and may not depart from them in individual cases. Furthermore, under Silco the Commissioner may not retroactively abrogate a ruling in an unclear area with respect to any taxpayer who has relied on it.

[Footnotes omitted]

For current transfers, the test is whether the decedent has a 50% chance of surviving for one year, with the test being presumed met by the decedent living for 18 months (overcome only by clear and convincing evidence).

10. Gifts of Limited Partnership Units as Present Interest Gifts.

(Turney P. Berry, Thomas E. Rutledge, January, 1998, in CCH LLC Advisor.)

The National Office of the Internal Revenue Service appeared to fire yet another warning shot with respect to family limited partnerships, as well as to family limited liability companies, in Technical Advice Memorandum 9751003, which disallowed annual exclusions for transfers of limited partnership interests. This article argues that TAM 9751003 is probably wrong, can be easily overcome even if it is correct, and therefore should not affect annual exclusion transfers of interests in well-drafted limited partnerships and limited liability companies.

The Facts, or How We Got Here In the First Place

The facts of the TAM set forth a complicated series of transfers of assets between family members and entities controlled by family members.

A widow, age 71, gave a building (Building #2) worth $110,000 to each of 11 family members on December 30, 1991. On January 1, 1992 those family members reallocated the ownership interests among themselves so that each of four "family units" owned 25% of the building. On September 24, 1992 the widow created an S corporation of which she was sole shareholder and capitalized it with $9800. The next day she created seven trusts, one for each of her minor grandnieces and grandnephews, each with $10. On December 22, 1992 the widow formed the limited partnership and on December 31, 1992 transferred a 94.77% interest in a rental building (Building #1) to the partnership for a 90.6% limited partnership interest and transferred the remaining interest in Building #1 to the S corporation. The S corporation in turn transferred its interest in the building to the limited partnership in exchange for a 5% general partnership interest. Simultaneously, the four family units transferred their interests in Building #2 to the limited partnership in exchange for 1.1% limited partnership units, per family unit, or 4.4% in total.

After the transfers above, the limited partnership had the following partners: the S corporation, a 5% general partner; the widow, a 90.6% limited partner, and the grandnieces and nephews, collectively, 4.4% limited partners. Next the widow gave limited partnership units totaling 29% to 35 family members and trusts. On March 10, 1993 another 42% of the widows units were given away to the same 35 individuals and trusts. In November 1993 the widow and corporation made capital contributions to the partnership which increased the widow's limited partnership interest to 27.6%. On January 1, 1994 the widow gave her 27.6% interest to the 35 individuals and trusts. Each time a gift was made, certain family members made other gifts within a family unit. In addition, the

IRS noted that on March 10, 1993 the partners consented to the intra-family transfers of December 31, 1992 and on January 1, 1994 the partners consented to the intra-family transfers of March 10, 1993. The applicable provisions of the partnership agreement will be discussed below. The widow claimed an annual exclusion for the gifts to family members and trusts for the 1993 and 1994 gifts.

The Annual Exclusion Generally.

Code § 2503(b) (all references to the "Code" will be to the Internal Revenue Code of 1986 as amended to date) provides for an exclusion from the definition of taxable gifts under a certain amount, "other than gifts of future interests in property". Treas. Reg. § 25.2503-3(a) defines a future interest as not only reversions and remainders but also "other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at future date or time." (See a discussion of another portion of that Regulation below.)

The Supreme Court discussed the meaning of future interest in Fondren v. Commissioner, 324 U.S. 18 at 20-21 (1945) stating: "The question is of time, not when title vests but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest within the meaning of the regulation." Fondren involved gifts to various trusts.

Annual Exclusions in the Partnership Context.

Limited partnerships by definition have general partners and at least one, and potentially more than one, class of limited partner. The rights of the partners are established by applicable state law or, more commonly, by the partnership agreement. Generally, the rights of the limited partner, at a minimum, are restricted with respect to such things as the ability to compel distributions, the ability to sell or gift the limited partnership interest, and the ability to otherwise manage the partnership assets. Similar limits apply to non-manager members in manager-managed LLCs, as well as to non-voting members in LLCs with voting and non-voting interests.

The IRS takes the position that if the authority of the general partner is overly broad, then the rights of the limited partner would be future in nature. A gift of such limited partnership interests would not qualify for the gift tax annual exclusion under Code § 2503(b). The issue for the IRS is the extent of the general partner's authority. In particular the IRS is concerned with the limited partner's right to receive distributions and to transfer the limited partnership interest.

The Agreement in TAM 9751003.

The Service set forth the following provisions of the limited partnership agreement as being relevant to its ruling:

(1) CONCERNING DISTRIBUTIONS OF INCOME

Section 5.1: the General Partner may distribute funds of the partnership to the partners at such times and in such amounts as the General Partner, in its sole discretion, determines to be appropriate. Without limiting the generality of the foregoing, the General Partner shall have complete discretion to retain funds within the partnership for future partnership expenditures OR FOR ANY OTHER REASON WHATSOEVER. [*Emphasis supplied.*]

(2) CONCERNING WITHDRAWAL/RETURN OF CAPITAL CONTRIBUTIONS

Section 3.2: [No right to withdraw or receive capital unless otherwise specified in the agreement.]

Section 7.4: No Limited Partner shall be entitled to . . . the return of its Capital Contributions except to the extent, if any, that distributions made pursuant to the express terms of this Agreement may be considered as such by law or upon dissolution and liquidation of the Partnership, and then only to the extent expressly provided for in the Agreement and as permitted by law.

Section 7.4: No Limited Partner shall be entitled to . . . withdraw from the Partnership except upon the assignment by it of all of its Partnership Interest IN ACCORDANCE WITH SECTION 10.2. [*Emphasis supplied.*]

(3) CONCERNING TRANSFERS OF THE INTERESTS

Section 10.2: Except as provided in this Article to the contrary, no Limited Partner's interest in the Partnership shall be assigned, mortgaged, pledged, subjected to a security interest or otherwise encumbered, in whole or in part, and any attempt by any Limited Partner to assign or otherwise encumber its interest shall be void ab initio. Notwithstanding the preceding sentence, [Donor] may, at any time and from time to time . . . transfer and assign her interest in the partnership by written instrument . . .

(4) CONCERNING SUBSTITUTION OF LIMITED PARTNERS

Section 10.3. No person may become a Substituted Limited Partner except an assignee who complies with this Section 10.3. No assignee of a Partnership Interest of a Limited Partner or any portion thereof shall have the right to become a Substituted Limited Partner unless all of the following conditions are satisfied:

(a) the assignor executes a written instrument of assignment together with such other instruments as the General Partner may deem necessary to effect the admission of the assignee as a Substituted Partner;

(b) such instrument has been delivered to, received and approved in writing by the General Partner; and (c) the Super Majority Vote of the Partners (which must also include the vote of the General Partner) to such substitution has been obtained, the granting or denial of which shall be within the sole discretion of each Partner.

A Super Majority Vote of the partners means (i) so long as Donor or her estate is a limited partner, a vote of Donor, or her estate, together with the vote of the partners holding at least 50 percent of the partnership interests held by partners other than Donor or her estate, or (ii) if neither Donor nor her estate is a limited partner, a vote of the partners holding at least 67 percent of the partnerships interests.

Application of Section 2503(b) To TAM 9751003.

The IRS first looked at the limited partners' rights to receive income. The TAM cited Commissioner v. Disston, 325 U.S. 442 (1945) (gifts in trust to minors where corpus was to be withheld until age 45 and although income could be distributed for education, comfort and support of a minor, the Court found that in fact no income was likely to be distributed); Maryland National Bank v. United States, 609 F. 2d 1078 (4th Cir. 1980) (gift of present right to receive income from property which historically produced no income); and Calder v. Commissioner, 85 T.C. 713 (1985) (no annual exclusion for gifts of artwork to a trust even though the trustee could convert it into income producing property because there was no indication the trustees intended to do so), summarizing their holdings as: "a right to receive income is a present interest only if, at the time of the gift, there is a requirement for a steady and ascertainable flow of income to the donee."

The limited partnership in question gave the general partner "complete discretion" whether or not to distribute or retain income, for "any reason whatsoever." The IRS concluded that the rights of the general partner were outside the scope of a business purpose; thus, the partnership overcame the fiduciary duty which is generally imposed on a general partner which "clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership." This effort to alleviate the general partner of a fiduciary obligation to withhold distributions for reasons having nothing to do with partnership and its business easily contrast with the usual rule of fidelity to the limited partners. *See, e.g., USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991); CALLISON, PARTNERSHIP LAW AND PRACTICE § 21.07 (1997).

The IRS denied the annual exclusion for the principal portion of the gift on similar grounds stating that an economic right requiring joint action with others is a contingent interest regarded as a future interest, citing Ryerson v. United States, 312 U.S. 405 (1941) (trust corpus subject to joint power in beneficiaries rather than sole power), Blasdel v. Commissioner, 478 F. 2d 226 (5th Cir. 1973) (distribution of income and corpus subject to majority approval of beneficiaries and majority approval of a local bank), and Chanin v. United States, 393 F. 2d 972 (Ct. Cl 1968) (gifts of stock into a closely-held corporation). Absent a super-majority (including the general partner's vote) as provided in Section 10.3 of the partnership agreement, the limited partnership interests could not be transferred nor the capital of the limited partner withdrawn until 2022. Thus, the IRS concluded that only title to the limited partnership interests vested in the donees and they lacked the necessary "tangible and immediate economic benefit required under section 2503(b)" to be a present interest.

Previous IRS Rulings.

In TAM 9131006, a Washington limited partnership was at issue and the IRS discussed, under Washington law, "that general partners have a fiduciary duty to limited partners and that limited partners should be able to expect the highest standard of conduct from general partners." (Citations omitted). The IRS noted specifically that: "The decedent, as general partner, possessed no powers that are not otherwise contained in the standard limited partnership agreement, regardless of whether the partners are related or not."

With respect to transfer restrictions, a limited partnership interest was subject only to a right of first refusal. The Service determined, therefore, that gifts of the limited partnership interests were present interests:

> In the instant case, the gifts of the partnership interests constituted outright gifts of ownership interests in a business entity. Each donee received the immediate use, possession and enjoyment of the subject matter of the gifts, gifts because there were no restrictions on the withdrawal of capital accounts in the partnership agreement. Put another way, the decedent could not legally resist another partner's demand for the repayment of his capital account. Thus, as in *Crummey*, each donee had the unrestricted, immediate right to withdraw and enjoy his gift "as so much cash put to his credit." *Id.* Accordingly, the decedent made gifts of a present interest which qualified for the annual exclusion from gift tax.

In Private Letter Ruling 9415007, the Service ruled similarly. The general partner was described as having "exclusive management control of the Partnership, including full discretion to determine the amount and timing of distributions to the partners ..." so long as any distributions were made in accordance with each partner's interest in the partnership. The Service cited the fiduciary duty of the general partner. Likewise in Technical Advice Memorandum 8611004, Oklahoma law was cited as to the fiduciary duties of the general partner with the result that the annual exclusion was allowed.

Somewhat similar is Revenue Ruling 76-360, 1976-2 C. B. 298, in which the IRS determined that a gift of non-income producing stock was not a present interest where the stock was subject to an agreement that the donees could transfer the stock only to a few family members for two years after the gift was made.

<u>Is TAM 9751003 Correct</u>?

There are at least two arguments that the determination made in TAM 9751003 is incorrect. The first is that the partnership agreement in question did not in fact overcome the fiduciary duty of the general partner. The success of such an argument is difficult to assess because the applicable state law is unknown. Apparently the Service believes that adding the language "or for any other reason whatsoever" to a general grant of discretion transforms the discretion from being subject to fiduciary duty into discretion which is not so bound. Is fiduciary duty really so easily overcome? Some courts have required specificity in any efforts to contractually alter the fiduciary duty standards. See, e.g., Newburger Loeb & Co. v. Gross, 563 F.2d 1057 (2nd Cir. 1977). Agreements permitting self-dealing transactions and the deriving of personal benefits from partnership property have been strictly construed. Froemming v. Gate City Fed Sav. & Loan Ass'n, 822 F.2d 733 (8th Cir. 1986). Other courts have said that fiduciary obligations are not subject to modification by agreement. See, e.g., Wartski v. Bedford, 962 F.2d 11 (1st Cir. 1991); Konover Dev Corp v. Zeller, 635 A.2d 798 (Conn. 1994); Labovitz v. Dolan, 545 N.E.2d 304 (Ill. 1990); Knopke v. Knopke, 837 S.W.2d 907 (Mo App 1992).

A second argument comes from a close reading of the cases cited by the TAM. Those cases deal with situations in which something which could be the gift of a present interest was not because of the entity or medium through which it was given. For example, property into a trust or a corporation where the rights to the property were limited by the trust or corporation. In TAM 9751003, however, the IRS determines that gifts of these particular limited partnership interests could not, under any circumstances (absent a rewriting of the partnership agreement) give rise to an annual exclusion. Is the Service really ruling that what was given were the buildings owned by the partnership, with a partnership wrapper that deprived the donee of any "present interest"? That is another version, in effect, of the argument the Service has made with respect to the valuation of limited partnership interests under a variety of theories -- step-transaction, substance over form, section 2703, (*see, e.g.*, TAMs 9719006, 9723009, 9725002, 9750002). Section 2703 is inapplicable to the present interest test -- that is, cannot be used to justify ignoring the terms of the limited partnership -- and the TAM did not make the other arguments.

Of interest is what the Treasury Regulations themselves say about interests in property that have properties of a future interest, by definition. Treas. Reg. § 25.2503-3(a) provides that:

> The term [future interest] has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer effecting a gift.

The Regulation would seem clear that it must be the instrument of transfer effecting a gift that creates the future interest, not the instrument creating the property which is given.

Effect of the IRS Position in TAM 9751003.

Limited partnerships are formed for a variety of tax and non-tax reasons. Generally those reasons require that the authority of the general partners be expanded and the rights of the limited partners be curtailed. For example, the ability of the creditors of a limited partner to obtain value from the limited partner's interest in the partnership is adversely affected if the limited partner cannot compel the partnership to distribute cash (or other readily marketable property). Likewise, it is often undesirable for spouses or non-family members to have the ability to become a partner and thus transfer restrictions are typically placed on the limited partnership interests. For gift tax valuation purposes the more the rights of the limited partners are restricted the lower the fair market value of the interests (subject to the application, if any, of Code §§ 2703 and 2704(b)).

Each advisor and client must determine the wisdom of ignoring the IRS ruling position. If compliance is determined to be advisable, it would seem clear that the general partner must remain a fiduciary with respect to the limited partner. That would appear to be possible while continuing to give the general partner the discretion needed to accomplish the other purposes of the partnership. Stated differently, if the general partner may distribute income or allow transfers in its sole discretion, but remains subject to the fiduciary duty set forth by applicable state law, the facts would be substantially different from those of TAM 9751003. May a fiduciary have sole discretion? Arguably yes -- the general partner may not act arbitrarily or with malice, but yet is not subject to any preset standard.

A few weeks later, PLR 9808010 concluded that transfers of limited partnership interests were completed gifts, without discussion. The ruling mostly dealt with section 2701, which applied. The Service refused to rule on the application of section 2703 because that is "factual."

11. Private Annuity. In Estate of Suzanne W. Cullison v. Commissioner, T.C.M. 1998-216, the court applied section 7520 to a private annuity entered into on August 29, 1989, the date on which the deeds to the property sold for the annuity were signed. The annuity agreement had been signed on December 23, 1988.

O. SECTION 2518 - DISCLAIMERS

1. Acceptance of Benefits. Taxpayers who live in the Fifth Circuit have an advantage: it consistently holds for the taxpayer as evidenced by the reversal of the Tax Court in Estate of Monroe v. Commissioner, 124 F.3d 699 (5th Cir. 1997). The panel was divided 2-1. The dissent states the facts most directly:

> J. Edgar Monroe, the decedent's husband, and Robert J. Monroe, his nephew, solicited and obtained disclaimers of specific bequests totaling $892,781 from twenty-nine legatees under Mrs. Monroe's will. Within days of the execution of the disclaimers, each disclaimant received a check from Mr. Monroe for the amount of the disclaimed legacy. It is apparent, and the Tax Court so found, that the disclaimers and subsequent checks were not isolated events. They were part of a well-intentioned plan to secure to the legatees the amount of their bequests without diminution for the substantial taxes -- in many cases, the tax haircut would have been seventy-five to eighty percent of the amount of the bequest -- that would otherwise have been chargeable to those bequests. The legatees from whom disclaimers were solicited were those who "had witnessed firsthand and had felt" Mr. Monroe's generosity. In soliciting the disclaimers, Robert Monroe informed the legatees that taxes would substantially reduce the amount of their legacies and that Mr. Monroe was upset by the high taxes. Robert Monroe made a point of reminding the

legatees that Mr. Monroe was a generous man. The Tax Court found that:

> The disclaimants may not have explicitly negotiated with or bargained with Monroe or the nephew for consideration in return for executing their disclaimers. Each of the disclaimers other than Tebo, however, was induced or, in some instances, coerced, into executing a disclaimer. Under these circumstances, the consideration for their disclaimers was the implied promise that they would be better off if they did what Monroe wanted them to do than if they refused to do so. Their disclaimers thus were not "unqualified" as required by section 2518.

Tebo is an exception because we are persuaded by her testimony that she voluntarily and without expectation of anything in return renounced her legacy for personal reasons. . . .

In addition, petitioner has failed to persuade us that Monroe's cash gifts to the 29 disclaimants were merely part of a pattern of generosity that Monroe had engaged in throughout his life. These "gifts" were all cash payments of specific and substantial amounts made to the disclaimants shortly after they executed disclaimers. The inference drawn from this targeted gift-giving is that Monroe made them "in return" for the disclaimants' renouncing their bequests and not from a "detached and disinterested generosity." . . . Even if Monroe had no legal obligation to compensate the disclaimants, they anticipated, and received, payments from him that left them in the same economic position as if they had accepted the legacies in the first place.

The majority opinion discussed what it believed the disclaimants had received as a result of the transaction:

> The real bone of contention is whether the disclaimers were "unqualified", and whether unqualified has some meaning beyond the possibilities carefully delineated in the applicable Treasury Regulations. None of the written disclaimers articulates any kind of disabling qualification, of course. Nevertheless, the Tax Court and the Commissioner assert that because all but one of the disclaimants "expected," because they were "induced" or "coerced" by Monroe, that they would eventually receive their bequests in the form of a gift or legacy, their renunciations were "qualified" to the extent of the expectation. As the Tax Court later put it, a disclaimer is not "unqualified" if it rests on an "implied promise" that the disclaimant will be better off executing the disclaimer than not doing so. Further, according to the Tax Court, the "implied promise" may exist even though the disclaimants did not negotiate or bargain with Monroe for later recompense.

We disagree with this interpretation of "unqualified." It is inconsistent with a holistic reading of section 2518(b), contrary to the governing Treasury Regulations and the Service's letter rulings, and intolerably, unnecessarily vague.

Section 2518(b) described a covered disclaimer as one which is "unqualified . . . but only if [the disclaimant] . . . has not accepted the interest or any of its benefits." A "qualification," therefore, would seem to depend on the tangible receipt of property, i.e., the "interest or any of its benefits." That is also the most sensible understanding of an unqualified disclaimer. One who disclaims an interest in property must do so without getting something in exchange; and since property has been given up, it follows that a "qualified disclaimer" would be one in which the renunciation is not complete because property has been kept or received in return.

The Commissioner and Tax Court would eliminate this statutory symmetry by holding that a disclaimer of property is "qualified" even though something less than property, e.g. an "expectation" or "implied promise," is received in return. While their reading would enhance the government's ability to disqualify disclaimers, it also rests on an incomprehensible subjective standard. How likely is it, in tax terms, that people would disclaim "a bird in the hand" purely altruistically? Yet the clear inference to be drawn from the Tax Court's approach to this case is that a "qualified disclaimer" demands no less than disinterest in the "property or its benefits." The court voided all of the disclaimers here except that of Ms. Tebo, who acted solely for personal reasons in executing a disclaimer. On the contrary, as the Service's letter rulings indicate, a primary purpose of the law authorizing qualified disclaimers is to facilitate post-mortem estate tax planning and to increase family wealth on the "expectation" that there will thus remain more wealth to pass on to disclaimants in the future. Consequently, if the Tax Court's subjective interpretation of "unqualified" disclaimer is accepted, it undermines the very purpose for which the provision was enacted. It also ensures litigation in virtually every disclaimer situation, because it can be assumed that heirs and legatees rarely execute disclaimers for tax purposes without having had some "expectations" or "inducements" based on conversations with advisers on the prospective benefits of such a course of action.

Not only does the statutory language conflict with the Tax Court's interpretation of an "unqualified disclaimer," but the Treasury Regulations are also incompatible with the "expectation" or "implied promise" theory. This is not to say that we are required to enforce Treasury Regulations instead of the statute, but rather, that the regulations mirror the correct understanding of the statute better than the

Commissioner's and Tax Court's present positions. The regulations set forth two situations in which a disclaimer expresses a mere qualified refusal to accept an interest in property: when the disclaimant accepts, expressly or impliedly, the interest or any of its benefits; and when the disclaimant receives "consideration" in return for executing the disclaimer. Treas. Reg. section 25.2518-2(d)(1). Consistent with our interpretation, a disclaimant cannot purport to disclaim, while taking actual advantage of the property "or any of its benefits." Further, the disclaimant cannot accept "benefits" from the property by receiving consideration in exchange for the disclaimer. The juxtaposition in the regulation between the "implied" acceptance of the interest or any of its benefits and the "consideration" that must be received in exchange for a disclaimer is not accidental. One may impliedly accept the benefits of property, for instance by pledging it as security for a loan, and therefore act inconsistently when making an alleged disclaimer. On the other hand, only by receiving "consideration" in the classic sense does one receive "property" or any of its benefits in exchange for executing the disclaimer. We thus agree with the estate that to have accepted the benefits of a disclaimed interest, the disclaimant must have received actual consideration in return for renouncing his legacy.

A disclaimant's mere expectation of a future benefit in return for executing a disclaimer will not render it "unqualified." "Consideration," used deliberately in the regulations, is a term of art. See Philpot v. Gruninger, 81 U.S. (14 Wall.) 570, 577, 20 L.Ed. 743 (1872); Fire Ins. Ass'n v. Wickham, 141 U.S. 564, 579, 12 S.Ct. 84, 88, 35 L.Ed. 860 (1891)(to constitute consideration, promise "must have been offered by one party, and accepted by the other, as one element of the contract"). This is the way the regulations are written and it is consistent with the Commissioner's letter rulings, which are properly cited as evidence of how the Commissioner has interpreted the law in the past. See Transco Exploration Co., 949 F.2d at 840. In each of the three rulings cited above, the obvious expectation that the disclaimant would be better off in the long-run by renouncing his interest in favor of the decedent's spouse did not violate the bar against acceptance of the disclaimed interest or its benefits. See LTR 8701001, LTR 9427030, and LTR 9509003, supra. In one letter ruling, the surviving spouse proposed to set up an inter vivos trust calling for the same distributions at her death as were provided in the trust established by the decedent. See LTR 9427030. In each case, the Commissioner cited the lack of an agreement between the parties as to what the disclaimants were to receive in the future. The Commissioner implicitly recognized the distinction between the expectation that renouncing is in the disclaimant's best interest and an expectation that rises to the level of consideration. The charitable contribution cases also recognize this

> distinction. See, e.g., Wardwell, 301 F.2d at 638 ("Motivation and personal expectation do not destroy the reality and genuineness of a given transaction, even in tax cases"). Thus, the question for each disclaimer is whether the decision to disclaim was part of mutually-bargained-for consideration or a mere unenforceable hope of future benefit, whether that unenforceable hope springs from family ties, long-term friendship or employment, or a generalized fear that benefits will be withheld in the future absent execution of the disclaimer.

A review of the specific facts with respect to each disclaimer is interesting for its discussion of what the Fifth Circuit regarded as a "close question:"

> Turning to an evaluation of the record relevant to each disclaimer, we conclude that for the majority of the disclaimants, the evidence as a matter of law does not support a finding of any agreement that would amount to consideration for the execution of the disclaimers. The duty to defer to the Tax Court's findings of fact applied only insofar as the Tax Court correctly applied the law, which it did not do here. And in any event, with regard to most of the disclaimers, there is no specific evidence other than that which only supports a finding that the disclaimers were made without consideration.
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> In addition to testimony indicating that they were made no promises and that they understood that they were giving up any right to claim something from Louise Monroe's estate, many legatees testified to some personal reason inconsistent with improper inducement or coercion by Monroe. These are the disclaimers executed by Clarence Landry, ground keeper for 14 years ($14,350); John McDonald, butler/chauffeur for 12 years ($8,975); Marie Louise Conway, household employee for 19 years ($9,430); Carol Monroe, ex-wife of Robert Monroe ($5,000); Edward Jameson, chauffeur for 27 summers in Newport, Rhode Island ($5,000); Dorothy Fujii, the Monroe's niece ($5,000); Beryl Fransen, Louise Monroe's cousin ($75,000); Anthony Farris, a gardener at the Monroe's [sic] Mississippi home ($5,000); Miriam Walmsley, daughter of the Monroes' closest friends in New Orleans ($5,000); Joseph P. Monroe, Robert Monroe's brother ($5,000); Joy Monroe, Joseph P. Monroe's wife ($5,000); Beatrice de la Vergne, distant cousin ($5,000); Robert Monroe ($5,000); Marjorie Monroe Colomb ($10,000), and Teche Bennett ($5,000).
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> There was no evidence about the disclaimer in the amount of $5,000 executed by Airline Animal Hospital other than the renunciation document itself. From the four corners of the document, there is no reason to doubt that it was executed voluntarily and without consideration.

The remaining disclaimers involve at least some evidence that Robert or Edgar Monroe may have gone further in their representations than Robert Monroe testified was his rehearsed presentation. Beginning with the largest disclaimer, that of the Hayward family, including Kathleen Hayward's renunciation of her interest in the income from a $500,000 bond and her three children's renunciation of their interest in the trust principal, the Tax Court cited her testimony on cross-examination that although Monroe "didn't state that" she would get her disclaimed inheritance either during Monroe's lifetime or in his will, she "sort of certainly assumed that" she would. Viewed in context, however, this testimony furnishes no support for a finding of actual consideration for executing disclaimers. First, each of her adult children executed disclaimers of their interests in the trust principal after being asked to do so by their mother. At a minimum, their disclaimers, which represented the bulk of the $535,781 present value of the bequest, warrants analysis separate from that of Kathleen Hayward. It is apparent that an adult's decision to renounce a bequest at the simple request of his mother, without any indication that he was promised anything in return for the disclaimer, does not take a disclaimer outside the strictures of section 2518(b).

Second, turning to Hayward's statements, we are convinced that it would be error to conclude that her assumption that Monroe would honor her aunt's request in his will made her disclaimer in return for in implicit promise from Monroe. Hayward did not testify that Monroe explicitly or implicitly created this expectation. In fact she testified that Monroe did not say that he would give her anything, that she renounced "[b]ecause my uncle was upset, and he is very important to me, and I didn't like to see him like that," that she understood, upon the advice of an attorney, that Monroe was under no obligation to give her anything, and that although she "probably would have been hurt" had Monroe not remembered her in his will, it would not have made a difference to her if she had not received the money because "[she didn't] really need it."

Elizabeth Monroe Richardson, Monroe's niece with the daughter who was ill with cancer, renounced her $5,000 bequest because "you don't go against Edgar if you ever want anything from him." This fear that she and her daughter might not be the beneficiaries of future support from Edgar if the bequest was not disclaimed apparently arose from Richardson's prior dealings with Monroe, because she did not testify that anything said to her in the discussions about the disclaimer indicated that Robert or Edgar Monroe explicitly or implicitly threatened her with a loss of future support. Although Richardson may have felt that irritating Edgar Monroe might jeopardize his future support, this does not invalidate the disclaimer any more than a generalized expectation that Monroe would be generous in the future if the bequest was renounced. Absent some promise or agreement specifically related to renouncing the bequest, an otherwise valid disclaimer should not be invalidated.

Marilyn Monroe Wolf, a niece of the Monroes, testified that Robert Monroe told her that because of estate taxes, she would only receive $1,800 of the $5,000 left to her. However "it would go to my uncle tax-free if I did renounce, and that I would not be promised anything in return for the renunciation; it was up to me if I wanted to do that or not." She decided to renounce because the amount she would receive "was not a significant amount to me, and since [Edgar Monroe] was upset about it, I wanted to keep him happy, so I agreed to do it." Wolf wanted to keep Monroe happy because "I had an expectation that I or my sons would be in his will, and I didn't want to do anything to interfere with that." However, she testified that she was not promised anything or "led to believe she would get anything" in return for renouncing the bequest. Wolf may have believed that she had a greater likelihood of keeping her family in Monroe's will by executing the disclaimer, but her expectation was not created by any promise or agreement made by Robert Monroe. Accordingly, her disclaimer, like that of Betsy Richardson, does not fall outside the scope of section 2518(b).

Finally, six of the disclaimers present fact issues which must be reconsidered by the Tax Court in light of the correct standard.

Lawrence Lee's testimony, excerpted earlier, indicated that although he felt that Monroe made no promises or guarantees, Monroe did say that "he would take care of it" or "take care of us [the household employees]." Lee had worked for the Monroes for 40 years as of Louise Monroe's death and renounced a bequest of $50,000 plus his annual salary of $10,806. Lee was highly likely to trust and rely on any implicit representation by Monroe. This is a close case. Although Monroe made no specific reference to a gift or subsequent bequest, the circumstances of the representation require further analysis based on the proper legal standard.

Judith Bazer, Monroe's great, great niece, who renounced a $5,000 bequest, executed an affidavit at the request of the I.R.S. agents. In the affidavit, she states that Robert Monroe told her that "if we would give the money back by executing the disclaimer, we would save on the taxes and my uncle (J. Edgar Monroe) would see to it that we get the full amount of our inheritance." Judith Bazer also stated in the affidavit that when Monroe later wrote her the $5,000 check, "it was accepted as a gift, although I knew the true purpose of the check." Judith Bazer also testified at trial that Robert Monroe only told her that "[y]our uncle has taken care of you, and he always will."

> Rachel Bazer, who disclaimed a $5,000 bequest, was present when Robert Monroe spoke to her sister, Judith Bazer, about renouncing.
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> Shane Bazer, great, great nephew of the Monroes, testified that he was not promised anything in return for his disclaimer of a $5,000 bequest. However, the Commissioner presented testimony from I.R.S. agent Raymond Gregson that Shane Bazer had hold Gregson in a prior interview that Robert Monroe said that Shane had a better chance of receiving the full amount of the bequest if he renounced.
>
> Vivian Simmons, the Monroe's maid for four years, signed an affidavit stating that Robert Monroe told her that "if I would sign the disclaimer, J. Edgar Monroe would see to it that I would get the full amount of money willed to me from the estate."
>
> Donatilda Harris, the Monroe's cook for over 50 years, testified that Robert Monroe asked her to renounce, stating that "he would take care of us." On cross-examination, Harris admitted telling I.R.S. agents on a prior occasion that she was told at the time of her disclaimer that she "could receive the money that you were disclaiming from J. Edgar Monroe."

The Court's discussion of the step-transaction doctrine is fascinating as well:

> Finally, we disagree with the Commissioner's contention that the Tax Court's decision should be affirmed on substance-over-form or step-transaction grounds. While the disclaimants, to varying degrees, may have thought they would eventually receive something from Monroe, even the actual amount of their legacy, the evidence shows that most really believed they were, in fact, giving up their legacy under Louise Monroe's will. Several legatees sought outside counsel before making their decision. As long as there was no implicit agreement that they would receive something from Monroe in return for their disclaimers, the fact that the legatees understood they were giving up their rights and actually did, in a manner effective under Louisiana law, give up their rights is sufficient. There is no evidence that any of the legatees who executed disclaimers that we have held to be "qualified disclaimers" under section 2518(b) believed they were receiving their inheritance under Louise Monroe's will when they received Edgar Monroe's gifts. Accordingly, Monroe's subsequent gifts do not change the legitimacy or legal effect of the legatee's renunciations.

The dissent's disagreement with the majority rests on what it believed was too restrictive an interpretation of section 2518:

To summarize, the majority's conception of a disqualifying disclaimer possesses three, perhaps four, distinguishing characteristics. First, disqualification of a disclaimer requires the existence of explicit negotiations or bargaining. Second, the disclaimant must receive property, as distinguished from a promise of property, in exchange for the disclaimer. Third, the property received must consist of "'consideration' in the classic sense." Majority Op. at 160. Fourth, because a check from Mr. Monroe in the full amount of the disclaimed bequest received a few days after the disclaimer would seem to constitute the kind of tangible property consideration for the disclaimer that would satisfy the second and third facets of the majority's rule but somehow does not, the Majority's characterization of disqualifying disclaimers may also require that the disclaimant receive the tangible property before the disclaimer. The estate argues for this position, and the majority arguably accepts it. All of these requirements result from an overly restrictive and unwarranted reading of the statute.

Section 2518 of the Internal Revenue Code defines an "unqualified disclaimer" as "an irrevocable and unqualified refusal by a person to accept an interest in property but only if . . . such person has not accepted the interest or any of its benefits." I.R.C. section 2518(b). The two statutory rationales for the Tax Court's decision represent a fair reading of the statute. First, giving up the bequest "in return for" a gift is akin to accepting the benefits of the bequest. Second, a refusal to accept a bequest from Mrs. Monroe "in return for" a gift from Mr. Monroe is not an unqualified refusal. Contrary to the reading adopted by the majority, the statute makes no mention of bargaining, tangible property, consideration or an enforceable obligation, and there is no warrant in the statute for compelling the Commissioner to litigate over these matters when challenging a disqualification.

The majority supports its reading of the statute by misreading Treas. Reg. section 25.2518-1(d)(1) to require that a disclaimant receive consideration in exchange for the disclaimer. As the Commissioner points out, the regulation describes several circumstances in which a disclaimant is deemed to have accepted the benefits of a legacy, the last among them (or, in the words of the regulation, "in addition" to the other circumstances listed in the regulation) being where the disclaimant accepts consideration in return for the disclaimer. The regulation cannot fairly be read to require consideration before disqualifying a disclaimer.

The majority likens the promise of gift or bequest implied from Mr. Monroe's words and actions to a "mere expectation" or unenforceable hope of future benefit and rejects the implied promise along with the mere expectation. As the private letter rulings make clear, in the absence of an express or implied agreement, the

> mere expectation or hope that a disclaimant may one day benefit from the disclaimed property (generally in the form of an inheritance) is too speculative to form the basis for disqualifying a disclaimer. But the crux of the inquiry is whether there is an express or implied agreement. Based on all of the evidence before it, including evidence of the words and deeds of Mr. Monroe and Robert Monroe, as well as the legatee's agreement to disclaim, the Tax Court reasonably deduced that an implied agreement existed between Mr. Monroe and the legatees. The Tax Court cannot fairly be read to have based its decision on a "mere expectation" or hope of future benefit on the part of the legatees.

The dissent objected as well to the fact-finding of the majority:

> Finally, the majority opinion contains a great deal of fact-finding, and the majority fails to acknowledge it as such. This case requires, first and foremost, credibility determinations about the testimony of Robert Monroe and the disclaimants, determinations properly relegated to the Tax Court. The Tax Court was not required to accept that testimony at face value, nor was it required to go through each piece of testimony and say that the court did not credit it. The Tax Court's opinion makes very clear that the court simply did not credit much of what it heard. We overstep the bounds of our authority as appellate judges when we go back through an appellate record and make our own credibility assessments about the witnesses' testimony. The majority opinion errs in that respect.

2. **Disclaimer of Tenancy By the Entireties Property**. In Estate of Hennessy v. United States, 81 A.F.T.R.2d ¶98-319 (S.D. Ind. 1997), the Court determined that the disclaimer of property held in tenancies by the entirety was invalid because it occurred more than nine months after the date on which the property interest was created.

This result is reversed for disclaimers after December 31, 1997 by final regulations issued by the IRS under section 2518. T.D. 8744. The effect of the final regulations is set forth by the IRS:

> Under the proposed regulations, the one-half survivorship interest in jointly-held property that was unilaterally severable could be disclaimed within 9 months of the date of death of the first joint tenant to die. the proposed regulations do not extend the same treatment to joint interests that are not unilaterally severable (e.g., tenancies by the entirety), but the preamble invited comments on this subject.
>
> The comments received unanimously suggested that a surviving joint tenant should be allowed to disclaim,

within 9 months of the date of death of the first joint tenant to die, his or her survivorship interest in a tenancy, whether or not that tenancy is unilaterally severable. The comments noted that parties purchasing a residence often do not make an informed decision regarding whether the residence should be held as joint tenants or tenants by the entirety, and generally are not aware that the decision to take title to the property as either joint tenants with right of survivorship or tenants by the entirety will affect the ability to disclaim their interest in the property after the death of the first joint tenant to die.

Accordingly, the final regulations allow the disclaimer of jointly-held property that is not unilaterally severable on the same basis as joint property that is unilaterally severable. Thus, a surviving joint tenant may disclaim the one-half survivorship interest in property that the joint tenant held either in joint tenancy with right of survivorship or in tenancy by the entirety, within 9 months of the death of the first joint tenant to die. The rule also significantly simplifies the disclaimer of jointly-held property, eliminating certain special rules that were dependent on the application of section 2515 to the creation of the tenancy.

The proposed regulations provided rules regarding the disclaimer of interests in joint bank accounts and brokerage accounts, generally recognizing that the creation of such accounts are not completed gifts under certain circumstances. Comments noted that other kinds of investment accounts, such as accounts held in mutual funds, accord the parties rights that are similar to the rights of parties with respect to joint bank accounts and brokerage accounts. Accordingly, the final regulations have expanded the special rule with respect to the disclaimer of jointly-held bank and brokerage accounts to include jointly-held investment accounts such as accounts held at mutual funds.

3. **<u>Disclaimer of Joint Property, Final Regulations</u>**. T.D. 8744 sets forth final regulations under section 2518. Those regulations expand the time during which disclaimers may be made:

JOINT PROPERTY -- (i) INTERESTS IN JOINT TENANCY WITH RIGHT OF SURVIVORSHIP OR TENANCIES BY THE ENTIRETY. Except as provided in paragraph (c)(4)(iii) of this section (with respect to joint bank, brokerage, and other investment accounts), in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation of the tenancy must be made no later than 9 months after the creation of the tenancy regardless of whether such interest can be unilaterally severed under local law. A qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint tenant to die must be made no later than 9 months after the death of the first joint tenant to die regardless of whether such interest can be unilaterally severed under local law and, except as provided in paragraph (c)(4)(ii) of this section (with respect to certain tenancies created on or after July 14, 1988), such interest is deemed to be a one-half interest in the property. (See, however, section 2518(b)(2)(B) for a special rule in the case of disclaimers by persons under age 21.) This is the case regardless of the portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent's gross estate under section 2040 and regardless of whether the interest can be unilaterally severed under local law. See paragraph (c)(5), Examples (7) and (8), of this section.

(ii) CERTAIN TENANCIES IN REAL PROPERTY BETWEEN SPOUSES CREATED ON OR AFTER JULY 14, 1988. In the case of a joint tenancy between spouses or a tenancy by the entirety in real property created on or after July 14, 1988, to which section 2523(i)(3) applies (relating to the creation of a tenancy where the spouse of the donor is not a United States citizen), the surviving spouse may disclaim any portion of the joint interest that is includible in the decedent's gross estate under section 2040. See paragraph (c)(5), Example (9), of this section.

(iii) SPECIAL RULE FOR JOINT BANK, BROKERAGE, AND OTHER INVESTMENT ACCOUNTS (E.G., ACCOUNTS HELD AT MUTUAL FUNDS) ESTABLISHED BETWEEN SPOUSES OR BETWEEN PERSONS OTHER THAN HUSBAND AND WIFE. In the case of a transfer to a joint bank, brokerage, or other investment account (e.g., an account held at a mutual fund), if a transferor may unilaterally regain the transferor's own contributions to the account without the consent of the other cotenant, such that the transfer is not a completed gift under section 25.2511-1(h)(4), the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, if a surviving joint tenant desires to make a qualified disclaimer with respect to funds contributed by a deceased cotenant, the disclaimer must be made within 9 months of the cotenant's death. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. See paragraph (c)(5), Examples (12), (13), and (14), of this section, regarding the treatment of disclaimed interests under sections 2518, 2033 and 2040.

The new examples are as follows:

Example (7). On February 1, 1990, A purchased real property with A's funds. Title to the property was conveyed to "A and B, as joint tenants with right of survivorship." Under applicable state law, the joint interest is unilaterally severable by either tenant. B dies on May 1, 1998, and is survived by A. On January 1, 1999, A disclaims the one-half survivorship interest in the property to which A succeeds as a result of B's death. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same whether or not A and B are married and regardless of the proportion of consideration furnished by A and B in purchasing the property.

Example (8). Assume the same facts as in Example (7) except that A and B are married and title to the property was conveyed to "A and B, as tenants by the entirety." Under applicable state law, the tenancy cannot be unilaterally severed by either tenant. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same regardless of the proportion of consideration furnished by A and B in purchasing the property.

Example (9). On March 1, 1989, H and W purchase a tract of vacant land which is conveyed to them as tenants by the entirety. The entire consideration is paid by H. W is not a United States citizen. H dies on June 1, 1998. W can disclaim the entire joint interest because this is the interest includible in H's gross estate under section 2040(a). Assuming that W's disclaimer is received by the executor of H's estate no later than 9 months after June 1, 1988, and the other requirements of section 2518(b) are satisfied, W's disclaimer of the property would be a qualified disclaimer. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (10). In 1986, spouses A and B purchased a personal residence taking title as tenants by the entirety. B dies on July 10, 1998. A wishes to disclaim the one-half undivided interest to which A would succeed by right of survivorship. If A makes the disclaimer, the property interest would pass under B's will to their child C. C, an adult, and A resided in the residence at B's death and will continue to reside there in the future. A continues to own a one-half undivided interest in the property. Assuming that the other requirements of section 2518(b) are satisfied, A may make a qualified disclaimer with respect to the one-half undivided survivorship interest in the residence if A delivers the written disclaimer to the personal representative of B's estate by April 10, 1999, since A is not deemed to have accepted the interest or any of its benefits prior to that time and A's occupancy of the residence after B's death is consistent with A's retained undivided ownership interest. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (11). H and W, husband and wife, reside in state X, a community property state. * * *

Example (12). On July 1, 1990, A opens a bank account that is held jointly with B, A's spouse, and transfers $50,000 of A's money to the account. A and B are United States citizens. A can regain the entire account without B's consent, such that the transfer is not a completed gift under section 25.2511-1(h)(4). A dies on August 15, 1998, and B disclaims the entire amount in the bank account on October 15, 1998. Assuming that the remaining requirements of section 2518(b) are satisfied, B made a qualified disclaimer under section 2518(a) because the disclaimer was made within 9 months after A's death at which time B had succeeded to full dominion and control over the account. Under state law, B is treated as predeceasing A with respect to the disclaimed interest. The disclaimed account balance passes through A's probate estate and is no longer joint property includible in A's gross estate under section 2040. The entire account is, instead, includible in A's gross estate under section 2033. The result would be the same if A and B were not married.

Example (13). The facts are the same as Example (12), except that B, rather than A, dies on August 15, 1998. A may not make a qualified disclaimer with respect to any of the funds in the bank account, because A furnished the funds for the entire account and A did not relinquish dominion and control over the funds.

Example (14). The facts are the same as Example (12), except that B disclaims 40 percent of the funds in the account. Since, under state law, B is treated as predeceasing A with respect to the disclaimed interest, the 40 percent portion of the account balance that was disclaimed passes as part of A's probate estate, and is no longer characterized as joint property. This 40 percent portion of the account balance is, therefore, includible in A's gross estate under section 2033. The remaining 60 percent of the account balance that was not disclaimed retains its character as joint property and, therefore, is includible in A's gross estate as provided in section 2040(b). Therefore, 30 percent (1/2 x 60 percent) of the account balance is includible in A's gross estate under section 2040(b), and a total of 70 percent of the aggregate account balance is includible in A's gross estate. If A and B were not married, then the 40 percent portion of the account subject to the disclaimer would be includible in A's gross estate as provided in section 2033 and the 60 percent portion of the account not subject to the disclaimer would be includible in A's gross estate as provided in section

2040(a), because A furnished all of the funds with respect to the account.

4. **Time for Disclaimers**. PLR 9818053 dealt with complicated facts. The IRS determined that a beneficiary of a trust could disclaim within nine months of the release of a general power of appointment by a prior beneficiary, because that release created the beneficiary's interest. This was true even though the trust had long been in existence.

The flavor of the facts can be inferred from the fact that the trust was created in 1935 by the disclaimant and her husband, and the beneficiary releasing the general power was their son.

5. **Disclaimer of Qualified Plan Benefits by Fiduciary**. May a fiduciary disclaim IRA proceeds or qualified plan benefits? Such could be desirable where the primary beneficiary is inappropriate in light of the circumstances at the time the benefits are paid. For instance, suppose benefits are needed to fill a credit shelter trust on account of the increase in the permitted size of the trust as the applicable credit amount increases.

In some instances tiered beneficiaries may be used. A QTIP trust may be named primary beneficiary and the surviving spouse secondary beneficiary. If beneficial, the trustee of the QTIP trust may disclaim the benefits, whereupon the surviving spouse may roll the benefits into an IRA and name another beneficiary.

In Nickel v. Estes, 122 F.3d 294 (5th Cir. 1997), the court held that the terms of a qualified plan governed rather than ERISA or Texas law. The literal language of the plan required the beneficiary to disclaim; the court held that the plan did not allow a personal representative to disclaim on the beneficiary's behalf even though a Texas statute allowed such. Presumably the result would have been different had the fiduciary, or an estate or trust, been named as beneficiary. The case points out the importance of reviewing plan and IRA documents.

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

1. **Payment of GST**. Section 2603(b) provides that specific reference to the GST must be made to override the payment of the tax from the generation skipping transfer. In TAM 9822001 the Service confronted a tax apportionment clause that did not specifically refer to the GST:

> My executor shall pay out of that portion of my probate estate not required to satisfy any non-residuary bequests and devises under this will, without apportionment or claim for reimbursement:
>
> (a) The expense of my last illness and funeral, of delivering and safeguarding bequests, and of the administration of my estate, including fees and expenses attributable to assets includible in my gross estate.
>
> (b) All my enforceable debts.
>
> (c) All federal and state death taxes (and any interest and penalties) payable by reason of my death.

The Service determined:

> In this case, Decedent's will does not direct by specific reference the source of payment of the GST tax resulting from the generation-skipping transfers. Therefore, we conclude that under section 2603(b), the GST tax imposed under section 2601 attributable to a direct skip is charged to the property constituting the direct skip. We also conclude that under section 2623, the GST tax paid with respect to each direct skip transfer should not be included in determining the taxable amount of the direct skip because the GST tax amount is not received by the transferee.

The estate also paid the GST late, thus causing an interest expense. However, the estate actually overpaid the tax, causing interest to accrue. The GST transfers were preresiduary bequests. With respect to reduction of the amount of the GST transfer on account of the interest, or vice versa, the Service stated:

> We note that there is no specific statutory language allowing interest on the underpayment of taxes to reduce the taxable amount of a direct skip GST. While sections 2621 and 2622 provide specific language allowing deductions for administration expenses in determining the taxable amount of taxable distributions and taxable terminations respectively, section 2623 provides no language permitting the deduction for interest on underpayment of taxes on a direct skip GST.
>
> In addition, section 2624(b) provides that direct skip property included in the gross estate is valued on the

date of the transferor's death (or alternative valuation date). In other words, direct skip property included in the gross estate is not valued on the date the transferee actually receives the property even though the property's value on the date of transferee receipt may be different than its value for estate tax purposes. Section 2624(b) directs that in the case of direct skip property included in the gross estate, the property's valuation for GST tax purposes is unaffected by any earnings on the property or any appreciation in the property's value occurring after the date of the transferor's death.

We also believe that in determining the taxable amount of a direct skip included in the gross estate, any interest on the underpayment of taxes should be treated in a manner similar to interest accruing on estate taxes in calculating a marital bequest. See Rev. Rul. 93-48, 1993-2 C.B. 270 (post-death interest accruing on deferred federal estate tax payable from a testamentary transfer does not ordinarily reduce the date-of-death value of the transfer). Any economic burden resulting from the late payment of the tax is offset by the economic benefit obtained from delaying the payment of the tax. Because the beneficiary has the use of the tax dollars from the date the tax payment is due until the date of the tax payment, expenditures for interest which enabled the beneficiary to retain use of the funds are offset by the economic benefit resulting from retaining the funds. Accordingly, we conclude that in determining the taxable amount with respect to a direct skip included in the gross estate, the amount passing to the beneficiary should not be reduced by interest on underpayment of taxes. See E. Peterson Marital Trust v. Comm'r, 102 T.C. 709 (1994), aff'd on other issue, 78 F.3d 795 (2d. Cir. 1996)(interest accrued and payable on a GST tax deficiency for a direct skip reduces the GST taxable amount when the direct skip constitutes a residual transfer of trust assets).

In addition, and in accordance with the above analysis, we believe any interest earned on an estate tax overpayment does not impact the taxable amount of a direct skip residuary bequest.

2. **Change of Investment Policy Did not Affect Grandfathered Status**. PLR 9809030 allowed a Trustee to change trust investment policy without affecting the trust's grandfathered status. The change was pursuant to a court order construing the instrument. The ruling states:

The issue bearing on the retention of a trust's grandfathered status for generation-skipping transfer tax purposes is whether any changes to the trust will alter the substantive provisions of the original trust in a manner such that the trust will no longer be considered to be the same trust that was exempt under

> section 1433(b)(2)(A) of the Act. In general, modifications that change the quality, value or timing of any of the powers, beneficial interests, rights or expectancies originally provided for under the terms of a trust will cause an exempt trust to lose its exempt status.
>
> In this case, the court merely construed the extent of the powers granted to the Trustee under the terms of Decedent's will. The Judgment issued by the court did not change the quality, value, or timing of any beneficiary's interest in the Trust and did not confer any additional powers or beneficial interests upon any of the Trust's beneficiaries. In addition, the Judgment did not create any additional generation-skipping transfers or increase the amount of any generation-skipping transfers. Accordingly, neither the Trust nor any distributions from the Trust will be subject to the generation-skipping transfer tax, even if the Trustee exercises discretion confirmed in Paragraph 1 of the Judgment by distributing realized capital gains to the income beneficiaries currently or within 65 days following the last day of the year.

3. Disclaimer of Amount of GST Exemption. PLR 9822014 considered this transaction:

> Grantor died on June 30, 1997 and no distributions have been made from the Trust since Grantor's death. Niece 1, Spouse 1, Niece 2, and Spouse 2 intend to disclaim a portion of their respective interests in Trust. Each couple will disclaim all right, title, and interest in a pecuniary amount of the respective trust for their benefit. The amount each couple will disclaim will be one-half of the Grantor's GST exemption available at Grantor's death. The executrixes of Grantor's estate executor *[sic]* have represented that Decedent did not use any of her GST exemption during her life and, hence, $1,000,000 of the exemption is available to allocate to any generation-skipping transfers at the Grantor's death.
>
> Under applicable state law, a disclaimant is treated as predeceasing the decedent. Under the terms of Trust, the amount disclaimed will pass outright to the issue of the respective niece, and therefore, $500,000 will pass to the issue of Niece 1 and $500,000 will pass to the issue of Niece 2. Niece 1 has four children and Niece 2 has one child. All of these children have reached their twenty-first birthday. The executrixes of Grantor's estate have represented that they will allocate Grantor's available GST exemption equally to each amount that will pass to each niece's issue.

The ruling held that the disclaimers were valid and that the decedent's executor could allocate GST exemption to the disclaimed property. The same result would have occurred had the amount of GST exemption been less than $1,000,000.

4. **Deemed Reverse QTIP Election**. Who is the transferor of a marital trust created prior to the GST effective date? PLR 9823028 considers these facts:

> You represent that the decedent, a United States Citizen, died testate on Date 1, survived by his spouse. The decedent's Will was executed on Date 2, and was amended by codicil dated Date 3. The marital trust created under Article III of the decedent's Will provided the surviving spouse with a qualifying income interest for life for purposes of section 2056(b)(7). The executor of the decedent's estate elected on the federal estate tax return, Form 706, to treat the property as qualified terminable interest property (QTIP). The executor did not make a reverse QTIP election under section 2652(a)(3) to treat the decedent as the transferor of the property for generation-skipping transfer tax purposes.
>
> You represent that no additions, constructive or otherwise, have been made to the trust since the date of the decedent's death.
>
> You request that we rule that, because the decedent's will and codicil were executed prior to October 22, 1986, and the decedent died before January 1, 1987, the decedent is treated as if he had made a reverse QTIP election under section 2652(a)(3) with respect to the property in the marital trust, and transfers from the trust will not be subject to the generation-skipping transfer tax.

The ruling concludes:

> Section 26.2601-1(b)(2) provides that the provisions of Chapter 13 do not apply to any generation-skipping transfer under a will or other revocable trust executed before October 22, 1986, provided that the document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer, and the decedent dies before January 1, 1987. This paragraph also provides that the rules contained in section 26.2601-1(b)(1)(iii) apply to any will or revocable trust within the scope of this paragraph.
>
> In the present case, the marital trust was not irrevocable on September 25, 1985. The decedent's Will and codicil were executed prior to October 22, 1986, and the decedent died before January 1, 1987. It is represented that there have been no additions, constructive or otherwise, to the marital trust since

the decedent's death. Accordingly, we conclude that the Will and codicil are within the scope of section 26.2601-1(b)(2) and therefore section 26.2601(b)(1)(iii) applies to the marital trust created under the decedent's Will. Thus, the decedent spouse is treated as if he had made a reverse QTIP election under section 2652(a)(3) with respect to the property in the marital trust. If there are no additions to the marital trust, transfers from the trust will not be subject to the generation-skipping transfer tax and the decedent will be treated as the transferor of the property.

5. **Partitioning Grandfathered Trusts**. In PLR 9809049 the IRS approved the partitioning of a grandfathered trust which had the following terms:

> The Decedent died testate in 1968, survived by Spouse and their two children, Child #1 and Child #2. Article SEVENTH of Decedent's will established Trust, an irrevocable trust, primarily for the benefit of Spouse and the issue of Decedent and Spouse. The original co-trustees were Spouse, Child #1 and Child #2. Spouse died in 1990, at which time Child #1 and Child #2 became the co-trustees. They continue to serve in that capacity.
>
> Under the terms of Trust, the entire income was to be paid to Spouse during her life. Spouse also had a noncumulative right in each calendar year to demand and receive from the principal the greater of $5,000 or 2 percent of the then current value of the principal. After Spouse's death, the income is to be paid to Child #1 and Child #2 in equal shares. At the death of the first to die of Child #1 and Child #2, that child's respective share of income will be paid equally to that child's issue, per stirpes, until the termination of the trust. If either Child #1 or Child #2 dies without issue, the income is to be paid to the surviving child. In addition, the trustees have the discretion to pay principal to Child #1, Child #2 and their issue for support and maintenance. However, any such amounts paid from principal must be charged as an "advance" against the distribution ultimately to be received by or through the payee.
>
> The Trust will terminate at the death of the survivor of Spouse, Child #1, and Child #2. At such time, the principal of the Trust is to be paid to the surviving issue of Child #1 and Child #2, per stirpes.
>
> During Spouse's life, the trustees paid her the entire net trust income. Since her death, the entire net income has been paid in equal shares to Child #1 and Child #2. No distribution of principal has ever been made. You represent that no actual additions have been made to trust principal. You also represent, as a consequence of Spouse's power of withdrawal, that 2 percent of the value of the principal of Trust as of the

> date of Spouse's death was included in Spouse's gross estate for estate tax purposes.
>
> The co-trustees propose to divide Trust into two separate and equal trusts: Trust #1 for the benefit of Child #1 and her issue and Trust #2 for the benefit of Child #2 and her issue. Trust #1 and Trust #2 will be administered under the terms set forth in Trust and will contain equal shares of each asset currently held in Trust. The entire net income of Trust #1 will be paid to Child #1 during her life and, at her death, to Child #1's surviving issue, per stirpes. Likewise, the entire net income of Trust #2 will be paid to Child #2 during her life and, at her death, to Child #2's surviving issue, per stirpes. The trustees of each new trust will be authorized to pay amounts from principal of that trust to the respective child or her issue for support or maintenance. Any such amounts paid from principal must be charged as an advance against the distribution ultimately to be received by or through the payee.
>
> Trust #1 and Trust #2 will terminate on the death of the survivor of Child #1 and Child #2. At that time the principal of Trust #1 will be paid to the surviving issue of Child #1, per stirpes, and the principal of Trust #2 will be paid to the surviving issue of Child #2, per stirpes. If either Child #1 or Child #2 dies without issue and is survived by the other child or, if a deceased child's issue do not survive the other child, the income of the deceased child's trust will be paid to the surviving child and, upon termination of the trusts, the principal of the deceased child's trust will be paid, per stirpes, to the issue of the second child to die.

Requiring principal distributions to be treated as advancements is unusual. Was that an essential part of the GST determination? The ruling states:

> The partition of Trust into Trust #1 and Trust #2 along family lines will not change the dispositive terms of Trust. The dispositive terms of each separate successor trust (Trust #1 and Trust #2) will be consistent with the dispositive terms of Trust. Thus, the partition will not result in any modification in a manner that will change the quality, value and timing of the beneficial interests under Trust or any powers, rights, or expectancies originally provided under the terms of Trust.
>
> Therefore, the proposed partition of Trust into the two separate successor irrevocable trusts will not be construed as a modification after September 25, 1985, that would subject the successor trusts to the generation-skipping transfer tax.

A second ruling was requested -- that the division would not have an income tax effect. On that issue the ruling stated:

An exchange of property results in the realization of gain or loss under section 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). There is a material difference when the exchanged properties embody legal entitlements "different in kind or extent" or if they confer "different rights and powers." 499 U.S. at 565.

New York courts have authorized divisible shares of an identified trust to be treated as separate trusts for purposes of limiting a power of invasion where the original trust document contains sufficient indicia of the testator's intent to do so. See, e.g., Matter of Horner, 237 N.Y. 489 (1924) (severance to salvage trust from violating the rule against perpetuities); Matter of Tonetti, 53 Misc.2d 501 (Surr. Ct., Rockland Co. 1967) (severance to protect testator's wife and to preserve presumed intent to qualify wife's trust for the marital deduction); Matter of Goldberg Irrevocable Trust, 159 Misc.2d 1107 (Surr. Ct., New York Co., 1994) (severance to facilitate disparate investment goals of trust beneficiaries).

The essential question is whether, upon establishment of the new trusts, Child #1 and Child #2 and/or their issue will have different rights to trust income and principal than they currently have. In this case it appears that Child #1 and Child #2 and/or their issue will not have different rights to trust income and principal than they currently have.

Under the terms of the original Trust, Decedent directed that the income be paid in equal shares to Child #1 and Child #2 and that any discretionary distributions of principal be charged as an "advance" against the distribution ultimately to be received by or through the payee. New York law would allow the division of the original Trust into separate trusts in this case and the issue of Child #1 and Child #2 will not have materially different entitlements.

Based on the analysis described above, the beneficiaries will not have different legal entitlements as a result of the proposed transaction and, thus, the original Trust and the new trusts are not materially different.

The 2% of the trust that was included in the spouse's estate was not grandfathered; spouse was the transferor.

6. **Proposed Legislative Change of the AICPA**. The American Institute of Certified Public Accountants has proposed a legislative change to the GST. The following changes are proposed:

SUGGESTED CHANGES

AUTOMATIC ALLOCATION OF GST EXEMPTION

This proposal would address the concerns described above by making allocation of GST exemption automatic in cases when most taxpayers would want an allocation to be made. This proposal would take an approach similar to the approach taken with section 453 of the Code on installment sales, which previously required taxpayers to make an affirmative election in order to use the installment method of accounting. When it became clear that installment reporting was almost always desired and that many taxpayers were inadvertently failing to make the election, the law was changed under section 453(a)(c) to provide an automatic election of the installment sale treatment to all taxpayers unless the taxpayer elects out under section 453(d). Similarly, taxpayers and practitioners could elect out of the automatic GST exemption allocation when they determine electing out is appropriate, but electing out would be more the exception than the rule. The automatic allocation of GST exemption would result in less burden on the taxpayer and his or her tax return preparers.

Under the proposal, taxpayers can elect not to have the automatic allocation rule apply. This can be done in the trust instrument, on an instrument of transfer or on a gift tax return. In addition, the automatic allocation rule will not apply to the following types of trusts, unless the taxpayer elects to have the rule apply.

> A trust that would be includible in a nonskip person's estate if the nonskip person died immediately after the transfer to the trust;
>
> A trust that provides that more than 25% of the trust corpus (i) must be distributed to a non-skip person if he or she is living on a date or dates or (ii) will be subject to a general power of appointment exercisable by a non-skip person if he or she is living on a date or dates and if it can be ascertained by actuarial standards that there is more than a 50% probability that such non-skip person, will be living on such date or dates; or
>
> A charitable lead annuity trust or a charitable remainder trust.

The automatic allocation of GST exemption is simple and fair. It would reduce compliance costs and give the average taxpayer the same benefits available to those who have and can afford more sophisticated advisers.

RELIEF AND SUBSTANTIAL COMPLIANCE

Regulation section 9100 relief would be allowed for allocations of GST exemption, including those taxpayers who made no election by reason of an inadvertent failure to timely file the appropriate return, and also for taxpayers who inadvertently missed opting out of the automatic allocation. The allocation or election out of the allocation would be treated as if made as of the date of transfer.

The substantial compliance doctrine would be made explicit. Allocation of GST exemption would be effective if the taxpayer demonstrates an intent to have a zero including ratio for trust. Evidence of that intent would include all relevant facts, including but not limited to correspondence or other documentation relating to the creation of any generation-skipping trust.

SEVERANCE

The proposal would allow the severance of trusts into two or more separate trusts. Allowing the severance of a trust that has an inclusion ratio between zero and one into two separate trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one, on a fractional basis, would result in shorter wills and revocable trusts, less complicated and less expensive estate planning, less frequent drafting and administration errors, and fewer trusts.

RETROACTIVE ALLOCATION

Late or retroactive allocations of the GST exemption would be allowed when there is an unnatural order of death. For example, it would be allowed when a child who is intended as the trust remainder beneficiary, dies before his or her parent who created the trust. Retroactive application is appropriate because the trust was not primarily designed to benefit skip persons.

The effects of the proposal would be positive, particularly in allowing severance of trusts that would have inclusion ratios of between one and zero into separate trusts, one with a ratio of one and the other with a ratio of zero. The deemed allocation rules are complex and can be thought of as a mechanism for reducing accountant and attorney malpractice when allocations are mistakenly not made or made incorrectly.

Q. <u>SECTIONS 2701-2704 - SPECIAL VALUATION RULES</u>

1. **Spousal Annuity Trust**. TAM 9741001 is another example of the National Office's ruling position that the power in the grantor to revoke the spouse's annuity interest has no value.

2. **Qualified Personal Residence Trust**. In PLR 9741004 the Internal Revenue Service approved the creations of a qualified personal residence trust on the following facts:

> Husband and Wife (taxpayers), residents of State X, are married and have four adult children. The taxpayers own fee simple title to Property, a parcel of property located in Community, a town in State X. Property consists of two lots that are contiguous to each other. Each lot consists of two acres. The first lot includes the taxpayers' residence and the second lot is an unimproved lot located behind the first lot. The first lot includes an easement for a driveway over the access "arm" to the second lot. The taxpayers have owned both lots and have treated them as one residence for over 30 years. It is represented that taxpayers have no intention of selling the unimproved lot.
>
> The taxpayers' residence, a large six-bedroom home, includes two sets of additional rooms. Each set has a separate entrance and includes its own bathroom and kitchen area. The taxpayers have allowed two individuals to use these sets of rooms on a monthly basis for a fee. One set of rooms has been occupied by the same individual for 27 years. The other set of rooms has been occupied by another individual for 6 years. Neither individual is related to the taxpayers. The taxpayers expect that these same individuals will continue to occupy the sets of rooms.
>
> The two sets of rooms consist of approximately 21 percent of the total square footage of the residence. The taxpayers' residential portion, including its garage, and the rental portion constitute a single building, and there is no way of dividing the two sets of rooms from the residential portion.
>
> The taxpayers propose to transfer their interests in Property to two qualified personal residence trusts that they will establish. Husband will transfer his undivided one-half interest in Property to Trust 1 and Wife will transfer her undivided one-half interest in Property to Trust 2. Both trusts will be governed by the laws of State X and the terms of each trust are intended to satisfy the requirements of section 25.2702-5(c) of the Gift Tax Regulations.

The Service stated:

> In this case, parcels in proximity to Property generally contain a similar amount of acreage. Although the Property consists of two contiguous lots, both lots have been used as one residence by the taxpayers for many years. Because the minimum acreage requirement for residences at that location is 2 acres and each lot is in excess of 2 acres, it appears that the zoning requirements in the Community may allow subdivision of Property into the two lots. However, any sale of the residence will result in the proceeds of the sale being subject to the qualified annuity interest provisions of the trust agreement. The structures on the Property consist only of a residence and an adjoining garage. In addition, the rental activity is secondary to the primary use of the residence as a residence by the taxpayers. Consequently, we conclude that Property, as described above, is reasonably appropriate for residential purposes and, thus, constitutes a personal residence within the meaning of section 2702(a)(3)(A)(ii) and section 25.2502-5(c)(2).

Also of interest is the fact that the trusts were identical, except one had a 10-year term and the other a 14-year term, including providing a trust for the spouses at the end of each term.

3. **Funding QPRTs With Half Interests**. PLR 9818014 approved the creation by husband and wife of identical QPRTs, each to own a one-half interest in the couple's residence. The IRS specifically did not rule on the value of the interests.

4. **Discussion of Family Limited Partnerships**. Family limited partnerships continue to be invaluable tools for reducing estate taxes despite the negative publicity you may have heard or read in recent months. They are particularly useful in situations involving marketable securities or real estate.

In brief, a family limited partnership works like this. Assets are contributed to the partnership by husband and wife or parent and child. The partnership has two kinds of units (units are to a partnership what stock is to a corporation): voting units (called "general" units) and nonvoting units (called "limited" units). A typical partnership might have 100 general units and 9900 limited units.

What are the purposes of a family limited partnership? Generally there are three purposes. One is to create a vehicle for common management and control of assets. The assets owned by a partnership are managed together, even if partnership units are owned by different family members. This can be especially valuable in real estate ownership, because having multiple owners of real estate often presents administrative difficulties. In addition, in many instances a family's securities are managed by a small number of managers; a partnership is a good way to maintain that arrangement.

A second common purpose of a family limited partnership is to protect the assets of the partnership from creditors, spouses, and, potentially, even the so-called black-sheep of the family. A partnership limits the ability of the owners of the limited units to dispose of the units or to spend the assets of the partnership, and restricts the rights of creditors and spouses as well.

A third common purpose of a family limited partnership is to facilitate the making of gifts from the senior generation in the family to the more junior generations. The gifts are typically made using limited partnership units. This effectively enables the control of the partnership to be separated from the ownership of the equity in the partnership. For instance, the senior generation might give away all of the limited partnership units -- representing as much as 99% of the equity -- while keeping all of the general partnership units -- representing all of the control.

An important point about family limited partnerships is that the value of the limited units is typically discounted by appraisers because the limited units have no influence over the management of the partnership. Although each partnership is different, typically the discount is between 35% and 50%. The effect of the discount is that more may be given away by the senior generation outside of the gift tax system.

To illustrate, suppose husband and wife have three children and six grandchildren. Together, they are allowed to give $20,000 to each every year -- that is $20,000 for nine descendants, which is $180,000. Suppose limited partnership units are used that are discounted 40%. The total value transferred becomes $300,000 (because $300,000 discounted by 40% is $180,000).

Even more dramatic results can be obtained when a donor uses his or her $625,000 lifetime gift exemption. Instead of giving away only $625,000, about $1,040,000 of limited partnership units may be given away, assuming again a 40% discount.

Documenting the discount with a quality appraisal is important as is disclosure on a timely filed gift tax return. If done properly such disclosure gives the Internal Revenue Service only three years -- no more -- to challenge the value of the limited partnership units. Once that statute of limitations has run the value of the gifts may not be reopened. That is new law, as of August 5, 1997.

Naturally the Internal Revenue Service would like for family limited partnerships to go away. Unfortunately all attacks on them thus far have failed. The most recent, last January, was an attempt to say that a gift of limited partnership units is not a current gift at all (technically is not a "present interest" gift). That position is almost certainly wrong, and the IRS position can be completely avoided by properly wording a partnership agreement.

President Clinton has also weighed in with proposals to eliminate family limited partnerships. Fortunately those ideas have gone nowhere in Congress. (The President also wants to do away with Crummey trust trusts which is an immensely unpopular idea.)

5. **Spouse's Right to Live in Residence After QPRT Term**. The IRS continues to issue favorable rulings in the QPRT area. PLR 9827037 states:

> In Rev. Rul. 70-155, 1970-1 C.B. 189, an elderly father continued to live rent-free in a residence that he had transferred to his son and daughter-in-law in accordance with an understanding by all parties that the father would retain use of the residence. The ruling notes that the donor's continued occupancy of a transferred residence rent free until death is as much an economic benefit as if the donor had rented the property and obtained the income therefrom. Accordingly, the donor's continued rent-free occupancy until death pursuant to the understanding resulted in inclusion of the property under section 2036. The ruling, however, notes that continued occupancy under the facts of the ruling may be distinguished from the case involving co-occupancy of the donor and donee-spouse. Where the donor and donee

are spouses, the co-occupancy does not of itself support an inference of an agreement or understanding as to retained possession or enjoyment by the donor. See Estate of Gutchess v. Commissioner, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2, where the court held that the value of a residence transferred from the donor spouse to the donee spouse 11 years before the death of the donor spouse is not includible in the gross estate of the donor spouse under section 2036, even though the spouses continued to reside in the residence until the donor spouse's death. The court found that no agreement with respect to the occupancy was implied from the fact that the spouses continued to reside in the residence after the transfer.

In the present case, the Settlor proposes to transfer residential property to a trust for an 18-year term. If the taxpayer survives the 18-year term, the property is to pass to the Successor Trust. Under the terms of the Successor Trust, Settlor's spouse is granted the right to use and possess the residence during her lifetime. At her death the property is to pass to the Settlor's children. As set forth in Rev. Rul. 70-155 and Estate of Gutchess, if the Settlor continues to live in the residence with his spouse after the 18-year term and then predeceases his spouse, no agreement with respect to the Settlor's occupancy will be implied from the fact that the Settlor and his spouse continue to reside in the residence.

If the Settlor survives the 18-year term and continues to use or possess the residence after the death of the Settlor's spouse, the Settlor represents that he will pay fair market value rental for the periods of time for which he has use or possession of the property. If the Settlor pays fair market value rental for these periods of use or possession, assuming that there is no express or implied understanding that the Settlor may retain use of the property whether or not rent is paid, the Settlor's continued use of the property will not result in the inclusion of the property in the Settlor's gross estate under section 2036(a).

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

1. **Rental Real Estate**. In PLR 9801009 the Service determined that a corporation which owned rental real estate would qualify for section 6166. The facts accepted were these:

On Date 2, Decedent formed Corporation A, a real estate management corporation, to manage and service his rental real estate properties. Decedent owned 92 percent of the stock of Corporation A, and his wife owed the remaining eight percent. Decedent personally operated, managed, maintained, repaired and serviced the properties on a full-time basis until he became physically incapacitated shortly before his death. Decedent was paid a monthly salary of $X by Corporation A for his services. For 29 years prior to his death, Decedent had no other employment.

In the present case, extensive documentary evidence substantiates that over the years the Decedent was actively involved in the day-to-day operations of the rental real estate properties. The evidence demonstrates that Decedent's responsibilities and activities included, but were not limited to: negotiating and renegotiating leases, screening applicants, collecting rents, maintaining good tenant relations, resolving complaints, personally performing and/or supervising necessary repairs and periodic maintenance projects, personally performing and/or supervising improvements (such as roofing, pouring concrete, and replacing drainage pipes), painting, landscaping, purchasing and hauling supplies and materials needed to make repairs and improvements, maintaining tools and equipment, maintaining books of account, paying bills, paying property taxes, paying insurance premiums, reviewing insurance coverage, making bank deposits, maintaining required records, preparing reports regarding rent control and permit matters, and consulting with accountants concerning business and tax matters.

Decedent was on call 24 hours and on weekends in case of an emergency or if urgent repairs (such as a broken water pipe, leaky roof, or blown fuse) were needed. The Decedent used a 24-hour answering service to ensure that he could be reached at all times. On rare occasions, certain specific jobs were performed by one of Decedent's children or a contractor. Decedent's son often assisted his father in large jobs such as roofing and drainage pipe repair. Decedent supervised all work that he did not personally perform.

Decedent continued to actively operate, manage, maintain, repair, service, and improve the properties until he became physically incapacitated in late Month 2, Year 2. On Month 1, Year 2, Decedent's son became more involved in the operation and management of the rental real estate properties because of his father's deteriorating health. On Date 3, less than two months before Decedent's death, Decedent engaged the services of an unrelated management company to help manage certain rental properties and Decedent's son managed the remaining properties.

The facts reveal that this arrangement was intended to be temporary. Decedent expected to recover and resume personal management and service of the rental real estate properties. As late as the week before his death, Decedent anticipated that he would soon be able to resume management of the properties. Even after hiring the management company, Decedent insisted that his son continue to oversee all of the properties

> because Decedent was concerned that the tenants might not like the new arrangement and might move. Until the time of his death, Decedent continued to ask his son about the status of the properties and the tenants.
>
> On Date 4, approximately two weeks prior to his death, Decedent created a revocable trust, Trust A. The rental real estate properties and other tangible personal property were transferred to Trust A. Under the terms of Trust A, Decedent was the sole beneficiary for his life. Upon Decedent's death, the trust provided that certain tangible personal property would be distributed to Decedent's wife and all remaining property (including the renal real estate properties) would be distributed equally to Decedent's children.

The ruling discussed the facts as follows:

> As the above revenue rulings suggest, the level of activity is the factor that distinguishes an "active business" from mere passive ownership of income producing assets. In determining the level of business activity carried on by a proprietorship, partnership and/or corporation, the activities of its agents and/or employees are taken into account. The activities of persons such as independent contractors or lessees who are neither agents nor employees, on the other hand, are not taken into account.
>
> Under the facts presented, Decedent handled the day-to-day operation, management, maintenance, repair, service, and improvement of the rental properties (with occasional assistance form his children or a contractor under his supervision) until his physical incapacitation immediately before his death. the level of Decedent's activity was more than a mere owner managing investment assets to obtain the rents ordinarily expected from them. The Decedent's level of activity and services is distinguishable from the level of activity in Rev. Ruls. 75-365 and 75-367. In the present case, the level of Decedent's activity more closely resembles that of Rev. Rul. 75-366. Decedent's exclusive activity and concern was the day-to-day operation, management, maintenance, repair, service, and improvement of the rental real estate properties. Therefore, Decedent's level of activity is sufficient to treat his interest in the rental real estate properties and in Corporation A as interests in a trade or business for purposes of section 6166 of the Code.
>
> Decedent was personally, and through the activities of his agents, actively involved in the trade or business as of the time immediately before his death. Shortly before his death, Decedent engaged the management company and his son as his agents to oversee the properties because of his physical incapacitation. In many cases, death will be preceded by a period of incapacity which greatly reduces or even terminates the active role of the individual in the business. Given

the purposes of section 6166 to reduce the consequences to a small business resulting from the death of an owner, it would be unreasonable to deny relief based on the fact that shortly before death the Decedent became incapacitated and could not participate in the trade or business at the precise time of death. Therefore, Decedent's delegation of certain management responsibilities shortly before his death because of physical incapacitation does not preclude a determination that Decedent's interest in Properties 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, and 11 and Corporation A are interests in a trade of business as of the time immediately before his death.

The cited revenue rulings were summarized in this way:

Rev. Rul. 75-365, 1975-2 C.B. 471, holds that rental commercial property, rental farm property, and notes receivable included in decedent's gross estate do not constitute an interest in a closely held business under section 6166 where decedent maintained a fully equipped business office, collected rental payments on the properties, received payments no notes receivable, negotiated leases, made occasional loans, and by contract directed the maintenance of the properties. Under these facts, decedent's relationship to the assets was merely that of an owner managing investment assets to obtain the income ordinarily expected from them.

Rev. Rul. 75-366, 1975-2 C.B. 472, holds that where a decedent paid 40 percent of the expenses, received 40 percent of the crops, and actively participated in the important management decisions of a tenant farm included in the decedent's estate, the farm constitutes an interest in a closely held business under section 6166. Under these facts, the decedent made almost daily visits to inspect and discuss operations and occasionally delivered supplies to the tenants.

Rev. Rul. 75-367, 1975-2 C.B. 472, holds that land owned by a decedent that was held for the purpose of building homes, decedent's ownership of stock in a corporation that built homes on such land, and a business office and warehouse owned by the decedent and used by both the corporation and decedent, qualify as an interest in a closely held business under section 6166. However, eight homes built by the decedent's corporation that were sold and later repurchased by the decedent, who collected the rents, made the mortgage payments and made the necessary repairs and maintenance to the homes in order to maintain the condition and appearance of the rental homes, were not an interest in a closely held business because the decedent's relationship to the properties was merely that of an owner managing investment assets to obtain the rents ordinarily expected from them.

S. TAX ADMINISTRATION

1. **Tax Administration**. The taxpayer was awarded attorney's fees against the IRS in Estate of Rao v. United States, 987 F. Supp. 249 (S.D. NY 1997). The facts and result were set forth by the court:

> According to the Internal Revenue Service, "Our goal at the IRS is to protect your rights so that you will have the highest confidence in the integrity, efficiency, and fairness of our tax system." See Complaint, Ex. K ("Your Rights as a Taxpayer"). Our goal at the federal courts is (among other things) to help the IRS keep its word. A modest award of costs and attorneys' fees to the prevailing plaintiff in this case may encourage such confidence.
>
> The underlying dispute traces back to December 28, 1989, when the executrix of the Estate of Paul P. Rao, former Chief Judge of the United States Court of International Trade, filed a U.S. Estate Tax Return that disclaimed any gift tax liability. Although the Government alleges that a gift tax notice of deficiency was mailed to the Estate on December 23, 1992, see Defendant's Memorandum of Law at 7, the Estate maintains that such a notice was never sent or received and that, accordingly, the Estate did not become aware of the alleged deficiency in time to raise a challenge in Tax Court within the 90-day prescribed period. See 26 U.S.C. section 6213; see also Memorandum of Law in Support of Plaintiff's Application at 2. When, however, the Estate received a notice of tax due on May 21, 1993, see Complaint, Ex. H, the Estate's representatives immediately sought to bring to the attention of the IRS, both orally and in writing, evidence not only of the non-receipt of the alleged notice of deficiency but also of the inaccuracy of the alleged deficiency itself. See Complaint, Ex. E. The IRS's only response was to file a notice of intent to levy on September 19, 1994, and a notice of a federal tax lien on May 18, 1995. See Complaint, Exs. L & O. Again, plaintiff attempted with vigor and persistence to bring the relevant facts to the IRS's attention, both orally and in writing, see Complaint, Exs. M, P, & S, only to be met, as the Government now concedes, with a wall of silence. See transcript of oral argument, September 12, 1997.
>
> Finally, in desperation, plaintiff filed suit in this Court on May 12, 1997, claiming that the tax lien was void. Within less than two months, the IRS conceded that it had made an error in assessing the deficiency, and agreed to lift its lien, thus mooting the action. See Stipulation & Order, July 16, 1997. However, the stipulation of dismissal expressly preserved plaintiff's right to seek an award of attorneys' fees and costs, see id. paragraph 2, and plaintiff thereafter moved for same under 26 U.S.C. section 7430. Having reviewed the parties' papers and oral arguments, the court now grants plaintiff's motion, finding that the plaintiff meets each of the prerequisites.

With respect to the requirement that the taxpayers have substantially prevailed, the court held:

> Plaintiff has also met the requirement that it have "substantially prevailed with respect to the amount in controversy, or . . . with respect to the most significant issue or set of issues presented." 28 U.S.C. section 7430(c)(4)(A)(i)(I-II). Such success need not take the form of a final adjudication on the merits; it is enough if the litigation produces voluntary action by the defendant that affords the plaintiff all or some of the relief that he sought through a judgment. See Association for Retarded Citizens v. Thorne, 68 F.3d 547, 551 (2d. Cir. 1995). See also Hewitt v. Helms, 482 U.S. 755, 760 (1987); LaRouche v. Kezer, 20 F.3d 68, 71 n.4 (2d Cir. 1994); Rose v. Heintz, 806 F.2d 389, 391 (2d Cir. 1986). From the history of this case, as described supra, it is obvious that the filing of this action was the catalyst for the release of the lien, which in turn was the "most significant issue . . . presented" to this court and the entire relief requested.
>
> Nonetheless, the Government -- making the kind of argument that only a lawyer could love -- contends that since the release of the lien was itself the result of the plaintiff's convincing the IRS that the plaintiff did not owe any gift tax at all, plaintiff has "really" prevailed on an issue not involved in this case (indeed, an issue over which the Court could not exercise jurisdiction, see supra) and hence is not entitled to attorneys' fees and costs. But to allow the Government to evade payment of attorneys' fees and costs because the reconsideration of the Estate's gift tax liability prompted by this suit gave plaintiff not only the specific relief that it requested in this action but also the greater relief to which it was also entitled would wholly undercut the policies of section 7430.
>
> That the Government is reduced to such a doubtful argument is not irrelevant to assessment of its further contention that its claim that a notice of deficiency was properly issued was "substantially justified," thereby precluding recovery of attorneys' fees and costs. A substantially justified position must have a reasonable basis in law and fact, see Pierce v. Underwood, 487 U.S. 552, 563-65 (1988), and no such reasonable basis exists where there has not been a diligent investigation, see Nicholson v. C.I.R., 60 F.3d 1020, 1029 (3d Cir. 1995). Here, the fact that the IRS -- having ignored plaintiff's repeated communications for more than four years -- completely accepted plaintiff's position across-the-board within a few months of the filing of this action, makes it abundantly clear that no prior diligent investigation of this matter was conducted by the defendant. Moreover, the Government's reliance on the presumption of administrative regularity that normally attaches to the

mailing of forms such as a notice of deficiency, see <u>Follum v. C.I.R.</u>, No. 97-4011, slip op, 191, 194 (2d Cir. Nov. 3, 1997), is here misplaced, since the IRS's studied refusal to respond to plaintiff's endless efforts to apprise the IRS of the non-receipt of the alleged notice serves fully to rebut any such presumption.

2. **Partnership Returns**. When a decedent was involved in a partnership there is a mechanism for opting out of the normal process of partnership income tax audits. Stated differently, partners normally may not challenge partnership audits independently of the partnership; however, an estate may. The mechanism is discussed by the Tax Court in <u>Estate of Callaway v. Commissioner</u>, 75 T.C.M. 1956 (1998):

> The notices of deficiency at issue in this case, so-called affected items notices of deficiency, were issued to petitioners pursuant to the unified audit and litigation procedures set forth in sections 6221 through 6233. Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 402(a), 96 Stat. 648. Pursuant to the TEFRA provisions, which apply with respect to all taxable years of a partnership beginning after September 3, 1982, the tax treatment of any partnership item generally is determined in a single proceeding at the partnership level. <u>Sparks v. Commissioner</u>, 87 T.C. 1279, 1284 (1986); <u>Maxwell v. Commissioner</u>, 87 T.C. 783, 789 (1986).
>
> Partnership items include each partner's proportionate share of the partnership's aggregate items of income, gain, loss, deduction, or credit. Sec. 6231(a)(3); sec. 301.6231(a)(3)-1(a)(1)(i), Proced. & Admin. Regs.
>
> Partnership items are distinguished from affected items which are defined in section 6231(a)(5) as any item to the extent such item is affected by a partnership item. <u>White v. Commissioner</u>, 95 T.C. 209, 211 (1990). The first type of affected item is a computational adjustment made to record the change in a partner's tax liability resulting from the proper treatment of partnership items. Sec. 6231(a)(6); <u>White v. Commissioner</u>, supra. Once partnership level proceedings are completed, the Commissioner is permitted to assess a computational adjustment against a partner without issuing a deficiency notice. Sec. 6230(a)(1); <u>N.C.F. Energy Partners v. Commissioner</u>, 89 T.C. 741, 744 (1987); <u>Maxwell v. Commissioner</u>, supra at 792 n.9.
>
> The second type of affected item is one that is dependent upon factual determinations to be made at the individual partner level. <u>N.C.F. Energy Partners v. Commissioner</u>, supra at 744. Section 6230(a)(2)(A)(i) provides that the normal deficiency procedures apply to

those affected items that require partner level determinations. For instance, additions to tax for negligence are affected items requiring factual determinations at the individual partner level. N.C.F. Energy Partners v. Commissioner, supra at 745.

Congress has vested the Secretary with the authority to prescribe exceptions to the unified partnership audit and litigation procedures. In particular, section 6231(c)(2) provides that, where the treatment of partnership items will interfere with the effective and efficient enforcement of the TEFRA provisions, the Secretary may promulgate regulations whereby such partnership items will be treated as nonpartnership items. One such special enforcement area is described in section 301.6231(c)-8T, Temporary Proced. & Admin. Regs., 52 Fed. Reg. 6794 (Mar. 5, 1987), which provides:

> Prompt assessment (Temporary). -- The treatment of items as partnership items with respect to a partner on whose behalf a request for a prompt assessment of tax under section 6501(d) is filed will interfere with the effective and efficient enforcement of the internal revenue laws. Accordingly, partnership items of such a partner arising in any partnership taxable year ending with or within any taxable year of the partner with respect to which a request for a prompt assessment of tax is filed shall be treated as nonpartnership items as of the date that the request is filed.

In sum, the partnership items of a partner on whose behalf a request for prompt assessment of income tax is filed under section 6501(d) shall be treated as nonpartnership items as of the date that the request for prompt assessment is filed.

The case itself involved jurisdiction over the estate -- denied -- and over the decedent's spouse, which was upheld even though her role was solely as a spouse filing jointly.

Experience suggests that a request for prompt assessment is rarely made.

3. **Duty of Consistency, Marital Deduction**. The estate of a surviving spouse was precluded by the duty of consistency from excluding a "marital trust" as part of the surviving spouse's estate where a marital deduction had been claimed in the estate of the first spouse to die. Estate of Letts v. Commissioner, 109 T.C. 290 (1997). The opinion set forth the circumstances surrounding the filing of the estate tax return for the first spouse:

1. MARITAL DEDUCTION

> The Estate of James Letts, Jr., claimed a $1,317,969 marital deduction. Of that amount, $317,705 was attributable to assets passing to decedent as joint tenant with the right of survivorship. The remaining $1,000,264 was for the Item II trust, which was described on Schedule M as a "qualified marital trust." The Estate of James Letts, Jr., did not state on its return whether or not the Item II trust property was terminable interest property. The Estate of James Letts, Jr., passed $1,317,969 to Decedent and paid no estate taxes.
>
> 2. RESPONSES BY THE ESTATE OF JAMES LETTS, JR., TO THE INSTRUCTIONS ON LINE 4 OF PAGE 2 AND ON SCHEDULE M OF THE ESTATE TAX RETURN IT FILED
>
> On Page 2 of the return filed by the Estate of James Letts, Jr., under "Elections by the Executor," the following question appears on line 4: "Do you elect to claim a marital deduction for qualified terminable interest property (QTIP) under section 2056(b)(7)?" The executor of the Estate of James Letts, Jr., placed an "x" in the box for "No."
>
> The instructions for line 4 say that if the gross estate exceeds $500,000, the property for which the election is being made must be listed on Schedule M and clearly marked as "qualified terminable interest property." The executor listed no property on Schedule M as QTIP.
>
> The estate tax return for the Estate James Letts, Jr., did not include a copy of the will of James Letts, Jr.
>
> James P. Letts, III signed the Federal estate tax return for the Estate of James Letts, Jr. It was filed on September 8, 1986. Respondent did not examine or make any adjustments to that return. The time to assess tax against the Estate of James Letts, Jr., expired on September 8, 1989, before decedent died.

The Estate of the surviving spouse argued that it and the first estate were different taxpayers, thus no duty of consistency:

> Petitioner contends that the duty of consistency does not apply between decedent's estate and the Estate of James Letts, Jr. We disagree.
>
> The duty of consistency can bind a beneficiary of an estate to a representation made on an estate tax return if the beneficiary was a fiduciary of the estate. <u>Beltzer v. United States</u>, supra; <u>Cluck v. Commissioner</u>, supra at 333; <u>LeFever v. Commissioner</u>, supra at 543; <u>Griffith v. United States</u>, 27 AFTR 2d 71-436, 71-1 USTC Par. 9280 (N.D. Tex. 1971); <u>McMillan v. United States</u>, 14 AFTR 2d 5704, 64-2 USTC par. 9720 (S.D. W. Va. 1964); accord <u>Hess v. United States</u>, supra. A husband and wife can have interests so closely aligned that one may be estopped under the duty of consistency by a prior

> representation of the other. Cluck v. Commissioner, supra at 333-336. The same can be true of the estates of a husband and wife. Whether there is sufficient identity of interests between the parties to apply the duty of consistency depends on the facts and circumstances of each case. Id. at 335.
>
> There is a sufficient identity of interests between the Estates of James Letts, Jr., and of decedent to trigger the duty of consistency. Decedent and James Letts, Jr., were married. Their estates were a single economic unit. Decedent's husband left his estate to decedent, James P. Letts, III, and JoAnne Magbee; and decedent left her estate to James P. Letts, III and JoAnne Magbee. Decedent was an executrix of her husband's estate. James P. Letts, III signed both estate tax returns. JoAnne Magbee is also a co-executor of, and signed the estate tax return for, decedent's estate.

The Estate also argued that the first estate had answered the QTIP question "no," thus giving the IRS notice. The court rejected the argument holding that what the first estate had "told" the IRS was that the trust property was not terminable interest property.

> The Estate of James Letts, Jr., included the value of the Item II trust in the marital deduction. That estate was entitled to claim the marital deduction for the property only (1) if it was not terminable interest property, or (2) if it was terminable interest property for which a QTIP election was made.
>
> The Estate of James Letts, Jr., clearly indicated that the property was not QTIP. James P. Letts, III, as executor for the Estate of James Letts, Jr., answered "No" to the question on line 4 of the return, "Do you elect to claim a martial deduction for qualified terminable interest property (QTIP) under section 2056(b)(7)?" Consistent with that answer, he did not separately list any terminable interest property in Schedule M. Thus, the estate eliminated one of the two grounds stated above for deducting the value of the Item II trust property as a marital deduction. The only other ground for including the value of the Item II trust property in the marital deduction would be if the Item II trust property was not terminable interest property. Thus, the Estate of James Letts, Jr., represented that the Item II trust property was not terminable interest property.

T. KENTUCKY DEVELOPMENTS

1. Decedent's Heirs Suing Decedent's Widow. Priestly v. Priestly, 949 S.W.2d 594 (Ky. 1997) allowed a decedent's heirs to sue the decedent's widow who had been the decedent's attorney-in-fact and was administratrix of the decedent's estate. Of more interest, however, is the Court's discussion of KRS 404.040. That statute provides:

> The husband shall not be liable for any debt or responsibility of the wife contracted or incurred before or after marriage, except to the amount or value of the property he received from or by her by virtue of the marriage; but he shall be liable for necessaries furnished to her after marriage.

The Court stated:

> In the trial court, appellants asserted that KRS 404.040 was unconstitutional as a gender-based classification in violation of the Equal Protection Clause of the Fourteenth Amendment to the Constitution of the United States. They relied upon Craig v. Boren, 429 U.S. 190, 97 S.Ct. 451, 50 L.Ed.2d 397 (1977), and Wengler v. Druggists Mutual Ins. Co., 446 U.S. 142, 100 S.Ct. 1540, 64 L.Ed.2d 107 (1980), and other decisions which have invalidated gender-based classification statutes. The factual predicate of appellants' claim in this regard arises from the trial court's determination that certain expenditures made by appellee during the period she served as the decedent's fiduciary were for the purchase of "necessaries" and thus were not improper expenditures.
>
> We will refrain from deciding this important constitutional issue in this case. The items in question are bills and expenses generally associated with operating a household, making home repairs, and paying insurance premiums. Appellants' interest is, at best, only indirect as the benefit to them would be merely enhancement of the decedent's estate. While the trial court characterized the expenses as "necessaries" for benefit of appellee, there is significant ambiguity associated with such expenditures in that they were largely for maintenance of the family household.
>
> Courts are not required to decide constitutional questions whenever a party makes the suggestion. Constitutional adjudication should be reserved for those cases in which the issue is well-defined and advanced by parties substantially affected by the controversy. The constitutional question here would be more appropriately asserted by a husband or wife adversely affected by the statute than by children whose inheritance is only modestly affected thereby.
>
> On this issue, we will follow the doctrine of self-restraint articulated in Craig v. Boren, supra, which is designed to minimize unwarranted intervention into controversies where the applicable constitutional questions are ill-defined and speculative. Accordingly,

we decline to decide the constitutionality of KRS 404.040.

2. **<u>Will's Validity in Ancillary Proceeding</u>**. In <u>Marr v. Hendrix</u>, 952 S.W.2d 693 (Ky. 1997), the Kentucky Supreme Court rendered an interesting decision about the determination of a Will's validity in an ancillary proceeding. The will had been admitted to probate in Florida where the decedent was domiciled. The decedent also owned real property in Kentucky. The decision distinguished between "formality of execution" and testamentary integrity.

The facts set forth by the Court were these:

> The testatrix, Mary Catherine Hendrix, after living most of her life in Kentucky and at an advanced age, was moved to Florida in 1988 by her daughter, Appellant Betty Jo Marr. Hendrix died in 1990, after residing in Florida for eighteen months. Her last will and testament, as well as a codicil thereto, were admitted to probate by a Florida court. Appellant was appointed executrix and proceeded to administer Hendrix's estate in Florida in accordance with Florida laws. The Florida court approved a final settlement in August 1991. Apparently, and based on admissions during oral argument, the probate of the will in Florida only proved satisfaction of the formalities in executing a will in accordance with the requirements prescribed by the statute. These requirements relate to the writing, signing, witnessing, and attestation of the will.
>
> At the time of her death in 1990, Hendrix owned real estate and personal property in Muhlenberg County, Kentucky. In 1993, pursuant to KRS 394.150, Appellant filed a petition in the Muhlenberg District Court for ancillary administration of the Kentucky property of her mother's estate. Because the requirements of KRS 394.150 had been satisfied, the district court ordered Hendrix's will admitted to probate in Kentucky in May 1993. In June 1993, pursuant to KRS 394.240, Appellees, Hendrix's heirs at law, filed this action in the Muhlenberg Circuit Court seeking to contest the validity of the Florida will on the grounds that Hendrix lacked the necessary testamentary capacity to execute a will or, alternatively, that the will resulted from Appellant's undue influence. The circuit court ruled that it lacked subject matter jurisdiction and ordered the will contest action dismissed.
>
> In dismissing this action, the trial court accepted the argument that KRS 394.120, KRS 394.150, and the Full Faith and Credit Clause of the United States Constitution effectively preclude a person's contesting the validity of a nonresident decedent's will, even in ancillary proceedings regarding the decedent's property located in this state, where the will was previously

> admitted to probate in the decedent's domiciliary state. The Court of Appeals reversed the circuit court, holding that KRS 394.240 is not limited to wills of Kentucky residents.

The Court discussed the statutes and held:

> KRS 394.120 and KRS 394.150 provide, in effect, that if the will of a nonresident of Kentucky is executed in accordance with the laws of the decedent's domicile, it is valid as to real and personal property located in this state, and it may also be admitted to probate in Kentucky if certain other requirements are satisfied. However, these statutes are concerned only with the execution of the foreign will in accordance with the laws of the testator's domicile; they contain no language purporting to address the underlying validity of such a will.
>
> There are two aspects to the validity of a will -- formality of execution and testamentary integrity. The extent of the finding of validity in Florida related to execution only. The Florida court did not address testamentary integrity. Consequently, testamentary integrity may be raised in Kentucky pertaining to real estate located therein. Notwithstanding the language in KRS 394.120 pertaining to the validity of a nonresident's will, KRS 394.150 also contemplates that evidence may be admitted in ancillary proceedings in Kentucky.
>
> Moreover, consideration of the foreign wills' underlying validity is not precluded by KRS 394.240. The language of that statute permitting an aggrieved person to bring an original action to contest a district court's action "admitting a will to record" contains nothing to indicate that it applies only to the wills of Kentucky residents.
>
> We do not interpret KRS 394.120 so broadly as to preclude any and all challenges to the testamentary capacity of a person devising real property in Kentucky. We believe the more reasonable interpretation is that a will probated in a foreign jurisdiction shall be valid in Kentucky to the same extent that it has been proven in the foreign jurisdiction. Where there has been no adjudication of the underlying validity of the will in the foreign jurisdiction, such issue may be raised in Kentucky pursuant to KRS 394.240.

Chief Justice Stephens dissented, joined by Justice Stumbo:

> According to KRS 394.120:
>
>> The will of a person domiciled out of this state at the time of his death *shall* be valid as to his personal property and his real property in this state, if it is executed according to the law of the place where he is domiciled (emphasis added).

> In the case at bar, the will was probated in Florida, the domicile of the testatrix, and found to be validly executed in accordance with Florida law. Therefore, the Kentucky court does not have jurisdiction to entertain any action contesting the validity of the will.
>
> While KRS 394.240 does not specifically indicate that it applies only to those wills executed by Kentucky residents, when read in conjunction with KRS 394.120 and 394.150, it is clear that it does not apply to the validly executed will of a nonresident.
>
> KRS 394.120 and KRS 394.150, along with the Full Faith and Credit Clause of the United States Constitution precludes the contest of Marr's will in any Kentucky court. Accordingly if the will was properly probated in Florida, and was valid in Florida we shall recognize its validity in Kentucky.

3. **Ethics Opinion**. E-401 has been issued. See Section F (page F-11) of this volume for text. The opinion must be reviewed carefully before beginning representation of a fiduciary. In general, the opinion provides that a lawyer represents only the fiduciary, not the entity (estate or trust) nor the beneficiaries. Where the attorney is likely to want to represent the beneficiaries too, or to represent them later (after an estate is closed, for instance), the representation must be specified and agreed to by the fiduciary.

4. **Retirement Plan Benefits, Divorce**. Divorce decrees may not be relied on to overcome beneficiary designations. Under Kentucky law life insurance beneficiary designations control. See Hughes v. Scholl, 900 S.W.2d 606 (Ky. 1995); Ping v. Denton, 562 S.W.2d 314 (Ky. 1978). Federal law provides the same rule for retirement plan benefits. Hendon v. E.I. DuPont De Nemours and Co., 1998 WL 199824 (6th Cir. 1998).

U. MISCELLANEOUS

1. **Section 212 - Legal Fees**. In TAM 9728002 the National Office determined the legal fees incurred by a limited partner in suing the general partners were deductible only under section 212, and thus subject to the 2% limitation, not under section 162 (as ordinary and necessary business expenses).

The reason for the suit was described by the Service:

> The origin and nature of the claim in the taxpayers' lawsuit is their investment in X. The claims in the lawsuit against the general partners of X arose from the failure of the general partners to abide by the agreements they made when they sold the limited partnership interests in X. The lawsuit did not arise out of the operation of X's real estate business activity. Thus, the settlement proceeds were not profits in the sense of compensation for business efforts. Rather, they were payment solely for investment losses. The legal and accounting fees and costs were incurred by the taxpayers in connection with litigating and negotiating a settlement of the claims against the general partners of X. Thus, they relate directly to the taxpayers' purchase of their limited partnership interest in X as an investment.

The TAM discusses the taxpayer's argument:

> The taxpayers contend that legal and accounting fees and costs incurred with respect to the litigation and settlement of claims against the general partners are deductible under section 162 rather than under section 212. The taxpayers cite Kornhauser v. United States, 276 U.S. 145 (1928), as authority for this position. In that case, the taxpayer incurred attorney fees in the defense of a suit against him for an accounting that was instituted by his former copartner. The suit in Kornhauser arose directly out of the conduct of the partnership business. The Court held that the attorney fees were deductible under a predecessor to section 162 because such expenses were directly connected with, or proximately resulted from, the taxpayer's business. Id. at 153. The Court also note that it made no difference whether the accounting was for services performed during the existence of the partnership or after its termination because in both cases, as to the general partner, the compensation constituted business earnings. Kornhauser, 276 U.S. at 152.
>
> Kornhauser, however, is distinguishable from the present case because it deals with the expenses of a general partner conducting a trade or business rather than the expenses of limited partners investing in a trade or business. A general partner, personally or through his agent, participates in and is responsible for the active management of the partnership's business activities. Consequently, courts look only to the business policies of the general partners, who manage the partnership affairs, when determining the intent or profit motive of a limited partnership. See Evans v. Commissioner, 908 F.2d 369, 373 (8th Cir. 1990)(the general partner's intent and profit objective is determinative of whether the proper profit motive exists); Estate of Freeland v. Commissioner, 393 F.2d 573, 584 (9th Cir.), cert. denied, 393 U.S. 845 (1968)(limited partner's tax liability was governed by the purpose of the partnership as established by the general partners); Taube v. Commissioner, 88 T.C. 464, 480 (1987)(profit objective

> determined by the intent of the general partners and the promoters since it is these individuals who actually controlled the partnership's activities). Thus, as held in Kornhauser, a general partner may be considered to be engaged in a trade or business.
>
> A limited partner, on the other hand, is primarily an investor who contributes capital and thereby acquires the right to share in the business profits. Evans v. Galardi, 546 P.2d 313, 320 (Cal. 1976)(en banc)(describing the difference between limited partners and general partners under the Uniform Limited Partnership Act). A limited partner's relationship to the partnership is detached and impersonal in character. Id.; e.g., Estate of Meyer v. Commissioner, 503 F.2d 556, 558 (9th cir. 1974)(holding that a limited partnership interest in rental real estate is of a different nature and character than a general partnership interest in rental real estate). A limited partner is a passive investor who does not take part in the management of the partnership's business; he strictly limits his liability, thereby avoiding the risks customarily attendant to trade or business activities. See, e.g., Woodruff v. Commissioner, 38 B.T.A. 739, 745 (1938), non-acq., 1939-1 C.B. 69 (distinguishing the interests of limited partners from those of general partners). Expenses incurred by a limited partner are more like expenses incurred by a shareholder because both a limited partner and a shareholder are merely investing, rather than participating, in a trade or business. A limited partner's investment in a partnership is really no different than holding corporate stock in that a certain cash flow or return is expected from the efforts of others. As an investor, the limited partner merely keeps records and collects income through managerial attention to his investments. Higgins, 312 U.S. at 218, cited in Whipple, 373 U.S. at 200. Thus, Kornhauser does not apply to the present case because the taxpayers were not general partners and did not incur the expenses in the conduct of the partnership trade or business.

This position may assist in reducing the value of the limited partnership interest.

2. **Florida Ethics -- Representing Spouses**. The Florida Bar Association has issued Opinion 95-4 (May 30, 1997) which states that where husband and wife develop a conflict, the lawyer's duty is to withdraw but not disclose the source of the conflict. The facts presented were as follows:

> Lawyer has represented Husband and Wife for many years in a range of personal matters, including estate planning. Husband and Wife have substantial individual assets, and they also own substantial jointly-held property. Recently, Lawyer prepared new updated wills

> that Husband and Wife signed. Like their previous wills, the new wills primarily benefit the survivor of them for his or her life, with beneficial disposition at the death of the survivor being made equally to their children (none of whom were born by prior marriage).
>
> Husband, Wife, and Lawyer have always shared all relevant asset and financial information. Consistent with previous practice, Lawyer met with Husband and Wife together to confer regarding the changes to be made in updating their wills. At no point since Lawyer first started to represent them did either Husband or Wife ever ask Lawyer to keep any information secret from the other, and there was never any discussion about what Lawyer might do if either of them were to ask Lawyer to maintain such a separate confidence.
>
> Several months after the execution of the new wills, Husband confers separately with Lawyer. Husband reveals to Lawyer that he has just executed a codicil (prepared by another law firm) that makes substantial beneficial disposition to a woman with whom Husband has been having an extra-marital relationship. Husband tells Lawyer that Wife knows about neither the relationship nor the new codicil, as to which Husband asks Lawyer to advise him regarding Wife's rights of election in the event she were to survive Husband. Lawyer tells Husband that Lawyer cannot under the circumstances advise him regarding same. Lawyer tells Husband that Lawyer will have to consider Lawyer's ethical duties under the circumstances. Lawyer tells Husband that, after consideration, Lawyer may determine to withdraw from representing Husband and Wife. Lawyer further tells Husband that, after consideration, Lawyer may determine to disclose to Wife the substance of Husband's revelation if Husband does not do so himself.

The Opinion deals with the key issue:

> We now turn to the central issue presented, which is the application of the confidentiality rule in a situation where confidentiality was not discussed at the outset of the joint representation. A lawyer is ethically obligated to maintain in confidence all information relating to the representation of a client. Rule 4-1.6. A lawyer, however, also has a duty to communicate to a client information that is relevant to the representation. Rule 4.1.4. These duties of communication and confidentially harmoniously coexist in most situations. In the situation presented, however, Lawyer's duty of communication to Wife appears to conflict with Lawyer's duty of confidentiality to Husband. Thus, the key question for our decision is: Which duty must give way? We conclude that, under the facts presented, Lawyer's duty of confidentially must take precedence. Consequently, if Husband fails to disclose (or give Lawyer permission to disclose) the subject information to Wife, Lawyer is not ethically required to disclose the information to Wife and does

not have discretion to reveal the information. To the contrary, Lawyer's ethical obligation of confidentially to Husband *prohibits* Lawyer from disclosing the information to Wife.

The lawyer-client relationship is one of trust and confidence. Gerlach v. Donnelly, 98 So.2d 493 (Fla. 1957). Rule 4-1.6 recognizes a very broad duty of confidentiality on the part of a lawyer. Save for a few narrow exceptions set forth in the rule, a lawyer is prohibited from voluntarily revealing any "information relating to the representation" of a client without the client's consent. Rule 4-1.6. The duty of confidentiality "applies not merely to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source" and "continues after the client-lawyer relationship has terminated." Comment, Rule 4-1.6.

It has been suggested that, in a joint representation, a lawyer who receives information from the "communicating client" that is relevant to the interests of the non-communicating client may disclose the information to the latter, even over the communicating client's objections and even where disclosure would be damaging to the communicating client. The committee is of the opinion that disclosure is not permissible and therefore rejects this "no-confidentiality" position. The argument for a "no-confidentiality" approach -- which is a departure from the usual rule of lawyer-client confidentiality -- is premised on two bases: (1) that joint clients have an expectation that everything relating to the joint representation that is communicated by one client to the joint lawyer will be shared by the lawyer with the other client (i.e., that joint clients have no expectation of confidentiality with the joint representation); and (2) that the law governing the evidentiary attorney-client privilege sets (or should set) the standard for the lawyer's ethical duties in the joint representation setting. Both of these foundations, in the committee's opinion, are flawed.

Significantly, existing Rule 4-1.6(c)(1) allows the joint clients' lawyer to share information received form one client with the other client, without the need to obtain consent from the communicating client, when such disclosure is reasonably necessary to further the interests of the joint representation. Thus, a presumption of "no confidentiality" is not needed to facilitate representation of joint clients with a mutual goal. Rather, such a presumption would serve only to permit the lawyer to reveal an adverse separate confidence, against the communicating client's wishes and outside the parameters of Rule 4-1.6. At that point in time, it is clear that a conflict of interests has arisen and any "community of interests" has been damaged or destroyed. See *Report of the Special Study Committee*

> *on Professional Responsibility* prepared by the American Bar Association Section of Real Property, Probate and Trust Law, 28 Real Prop., Prob. & Tr. L.J. 765, 776-77 (1994)(hereinafter the "Study Committee Report")("Because these expectations [of joint clients] may change, the lawyer must reassess these expectations as the representation progresses.").
>
> Furthermore, accurately predicting the expectations of a typical client in a given situation is risky business. See, e.g., Zacharias, *Rethinking Confidentiality*, 74 Iowa L. Rev. 351 (1989). This would seem to be especially true concerning separate confidences imparted by one joint client to the lawyer that are in some way adverse to the other joint client. Even commentators who oppose maintaining the usual confidentiality rule in the joint client setting acknowledge that client expectations concerning confidentiality may be different in the case of separate confidences that are adverse to the non-communicating client than they are when the communication clearly furthers the objectives of the joint representation. See, e.g., *Study Committee Report*, at 788 ("Most [separate] confidences would not be imparted if the client were mindful of the lawyer's competing duty [of communication] to the other spouse.") Collett, *Disclosure, Discretion, or Deception: The Estate Planner's Ethics Dilemma from a Unilateral Confidence*, 28 Real Prop., Prob. & Tr. L.J. 683 (1994)(hereinafter, Collett), at 684 ("Absent agreement concerning the nature of the relationship, clients may have different expectations concerning the lawyer's obligation to maintain individual confidences.") Moreover, a leading case in the area of attorney-client privilege in joint representations states, "As between joint clients, there can be no 'confidences' or 'secrets' *unless one client manifests a contrary intent.*" Brennan's, Inc. v. Brennan's Restaurants, Inc., 590 F.2d 168, 173 (5th Cir. 1979)(emphasis added). The committee is of the opinion that it would be inadvisable to rely on such a speculative basis as "joint client expectations" to justify altering the usual lawyer-client confidentiality rule when applied to joint representation situations. This is especially true where-confusion or misunderstanding on the part of the clients may be minimized or eliminated by means of a discussion between the lawyer and the clients at the outset of the representation. See Collett, at 738-39.

The Opinion rejects giving the lawyer discretion:

> It has been argued in some commentaries that the usual rule of lawyer-client confidentiality does not apply in a joint representation and that the lawyer should have the *discretion* to determine whether the lawyer should disclose the separate confidence to the non-communicating client. This discretionary approach is advanced in the *Restatement*, sec. 112, comment 1. This result is also favored by the American College of Trusts

> and Estates in its *Commentaries on the Model Rules of Professional Conduct* (2d ed. 1995)(hereinafter the "ACTEC" Commentaries"). The *Restatement* itself acknowledges that no case law supports the discretionary approach. Nor do the ACTEC *Commentaries* cite any supporting authority for this proposition.
>
> The committee rejects the concept of discretion in this important area. Florida lawyers must have an unambiguous rule governing their conduct in situations of this nature. We conclude that Lawyer owes duties of confidentiality to both Husband and Wife, regardless of whether they are being represented jointly. Accordingly, under the facts presented Lawyer is ethically precluded from disclosing the separate confidence to Wife without husband's consent.

The Opinion also held that lawyers need not advise spouses of potential conflicts, although it may be helpful.

3. **Florida Intangibles Tax**. Florida has amended its intangible tax to provide that a trust does not have a Florida situs for intangible tax purposes unless (1) all trustees are Florida residents, or (2) a majority of the trustees are Florida residents (if three or more), or (3) if multiple trustees, the Florida trustee(s) have control or managemnet of the trust. HB 4413 §25.

4. **Note in Divorce Creates Deductible Interest**. In Armacost v. Commissioner, 75 T.C.M. 2177 (1998), the court determined that where husband received more than his half of community assets and gave wife a note as compensation, the interest on the note is deductible as investment interest. The case points out the importance of tax planning in divorce and property settlement matter.

5. **State Law - Other**. In Moeller v. Superior Court, 947 P.2d 279 (Cal. 1997), the Court held that a trustee cannot shield communications from its attorney by asserting the attorney-client privilege when the party requesting the communications is the successor trustee. The opinion states:

> The powers of a trustee are not personal to any particular trustee but, rather, are inherent in the office of trustee. It has been the law in California for over a century that a new trustee "succeed[s] to all the rights, duties, and responsibilities of his predecessors." (Fatio v. Swasey (1896) 111 Cal. 628, 636, 44 P. 225; see also Baumann v. Harrison (1941) 46

> Cal.App.2d 84, 93, 115 P.2d 530). In accord is the Restatement Second of Trusts section 196, page 431:
>
>> "The powers conferred upon a trustee can properly be exercised by his successors, unless it is otherwise provided by the terms of the trust."
>
> California courts have explicitly adopted this rule as the law of this state. (See In re De La Montanya's Estate (1948) 83 Cal.App.2d 322, 328, 188 P.2d 494; Estate of Canfield 1947) 80 Cal.App.2d 443, 447, 181 P.2d 732). The rule applies, of course, to powers essential to effective administration of the trust. (Rest.2d Trusts, § 196, com. b.) As discussed earlier, the power to assert the attorney-client privilege follows from the trustee's power to hire an attorney in order to obtain advice regarding administration of the trust and to litigate to protect trust property. The trustee's power to assert that privilege thus is certainly essential to its effective administration of the trust. Therefore, when a successor trustee takes office it assumes all of the powers of trustee, including the power to assert the privilege with respect to confidential communications between a predecessor trustee and an attorney on matters of trust administration.

The Court recognized that in some instances a trustee might want its own personal counsel:

> We recognize that, under the rule we adopt, a trustee must take into account the possibility that its confidential communications with an attorney about trust administration may someday be disclosed to a successor trustee. This is, however, not unfair in light of the nature of a trust and the trustee's duties. A trust is a fiduciary relationship with respect to property in which the person holding legal title to the property -- the trustee -- has an equitable obligation to manage the property for the benefit of another -- the beneficiary. (Estate of Shaw (1926) 198 Cal. 352, 360, 246 P.48; Askew v. Resource Funding, Ltd. (1979) 94 Cal.App.3d 402, 407, 156 Cal.Rptr. 208; Rest.2d Trusts, § 2.) A trustee must always act solely in the beneficiaries' interest. (§ 16002, subd. (a); Estate of Feraud (1979) 92 Cal. App. 2d 717, 723, 154 Cal.Rptr. 889.) If the trustee violates any duty owed to the beneficiaries, the trustee is liable for breach of trust. (§ 16400.) And professional trustees like Sanwa are held to a higher standard of care in discharging their legal duties than are others. (Coberly v. Superior Court of Los Angeles County (1965) 231 Cal.App.2d 685, 689, 42 Cal.Rptr. 64.) In a trust relationship, then, the benefits belong to the beneficiaries and the burdens to the trustee. The office of trustee is thus by nature an onerous one, and the proper discharge of its duties necessitates great circumspection. Liability to beneficiaries for mismanagement of trust assets is merely one of the

burdens professional trustees take on -- for, presumably, an appropriate fee.

Most importantly, the successor trustee inherits the power to assert the privilege only as to those confidential communications that occurred when the predecessor, in its fiduciary capacity, sought the attorney's advice for guidance in administering the trust. If a predecessor trustee seeks legal advice in its personal capacity out of a genuine concern for possible future charges of breach of fiduciary duty, the predecessor may be able to avoid disclosing the advice to a successor trustee by hiring a separate lawyer and paying for the advice out of its personal funds.

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In Talbot v. Marshfield, supra, 62 Eng. Rep. 728, the residual legatees of a testamentary trust sought to compel the trustees to produce two opinions of counsel. Although Talbot was a dispute over privileged information between beneficiaries and trustees, a subject we do not here address, the opinion nicely articulates the distinction between a trustee consulting an attorney as trustee to further the beneficiaries' interests, and a trustee consulting an attorney in his personal capacity to defend against a claim by the beneficiaries:

> The first . . . opinion [of counsel], the production of which is sought, [was] respectively stated and taken by the [trustees] to guide them in the exercise of a power delegated to them by the trusts of the will, and which, if exercised, would affect the interests of the other cestuis que trust. The opinion was taken before proceedings were commenced or threatened, and in relation to the trust. Under these circumstances it appears . . . that all the cestuis que trust have a right to see that . . . opinion. It was contended that it was not taken for the benefit of all the cestuis que trust; but all the cestuis que trust have an interest in the due administration of the trust, and in that sense it was for the benefit of all, as it was for the guidance of the trustees in their execution of their trust. Besides, if a trustee properly takes the opinion of counsel to guide him in the execution of the trust, he has a right to be paid the expense of so doing out of the trust estate; and that alone would give any cestuis que trust a right to see the . . . opinion. The other . . . opinion, however, stands on a totally different footing. This was not to guide the trustees in the execution of their trust; but, after proceedings had been commenced against them, they took advice to know in what position they stood, and how they should defend themselves in the suit. It appears . . . that the cestuis que

trust have no right to see this . . . opinion, unless they can make out that the trustees can charge the expense thereof on the trust funds. As to this there is no proof; the trustees may themselves have to bear the expense of this . . . opinion, as having been stated and taken by them as litigant parties with the cestuis que trust.

PROCEDURE FOR TAXATION OF QTIP PROPERTY [*Section 2056 (b) (7) Property – See KRS 140.100 (4)*] AT DEATH OF SURVIVING SPOUSE

- Kentucky Revenue Cabinet Announcement -

Since Kentucky statutes do not give direction as to the tax rates and exemptions that should be used to calculate the inheritance tax due for the QTIP in the second estate, the Kentucky Revenue Cabinet had determined that the rates and exemptions in effect at the date of death of the first spouse should be used in computing the tax due in the second estate.

It was our position that the statutes were designed to accomplish the same goal as the federal tax law. The federal law postpones the tax until the death of the second spouse. To compute the inheritance tax due on the QTIP in the second estate for each beneficiary of the QTIP, the QTIP was combined with the distributive share received from the first spouse's estate, if any. The result of the tax due was reduced by any tax previously paid by the beneficiary in the first spouse's estate.

Prior to the phase-out of the inheritance tax for class A beneficiaries, this policy was not controversial because in most cases the tax rates and exemptions in effect on the death of the second spouse were the same as the tax rates and exemptions that were in effect on the date of death of the first decedent.

After such discussion and research with tax practitioners, legal advisors and legislative research employees, the Inheritance & Estate Tax Section has established a new policy concerning the method of computing tax due when QTIP is included in the second estate. This policy is to use the tax rates and exemptions in effect on the date of death of second spouse.

The taxing of QTIP is a complex and technical issue, however, this new policy is more in line with the intent of the General Assembly to phase-out the inheritance tax for Class A beneficiaries for decedents passing away after July 1, 1998.

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COMMONWEALTH OF KENTUCKY

REVENUE CABINET

FRANKFORT

40620

TO: Personal Representatives, Financial Institutions, Broker-Dealers, and Other Interested Persons

FROM: Linda Sheets, Supervisor Linda Sheets
Inheritance and Estate Tax Section

DATE: June 5, 1998

SUBJECT: Inheritance Tax Lien Releases and Inventory of Safe Deposit Boxes

Effective July 1, 1998, the Kentucky Revenue Cabinet (KRC) will no longer require that a person obtain prior written consent (lien release) from the KRC for the transfer of specific property owned by a resident or nonresident decedent at death, nor will a representative of the KRC be present at the opening of a safe deposit box for the purpose of inventorying the contents at any time after the death of a person who had access to the box.

Pursuant to the authority granted to the KRC in Chapter 140 of the Kentucky Revised Statutes, this notice grants a blanket lien release (consent) on all property owned by any decedent as a result of his or her death or any interest therein including, but not limited to, real estate, stocks, bonds, cash accounts, trust funds, life insurance, employee retirement accounts and trusts of all types, safe deposit box contents, etc.

Also, financial or other institutions or persons renting safe deposit boxes or similar receptacles may permit access to any and all boxes without requiring a specifically written consent or the presence of the KRC or the local PVA prior to entering the box after the death of a person who had access to the box.

The above actions were taken as a result of the phase-out of the inheritance tax on Class A beneficiaries and for the purpose of easing the administration of estates for personal representatives, beneficiaries and other affected parties. More efficient services to the taxpayers of the Commonwealth will result from these actions.

This document may be duplicated and used as verification that the inheritance tax lien no longer exists on a decedent's property regardless of the date of death. However, it does not mean that personal representatives or beneficiaries are relieved of any inheritance tax liability that they may owe in their individual capacity.

Questions regarding this notice may be directed to Linda Sheets at (502)564-4810 or to Bruce McCutchen in the Division of Tax Policy at (502)564-6843.

APPROVED:

Sarah Jane Schaaf

Sarah Jane Schaaf, Secretary
Kentucky Revenue Cabinet

ESTATE AND INHERITANCE TAX APPORTIONMENT
To Apportion Or Not: An Overview

Kelly S. Henry
Melony J. Lane
Ogden Newell & Welch

Whether to apportion estate and inheritance taxes (and if so, how) is a major consideration for estate planners. If the issue of tax apportionment is not carefully considered and appropriately resolved in the estate planning documents, a testator's intent may be inadvertently thwarted. This outline is intended to serve as a general overview of tax apportionment and important apportionment considerations.

I. TYPES OF APPORTIONMENT

A. Residual. Traditionally, taxes have been paid from the residuary probate estate before looking to other types of dispositions (specific, demonstrative, or general). While a simple "pay all taxes from the residue" tax clause may be the easiest to administer, it will not always achieve the testator's intent.

B. Inside Apportionment. A tax clause that apportions taxes among all beneficiaries within a probate estate is called an inside apportionment clause. All beneficiaries within an estate bear a proportionate share of the taxes, regardless of the type of disposition or the class of the disposition.

C. Outside Apportionment. Outside apportionment apportions taxes among the beneficiaries of the non-probate property as well as the beneficiaries of the probate estate, and provides that the recipient of the property pay the portion of the tax that is attributable to the inclusion of the property in the taxable estate. Situations to watch for include:

1. property transferred for less than full and adequate consideration as to which the decedent retained an interest described in §§ 2036, 2037, and 2038:

    a. a life interest;

    b. a prohibited form of reversion;

    c. a prohibited degree of control over the use or enjoyment of income or principal;

2. annuities included in the decedent's estate under §2039;

3. property included in the decedent's estate by reason of joint ownership with rights of survivorship or tenants by the entirety (§2040);

4. general power of appointment property (§2041);

5. life insurance proceeds as to which the decedent possessed incidents of ownership within three years of decedent's death (§2042); and

6. Qualified Terminable Interest Property (QTIP) property included in the decedent's estate under § 2044.

D. **Equitable Apportionment**. Equitable apportionment clauses provide that the dispositions generating estate tax deductions (such as marital and charitable distributions) receive the whole benefit for the deduction, rather than allowing all beneficiaries to benefit from the resulting deduction.

E. **Other Apportionment Considerations**. Other apportionment considerations that are closely related to equitable apportionment include:

1. **Rate Differentials** - whether to apportion the benefit of lower estate tax rates to the beneficiaries of the property producing the rate differential. (e.g.- Special use valuation under §2032A and the potential for recapture.)

2. **Credits** - whether to apportion the benefit of estate tax credits among the beneficiary(ies) receiving the property which generated the credit or to allow all beneficiaries to benefit therefrom. (e.g.- §2013-previously taxed property credit.)

3. **Temporal Interests** - how to apportion taxes that are attributable to property that is divided into temporal interests. (e.g.- life estates, terms of years.)

4. **Multiple Entities** - how to apportion taxes among the various estate planning entities such as the probate estate, revocable trusts, irrevocable trusts, etc.

II. FEDERAL RULES PERTAINING TO APPORTIONMENT

A. **In General**. The general federal rule for payment of death taxes is that the probate estate bears the tax liability. This rule is set out in §2205 which provides that the beneficiaries of non-probate assets are entitled to reimbursement from the probate estate for any death taxes that are paid from the non-probate property. Thus, the executor has the ultimate responsibility for the payment of estate taxes.

B. **Reimbursement Provisions**. Notwithstanding the general rule, unless the decedent's estate planning documents state otherwise, there are four exceptions to the general rule which allow the executor to seek reimbursement from the beneficiary of particular types of assets for taxes generated by such property that have been actually paid from the probate estate. It is important to note, however, that these are reimbursement provisions, and not apportionment provisions, which will not resolve liquidity problems for a non-liquid probate estate.

1. **Life Insurance Proceeds** - §2206 entitles the executor to reimbursement from the named beneficiaries of proceeds of life insurance that are included in the decedent's estate. The executor is entitled to recover from each beneficiary the proportion of the total taxes that the beneficiary's life insurance proceeds bear to the taxable estate.

2. **Power of Appointment Property** - Under §2207, the executor is entitled to recover a proportionate share of the estate taxes from the beneficiary of property that was subject to the decedent's general power of appointment, regardless of whether or not the decedent exercised such power.

3. **Qualified Terminable Interest Property** - §2207A also entitles a decedent's estate to reimbursement from the beneficiaries of property that is included in the decedent's taxable estate as property for which the marital deduction was previously allowed. Here, the estate is entitled to recover the amount by which the taxes actually paid exceeds what the tax liability would have been if the QTIP property had not been included in the decedent's estate.

4. **Retained Interest** - §2207B provides the estate a right of reimbursement from the beneficiaries of property which was included in the decedent's gross estate by reason of the decedent's retained life interest as described in §2036. However, §2207B does <u>not</u> apply to inclusion under §§2037 or 2038.

C. <u>Generation-Skipping Transfer Taxes</u>. Who bears the liability for generation-skipping transfer taxes depends upon the type of transfer. §2603(a) provides that (1) the transferee is liable for the tax imposed on a taxable distribution; (2) the trustee must pay the tax imposed on a taxable termination; and (3) the transferor bears the liability for taxes resulting from direct skips. However, §2603(a) is supplemented by §2603(b) which provides on a basic level that generation-skipping transfer taxes be paid from the property constituting the offending transfer. Thus, generation-skipping transfer taxes are ultimately paid from the transferred property.

III. STATE LAWS RELATING TO APPORTIONMENT

A. **<u>Kentucky</u>**. Kentucky statutory law does not address apportionment of federal estate taxes. Thus, federal estate tax apportionment is determined by case law.

1. **General Rule** - In the absence of a contrary provision in the decedent's will, federal estate tax will be apportioned among all persons interested in the

estate, regardless of whether the interest arises from probate or non-probate property. McKinney v. Mt. Sterling Nat'l Bank, 220 S.W.2d 379 (Ky. 1949).

2. **Inside Apportionment** - Apportionment is based on the share that each person interested in the estate receives relative to the value of all interests in the estate. Trimble v. Hatcher's Ex'rs, 173 S.W.2d 985 (Ky. 1943).

3. **Outside Apportionment** - The case law is unclear on this issue. But see Trimble v. Hatcher's Ex'rs, 173 S.W.2d 985 (Ky. 1943), in which the court apportioned federal estate tax to the beneficiaries of gifts made within two years of the decedent's death.

4. **Right of Recovery** - The executor may recover a proportionate share of the estate taxes from the beneficiary of non-probate assets. Trimble v. Hatcher's Ex'rs, 173 S.W.2d 985 (Ky. 1943).

5. **Equitable Apportionment** - Dispositions which generate an estate tax deduction receive the benefit from such deduction. Lincoln Bank & Trust Co. v. Huber, 240 S.W.2d 89 (Ky. 1951).

6. **Apportionment of Kentucky Inheritance Tax** - Inheritance tax is imposed on each beneficiary's share of the estate (KRS 140.190 and 140.220).

B. **Indiana**. Indiana laws pertaining to the apportionment of estate and inheritance taxes may be found in Title 29, Article 2, Chapter 12 of the Indiana Code.

1. **General Rule** - In the absence of a contrary provision in the decedent's will, federal estate tax will be apportioned among all persons interested in the estate, regardless of whether the interests arise from probate or non-probate property (Ind. Code Ann. § 29-2-12-2).

2. **Inside Apportionment** - Apportionment is based on the share that each person interested in the estate receives relative to the value of all interests in the estate (Ind. Code Ann. § 29-2-12-4).

3. **Outside Apportionment** - Recipients of non-probate assets included in the decedent's net taxable estate pay a pro-rata share of the estate taxes (Ind. Code Ann. § 29-2-12-4).

4. **Right of Recovery** - The executor is entitled to recover from the recipient of non-probate assets the recipient's proprotionate share of the estate taxes paid from the probate estate (Ind. Code Ann. §§ 29-2-12-3 and 29-2-12-6).

5. **Equitable Apportionment** - Dispositions which generate an estate tax deduction receive the benefit from such deduction (Ind. Code Ann. § 29-12-2).

6. **Apportionment of Indiana Inheritance Tax** - Inheritance tax is imposed on each beneficiary's share of the estate (Ind. Code Ann. § 6-4.1-2-1).

C. **Florida**. Florida laws concerning the apportionment of estate taxes are contained in Title XLII, Chapter 733, Part VIII of the Florida Statutes.

1. **General Rule** - In the absence of an unequivocal direction in the decedent's will to the contrary, federal estate tax will be apportioned among probate and non-probate assets (Fla. Stat. Ann. § 733.817(1)(e)). To override this statutory rule, the decedent's will must expressly refer to the statute or expressly indicate that the estate is to bear the burden of the estate tax attributable to property passing outside the will. Ferrone v. Soffes, 558 So. 2d 146, 147 (Fla. Dist. Ct. App. 1990).

2. **Inside Apportionment** - Beneficiaries of residuary bequests are primarily liable for the payment of federal estate tax and share such liability proportionally (Fla. Stat. Ann. § 733.817(1)(b), (c)(i)). Recipients of specific or general bequests are liable for federal estate tax only to the extent that the residue is insufficient to pay such tax (Fla. Stat. Ann. § 733.817(1)(a), (c)(i)).

3. **Outside Apportionment** - Recipients of non-probate assets included in the decedent's net taxable estate are liable for their pro-rata share of the estate taxes (Fla. Stat. Ann. §733.817(1)(e)).

4. **Right of Recovery** - The personal representative is entitled to recover from the recipient of non-probate assets the proportionate amount of estate taxes attributable to such non-probate assets. In addition, the personal representative is required to pursue such recovery unless the court relieves the personal representative from such duty. (Fla. Stat. Ann. § 733.817(3).)

5. **Equitable Apportionment** - Case law has established that, with respect to the marital deduction, dispositions which generate a marital deduction benefit therefrom. Tarbox v. Palmer, 564 So.2d 1106 (Fla. Dist. Ct. App. 1990). However, there is no authority that dispositions which generate other tax deductions benefit from the deductions they generate.

6. **Temporal Apportionment** - Federal estate taxes charged to temporal interests will be paid from the trust principal and will not be apportioned between temporary and remainder interests (Fla. Stat. Ann. § 733.817(1)(c)(ii), (e)).

IV. OTHER PLANNING CONSIDERATIONS

A. Here is a laundry list of other issues that should be considered during the estate planning process:

1. **Partial QTIP Election** - Consideration should be given to directing that the increase in taxes caused by a less than full QTIP election be paid from the non-elected portion of the trust. This is particularly important in situations where the ultimate beneficiaries of the QTIP trust are different than the beneficiaries of the credit shelter trust or residual estate.

   For example, assume that the decedent provides for the surviving spouse in the form of a fixed bequest that will be held in a QTIP trust the remainder of which will be distributed in fee to the children of that marriage upon the surviving spouse's death, and bequeaths the residual estate in fee to the children of the first marriage. If a full QTIP election is made, the QTIP property will eventually incur the estate tax under §2207A. However, if a partial QTIP election is made, the residual estate beneficiaries may end up paying the increased tax liability if such tax is not properly apportioned to the non-elected property.

2. **Disclaimer** - The concerns surrounding the possibility of a spouse disclaiming property that otherwise would have generated a deduction are similar to those relating to a partial QTIP election. Here, you would encounter the same concerns as for a partial QTIP election if a surviving spouse disclaimed property that passes in default to beneficiaries other than the residual beneficiaries, or if the disclaimer results in a generation-skipping transfer and the payment of generation-skipping taxes are not adequately provided for.

3. **Special Use Recapture** - When planning for the use of the §2032A special use valuation, the testator's intention should be ascertained regarding who should bear the potential liability for recapture as well as who should receive the benefit of the initial reduced valuation.

4. **Estate Tax Deferral (§6166)** - Similar consideration should be given to planning situations which involve the potential for deferral of estate taxes relating to closely held business assets under §6166.

5. **Gift Taxes Paid** - Another potential problem involves the inclusion of gift taxes paid within three years of a decedent's death if the donees of the gifts are different than the estate beneficiaries. Pay particular attention to situations where the inclusion of the gift taxes paid grosses up the estate tax to a level that exceeds the value of the probate estate, especially where the estate beneficiaries are not the donees of the gifts.

6. **Generation Skipping Tax Exemption** - Related to the allocation of generation-skipping taxes is the allocation of a decedent's generation-skipping tax exemption. An equitable allocation of the exemption may not always achieve the testator's goals. Care should be taken to ascertain the testator's intent regarding generation skipping taxes and the corresponding exemption, particularly where the testator favors some beneficiaries over others.

7. **Illiquid Assets** - Another situation where it is important to specify the testator's intention surrounds bequests of illiquid assets. For example, consider a testator who devises a farm to child #1 (who farms the property) and bequeaths the liquid assets to children #2 and #3. Does the testator intend child #1 to receive the farm free from estate tax liability? Does the testator intend child #1 to incur an equal share of the tax liability? If so, where will the child obtain the funds with which to pay the taxes? Will child #1 be forced to sell a portion of the farm in order to pay the taxes?

B. Coordination Among Entities. Finally, tax payment provisions should be carefully coordinated among all estate planning documents -- testamentary and non-testamentary alike.

For comprehensive reading regarding estate tax apportionment, see Pennell, Jeffrey N., "Tax Payment Provisions and Equitable Apportionment," Estate Planning in Depth, SB90 ALI-ABA 637 (June 15, 1997).

APPENDIX A

SELECTED INDIANA STATUTES

WEST'S ANNOTATED INDIANA CODE
TITLE 29. PROBATE
ARTICLE 2. MISCELLANEOUS PROVISIONS
CHAPTER 12. APPORTIONMENT OF FEDERAL ESTATE TAXES

29-2-12-2 Heirs and beneficiaries; charitable or marital deduction or exemption

Unless a decedent shall otherwise direct by will, the federal estate tax imposed upon decedent's estate, shall be apportioned among all of the persons, heirs and beneficiaries of decedent's estate who receive any property which is includable in the total gross estate of said decedent for the purpose of determining the amount of federal estate tax to be paid by said estate. Provided, that no part of the federal estate tax shall be apportioned against property which, in the absence of any apportionment whatsoever, would qualify for any charitable, marital or other deduction or exemption, nor against recipients of such property on account thereof.

29-2-12-1.5 "Will" defined

As used in this chapter, "will" includes a trust or other instrument governing the distribution of assets following an individual's death.

29-2-12-4 Method of apportionment

The portion of such federal estate tax to be paid by each person, heir, or beneficiary of said estate shall be determined by dividing the value of the property received by such person, heir or beneficiary, which is included in the net taxable estate, by the amount of the net taxable estate, and multiplying the result by the amount of the total federal estate tax paid.

APPENDIX B

FLORIDA APPORTIONMENT STATUTE

WEST'S FLORIDA STATUTES ANNOTATED
TITLE XLII. ESTATES AND TRUSTS
CHAPTER 733. PROBATE CODE: ADMINISTRATION OF ESTATES
PART VIII. SPECIAL PROVISIONS FOR DISTRIBUTION

Current through End of 1997 1st Reg. Sess.

733.817. Apportionment of estate taxes

<Text of section effective until Oct. 1, 1998>

(1) Any estate, inheritance, or other death tax levied or assessed under the tax laws of this or any other state, political subdivision, or country or under any United States revenue act concerning any property included in the gross estate under the law, including the tax levied by s. 4980A of the Internal Revenue Code, [FN1] but excluding taxes for which sources of payment are provided within ss. 2206, 2207, and 2603 of the Internal Revenue Code, [FN2] shall be apportioned in the following manner:

(a) If a part of the estate passed under a will as a devise to be satisfied by reference to a specific property or type of property, fund, sum, or statutory amount or in any other nonresiduary form, exclusive of property over which the decedent had a power of appointment as defined from time to time under the estate tax laws of the United States, the net amount of the tax attributable to it shall be charged to and paid from the residuary estate without requiring contribution from persons receiving the interests, except as otherwise directed by the governing instrument. In the event the residuary estate is insufficient to pay the tax attributable to the interests, any balance of the tax shall be equitably apportioned among the recipients of the interests in the proportions that the value of each interest included in the measure of the tax bears to the total of all interests so included, except as otherwise directed by the governing instrument.

(b) If a part of the estate passed under the will as a residuary interest, exclusive of property over which the decedent had power of appointment, the net amount of tax attributable to it shall be equitably apportioned among the residuary beneficiaries in the proportions that the value of the residuary interest of each included in the measure of the tax bears to the total of all residuary interests so included, except as otherwise directed by the governing instrument. When a residuary interest is a temporary interest, the tax attributable to it shall be charged to corpus and not apportioned between temporary and remainder interests.

(c) If a part of the property concerning which the tax is levied or assessed is held under the terms of any trust created inter vivos, then, unless the governing instrument directs otherwise:

1. If any portion of the trust is directed to pass or to be held in further trust by reference to a specific property, or type of property, fund, sum, or statutory amount, or in any other nonresiduary form, the net amount of the tax attributable to that portion must be charged to and paid from the corpus of the residuary share of the trust without requiring contribution from the nonresiduary interest or the persons receiving or benefiting from that interest. If the residuary portion of the trust is insufficient to pay the tax attributable to all nonresiduary interests, any balance of the tax must be equitably apportioned among the recipients of those interests in the proportions that the value of each interest included in the measure of the tax bears to the total of all interest so included.

2. The net amount of the tax directly attributable to the residuary share of the trust, if any, must be charged as follows: the net amount of the tax attributable to each residuary temporary interest must be charged to that portion of residuary principal that supports the temporary interest without apportionment, and the net amount of the tax attributable to the balance of the residuary share must be equitably apportioned among the residuary beneficiaries, by charge to the corpus of their interest in the proportions that the value of the residuary interest of each included in the measure of the tax bears to the total of all residuary interests included.

(d) Real property or mobile home homesteads that are exempt from execution by law shall be exempt from apportionment of taxes. Persons taking an interest in the homesteads shall not be liable for apportionment of taxes on account of the homesteads. The net amount of the tax attributable to homestead property shall be paid from other assets of any trust or the estate subject to administration in the order as directed by the governing instrument or, absent this direction, in the following order:

1. Property not disposed of by the will or trust.

2. Property passing as the residuary estate.

3. Property not specifically or demonstratively devised.

4. Property specifically or demonstratively devised.

(e) The balance of the net amount of the tax, including, but not limited to, any tax imposed concerning jointly held properties passing by survivorship, property passing by intestacy, annuities not created under the will or an inter vivos trust, and the tax imposed by s. 4980A of the Internal Revenue Code, shall be equitably apportioned among, and paid by, the recipients and beneficiaries of the properties or interests, in the proportion that the value of the property or interest of each included in the measure of the tax bears to the total value of all the properties and interests included in the measure of the tax, except as otherwise directed by the governing instrument. With respect to a temporary interest not in trust, the amount charged to the recipients or beneficiaries shall not be apportioned between temporary and remainder interests but shall be charged to and paid out of the corpus of the property or fund, except as otherwise directed by the governing instrument.

(f) Nothing herein contained shall be construed to require the personal representative or other concerned fiduciary to pay any estate, inheritance, or other death taxes levied or assessed by any foreign country, unless specific directions to that effect are contained in the will or other instrument under which the fiduciary is acting.

(2)(a) The net amount of tax attributable to the interests encompassed by any one of paragraphs (1)(a) through (e) shall be the part of the net amount of the tax as finally determined, with interest on it, as the value of interests included in the measure of the tax and included in the paragraph bears to the amount of the net estate, except that, in the case of an inheritance or similar tax, the tax that is imposed on each beneficiary's interest, as determined under the law of the state, country, or political subdivision then under consideration, shall be deemed the tax attributable to the interest.

(b) As used in this section, the term:

1. "Net estate" means the gross estate, as defined by the estate, inheritance, or death tax laws of the particular state, country, or political subdivision whose tax is being apportioned, less the deductions, other than the specific exemption, allowed. All proportions based on net estate shall be determined without regard to any diminution in deductions resulting from the charge of any part of the tax to a deductible interest.

2. "Included in the measure of the tax" means each separate tax that an interest may incur and in determining the proportion that each interest bears to the total value of all interests included in the measure of each tax, only interests included in the measure of that particular tax are considered. The term does not include any property or interest, whether passing under the will or not, to the extent the property or interest is exempt or is initially deductible from the gross estate, without regard to any subsequent diminution of the deduction by reason of the charge of any part of the tax to the property or interest.

3. "Value" means the pecuniary worth of the interest involved as finally determined for purposes of the tax then under consideration, without regard to any diminution of it by reason of the charge of any part of tax.

4. "Governing instrument" means a will, a trust agreement, or any other document controlling the devolution of an asset at the death with respect to which the tax is being levied, but a direction in the will or such other instrument for the payment of tax in a manner different than that provided for herein is effective to allocate and pay tax only from assets the devolution of which is subject to control under that instrument, except that a will direction to pay tax from a trust of which the testator was the grantor and which was revocable by the grantor until the date of the grantor's death, is effective if a

contrary direction is not contained in the trust agreement.

5. "Temporary interest" means an interest in income or an estate for a specific period of time or for life or for some other period controlled by reference to extrinsic events.

(c) Except when the governing instrument otherwise provides, in the event a credit is given under the estate tax laws of the United States for any taxes paid to other countries or political subdivisions, the credit shall be apportioned under this section among the recipients of interests finally charged with the payment of the foreign tax in reduction of any United States estate tax chargeable to the recipients or interests, whether or not the United States estate tax is attributable to the foreign interests. Any excess of the credit shall be applied in reduction of the part of United States estate tax chargeable to residue, and any excess of the credit over the United States estate tax chargeable to residue shall be apportioned ratably among those persons or interests finally charged with the balance of the payment of United States estate tax.

(d) A direction against apportionment under this section may be explicit or implicit from the terms of the governing instrument, but must be clear and unequivocal; provided, however, that an implicit direction against apportionment is not sufficient to avoid the apportionment under state or applicable federal law unless the court also finds that the testator considered and made a deliberate and informed decision about the burden of taxation.

(3) Unless otherwise directed by the governing instrument, the tax shall be paid by the personal representative out of the estate, or if a personal representative is not acting under appointment, by a person receiving or holding the interests included in the measure of the tax. In all cases in which any property required to be included in the gross estate does not come into the possession of the personal representative, he or she shall recover:

(a) From the fiduciary in possession of the corpus of the trust or of property subject to the power of appointment in cases in which property of a trust created inter vivos or property subject to a power of appointment is included in the gross estate; and

(b) In all other cases, from the recipient or beneficiaries of property or interests with respect to which the tax is levied or assessed,

the proportionate amount of the tax payable by the fiduciary or persons with which they are chargeable under the provisions of this act, unless relieved of the duty as provided in subsection (6). This subsection shall not authorize the recovery of any taxes from any company issuing insurance included in the gross estate, or from any bank, trust company, savings and loan association, or similar institution with respect to any account in the name of the decedent and any other person that passed by operation of law on the decedent's death. If the fiduciary brings an action to recover a share of tax apportioned to an interest not within his or her control, the judgment he or she obtains may include costs and reasonable attorney's fees.

(4) No personal representative or other fiduciary shall be required to transfer any property until the amount of any tax due from the transferee is paid or, if the apportionment of tax has not been determined, until adequate security is furnished for the payment. The fiduciary shall not be required to distribute assets that he or she reasonably anticipates may be necessary to pay any state or federal taxes.

(5) After the amount of all estate, inheritance, and death taxes is finally determined, the personal representative or other fiduciary shall petition for an order of apportionment and shall give formal notice of the petition and the hearing to all interested persons. The personal representative shall be entitled, and it shall be his or her duty, except as provided in subsection (6), to attempt to effect apportionment as determined by the order, and the apportionment shall be prima facie correct in proceedings in any court or jurisdiction. The personal representative shall not be required to seek collection of any portion of tax attributable to any interest not within his or her control until after entry of the order.

(6)(a) A personal representative or other fiduciary who has the duty under this section of collecting the apportioned tax from persons interested in the estate may be relieved of the duty to collect the tax by an order of the court finding:

1. That the estimated court costs and attorney fees in collecting the apportioned tax from a person interested in the estate will approximate the amount of the recovery.

2. That the person interested in the estate is a resident of a foreign country other than Canada and refuses to pay the apportioned tax on demand.

3. That it is impracticable to enforce contribution of the apportioned tax against any person interested in the estate in view of the improbability of obtaining a judgment or the improbability of collection under any judgment that might be obtained, or otherwise.

(b) The fiduciary shall not be liable for failure to attempt to enforce collection if the attempt would in fact have been economically impracticable. Nothing in this section shall limit the right of any person who is charged with more than the amount of the tax apportionable to him or her to obtain contribution from those who shall not have paid the full amount of the tax apportionable to them, and that right is hereby conferred.

(c) If a fiduciary obtains an order described above, the share of tax to which it refers shall be paid from assets of the estate in the order provided by s. 733.805. Any apportioned tax that is not collected shall also be paid from assets in the same order.

CR01

[FN1] 26 U.S.C.A. § 4980A.

[FN2] 26 U.S.C.A. §§ 2206, 2207, and 2603.

<For text of section effective Oct. 1, 1998, see § 733.817, post>

733.817. Apportionment of estate taxes

<Text of section effective Oct. 1, 1998>

(1) For purposes of this section:

(a) "Fiduciary" means a person other than the personal representative in possession of property included in the measure of the tax who is liable to the applicable taxing authority for payment of the entire tax to the extent of the value of the property in his possession.

(b) "Governing instrument" means a will, trust agreement, or any other document that controls the transfer of an asset on the occurrence of the event with respect to which the tax is being levied.

(c) "Gross estate" means the gross estate, as determined by the Internal Revenue Code [FN1] with respect to the federal estate tax and the Florida estate tax, and as such concept is otherwise determined by the estate, inheritance, or death tax laws of the particular state, country, or political subdivision whose tax is being apportioned.

(d) "Included in the measure of the tax" means that for each separate tax that an interest may incur, only interests included in the measure of that particular tax are considered. The term "included in the measure of the tax" does not include any interest, whether passing under the will or not, to the extent the interest is initially deductible from the gross estate, without regard to any subsequent diminution of the deduction by reason of the charge of any part of the applicable tax to the interest. The term "included in the measure of the tax" does not include interests or amounts that are not included in the gross estate but are included in the amount upon which the applicable tax is computed, such as adjusted taxable gifts with respect to the federal estate tax. If an election is required for deductibility, an interest is not "initially deductible" unless the election for deductibility is allowed.

(e) "Internal Revenue Code" means the Internal Revenue Code of 1986, as amended from time to time.

(f) "Net tax" means the net tax payable to the particular state, country, or political subdivision whose tax is being apportioned, after taking into account all credits against the applicable tax except as provided in this section. With respect to the federal estate tax, "net tax" is determined after taking into account all credits against the tax except for the credit for foreign death taxes.

(g) "Nonresiduary devise" means any devise that is not a residuary devise.

(h) "Nonresiduary interest" in connection with a trust means any interest in a trust which is not a residuary interest.

(i) "Recipient" means, with respect to property or an interest in property included in the gross estate, an heir at law in an intestate estate, devisee in a testate estate, beneficiary of a trust, beneficiary of an insurance policy, annuity, or other contractual right, surviving tenant, taker as a result of the exercise or in default of the exercise of a general power of appointment, person who receives or is to receive the property or an interest in the property, or person in possession of the property.

(j) "Residuary devise" has the meaning set forth in s. 731.201(30).

(k) "Residuary interest," in connection with a trust, means an interest in the assets of a trust which remain after provision for any distribution that is to be satisfied by reference to a specific property or type of property, fund, sum, or statutory amount.

(l) "Revocable trust" means a trust as defined in s. 731.201(33) created by the decedent to the extent that the decedent had at his or her death the power to alter, amend, or revoke the trust either alone or in conjunction with any other person.

(m) "State" means any state, territory, or possession of the United States, the District of Columbia, and the Commonwealth of Puerto Rico.

(n) "Tax" means any estate tax, inheritance tax, generation skipping transfer tax, or other tax levied or assessed under the laws of this or any other state, the United States, any other country, or any political subdivision of the foregoing, as finally determined, which is imposed as a result of the death of the decedent, including, without limitation, the tax assessed pursuant to s. 4980A of the Internal Revenue Code. The term also includes any interest and penalties imposed in addition to the tax. Unless the context indicates otherwise, the term "tax" means each separate tax.

(o) "Temporary interest" means an interest in income or an estate for a specific period of time or for life or for some other period controlled by reference to extrinsic events, whether or not in trust.

(p) "Tentative Florida tax" with respect to any property means the net Florida estate tax that would have been attributable to that property if no tax were payable to any other state in respect of that property.

(q) "Value" means the pecuniary worth of the interest involved as finally determined for purposes of the applicable tax after deducting any debt, expense, or other deduction chargeable to it for which a deduction was allowed in determining the amount of the applicable tax. A lien or other encumbrance is not regarded as chargeable to a particular interest to the extent that it will be paid from other interests. The value of an interest shall not be reduced by reason of the charge against it of any part of the tax.

(2) An interest in homestead property shall be exempt from the apportionment of taxes if such interest passes to a person to whom inures the decedent's exemption from forced sale under the State Constitution.

(3) The net tax attributable to the interests included in the measure of each tax shall be determined by the proportion that the value of each interest included in the measure of the tax bears to the total value of all interests included in the measure of the tax. Notwithstanding the foregoing:

(a) The net tax attributable to interests included in the measure of the tax by reason of s. 2044 of the Internal Revenue Code [FN2] shall be determined in the manner provided for the federal estate tax in s. 2207A of the Internal Revenue Code, [FN3] and the amount so determined shall be deducted from the tax to determine the net tax attributable to all remaining interests included in the measure of the tax.

(b) The foreign tax credit allowed with respect to the federal estate tax shall be allocated among the recipients of interests finally charged with the payment of the foreign tax in reduction of any federal estate tax chargeable to the recipients of the foreign interests, whether or not any federal estate tax is attributable to the foreign interests. Any excess of the foreign tax credit shall be applied to reduce proportionately the net amount of federal estate tax chargeable to the remaining recipients of the interests included in the measure of the federal estate tax.

(c) The reduction in the Florida tax on the estate of a Florida resident for tax paid to other states shall be allocated as follows:

1. If the net tax paid to another state is greater than or equal to the tentative Florida tax attributable to the property subject to tax in the other state, none of the Florida tax shall be attributable to that property.

2. If the net tax paid to another state is less than the tentative Florida tax attributable to the property subject to tax in the other state, the net Florida tax attributable to the property subject to tax in the other state shall be the excess of the amount of the tentative Florida tax attributable to the property over the net tax payable to the other state with respect to the

property.

3. Any remaining net Florida tax shall be attributable to property included in the measure of the Florida tax exclusive of property subject to tax in other states.

4. The net federal tax attributable to the property subject to tax in the other state shall be determined as if it were located in the state.

(d) The net tax attributable to a temporary interest, if any, shall be regarded as attributable to the principal that supports the temporary interest.

(4)(a) Except as otherwise effectively directed by the governing instrument, if the Internal Revenue Code including, but not limited to, ss. 2032A(c)(5), 2206, 2207, 2207A, 2207B, and 2603 of the Internal Revenue Code [FN4] applies to apportion federal tax against recipients of certain interests, all net taxes, including taxes levied by the state attributable to each type of interest, shall be apportioned against the recipients of all interests of that type in the proportion that the value of each interest of that type included in the measure of the tax bears to the total of all interests of that type included in the measure of the tax.

(b) The provisions of this subsection do not affect allocation of the reduction in the Florida tax as provided in this section with respect to estates of Florida residents which are also subject to tax in other states.

(5) Except as provided above or as otherwise directed by the governing instrument, the net tax attributable to each interest shall be apportioned as follows:

(a) For property passing under the decedent's will:

1. The net tax attributable to nonresiduary devises shall be charged to and paid from the residuary estate whether or not all interests in the residuary estate are included in the measure of the tax. If the residuary estate is insufficient to pay the net tax attributable to all nonresiduary devises, the balance of the net tax attributable to nonresiduary devises shall be apportioned among the recipients of the nonresiduary devises in the proportion that the value of each nonresiduary devise included in the measure of the tax bears to the total of all nonresiduary devises included in the measure of the tax.

2. The net tax attributable to residuary devises shall be apportioned among the recipients of the residuary devises included in the measure of tax in the proportion that the value of each residuary devise included in the measure of the tax bears to the total of all residuary devises included in the measure of the tax.

(b) For property passing under the terms of any trust other than a trust created in the decedent's will:

1. The net tax attributable to nonresiduary interests shall be charged to and paid from the residuary portion of the trust, whether or not all interests in the residuary portion are included in the measure of the tax. If the residuary portion of the trust is insufficient to pay the net tax attributable to all nonresiduary interests, the balance of the net tax attributable to nonresiduary interests shall be apportioned among the recipients of the nonresiduary interests in the proportion that the value of each nonresiduary interest included in the measure of the tax bears to the total of all nonresiduary interests included in the measure of the tax.

2. The net tax attributable to residuary interests shall be apportioned among the recipients of the residuary interests included in the measure of the tax in the proportion that the value of each residuary interest included in the measure of the tax bears to the total of all residuary interests included in the measure of the tax.

(c) The net tax attributable to an interest in homestead property which is exempt from apportionment pursuant to subsection (2) shall be apportioned against the recipients of other interests in the estate or passing under any revocable trust in the following order:

1. Class I: Recipients of interests not disposed of by the decedent's will or revocable trust which are included in the measure of the federal estate tax.

2. Class II: Recipients of residuary devises and residuary interests that are included in the measure of the federal estate tax.

3. Class III: Recipients of nonresiduary devises and nonresiduary interests that are included in the measure of the federal estate tax. The net tax apportioned to a class, if any, pursuant to this paragraph shall be apportioned among the recipients in the class in the proportion that the value of the interest of each bears to the total value of all interests included in that class.

(d) In the application of this subsection, paragraphs (a), (b), and (c) shall be applied to apportion the net tax to the recipients of the estate and the recipients of the decedent's revocable trust as if all recipients, other than the estate or trusts themselves, were taking under a common instrument.

(e) The net tax imposed under s. 4980A of the Internal Revenue Code [FN5] shall be apportioned among the recipients of the interests included in the measure of that tax in the proportion that the value of the interest of each bears to the total value of all interests included in the measure of that tax.

(f) The net tax that is not apportioned under paragraphs (a), (b), and (c), including, but not limited to, the net tax attributable to interests passing by intestacy, jointly held interests passing by survivorship, insurance, properties in which the decedent held a reversionary or revocable interest, and annuities, shall be apportioned among the recipients of the remaining interests that are included in the measure of the tax in the proportion that the value of each such interest bears to the total value of all the remaining interests included in the measure of the tax.

(g) If the court finds that it is inequitable to apportion interest, penalties, or both, in the manner provided in paragraphs (a)-(f), the court may assess liability for the payment thereof in the manner it finds equitable.

(h)1. To be effective as a direction for payment of tax in a manner different from that provided in this section, the governing instrument must direct that the tax be paid from assets that pass pursuant to that governing instrument, except as provided in this section.

2. If the decedent's will provides that the tax shall be apportioned as provided in the decedent's revocable trust by specific reference to the trust, the direction in the revocable trust shall be deemed to be a direction contained in the will and shall control with respect to payment of taxes from assets passing under both the will and the revocable trust.

3. A direction in the decedent's will to pay tax from the decedent's revocable trust is effective if a contrary direction is not contained in the trust agreement.

4. For a direction in a governing instrument to be effective to direct payment of taxes attributable to property not passing under the governing instrument from property passing under the governing instrument, the governing instrument must expressly refer to this section, or expressly indicate that the property passing under the governing instrument is to bear the burden of taxation for property not passing under the governing instrument. A direction in the governing instrument to the effect that all taxes are to be paid from property passing under the governing instrument whether attributable to property passing under the governing instrument or otherwise shall be effective to direct the payment from property passing under the governing instrument of taxes attributable to property not passing under the governing instrument.

5. If there is a conflict as to payment of taxes between the decedent's will and the governing instrument, the decedent's will controls, except as follows:

a. The governing instrument shall be given effect with respect to any tax remaining unpaid after the application of the decedent's will.

b. A direction in a governing instrument to pay the tax attributable to assets that pass pursuant to the governing instrument from assets that pass pursuant to that governing instrument shall be effective notwithstanding any conflict with the decedent's will, unless the tax provision in the decedent's will expressly overrides the conflicting provision in the governing instrument.

(6) The personal representative or fiduciary shall not be required to transfer to a recipient any property in possession of the personal representative or fiduciary which he or she reasonably anticipates may be necessary for the payment of taxes. Further, the personal representative or fiduciary shall not be required to transfer any property in possession of the personal representative or fiduciary to the recipient until the amount of the tax due from the recipient is paid by the recipient. If property is transferred before final apportionment of the tax, the recipient shall provide a bond or other security for his apportioned liability in the amount and form prescribed by the personal representative or fiduciary.

(7)(a) The personal representative may petition at any time for an order of apportionment. If no administration has been commenced at any time after 90 days from the decedent's death any fiduciary may petition for an order of apportionment in the court in which venue would be proper for administration of the decedent's estate. Formal notice of the petition for order of apportionment shall be given to all interested persons. At any time after 6 months from the decedent's death, any recipient may petition such court for an order of apportionment.

(b) The court shall determine all issues concerning apportionment. If the tax to be apportioned has not been finally determined, the court shall determine the probable tax due or to become due from all interested persons, apportion the probable tax, and retain jurisdiction over the parties and issues to modify the order of apportionment as appropriate until after the tax is finally determined.

(8)(a) If the personal representative or fiduciary does not have possession of sufficient property otherwise distributable to the recipient to pay the tax apportioned to the recipient, whether under this section, the Internal Revenue Code, or the governing instrument, if applicable, the personal representative or fiduciary shall recover the deficiency in tax so apportioned to the recipient:

1. From the fiduciary in possession of the property to which the tax is apportioned, if any; and

2. To the extent of any deficiency in collection from the fiduciary, or to the extent collection from the fiduciary is excused pursuant to subsection (9) and in all other cases, from the recipient of the property to which the tax is apportioned, unless relieved of this duty as provided in subsection (9).

(b) In any action to recover the tax apportioned, the order of apportionment shall be prima facie correct.

(c) In any action for the enforcement of an order of apportionment, the court shall award taxable costs as in chancery actions, including reasonable attorney's fees, and may award penalties and interest on the unpaid tax in accordance with equitable principles.

(d) This subsection shall not authorize the recovery of any tax from any company issuing insurance included in the gross estate, or from any bank, trust company, savings and loan association, or similar institution with respect to any account in the name of the decedent and any other person which passed by operation of law on the decedent's death.

(9)(a) A personal representative or fiduciary who has the duty under this section of collecting the apportioned tax from recipients may be relieved of the duty to collect the tax by an order of the court finding:

1. That the estimated court costs and attorney's fees in collecting the apportioned tax from a person against whom the tax has been apportioned will approximate or exceed the amount of the recovery;

2. That the person against whom the tax has been apportioned is a resident of a foreign country other than Canada and refuses to pay the apportioned tax on demand; or

3. That it is impracticable to enforce contribution of the apportioned tax against a person against whom the tax has been apportioned in view of the improbability of obtaining a judgment or the improbability of collection under any judgment that might be obtained, or otherwise.

(b) A personal representative or fiduciary shall not be liable for failure to attempt to enforce collection if the personal representative or fiduciary reasonably believes it would have been economically impracticable.

(10) Any apportioned tax that is not collected shall be reapportioned in accordance with this section as if the portion of the property to which the uncollected tax had been apportioned had been exempt.

(11) Nothing in this section shall limit the right of any person who has paid more than the amount of the tax apportionable to such person, calculated as if all apportioned amounts would be collected, to obtain contribution from those who have not paid the full amount of the tax apportionable to them, calculated as if all apportioned amounts would be collected, and that right is hereby conferred. In any action to enforce contribution, the court shall award taxable costs as in chancery actions, including reasonable attorney's fees.

(12) Nothing herein contained shall be construed to require the personal representative or fiduciary to pay any tax levied or assessed by any foreign country, unless specific directions to that effect are contained in the will or other instrument under which the personal representative or fiduciary is acting.

CR01

[FN1] 26 U.S.C.A. § 1 et seq.

[FN2] 26 U.S.C.A. § 4980A.

[FN3] 26 U.S.C.A. § 2044.

[FN4] 26 U.S.C.A. § 2207A.

[FN5] 26 U.S.C.A. §§ 2032A(c)(5), 2206, 2207, 2207A, 2207B, 2603.

<For text of section effective until Oct. 1, 1998, see § 733.817, ante>

CREDIT(S)

1998 Electronic Update

CR01 Amended by Laws 1997, c. 97-102, § 1026, eff. July 1, 1997. Laws 1997, c. 97-240, § 9, eff. Oct. 1, 1998.

1998 KENTUCKY GENERAL ASSEMBLY
LEGISLATION AFFECTING WILLS AND ESTATES

Stephen A. Watkins; Chair, Kentucky Bar Association Trust and Estates Section

Living Will Organ Donation—HB 529

Rep. Bob Helringer sponsored HB 529, which adds statutory language permitting a Living Will to authorize organ donations and other anatomical gifts for medical and educational uses. The law offers a suggested form incorporating the new language. It also refers to KRS 311.185, which provides:

The following persons may become donees of gifts of bodies or parts thereof for the purposes stated:
(1) Any hospital, surgeon, or physician, for medical or dental education, research, advancement of medical or dental science, therapy, or transplantation; or
(2) Any accredited medical or dental school, college or university for education, research, advancement of medical or dental science, or therapy; or
(3) Any bank or storage facility, for medical or dental education, research, advancement of medical or dental science, therapy, or transplantation; or
(4) Any specified individual for therapy or transplantation needed by him.

The statutory form is adequate for most purposes, but some clients will make a distinction between the permissible uses of anatomical gifts. Some clients may find organ donation acceptable, but won't want to become "the man in the pan" at some medical school. A bequest of the body for medical school purposes is ordinarily part of a Last Will, which should be coordinated with this language. Other clients may want to modify the language to prohibit all anatomical gifts.

An alternative form is provided in the materials. The anatomical gift section of this form adds a requirement to consult with the family and spells out the particular uses. It should be useful if the client moves or visits another state.

We also put the same anatomical gift language in our long durable power of attorney form.

Marriage Does Not Revoke Last Will—HB 313

Professor Richard V. Wellman, Executive Director of the Joint Editorial Board for the Uniform Probate Code, spoke in favor of HB 313, acting as a consultant to the AARP. HB 313 was sponsored by Rep. Rob Wilkey. Prior to HB 313, marriage would revoke any last will and testament of the parties, except for certain circumstances. Professor Wellman argued that the prior law contravened the intent of most people, as reflected in the Uniform Probate Code. HB 313 now provides that marriage will not revoke a last will. Presumably, a spouse's right to elect against a will and take a statutory share offers adequate protection to surviving spouses. Obviously, however, marriage is an event requiring full review of an estate plan.

Uniform TOD Security Registration Act—HB 314

HB 314, sponsored by Rep. Rob Wilkey is another AARP provision. HB 314 incorporates into Kentucky law the Uniform TOD Security Registration Act, which is also part of the Uniform Probate Code. Kentucky securities dealers who spoke on behalf of its passage supported HB 314.

HB 314 facilitates having securities or security accounts in a form that avoids probate. This form of ownership is optional for the issuer. The security or account is transferred to a designated beneficiary upon death of the owner—like a POD checking account. Section 2 of the new law forces co-owners to hold as joint tenants with rights of survivorship rather than as tenants in common, and the designated beneficiary takes only after the death of all co-owners. Section 5 gives the language necessary to create a TOD beneficiary form of ownership. Section 6 clarifies that the beneficiary is revocable by the owner or owners without the beneficiary's consent. Section 7 specifies that if there is more than one beneficiary, they take as tenants in common until the security or security account is divided. If no beneficiary survives, the owner is the estate of the owner (or the estate of the last to die of the co-owners). Section 8 offers protection to issuers who permit beneficiary form ownership. Section 10 permits contingent beneficiaries, including a designation of "LDPS" to have "lineal descendants per stirpes" take as substitutes for a named beneficiary who is deceased.

Transfer of Property on Death—HB 165

HB 165 was drafted and supported by the Legislative Committee of the KBA Trust & Estate Section. There are three distinct parts of the law, representing adoption of three separate uniform codes.

HB 165, Sections 1 to 9—Uniform Simultaneous Death Act

Kentucky had an outdated version of the Uniform Simultaneous Death Act. Under the old law, litigators fought to show that one or another person breathed the last breath. To the contestants, there was never a true simultaneous death; never was there "no sufficient evidence" of the true order of deaths. This bill updates Kentucky law and provides a better resolution of this issue where it is not resolved in a governing instrument like a last will or trust. The new language simply requires an objective test: clear evidence of survival by 120 hours. The concept is to specify enough time for death to occur if it is likely following a mutual accident, but not so long as to delay aid for a designated beneficiary who needs it. This is a default provision that can be overridden by specific language in a will or trust or other document.

HB 165, Section 10—Uniform Testamentary Additions to Trusts Act

Kentucky had an outdated version of the Uniform Testamentary Additions to Trusts Act. This bill updates Kentucky law. This is an important provision given the proliferation of Living Trusts in Kentucky as elsewhere. It is intended to avoid malpractice traps such as signing the trust before the will, failing to have a trust corpus (the $1 bill), or of having to sign a new will if the trust is amended after the will is signed.

HB 165, Section 11—Uniform Non-Probate Transfers at Death

Kentucky had an outdated version of the Uniform Non-Probate Transfers Act. This bill updates Kentucky law, adding specific reference to many types of assets that did not exist or were not common when the old law was drafted.

Disclaimer of Inheritance—HB 166

This is another legislative provision drafted and supported by the Legislative Committee of the KBA Trust & Estate Section. It was primarily intended to remove a federal estate tax disadvantage for Kentucky residents. A Kentucky case held that where joint real property is held with rights of survivorship, one owner cannot unilaterally transfer his or her share and thereby sever the survivorship rights. This is contrary to common law in Kentucky and other jurisdictions. The Kentucky Court felt, however, that co-owners with survivorship rights create those rights as a mutual promise or bargain to one another and that it is unfair to permit them to "change the deal" unilaterally. The common law rule treated the survivorship rights not as inalienable property rights, but as a convenient way for the owners to designate a beneficiary. The common law view permits a terminally ill co-owner to transfer his or her interest so as to change the "beneficiary" of his or her part of the property.

Apart from the property rights questions, the Kentucky case had unanticipated tax effects. A subsequent federal case disallowed a disclaimer of jointly owned property for estate tax purposes because of this Kentucky limitation on severing the tenancy. The federal law was recently changed to permit disclaimers by ignoring State law restrictions such as Kentucky's. Since this was the primary focus of the provision, the Section representatives attempted to stop passage of HB 166 to permit further review. HB 166 passed despite these efforts of its drafters. Personally, however, I favor the balance struck by the HB 166 as to the non-tax issues. The common law rule that a single co-owner can sever the survivorship rights unilaterally is restored except for the principal residence of spouses.

Litigation Over Inheritance—HB 61

This is another legislative provision drafted and supported by the Legislative Committee of the KBA Trust & Estate Section. There are two distinct sections to the bill. A third section, dealing with the limitations period for substituting parties in litigation, was stricken from the law at the drafters' request because the KBA Board of Governors wanted more input from the litigation bar.

HB 61, Section 1—Hearing to Determine Interests in Property

KRS 391.050 gives Kentuckians an alternative procedure to an Affidavit of Descent to resolve title issues. A Kentucky court case (*Sirls v. Jordan*, 625 S.W.2d 106) held that bona fide purchasers of real estate took subject to the rights of an undisclosed heir even in light of a proper Affidavit of

Descent. While title insurance companies offer some protection in this situation, business ventures will be helped by providing a binding hearing procedure to better protect all the parties to a transaction. HB 61 adds language expressly providing that the procedure is binding on all parties, whether known or unknown.

HB 61, Section 2—Limitation of Actions Clarification

Section 2 provides that claims against the personal representative and distributees of a decedent's estate are barred after two years from the order of discharge of the personal representative except in cases of fraud. Fraud is well-defined legally. The prior statutory language included an exception for "misrepresentation, or inadequate disclosure" which was not well defined and which was too broad.

Legal Representatives (Durable Powers of Attorney)—HB 60

This is another legislative provision drafted and supported by the Legislative Committee of the KBA Trust & Estate Section. Several sections of the bill as drafted were stricken by the House Judiciary Committee.

With our aging population, durable powers of attorney are becoming an even more important estate planning tool to guard against temporary or permanent disability. This bill clarifies current law on durable powers of attorney and resolves certain related problems.

HB 60 defines a "durable power of attorney" whereas prior law had no definition. There should be improved acceptance of Kentucky durable powers because the law not expressly provides that passage of time does not affect them unless specified in the instrument. Resistance by financial institutions and others to "stale" powers of attorney is a serious problem causing delays and frustration.

Section 1 also resolves a conflict between a Living Will and the attorney-in-fact's authority to make medical decisions. A wife who signed a Living Will stating her "abhorrence for tube feeding" and prohibiting it was forced onto tube feeding after her husband consented using a power of attorney dated after the Living Will. He then died and the nursing home refused to remove the feeding tube. Under the new law, a court-appointed fiduciary would be bound by the Living Will. An attorney-in-fact is not expressly bound by a Living Will, but may be by implication. To be safe, the power of attorney should state that the attorney-in-fact must follow any Living Will directions.

Some durable powers of attorney are "springing" in that they only become effective if disability actually occurs. The new law provides a clear definition of disability for the limited purpose of effectiveness of the power where the document fails to do so—a failure common in short-form powers.

HB 60 should also encourage people to act as attorneys-in-fact by offering them and third parties legal protection if they act without notification of termination of the power of attorney by death or revocation. This will simplify the process for things like real estate closing involving the use of powers of attorney.

The parts of HB 60 stricken by the House Judiciary Committee would have resolved issues arising when a court appoints a guardian or conservator while an agent is acting under a durable power of attorney. The stricken language would have expressly permitted nomination of a guardian or conservator within a durable power of attorney, and would have permitted the attorney-in-fact to continue to serve, accounting to the court-appointed fiduciary who could revoke or amend the power of attorney. In the absence of a nomination by the disabled person, the attorney-in-fact would have been first in line for appointment as court-appointed fiduciary absent good cause. Since these parts of the bill are not part of the new law, case law permits a court to override the attorney-in-fact choice of the disabled person. Hopefully, however, judges will exercise their discretion reasonably, since they must still "give due respect" under KRS 387.300 to the attorney-in-fact in picking a fiduciary.

AN ACT relating to legal representatives.

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

SECTION 1. A NEW SECTION OF KRS 311.621 TO 311.643 IS CREATED TO READ AS FOLLOWS:

If, following the execution of an advance directive under KRS 311.623, a court of the grantor's principal domicile appoints a fiduciary charged with the care and protection of the grantor's person, the fiduciary shall be bound by the terms of the grantor's advance directive. If the advance directive designates a surrogate to make health care decisions for the grantor, the surrogate may continue to act.

Section 2. KRS 386.093 is amended to read as follows:

(1) As used in this section, "durable power of attorney" means a power of attorney by which a principal designates another as the principal's attorney in fact in writing and the writing contains the words, "This power of attorney shall not be affected by subsequent disability or incapacity of the principal, or lapse of time", or "This power of attorney shall become effective upon the disability or incapacity of the principal", or similar words showing the intent of the principal that the authority conferred shall be exercisable notwithstanding the principal's subsequent disability or incapacity, and, unless it states a time of termination, notwithstanding the lapse of time since the execution of the instrument.

(2) All acts done by an attorney in fact under a durable power of attorney during any period of disability or incapacity of the principal have the same effect and inure to the benefit of and bind the principal and the principal's successors in interest as if the principal were competent and not disabled. Unless the instrument states a time of termination, the power is exercisable notwithstanding the lapse of time since the execution of the instrument.

(3) The death of a principal who has executed a written power of attorney, durable or otherwise, does not revoke or terminate the agency as to the attorney in fact or

other person, who, without actual knowledge of the death of the principal, acts in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds successors in interest of the principal.

(4) The disability or incapacity of the principal who has previously executed a written power of attorney that is not a durable power does not revoke or terminate the agency as to the attorney in fact or other person, who, without actual knowledge of the disability or incapacity of the principal, acts in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds the principal and the principal's successors in interest.

(5) If the power of attorney is to become effective upon the disability or incapacity of the principal, the principal may specify the conditions under which the power is to become effective and may designate the person, persons, or institution responsible for making the determination of disability or incapacity. If the principal fails to so specify, the power shall become effective upon a written determination by two (2) physicians that the principal is unable, by reason of physical or mental disability, to prudently manage or care for the principal's person or property, which written determination shall be conclusive proof of the attorney in fact's power to act pursuant to the power of attorney. The two (2) physicians making the determination shall be licensed to practice medicine[~~When a principal designates another his attorney in fact or agent by a power of attorney in writing and the writing contains the words "This power of attorney shall not be affected by the disability of the principal," or "This power of attorney shall become effective upon the disability of the principal," or similar words showing the intent of the principal that the authority conferred shall be exercisable notwithstanding his disability, then the authority of the attorney in fact or agent is exercisable by him as provided in the power on behalf of the principal notwithstanding later disability or incapacity of the principal at law or later uncertainty as to whether the principal is~~

~~dead or alive. All acts done by the attorney in fact or agent, pursuant to the power during any period of disability or incompetence or uncertainty as to whether the principal is dead or alive, have the same effect and inure to the benefit of and bind the principal or his heirs, devisees and personal representative as if the principal were alive, competent and not disabled. If a fiduciary is thereafter appointed by the court for the principal the power of the attorney in fact shall thereupon terminate and he shall account to the court's appointed fiduciary~~].

Section 3. KRS 387.530 is amended to read as follows:

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

(a) The name and address of the respondent;

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

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

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

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

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

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

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

(i) The name and address of the petitioner's attorney, if any*<u>; and</u>*

<u>(j) The name and address of any person or entity appointed by the respondent as respondent's attorney in fact under a durable power of attorney, as</u>

defined in subsection (1) of Section 2 of this Act, or as respondent's surrogate to make health care decisions under an advance directive.

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

AN ACT relating to civil actions.

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

Section 1. KRS 391.035 is amended to read as follows:

(1) *If*[~~Whenever~~] real or personal property passes by the laws of intestate succession, or under a will to a beneficiary not named in *the*[~~such~~] will, proceedings may be had in the District Court to determine the persons entitled to *the*[~~such~~] property.

(2) (a) If an estate is in process of administration the executor, administrator*,* or any person claiming an interest in the property may file a motion in the District Court where administration is in process. If there is no pending administration or administration has been dispensed with, any person claiming an interest in the property may file a motion in the District Court of the county in which the decedent last resided or*, if*[~~ in the event~~] the decedent was not a Kentucky resident, in the District Court of the county in which the property, or the greater part thereof, is located;

(b) The motion shall set forth all of the facts known to *the* movant relating to the matter, including the names, ages*,* and addresses of all persons who are or may be entitled to share in *the*[~~such~~] property and their relationship to the decedent or to the class of beneficiaries entitled to share. The motion shall also describe the property under consideration and an estimate of its value;

(c) The motion shall be served in a manner authorized by the Rules of Civil Procedure for the initiation of a civil action and shall set forth the place and time*,* [~~(~~]which shall not be less than twenty (20) days from the date of service*,*[~~)~~] when the motion will come on for hearing.

(3) Upon the hearing on the motion any person claiming an interest in the property may introduce proof in support of his claim and the court may entertain the admission of any other relevant evidence to aid the court in determining the persons entitled to share in the property.

(4) After hearing all the evidence the court shall enter judgment in which the names, ages, and addresses of the persons entitled to share in the property are set forth and the proportionate interest of each. ***The judgment shall be conclusive evidence of the facts determined therein as against all parties, whether known or unknown, to the proceeding.***

(5) In a case where some or all of the property is real ***property***~~[estate]~~ located in this state, a certified copy of the judgment shall be recorded in the office of the appropriate county clerk in lieu of the affidavit required by KRS 382.120. ***The judgment shall be conclusive evidence of the facts determined therein as against all parties, whether known or unknown, to the proceeding.***

(6) Any party may at any time prior to judgment institute an adversary proceeding in Circuit Court pursuant to KRS 24A.120(2).

(7) Any aggrieved party may no later than thirty (30) days from the date of the judgment, institute an adversary proceeding in Circuit Court pursuant to KRS 24A.120(2).

(8) Any unknown defendants before the court by constructive service alone shall be entitled to the protection afforded by Civil Rule 4.11.

(9) No proceedings under this section shall be conducted by or before a commissioner of the District Court.

Section 2. KRS 396.205 is amended to read as follows:

Notwithstanding any other statute to the contrary, no cause of action on any claim not otherwise barred by the provisions of KRS 396.011 and subsection (1) of KRS 396.055, or any other applicable statute of limitations, shall be brought against the personal representative or against any distributee after the expiration of two (2) years from the date of the order of discharge of the personal representative. The foregoing limitation shall not preclude an action by any claimant against the personal representative ***or any distributee*** for fraud~~[, misrepresentation or inadequate disclosure related to the settlement of the decedent's estate]~~.

AN ACT relating to disposition of property at death.

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

SECTION 1. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

As used in this chapter, unless the context requires otherwise:

(1) "Co-owners with right of survivorship" means and includes joint tenants, tenants by the entireties, and other co-owners of property or accounts held under circumstances that entitle one (1) or more to the whole of the property or account on the death of the other or others;

(2) "Governing instrument" means a deed, will, trust, insurance or annuity policy, account with payment on death (POD) designation, pension, profit-sharing, retirement, or similar benefit plan, instrument creating or exercising a power of appointment or a power of attorney, or a donative, appointive, or nominative instrument of any other type; and

(3) "Payor" means a trustee, insurer, business entity, employer, government, governmental agency, subdivision, or instrumentality, or any other person authorized or obligated by law or a governing instrument to make payments.

SECTION 2. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

Except as provided in Section 6 of this Act, if the title to property, the devolution of property, the right to elect an interest in property, or the right to exempt property, homestead, or family allowance depends upon an individual's survivorship of the death of another individual, an individual who is not established by clear and convincing evidence to have survived the other individual by one hundred and twenty (120) hours is deemed to have predeceased the other individual. This section shall not apply if its application would result in a taking of intestate estate by the state.

SECTION 3. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

Except as provided in Section 6 of this Act, for purposes of a donative provision of a governing instrument, an individual who is not established by clear and convincing evidence to have survived an event, including the death of another individual, by one hundred and twenty (120) hours is deemed to have predeceased the event.

SECTION 4. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

Except as provided in Section 6 of this Act:

(1) If it is not established by clear and convincing evidence that one (1) of two (2) co-owners with right of survivorship survived the other co-owner by one hundred and twenty (120) hours, one-half (1/2) of the property shall pass as if one (1) had survived by one hundred and twenty (120) hours and one-half (1/2) as if the other had survived by one hundred and twenty (120) hours.

(2) If there are more than two (2) co-owners and it is not established by clear and convincing evidence that at least one (1) of them survived the others by one hundred and twenty (120) hours, the property shall pass in the proportion that each bears to the whole number of co-owners.

SECTION 5. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

In addition to the rules of evidence in courts of general jurisdiction, for the purposes of Sections 1 to 7 of this Act only, the following rules relating to a determination of death and status shall apply:

(1) Death shall be deemed to occur when the requirements of KRS 446.400 have been met.

(2) A certified or authenticated copy of a death certificate purporting to be issued by an official or agency of the place where the death purportedly occurred shall be

prima facie evidence of the fact, place, date, and time of death and the identity of the decedent.

(3) A certified or authenticated copy of any record or report of a governmental agency, domestic or foreign, that an individual is missing, detained, dead, or alive shall be prima facie evidence of the status and of the dates, circumstances, and places disclosed by the record or report.

(4) In the absence of prima facie evidence of death under subsection (2) or (3) of this section, the fact of death shall be established by clear and convincing evidence, including circumstantial evidence.

(5) An individual whose death is not established under subsection (2), (3), or (4) of this section and who is absent for a continuous period of seven (7) years, during which the individual has not been heard from, and whose absence is not satisfactorily explained after diligent search or inquiry, shall be presumed dead. His or her death shall be presumed to have occurred at the end of the period unless there is sufficient evidence for determining that death occurred earlier.

(6) In the absence of evidence disputing the time of death stipulated on a document described in subsection (2) or (3) of this section, a document described in subsection (2) or (3) of this section that stipulates a time of death one hundred and twenty (120) hours or more after the time of death of another individual, however the time of death of the other individual is determined, establishes by clear and convincing evidence that the individual survived the other individual by one hundred and twenty (120) hours.

SECTION 6. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

Survival by one hundred and twenty (120) hours is not required if:

(1) The governing instrument contains language dealing explicitly with simultaneous deaths or deaths in a common disaster and that language is operable under the facts of the case;

(2) The governing instrument expressly indicates that an individual is not required to survive an event, including the death of another individual, by any specified period or expressly requires the individual to survive the event for a stated period, but survival of the event or the specified period shall be established by clear and convincing evidence;

(3) The imposition of a one hundred and twenty (120) hour requirement of survival would cause a nonvested property interest or a power of appointment to be invalid under the Rule Against Perpetuities, but survival shall be established by clear and convincing evidence; or

(4) The application of a one hundred and twenty (120) hour requirement to multiple governing instruments would result in an unintentional failure or duplication of a disposition, but survival shall be established by clear and convincing evidence.

SECTION 7. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

(1) (a) A payor or other third party shall not be liable for having made a payment or transferred an item of property or any other benefit to a beneficiary designated in a governing instrument who, under this chapter, is not entitled to the payment or item of property, or for having taken any other action in good faith reliance on the beneficiary's apparent entitlement under the terms of the governing instrument, before the payor or other third party received written notice of a claimed lack of entitlement under this chapter. A payor or other third party shall be liable for a payment made or other action taken after the payor or other third party received written notice of a claimed lack of entitlement under this chapter.

(b) Written notice of a claimed lack of entitlement under paragraph (a) of this subsection shall be mailed to the payor's or other third party's main office or home by registered or certified mail, return receipt requested, or served upon the payor or other third party in the same manner as a summons in a civil action. Upon receipt of written notice of a claimed lack of entitlement under this chapter, a payor or other third party shall pay any amount owed, or transfer or deposit any item of property held by it, to or with the court having jurisdiction of the probate proceedings related to the decedent's estate, or if no proceedings have been commenced, to or with the court having jurisdiction of probate proceedings relating to the decedent's estate located in the county of the decedent's residence. The court shall hold the funds or item of property and, upon its determination under this chapter, shall order disbursement in accordance with the determination. Payments, transfers, or deposits made to or with the court shall discharge the payor or other third party from all claims for the value of amounts paid to or items of property transferred to or deposited with the court.

(2) A person who purchases property for value and without notice, or who receives a payment or other item of property in partial or full satisfaction of a legally enforceable obligation, shall not be obligated under this chapter to return the payment, item of property, or benefit and shall not be liable under this chapter for the amount of the payment or the value of the item of property or benefit. But a person who, not for value, receives a payment, item of property, or any other benefit to which the person is not entitled under this chapter shall be obligated to return the payment, item of property, or benefit or shall be personally liable for the amount of the payment of the value of the item of property or benefit, to the person who is entitled to it under this chapter.

(3) If this chapter, or any part of this chapter, is preempted by federal law with respect to a payment, an item of property, or any other benefit covered by this chapter, a person who, not for value, receives the payment, item of property, or any other benefit to which the person is not entitled under this chapter shall be obligated to return the payment, item of property, or benefit or shall be personally liable for the amount of the payment or the value of the item of property or benefit, to the person who would have been entitled to it were this chapter, or part of this chapter, not preempted.

SECTION 8. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

This chapter shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this chapter among states enacting it.

SECTION 9. A NEW SECTION OF KRS CHAPTER 397 IS CREATED TO READ AS FOLLOWS:

This chapter may be cited as the Uniform Simultaneous Death Act (1991).

SECTION 10. A NEW SECTION OF KRS CHAPTER 394 IS CREATED TO READ AS FOLLOWS:

(1) A will may validly transfer property to the trustee of a trust:

(a) Established during the testator's lifetime by the testator, by the testator and one (1) or more other persons, or by one (1) or more other persons, including a funded or unfunded life insurance trust, although one (1) or more persons other than the trustee have reserved any or all rights of ownership of the insurance contracts; or

(b) Established at the testator's death by the testator's transfer to the trustee, if the trust is identified in the testator's will and its terms are set forth in a written instrument, other than a will, executed before, concurrently with, or after the execution of the testator's will or in another individual's will if that

other individual has predeceased the testator, regardless of the existence, size, or character of the corpus of the trust.

(2) A transfer referred to in subsection (1) of this section shall not be invalid because the trust is amendable or revocable, or because the trust was amended after the execution of the will or the testator's death.

(3) Unless the testator's will provides otherwise, property transferred to a trust in accordance with subsection (1) of this section shall not be held under a testamentary trust of the testator but shall become a part of the trust to which it is transferred. The property shall be administered and disposed of in accordance with the provisions of the governing instrument setting forth the terms of the trust, including any amendments to it made before or after the testator's death.

(4) Unless the testator's will provides otherwise, a revocation or termination of the trust before the testator's death shall cause the devise or bequest to lapse.

(5) This section shall be effective for any devise or bequest made by wills of decedents dying on or after the effective date of this Act.

(6) This section shall be construed to effectuate its general purpose to make uniform the law of those states that enact it.

(7) This section may be cited as the Uniform Testamentary Additions to Trusts Act.

Section 11. KRS 391.360 is amended to read as follows:

(1) *A written provision for a nonprobate transfer on death*[~~Any of the following provisions~~] in an insurance policy, contract of employment, bond, mortgage, promissory note, *certified or uncertified security account agreement, custodial agreement,* deposit agreement, ***compensation plan,*** pension plan, ***individual retirement plan, employee benefit plan,*** trust[~~ agreement~~], conveyance*, deed of gift, marital property agreement,* or[~~ any~~] other written instrument *of a similar nature is*[~~effective as a contract, gift, conveyance, or trust is deemed to be~~] nontestamentary*. These written provisions shall include, but not be limited to,*

written provisions which provide that:~~[, and KRS 391.300 to 391.355 does not invalidate the instrument or any provision;]~~

(a) ~~[That]~~Money or other benefits~~[theretofore]~~ due to, controlled***,*** or owned by a decedent ***before death*** shall be paid after ***the decedent's***~~[his]~~ death to a person ***whom***~~[designated by]~~ the decedent ***designates***~~[in]~~ either ***in*** the instrument or ***in*** a separate writing, including a will, executed ***before,*** at the same time***, or after***~~[as]~~ the instrument ***is executed***~~[or subsequently]~~;

(b) ~~[That any]~~Money due or to become due under the instrument shall cease to be payable in ***the*** event of the death of the promisee or the promissor before payment or demand; or

(c) ~~[That]~~Any property***, controlled by or owned by the decedent before death,*** which is the subject of the instrument shall pass to a person~~[designated by]~~ the decedent ***designates***~~[in]~~ either ***in*** the instrument or ***in*** a separate writing, including a will, executed ***before,*** at the same time***, or after***~~[as]~~ the instrument ***is executed***~~[or subsequently]~~.

(2) ~~[Nothing in]~~This section ***shall not limit***~~[limits]~~ the rights of creditors under other laws of this state.

Section 12. The following KRS sections are repealed:

394.075 Uniform Testamentary Additions to Trusts Act.

397.010 No sufficient evidence of survivorship.

397.020 Survival of beneficiaries.

397.030 Joint tenants or tenants by the entirety.

397.040 Insurance policies.

397.050 Chapter not retroactive.

397.060 Chapter does not apply if decedent provides otherwise.

397.070 Uniformity of interpretation.

397.080 Short title.

Section 13. An act done before this Act's effective date in any proceeding and any accrued right shall not be impaired by Sections 1 to 7 of this Act. If a right is acquired, extinguished, or barred upon the expiration of a prescribed period of time that has commenced to run by the provisions of any statute before this Act's effective date, the provisions shall remain in force with respect to that right, notwithstanding Sections 1 to 7 of this Act.

Any rule of construction or presumption provided in Sections 1 to 7 of this Act shall not apply to instruments executed and multiple-party accounts opened before this Act's effective date.

The provisions of Sections 1 to 7 of this Act shall not apply to persons who die prior to the effective date of this Act.

AN ACT relating to property.

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

Section 1. KRS 381.120 is amended to read as follows:

Joint tenants may be compelled to make partition, and when a joint tenant dies, *the joint tenant's*[~~his~~] part of the joint estate, real or personal, shall descend to *the joint tenant's*[~~his~~] heirs, or pass by devise, or go to *the joint tenant's*[~~his~~] personal representative, subject to debts, curtesy, dower*,* or distribution.

Section 2. KRS 381.130 is amended to read as follows:

(1) KRS 381.120 shall not apply to any estate which joint tenants hold as executors or trustees, nor*, except as provided in subsection (2) of this section,* to an estate conveyed or devised to persons in their own right, when it manifestly appears, from the tenor of the instrument, that it was intended that the part of the one dying should belong to the others, neither shall it affect the mode of proceeding on any joint contract or judgment.

(2) (a) 1. Except as provided in paragraph (b) of this subsection, one (1) or more joint tenants of real property may partition their interest in the real property during their lifetime by deed or other instrument.

2. The deed or other instrument shall express the intent of the joint tenant to partition the joint tenant's interest in the real property and shall be recorded at the office of the county clerk in the county where the real property or any portion of the real property is located.

3. The partitioning shall be effective at the time the deed or other instrument is recorded.

(b) Residential real property that is owned exclusively by husband and wife as joint tenants with a right of survivorship and actually occupied by them as a principal residence shall not be partitioned as provided in paragraph (a) of this subsection.

(c) The deed or other instrument shall convert the partitioning joint tenant's interest in the real property into a tenancy in common with the remaining joint tenants. If there are two (2) or more nonpartitioning joint tenants, the interests of the nonpartitioning joint tenants in relation to each other shall be governed pursuant to the terms of the instrument creating the interest.

Section 3. KRS 394.610 is amended to read as follows:

(1) As used in this section, the "legal representative of a living person" includes the person's conservator, limited conservator, guardian, limited guardian, and attorney-in-fact.

(2) A *living* person, or the *legal* representative of *a living*[~~an incapacitated or protected~~] person, who is an heir, next of kin, devisee, legatee, *joint tenant,* person succeeding to a disclaimed interest, beneficiary under a testamentary instrument, or appointee under a power of appointment exercised by a testamentary instrument, may disclaim in whole or in part the right of succession to any property or interest therein, including a future interest, by filing a written disclaimer under KRS 394.610 to 394.670. The right to disclaim shall survive the death of the person having it and may be exercised by the personal representative of such person's estate *without authorization of the court having jurisdiction over the estate of the person*. The instrument shall*:*

(a)[~~(1)~~] Describe the property or interest disclaimed*;*[~~,~~]

(b)[~~(2)~~] Declare the disclaimer and extent thereof*;*[~~,~~] and

(c)[~~(3)~~] Be signed by the disclaimant.

(3) No disclaimer by a living person's legal representative, except for the person's attorney-in-fact, shall be made unless the court having jurisdiction of the estate of the disabled, incapacitated, or protected person has authorized the disclaimer. No disclaimer by the person's attorney-in-fact shall be made unless the instrument governing the attorney-in-fact's authority expressly authorizes a disclaimer.

HOUSE BILL 313
Kentucky General Assembly
1998 Regular Session

AN ACT relating to wills.

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

Section 1. KRS 394.090 is amended to read as follows:

A[~~Every~~] will shall ***not*** be revoked by the marriage of the person who made the will[~~, except:~~

~~(1) A will made in exercise of a power of appointment when the estate thereby appointed would not, in default of such appointment, pass to the heir, personal representative, or next of kin of the person who made the will;~~

~~(2) A will that expressly provides that it is intended that a subsequent marriage shall not revoke the will;~~

~~(3) A will that expressly provides for the person who later becomes the spouse of the deceased and is married to the testator on the date of death~~].

Section 2. KRS 394.080 is amended to read as follows:

No will or codicil, or any part thereof, shall be revoked, except:

(1)[~~ As provided in KRS 394.090;~~

~~(2)~~] By subsequent will or codicil;

(2)[~~(3)~~] By some writing declaring an intention to revoke the will or codicil, and executed in the manner in which a will is required to be executed; or

(3)[~~(4)~~] By the person who made the will, or some person in his presence and by his direction, cutting, tearing, burning, obliterating, canceling, or destroying the will or codicil, or the signature thereto, with the intent to revoke.

HOUSE BILL 516 (Excerpt)
Kentucky General Assembly
1998 Regular Session
- amending KRS 287.235 - Common Trust Fund Not Separate Entity For Tax Purposes -

Section 31. KRS 287.235 is amended to read as follows:

(1) Common trust funds shall not be considered as an entity for income or other tax purposes, nor shall investment in such fund make taxable any property which is otherwise exempt therefrom; and for purposes of taxation, the status of the common trust fund and of each participant therein shall be determined as though there were no common fund and as though each participant was the owner of its proportionate share of every asset held in the common fund. The bank or trust company maintaining said fund shall file a report of said fund with the property valuation administrator as of the ad valorem tax date and shall file annually such income tax information as may be required by the Revenue Cabinet.

(2) Notwithstanding subsection (1) of this section, if a common trust fund transfers substantially all of its assets to one (1) or more regulated investment companies in exchange solely for stock in the company or companies to which such assets are transferred and such stock is distributed by such common trust fund to the participants in such common trust fund in a transaction which would qualify under Section 584(h) of the Internal Revenue Code of 1986, as amended, for the nonrecognition of gain or loss of such transfer or distribution by the common trust fund, then no gain or loss shall be recognized for Kentucky income tax purposes by the common trust fund by reason of such transfer or distribution or by the participants in such common trust fund by reason of such exchange.

Section 32. The following KRS sections are repealed:

287.061 Application for approval -- Hearing.

287.205 When national bank may act as fiduciary.

HOUSE BILL 708
Kentucky General Assembly
1998 Regular Session

AN ACT relating to the use of information technology.

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

SECTION 1. KRS CHAPTER 369 IS HEREBY ESTABLISHED AND A NEW SECTION CREATED TO READ AS FOLLOWS:

Sections 1 to 3 of this Act shall be construed consistent with what is commercially reasonable under the circumstances and to effectuate the following purposes:

(1) To facilitate and promote on-line state government services;

(2) To facilitate the flow of authorized electronic records within state government, between the public and private sectors, and between private sector entities; and

(3) To promote public confidence in the integrity and reliability of electronic records.

SECTION 2. A NEW SECTION OF KRS CHAPTER 369 IS CREATED TO READ AS FOLLOWS:

For purposes of Sections 1 to 3 of this Act, unless the context expressly requires otherwise:

(1) "Electronic" means relating to or by means of electrical, digital, magnetic, optical, electromagnetic, or any other form of technology that entails capabilities similar to these technologies;

(2) "Electronic record" means any digital representation of data or information generated, communicated, received, or stored by electronic means for use in an information system or for transmission from one information system to another;

(3) "Electronic signature" means an electronic identifier whose use is intended by the person using it to have the same force and effect as the use of a manual signature and containing the following characteristics:

(a) It is unique to the person using it;

(b) It is capable of verification; and

(c) It is under the sole control of the person using it; and

(4) "Record" means information that is inscribed, stored, or otherwise fixed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

SECTION 3. A NEW SECTION OF KRS CHAPTER 369 IS CREATED TO READ AS FOLLOWS:

(1) Sections 1 to 3 of this Act do not apply to:

(a) Any situation in which their application would be inconsistent with the express intent of the parties to a written document;

(b) Any legal requirement governing the creation or execution of any document that serves to convey rights and obligations under a will or trust;

(c) Any legal requirement governing the conveyance of any interest in real property;

(d) Any legal requirement governing the creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title.

(2) Nothing in Sections 1 to 3 of this Act shall be construed to:

(a) Require a recipient or any other person asked to rely on an electronic record or an electronic signature to accept the electronic record or electronic signature or to respond to or act upon an electronic record or electronic signature, unless the parties have freely and voluntarily agreed to the use of an electronic record or electronic signature prior to transmission;

(b) Preclude the recipient of an electronic record or an electronic signature from establishing the conditions under which the recipient will accept the electronic record or electronic signature, unless the parties have freely and voluntarily agreed to the conditions under which the recipient would accept the electronic record or electronic signature prior to transmission; or

(c) Require a state or local governmental entity or agency to accept an electronic record or electronic signature, unless the entity or agency has

agreed to accept the electronic record or electronic signature in advance of transmission and the manner and medium of transmission is acceptable to the entity or agency.

(3) If all parties to a private sector transaction agree to the use of an electronic record or an electronic signature, or, in dealings with a state or local governmental entity or agency, if that entity or agency agrees to accept an electronic record or an electronic signature:

(a) Information, records, and electronic signatures shall not be denied legal effect, validity, or enforceability solely on the grounds that they are in electronic, duplicate, or imaged form.

(b) Where a statute or administrative regulation requires a manual signature, or provides for certain consequences if a document is not manually signed, an electronic signature shall have the same force and effect as the use of a manual signature.

(c) Where a statute or administrative regulation requires information to be "written," or "in writing," or provides for certain consequences if it is not, that statute or administrative regulation shall be satisfied by an electronic record.

(d) Where a statute or administrative regulation requires information to be presented or retained in its original form, or provides consequences for the information not being presented or retained in its original form, that statute or administrative regulation shall be satisfied by an electronic record if there exists reliable assurance as to the integrity of the data or the information from the time when it was first generated to its final form, as an electronic record or otherwise.

Section 4. KRS 61.950 is amended to read as follows:

(1) The commission shall meet at least four (4) times each year and report its findings no less than semiannually to the Legislative Research Commission and the Governor. All reports of the commission shall be made available to the general public. In addition, the commission, upon the call of its officers, may hold meetings at any time it deems necessary.

(2) The commission's roles and duties shall include the following:

(a) Providing overall leadership, policy direction, strategic planning, and coordination of information resources management for the executive branch of state government and public universities;

(b) Formulation of a five (5) year statewide information resources management plan, to be updated every two (2) years, from long-range information resources management plans submitted by agencies of the executive branch, including the public universities, as the commission may require;

(c) Defining, maintaining, and publishing a timely information resources management architecture relating to the management of information resources by executive branch state agencies, and implementing processes and procedures to ensure compliance with the information resources management architecture;

(d) Coordinating, through policy and interagency agreements and monitoring, an appropriate program of training and education for executive branch state and local agencies regarding strategic information systems planning, and the selection and use of information technologies to facilitate effective information resources management, appropriate employee skill building, and career development;

(e) Promoting executive level awareness, support, and involvement with information resources management throughout the executive branch of government;

(f) Reviewing and approving or disapproving, in whole or part, executive branch agency five (5) year strategic information resources plans, and forwarding those plans with findings and recommendations to the agency head, the Governor's Office for Policy and Management, and the Legislative Research Commission for use during the preparation and enactment of the biennial budget. Commission review shall be based upon the extent to which the plan is compliant with statewide information resources standards, policies and guidelines; is suited to supporting the mission of the agency; and furthers implementation of statewide initiatives identified in the statewide plan. As part of the review process, the commission shall monitor and evaluate the progress of the current plan and the executive branch agency's use of information technologies and shall include its assessment of these activities in the findings and recommendations;

(g) Identifying and assessing opportunities for multiagency development and use of information resources, or the development of executive branch agency projects which would improve the quality and availability of information. When identifying these opportunities the commission may require executive branch agencies to evaluate the opportunities as alternatives to their own plans, and may forward these findings as provided in paragraph (f) of this subsection;

(h) Maintaining supportive relationship and coordinating activities with the adjunct Communications Advisory Council provided for in KRS 61.955 and 61.957, and the Geographic Information Advisory Council established by Executive Order 92-1049, October 1, 1992, as necessary to ensure coordination and implementation of unified, comprehensive, statewide strategies involved with, or affected by, information technology;

(i) Establishing and maintaining relationships with other planning organizations as necessary to ensure coordination and implementation of comprehensive statewide strategies involved with, or affected by, information technology;

(j) Reviewing and recommending to the Department of Personnel and other associated agencies appropriate job classifications related to information resources management, to include both technical and managerial positions;

(k) Establishing and maintaining an information dissemination service or clearinghouse for:

1. Current practices of state agencies regarding information resources management;
2. Emerging and advancing information resources technologies;
3. Information resources vendor performance in the public sector;
4. Technical resources in the Commonwealth; and
5. Elements of the information resources management architecture;

(l) Establishing and maintaining research and development capacity for beneficial applications of information resources technology for the state's public sector, which includes:

1. Conducting research on current and emerging information resources technologies and their potential to enhance governmental services; and
2. Sponsoring and evaluating pilot projects to assist with the successful adoption by other state agencies;

(m) Fostering and encouraging the interest and cooperation of the state information resources technology community for improvement and enhancement of public services delivery;

(n) Serving as catalyst for information technology advancements in the public sector;

(o) Recommending procedures and legislation to improve the accessibility of machine readable public records by state agencies, citizens, and businesses; and

(p) Recommending procedures and legislation to ensure the privacy of individuals, with particular emphasis on the potential for invasion of individual privacy.

(3) Nothing in KRS 61.940, 61.945, or this section shall be construed to alter or diminish the provisions of KRS 171.410 to 171.740 or the authority conveyed by these statutes to the Archives and Records Commission and the Department for Libraries and Archives.

(4) The commission may promulgate necessary administrative regulations for the furtherance of this section*, including administrative regulations establishing electronic signature standards for the executive branch of state government*.

(5) The commission may establish committees or work groups composed of commission and noncommission members as necessary to advise the commission in carrying out its responsibilities, duties, and powers. Persons connected with the automated information and communications resources industries, as specified in KRS 61.945, may participate on committees or work groups, but shall not have a vote.

(6) The commission may adopt bylaws and operating policies necessary for its efficient and effective operation.

THE ESTATE TAX DEDUCTION FOR QUALIFIED FAMILY-OWNED BUSINESS INTERESTS

Section 2057

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SECTION B

Explanation Of This Course Outline

This course outline contains excerpts from the pre-publication manuscript of a book being published by the RIA Group of Warren, Gorham & Lamont later this year (1998). The title of the book will be "Estate Taxation Of Farms and Other Qualified Family-Owned Businesses Under Sections 2032A and 2057." The authors are Robert M. Bellatti and his associate, Shari L. West.

All references in the course outline are to this book unless otherwise specifically stated.

THE ESTATE TAX DEDUCTION FOR QUALIFIED FAMILY-OWNED BUSINESS INTERESTS: SECTION 2057

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THE ESTATE TAX DEDUCTION FOR QUALIFIED FAMILY-OWNED BUSINESS INTERESTS: SECTION 2057

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A. What is §2057?

1. It Replaces §2033A Retroactively to January 1, 1998

The Taxpayer Relief Act of 1997 ("1997 Act") added §2033A to the Internal Revenue Code, effective for estates of decedents dying after December 31, 1997. The Internal Revenue Service Restructuring and Reform Act of 1998 ("1998 Act") was agreed to by the Conference Committee on June 24, 1998 and passed by the House of Representatives on June 25, 1998. It is expected that the Senate will pass the conference bill in the week of July 6 and that the President will sign it a few days thereafter. The 1998 Act (H.R. 2676) contains technical corrections to the 1997 Act, and one of those "technical corrections" repeals §2033A retroactively so that it will not have ever been in effect, and replaces it with new §2057 of the Internal Revenue Code, effective for estates of decedents dying after December 31, 1997.

2. §2057 is Very Similar to §2033A

§2033A provided for an estate tax value exclusion for certain Qualified Family-Owned Business Interests ("QFOBI's"). §2057 instead provides an estate tax deduction for those QFOBI's (see §2057(a)(1)). There are some very important ramifications from changing the §2033A value exclusion to a §2057 deduction, but the two sections are otherwise almost identical, except for several other "technical corrections" made to §2033A when it was converted to §2057 by the 1998 Act.

3. Maximum §2057 Deduction Fixed At $675,000

One of the controversial and complicated aspects of the §2033A value exclusion was the variable dollar amount limitation on the maximum exclusion, depending upon the year of the decedent's death. That limitation was designed so that the combined maximum amount of the §2010 applicable exclusion amount and the §2033A exclusion would always be $1,300,000, but the §2033A maximum value exclusion amount declined from $675,000 in 1998 to $300,000 in 2006 and thereafter, as the §2010 applicable exclusion amount increased from $625,000 in 1998 to $1,000,000 in 2006 and thereafter. This became politically unacceptable when it was realized after §2033A was enacted that the estate taxes on QFOBI's would actually increase after 1998 as part of the §2033A value exclusion (saving estate taxes at the estate's top tax rate brackets) was gradually converted into the applicable credit (saving estate taxes at the estate's bottom tax rate brackets).

§2057 adopted a very simple solution to this "political problem" by fixing the maximum amount of the §2057 deduction permanently at $675,000 (see §2057(a)(2)), and also fixing the applicable exclusion amount for estates electing §2057 at $625,000 (see §2057(a)(3)(A)).

The above discussion assumes that an estate electing §2057 includes QFOBI's in its gross estate having a Chapter 11 value of $675,000 or higher. If the Chapter 11 value of the QFOBI's is less than $675,000, then the §2057 deduction is limited to the value of the QFOBI's (less than $675,000) and the estate's applicable exclusion amount is increased by the amount that the value of the QFOBI's is less than $675,000, but the applicable exclusion amount cannot exceed what it would be if the estate had not elected §2057 (see §2057(a)(3)(B)).

For example, if the estate's QFOBI's have a Chapter 11 value of $500,000 and the decedent died in 2003 when the applicable exclusion amount is $700,000, then the applicable exclusion amount could only be increased from $625,000 to $700,000, even though $500,000 is $175,000 less than $675,000. However, if that same decedent had lived another year, then the applicable exclusion amount could be increased from $625,000 by the $175,000 ($675,000 - $500,000) amount to $800,000, because in 2004 the applicable exclusion amount for an estate not electing §2057 will be $850,000.

All of the above discussion assumes that none of the decedent's applicable exclusion is used on lifetime gifts.

4. <u>Estate Tax Savings From §2057 Election</u>

Since the §2057 value deduction maximum amount is now fixed at $675,000, this means that at a 55% top estate tax rate an estate will always be able to reduce estate taxes by $371,250 (55% of $675,000) as a result of the §2057 election, and the maximum offset reduction in estate tax savings from the reduced applicable credit will be zero for estates of decedents dying in 1998 and increase to $143,750 for decedents dying in 2006 and thereafter, meaning that the net maximum §2057 estate tax savings at a 55% estate tax bracket will decline from $371,250 in 1998 to $227,500 in 2006 and thereafter, as shown in the following table:

Year of Death	Applicable Exclusion Without §2057	Applicable Credit Without §2057	Credit Lost by §2057 (excess over $202,050)	Taxes Saved by §2057 Deduction (55%)	Net Taxes Saved by §2057
1998	$ 625,000	$ 202,050	$ 0	$371,250	$371,250
1999	650,000	211,300	9,250	371,250	362,000
2000	675,000	220,550	18,500	371,250	352,750
2001	675,000	220,550	18,500	371,250	352,750
2002	700,000	229,800	27,750	371,250	343,500
2003	700,000	229,800	27,750	371,250	343,500
2004	850,000	287,300	85,250	371,250	286,000
2005	950,000	326,300	124,250	371,250	247,000
2006 and after	$1,000,000	345,800	143,750	371,250	227,500

5. Implications For Lifetime Use of Applicable Exclusion for Gifts

If a decedent has made lifetime taxable gifts of $1,000,000 using all $1,000,000 of applicable exclusion and $345,800 of applicable credit in 2006, and then the decedent dies in 2007 and the estate receives a maximum $675,000 §2057 deduction, the estate will have to pay estate tax on $375,000 of the lifetime taxable gifts because the estate's applicable exclusion amount is reduced to $625,000 by the §2057 election, but no delinquent gift taxes will be owed because of the decedent-donor's use of that $375,000 of applicable exclusion for gift tax purposes.

B. ELIGIBILITY REQUIREMENTS FOR §2057

1. Residency

§2057(b)(1)(A) requires that the decedent must have been a citizen or resident of the United States on the decedent's date of death.

2. Period of Ownership

§2057(b)(1)(D)(i) requires that "during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which such interests were owned by the decedent or a member of the decedent's family". The reference to "such interests" in §2057(b)(1)(D)(i) must refer to "the qualified family-owned business interests described in paragraph (2)" which appears in §2057(b)(1)(C)(i), because that is the only prior place that the word "interests" is described in §2057(b)(1). §2057(b)(2) provides that "the qualified family-owned business interests described in this paragraph are the interests which -

(A) are included in determining the value of the gross estate (without regard to this section), and

(B) are acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of section 2032A(e)(9))".

a. §1031 and §1033 Transactions

§2057(i)(3)(J) provides that rules similar to §2032A(e)(14) relating to treatment of replacement property acquired in §1031 or §1033 transactions shall apply for all purposes of §2057.

§2032A(e)(14) provides that as to any "qualified replacement property" owned by the decedent at the date of death, any period during which there was ownership, qualified use, or material participation with respect to the "replaced property" by the decedent or any member of the decedent's family shall be treated as a period during which there was such ownership, use or material participation (as the case may be) with respect to the qualified replacement property. §2032A(e)(14)(C)(i) defines "qualified replacement property" as any real property which is acquired in an exchange which qualifies under §1031 or the acquisition of which results in the non-recognition of gain under §1033, provided that such acquired property is used for the same qualified use as the replaced property was being used for before the acquisition. §2032A(e)(14)(C)(ii) defines "replaced property" as being either the property transferred in the exchange which qualifies under §1031 or the property compulsorily or involuntarily converted (within the meaning of §1033). §2032A(e)(14)(B) provides that the "tacking" permitted by §2032A(e)(14) shall not apply to the extent that the fair market value of the qualified replacement property (as of the date of its acquisition) exceeds the fair market value of the replaced property (as of the date of its disposition).

In summary, the 5 out of 8 year prior to death ownership requirement will not disqualify assets acquired in §1031 or §1033 transactions in the 8 year period prior to death, if the "tacking" permitted by §2057(i)(3)(J) results in satisfaction of the 5 out of 8 year prior to death ownership requirement.

b. Corporate, Partnership and Trust Transactions

It should be noted that neither the §2057 statute or the Conference Agreement for the 1997 Act make any specific provisions for corporation or partnership transactions that might occur during the 8 year period prior to death. §2057(i)(3)(L) does provide that for all purposes of §2057 rules similar to §2032A(g) (relating to application to interests in partnerships, corporations and trusts) shall apply. §2057 regulations should permit tacking of periods of ownership and material participation when such transactions have occurred in a manner similar to Treas. Reg. §20.2032A-3(f)(1)(d), but should not limit such tacking to only tax-free transactions. There have been some favorable rulings in connection with such transactions during the recapture period under §203<u>2</u>A (see ¶6.03(5) and (9)(a)), and the §2057 regulations should include provisions similar to those rulings.

c. <u>Purchases From Non-Family Members</u>

The 5 out of 8 year prior to death required ownership by the decedent or the decedent's family will preclude business assets purchased from non-family members within 5 years prior to the decedent's death from being QFOBI's which qualify for the §2057 deduction and will also preclude such purchases from being used to help the decedent's estate meet the 50% requirement to qualify other assets for the §2057 deduction (see ¶10.02(5)).

3. <u>Interest in Business Must Pass To or Be Acquired By Qualified Heir From Decedent</u>

Before going through the sometimes complicated analysis of whether the QFOBI characterizations rules are satisfied and the sometimes even more complicated analysis of whether the estate's 50% requirement is satisfied, it should first be determined whether the requirement of §2057(b)(2)(B), which requires that those interests "are acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of section 203<u>2</u>A(e)(9)", is met.

a. <u>"Passing To or Acquired By"</u>

§203<u>2</u>A(e)(9) provides that "property shall be considered to have been acquired from or to have passed from the decedent if -

> (A) such property is so considered under section 1014(b) (relating to basis of property acquired from a decedent),
>
> (B) such property is acquired by any person from the estate, or
>
> (C) such property is acquired by any person from a trust (to the extent such property is includable in the gross estate of the decedent)."

The most important thing to understand about §203<u>2</u>A(e)(9) is that it not only permits the "passing to" requirement to be satisfied by a gift to a qualified heir by the decedent's will or living trust, but it also permits the "passing to" requirement to be satisfied by a post mortem transaction whereby the qualified heir purchases the decedent's business interest from the decedent's estate or living trust, even though the will or trust disposes of the business interest in a manner that does not satisfy the "passing to qualified heir" requirement. In the interpretations of §2032A(e)(9) under §2032A, it has been held that a post mortem transaction must be executed by the time the estate tax return is filed in order to take advantage of this method of satisfying the "passing to" requirement.

b. 10 Year Employee Is A Qualified Heir

§2057(i)(1) provides that for all purposes of §2057, the term "qualified heir" has the meaning given to such term by §2032A(e)(1) and it also includes "any active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business for a period of at least 10 years before the date of the decedent's death".

This latter portion of the qualified heir definition under §2057, which does not apply for purposes of §2032A, means that under a normal buy-sell arrangement between the decedent and a non-family member key (10 year) employee funded by life insurance on the decedent owned by the key (10 year) employee, if all the other §2057 requirements are satisfied the decedent's estate can sell the decedent's interest in the business to the key employee at its estate tax value, the decedent's heirs can get the benefit of the estate tax savings from §2057 even though they received "full value" from the estate's sale to the key employee, and the estate will have no capital gain on the sale because under §1014 the estate's basis in the business interests is not reduced by the §2057 election (see ¶10.04(1) and ¶15.01). Note that the same result can be reached even if there was no buy-sell agreement in place at the decedent's death, as long as the sale to a 10 year employee is completed prior to the time the estate tax return is filed. Note also that the 10 year employee must sign the §2057 agreement to be filed with the estate tax return and agree to be personally liable for the §2057 recapture tax (see ¶10.06(2) and ¶16.02). Understandably, the employee may negotiate some concessions as to the sale price and/or terms before signing that §2057 agreement. Even so, the net benefit of this transaction and the §2057 estate tax savings to the decedent's heirs could still be very significant.

c. "Family Member" Definition

§2032A(e)(1), which is incorporated by reference into the §2057(i)(1) definition of "qualified heir" for all purposes of §2057, states that "the term 'qualified heir" means, with respect to any property, a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent. If a qualified heir disposes of any interest in qualified real property to any member of his family, such member shall thereafter be treated as the qualified heir with respect to such interest." Presumably, the last sentence of §2032A(e)(1) will be interpreted in the §2057 context to refer to "the QFOBI for which §2057 was elected" rather than "qualified real property".

To determine who are the "members of the decedent's family" referred to in §2032A(e)(1) for purposes of identifying who are "qualified heirs" for purposes of §2057, and to determine what "member of the family" means for all other purposes under §2057 as directed by §2057(i)(2), the definition of "member of the family" in §2032A(e)(2) is to be used. §2032A(e)(2) states that "the term 'member of the family' means with respect to any individual, only -

> (A) an ancestor of such individual,
>
> (B) the spouse of such individual,
>
> (C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or
>
> (D) the spouse of any lineal descendant described in subparagraph (C).

For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood." Presumably, all of the cases and rulings as to this definition under §2032A will be applicable for purposes of §2057 (see ¶1.02(7)).

The application of §2032A(e)(2) in defining who the decedent's qualified heirs are for purposes of §2057, in addition to the 10 year employees, results in the following persons also being eligible to be considered qualified heirs of the decedent for all purposes of §2057:

> (A) the decedent's ancestors,
>
> (B) the decedent's spouse,
>
> (C) all of the decedent's lineal descendants, all of the lineal descendants of the decedent's spouse, and all of the lineal descendants of the decedent's parents, and
>
> (D) the spouses of all of the lineal descendants referred to in (C).

For purposes of determining all of the above relationships, relationship created by legal adoption are to be treated the same as blood relationships.

d. Qualified Heirs Who Are Not U.S. Citizens

§2057(g)(1) provides that if a qualified heir is not a citizen of the United States, any interest under §2057 passing to or acquired by such heir will be treated as a QFOBI only if the interest passes or is acquired (or is held) in a "qualified trust". §2057(g)(2) defines a "qualified trust" as a trust which is organized under and governed by, the laws of the United States or a State, and, except as otherwise provided in regulations, with respect to which the trust instrument requires that at least 1 trustee of the trust be an individual citizen of the United States or a domestic corporation.

The only exception to the qualified trust ownership rule for a qualified heir who is not a citizen of the U.S. is stated in §2057(g)(1), where it refers to §2057(i)(3)(F) as being an exception, if applicable. §2057(i)(3)(F) refers to §2032A(c)(5).

§2032A(c)(5) provides that "the qualified heir shall be personally liable for the additional tax imposed by §2032A(c) with respect to his interest unless the heir has furnished bond which meets the requirements of §2032A(e)(11)". §2032A(e)(11) provides that the qualified heir has to make written application to the Secretary of the Treasury for determination of the maximum amount of the additional tax which may be imposed by §2032A(c) with respect to the qualified heir's interest. The Secretary of the Treasury is required to respond to the application within 1 year, notifying the qualified heir of such maximum amount. The qualified heir then can get discharged from personal liability for any additional tax imposed by §2032A(c) by furnishing the Secretary of the Treasury with a bond in such amount and for such period as is required by the Secretary.

The statement about this issue in the Conference Agreement for the 1997 Act is that the only alternative to using a qualified trust for a non-citizen qualified heir is to provide "other security arrangements that meet the satisfaction of the Treasury Secretary".

e. The §2057(e)(3)(C) Rule for Attributing Ownership of Interests Owned by Trusts to Trust Beneficiaries

The second sentence of §2057(e)(3)(C) states that a person shall be treated as a beneficiary of a trust only if the person has a present interest in the trust. It is not clear what this sentence means or why it is located in §2057(e)(3)(C), and the Conference Agreement for the 1997 Act provides no explanation of what is intended by this sentence. The first sentence of §2057(e)(3)(C) provides that an interest owned by an entity is deemed to be owned proportionately by the owners of that entity. Thus, the second sentence would appear to be intended merely to provide that a business interest owned by a trust will be deemed to be owned proportionately by the persons who have "present interests" in the trust.

In all likelihood, what is meant by "present interest" is actually a "current interest", as opposed to a future interest, not "present interest" as that term is used in §2503(c). Perhaps it will be interpreted similarly to §2652(c)(1), under which a person is deemed to have an interest in property held in trust only if he or she has a current right to either income or principal distributions or is a permissible current recipient of income or principal distributions.

It is also likely that this sentence in §2057(e)(3)(C) is intended to facilitate qualification for §2057 and avoidance of the §2057 recapture tax and to simplify the administration and application of §2057 to QFOBI's held in trust for the government and taxpayers by clarifying that at any given time only the present interest beneficiaries, and not the future or remainder interest beneficiaries, need to be considered. This will need to be clarified by regulation, since many interests in many family-owned businesses are owned by trusts.

For a more complete analysis of the "passing to" requirement, including the "successive interest" rule, special considerations with respect to interests in the business passing from the decedent to a trust and the potentially adverse consequences of a redemption of the decedent's shares of stock upon the decedent's death, see ¶5.04 and Chapter 16.

4. <u>Decedent's Interest in Business Must Be a Qualified Family-Owned Business Interest ("QFOBI")</u>

Only a QFOBI as defined in §2057(e) is eligible for the §2057 deduction. There are several specific exclusions from QFOBI characterization under §2057(e)(2), a general "trade or business" requirement for QFOBI characterization under §2057(e)(1), rules regarding minimum percentages of ownership of business entities owned by more than one family for characterization as a QFOBI under §2057(e)(1) and rules for determining how entities are owned under §2057(e)(3) for purposes of applying the other requirements for characterizations as a QFOBI.

The process for applying those rules to a particular set of facts to determine whether a particular interest is a QFOBI can be briefly summarized as follows:

a. Be sure that the interest is not specifically excluded from QFOBI characterization by §2057(e)(2) (that it is <u>not</u> an interest in a "foreign business", that it is <u>not</u> a "marketable security", and that it is <u>not</u> an interest in an entity which receives more than 35% of its adjusted gross income in the form of income of the kind described as personal holding company income - unless it is a bank or a building and loan association).

b. Be sure that it is an interest in a "trade or business".

c. Determine whether a portion of the interest in the trade or business is excluded from QFOBI treatment because it is attributable to assets owned by the trade or business which produce personal holding company income or which are cash or marketable securities in excess of the reasonable day to day working capital needs of the trade or business.

d. Determine whether decedent and members of decedent's family (§2032A(e)(2) definition) own a sufficient percentage of the trade or business:

(1) Decedent must own 100% if it is a sole proprietorship;

(2) Decedent and his family must own 50% of any entity which carries on the trade or business, unless 2 families own 70% of the entity or 3 families own 90% of the entity, in either of which cases the decedent and his family then only have to own 30% of the entity.

e. If the trade or business is carried on by an entity which has more than one type of equity ownership or which is part of a tiered entity ownership structure, then the complicated rules regarding ownership in §2057(e)(3) must be applied to determine whether the QFOBI percentage ownership and type of income characterization requirements have been satisfied.

In many cases the only real issue under the QFOBI characterization rules will be whether the interest is in a "trade or business". The 1998 Act amended §2057 in two places to try to clarify that the decedent does not have to personally use the QFOBI in a trade or business, as long as a family member uses that QFOBI in a trade or business. At the end of §2057(e)(1) the following sentence was added:

> "For purposes of the preceding sentence, a decedent shall be treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business."

And at the end of §2057(e)(2) the following new sentence was added:

> "In the case of a lease of property on a net cash basis by the decedent to a member of the decedent's family, income from such lease

shall not be treated as personal holding company income for purposes of subparagraph (C), and such property shall not be treated as an asset described in subparagraph (D)(ii), if such income and property would not be so treated if the lessor had engaged directly in the activities engaged in by the lessee with respect to such property".

See Appendix A for an example of a worksheet which might be used to determine whether the decedent's interest in a business is a QFOBI for purposes of §2057.

5. <u>The 50% Requirement For The Decedent's Estate</u>

By far the most complicated and difficult §2057 requirement is the 50% requirement for the decedent's estate. It is extremely complicated to just explain how to compute the percentage, and it will be very difficult in many cases to obtain all of the gift information necessary to compute the percentage with complete accuracy including all of the data the statute purports to require. It is anticipated that taxpayers and the IRS will have to settle for less than complete accuracy in many situations.

It will be mandatory for the IRS to provide a complete worksheet for computing the percentage with detailed explanations of the information required in each line of the worksheet. Ideally, this will be on the part of the Form 706 which must be completed for each §2057 election, just as Schedule A-1 is now required for each §203<u>2</u>A election. Perhaps the §2057 election can be on a new Schedule N as part of Form 706.

It is hard to even describe or refer to this test in a brief manner. It is <u>not</u> correct to refer to it as being a requirement that the value of the QFOBI assets be 50% of the value of the estate, since both the numerator and the denominator of the fraction must be adjusted for lifetime gifts, as well as for decedent's debts and other factors. Indeed, one of the real traps for the unwary will be failure to thoroughly research all of the lifetime gifts of QFOBI to family members made by a decedent in a case where the value of the QFOBI owned by the decedent at death is less than 50% of the decedent's adjusted gross estate computed without taking into account lifetime gifts.

The research as to lifetime gifts by the decedent is made particularly difficult because of the fact that it cannot be limited to just reviewing all of the decedent's gift tax returns.

a. <u>The Fraction Specified in the Statute</u>

§2057(b)(1)(C) states that the sum of (A) the "adjusted value of the QFOBI described in §2057(b)(2)", which is defined in

§2057(d), plus (B) the amount of the gifts of QFOBI determined under §2057(b)(3), must exceed 50 percent of (C) the adjusted gross estate, which is defined in §2057(c). It would seem that nothing could be easier than computing this 50% requirement, because the fraction which must be greater than 50% can be summarized as: $\frac{A + B}{C}$.

Unfortunately, this apparent simplicity is very misleading, because the process of computing each of the factors (A, B and C) in the fraction according to the specifications in the statute is very complicated, and sometimes the information required by the statute is not going to be available.

b. <u>The Numerator of the Fraction</u>

As explained above, the numerator of the fraction consists of two factors specified in the statute, referred to above as A and B. A is the "adjusted value of the QFOBI described in §2057(b)(2)", which is defined in §2057(d). B is the amount of the gifts of QFOBI determined under §2057(b)(3).

(1) <u>§2057(d): Factor A in the Numerator</u>

§2057(b)(1)(C)(i) provides that Factor A in the numerator of the 50% fraction is "the adjusted value" of the QFOBI's "described in paragraph (2)". §2057(b)(2) describes QFOBI's which are included in determining the value of the decedent's gross estate and meet the "passing to" requirement explained in ¶10.02(3). §2057(d) specifies how "the adjusted value" of a QFOBI is to be computed, and is summarized in Appendix B.

(2) <u>§2057(b)(3): Factor B in the Numerator</u>

§2057(b)(3) specifies how the amount of the gifts of QFOBI's to be included in the numerator of the 50% fraction under §2057(b)(1)(C)(ii) is to be computed, and is summarized in Appendix C.

It should be noted that there is no provision in the statute that states when the decedent's gifts of QFOBI interests are to be valued for purposes of the above computation. The Conference Agreement for the 1997 Act states that they are to be valued as of the date of the gift. In many cases it will be difficult to determine the date of gift values, especially for gifts which did not require the filing of a Form 709 because of the §2503(b) gift tax annual exclusion.

The parenthetical clause "(other than the decedent's spouse)" which appears under the continuously held language near the end of §2057(b)(3)is confusing. It would be possible to argue that by putting the parenthetical clause where it is in the statute, it was intended to mean that the spouse did not have to continuously hold the gifts of QFOBI received from the decedent in order to include those gifts in the numerator. However, the Conference Agreement for the 1997 Act states the numerator is not to include gifts of QFOBI made by the decedent to the decedent's spouse. The General Explanation of the 1997 Tax Laws by the Joint Committee on Taxation ("Blue Book") is identical to the Conference Agreement in this respect. Furthermore, gifts to a spouse will never be taken into account under §2001(b)(1)(B) or excluded by §2503(b) because of the unlimited marital deduction, so they are not included in the numerator of the fraction by §2057(b)(3) in any event.

c. <u>The Denominator of the Fraction: "The Adjusted Gross Estate"</u>

§2057(c) specifies how the "adjusted gross estate" for all purposes of §2057, which includes for being the denominator of the fraction to determine the 50% test, is to be computed, and is summarized in Appendix D.

d. <u>Planning To Meet the 50% of Adjusted Gross Estate Requirement</u>

(1) <u>Gifts To A Spouse</u>

Perhaps the biggest trap for the unwary in planning to meet the §2057 50% of adjusted gross estate requirement for a married couple is the treatment of gifts to a spouse in the statutory definitions of the numerator and denominator of the fraction which determines whether the 50% requirement is met. As described above, in computing Factor B in the numerator of the fraction (the amount of lifetime gifts of QFOBI's to family members), gifts of QFOBI's to a spouse are not included. On the other hand, in computing the denominator of the fraction all gifts of non-QFOBI assets from the decedent to the decedent's spouse within 10 years prior to the decedents death are included, except de minimis (?) gifts. There is nothing in the statute or legislative history for §2057 which defines "de minimus" for this purpose.

While the statute seems to indicate that the date of gift value of all assets transferred from a decedent to the decedent's spouse within 10 years of the decedent's death are included in the denominator, apparently the Treasury Department is going to interpret the words "other transfers" in §2057(c)(2)(A)(ii) to mean other than gifts of QFOBI's referred to in §2057(c)(2)(A)(i), even though those gifts by definition cannot refer to gifts of QFOBI's to a spouse. Even though this interpretation of the statute is questionable, it is much more helpful to taxpayers than if the statute was more accurately interpreted as requiring inclusion in the denominator of the date of gift value of all transfers of all types of assets from the decedent to the decedent's spouse within 10 years prior to the decedent's death.

There is no policy consideration which justifies this trap for the unwary in the statute, and in fact it seems to violate the unlimited marital deduction policy which has been part of federal tax law since 1981. Technical corrections legislation should include gifts of QFOBI to spouses in the numerator and denominator of the fraction, but no other gifts to spouses in the denominator, or should eliminate all transfers to spouses from both the numerator and denominator.

(2) <u>Gifts of QFOBI To Other Family Members</u>

Except for gifts to spouses as described above, gifts of QFOBI to other family members generally will not cause a failure to meet the 50% requirement, since they are brought back in to both the numerator and denominator of the fraction, unless the QFOBI's appreciate substantially in value from the date of gift to the date of death, in which case the "lost appreciation" in the gift QFOBI's will make the percentage determined by the fraction smaller than if the gifts had not been made.

(3) <u>Other Annual Exclusion Gifts To Family Members</u>

Without exception annual exclusion gifts of non-QFOBI assets to any persons and charitable gifts of non-QFOBI assets will help the donor's estate meet the §2057 50% requirement because they will reduce the denominator of the fraction.

(4) <u>Sales of QFOBI's</u>

QFOBI's should not be sold if the §2057 50% requirement is a concern, because such sales reduce the numerator of the fraction and do not decrease the denominator of the fraction.

(5) <u>Gifts Within 3 Years Prior to Death</u>

Gifts in excess of gift tax annual exclusion amounts within 3 years prior to the donor's death will not make it easier to meet the §2057 50% requirement, because such gifts do not change the numerator or denominator of the fraction (compared to not making the gifts). In fact, if the gifts are QFOBI gifts to family members, such gifts may make it harder to meet the 50% requirement if the QFOBI appreciated from the date of gift to date of death, because of the "lost appreciation" (compared to not making the gifts).

(6) <u>Gifts of Non-QFOBI Assets to Spouse</u>

Gifts of non-QFOBI assets to a spouse, even if made within 10 years of the donor spouse's death, may help the donor spouse's estate meet the 50% requirement (compared to not making such gifts) if those assets appreciate from the date of gift to the date of death, because the appreciation will be removed from the denominator of the fraction.

(7) Gifts of Life Insurance Policies

Gifts of life insurance policies by the donor more than 3 years prior to the donor's death will help the donor's estate meet the §2057 50% requirement by reducing the denominator of the fraction by the difference between the proceeds of the policy and the interpolated terminal reserve value of the policy at the date of gift.

(8) Purchase of QFOBI

The purchase of QFOBI's from family members will immediately help the purchaser's estate meet the §2057 50% requirement if the family members have owned the purchased QFOBI's for at least 5 years. The purchase of QFOBI's from non-family members will only help meet the 50% requirement if the purchaser lives for 5 years after the purchase.

(9) Gifts of Non-QFOBI Assets in Excess of Annual Exclusions More than 3 Years Prior to Donor's Death

Gifts of non-QFOBI assets in excess of annual exclusion amounts more than 3 years prior to the donor's death help meet the §2057 50% requirement because they reduce the denominator of the fraction.

(10) Incurring Debt

Incurring debt against a qualified residence for which the interest paid is deductible for income tax purposes under §163(h)(3), debt to pay educational and medical expenses and up to $10,000 of other debt (all as described in §2057(d)(2)) will help the debtor's estate meet the §2057 50% requirement because such debt does not reduce the numerator of the fraction and does reduce the denominator of the fraction. All other debt makes it more difficult to meet the §2057 50% requirement because it reduces both the numerator and denominator of the fraction. In particular, other debt which is also not for the acquisition of QFOBI makes it more difficult to meet the 50% requirement because its reduction of the numerator is not offset by adding QFOBI to the numerator. And remember, a purchased QFOBI cannot be included in the numerator until it has been owned within the family for 5 years. This is different than the 50% requirement under §2032A, where a purchased farm can immediately help meet that 50% test.

(11) Life Insurance Payable to Business Entity

If life insurance proceeds are payable to a business entity as a result of the decedent's death, and those proceeds are not needed for the reasonable day to day working capital needs of the business, then the portion of the decedent's interest in the entity attributable to those proceeds is excluded from Factor A in the numerator by §2057(e)(2)(D)(i), as described in ¶11.02(4). If those proceeds also increase the value of the business, then they increase the denominator of the fraction for determining the 50% test. Thus, such life insurance proceeds may not help the decedent's estate meet that 50% requirement, and could make it more difficult to meet that requirement.

6. The Material Participation Requirement

a. Generally The Same As The §2032A Material Participation Requirement

§2057(b)(1)(D)(ii) provides that in order for an estate to be eligible to elect the §2057 deduction for a QFOBI, during the 8-year period ending on the date of the decedent's death there must have been periods aggregating 5 years or more during which there was material participation (within the meaning of §2032A(e)(6)) by the decedent or a member of the decedent's family in the operation of the business to which the QFOBI relates.

§2032A(e)(6) states that "material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of §1402(a) (relating to net earnings from self-employment)." The §2032A regulations on material participation (published in 1980) are found at Treas. Reg. §20.2032A-3.

b. Date of Retirement and Disability Rules Like §2032A

§2057(i)(3)(A) provides that rules similar to §2032A(b)(4) (relating to decedent's who are retired or disabled) shall apply for purposes of §2033A. §2032A(b)(4) provides generally that if the material participation requirement is not met by the decedent or his family during the 8 years prior to death, then that requirement may be satisfied during the 8 year period prior to the date on which the decedent became disabled for a continuous period ending at decedent's death or on which the decedent started receiving old age Social Security benefits for a continuous period ending at decedent's death.

c. Active Management By Certain Surviving Spouses Like §2032A

§2057(i)(3)(B) provides that rules similar to §2032A(b)(5) (relating to special rules for surviving spouses) shall apply for purposes of §2033A. §2032A(b)(5) provides generally that if a surviving spouse receives property from the first spouse to die and that property was eligible for §2032A valuation in the first estate, whether §2032A was elected in the first estate or not, then for purposes of determining whether that property is eligible for §2032A valuation in the surviving spouse's estate, active management by the surviving spouse in the operation of that property shall be deemed to be material participation by the surviving spouse.

"Active management" is defined in §2032A(e)(12) as "the making of the management decisions of a business (other than the daily operating decisions)". It is not a significantly lower standard of involvement in the business than the material participation requirement, at least compared to material participation by or for a landlord under a farm crop share lease.

d. <u>What Level of Involvement Will Satisfy The Material Participation Requirement?</u>

The Conference Agreement for the 1997 Act states that "material participation" for purposes of §2057 "is defined as under present-law §2032A (special use valuation) and the regulations promulgated thereunder. See, e.g. Treas. Reg. §20.2032A-3. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) must be considered. Physical work and participation in management decisions are the principal factors to be considered. For example, an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed."

An analysis of some of the §2032A material participation rules applicable to §2057 non-farm businesses is provided in Chapter 13, and a complete discussion of the §2032A material participation requirement is provided in Chapter 3.

C. <u>THE §2057(f) ADDITIONAL ESTATE ("RECAPTURE") TAX ON QUALIFIED HEIR</u>

1. <u>The Imposition of the Recapture Tax</u>

§2057(f)(1) imposes "an additional estate tax if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death" one of four specified recapture events occurs. As under §2032A, if the decedent creates successive interests in more than one qualified heir in the same QFOBI, the 10 year recapture period is not shortened by the deaths of qualified heirs unless all of the qualified heirs with successive interests in the same QFOBI die within 10 years after the decedent's death. The only exception is that if the successive interests are in a marital trust, QTIP or otherwise, then the IRS in Letter Ruling 9038016 has taken the position under §2032A that the death of the surviving spouse within 10 years of the death of the predeceased spouse does terminate the §2032A recapture period with respect to the §2032A election made in the predeceased spouse's estate.

2. Each Qualified Heir Personally Liable For Pro-Rata Part of Recapture Tax

§2057(f)(1) does not state on whom the recapture tax is imposed, and one might assume it is imposed on the decedent's estate, since it is called an "additional estate tax". However, §2057(i)(3)(F) states that rules similar to §2032A(c)(5) (relating to liability for tax; furnishing bond) shall apply for purposes of §2057.

§2032A(c)(5) provides that "the qualified heir shall be personally liable for the additional tax imposed by this subsection with respect to his interest unless the heir has furnished bond which meets the requirements of subsection (e)(11)." §2032A(e)(11) is discussed in ¶10.02(3).

The Conference Agreement for the 1997 Act provides the following example to illustrate how each qualified heir is personally liable for his or her respective portion of the recapture tax.

> Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test. If she ceases to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the recapture tax; that is, each would be liable for the recapture tax attributable to his or her interest.

3. The Four "Recapture Events"

The four generic "recapture events" specified in §2057(f)(1) are as follows:

a. Failure to Meet Material Participation Requirement

§2057(f)(1)(A) imposes the §2057 recapture tax if the material participation requirements in §2032A(c)(6)(B) are not met with respect to the QFOBI which was acquired (or passed from) the decedent.

§2032A(c)(6)(B) provides that:

> (B) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating more than 3 years during which -
>
> (i) in the case of periods during which the property was held by the decedent, there was no material participation by the decedent or any member of his family in the operation of the farm or other business, and
>
> (ii) in the case of periods during which the property was held by any qualified heir, there was no material participation by such qualified heir or any member of his family in the operation of the farm or other business.

(1) <u>Cash Renting By Qualified Heirs to Their Family Members Permitted</u>

The Conference Agreement for the 1997 Act also provides that "if a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision".

(2) <u>Active Management Sufficient For Certain Qualified Heirs</u>

§2032A(c)(7), which is made applicable to §2057 by §2057(i)(3)(G), also provides an exception to the material participation for a qualified heir who:

(A) is the surviving spouse of the decedent,

(B) has not attained the age of 21,

(C) is disabled (within the meaning of subsection (b)(4)(B)), or

(D) is a student.

"Active management" <u>by</u> the qualified heirs described in (A) or (D) or <u>for</u> the qualified heirs described in (B) or (C) is deemed to meet the material participation requirement for those heirs.

"Active management" is defined in §2032A(e)(12) as "the making of the management decisions of a business (other than the daily operating decisions)". It is not a significantly lower standard of involvement in the business than the material participation requirement, at least compared to material participation by or for a landlord under a farm crop share lease.

(3) Who Must Materially Participate When QFOBI Passes To a Trust?

By analogy to Letter Rulings 9022007 and 9043044 in which the IRS held that only the income beneficiaries of a trust holding §2032A farmland have to meet the §2032A(c) qualified use and material participation requirements, only the income beneficiaries of a trust should be required to meet the §2057(f)(1)(A) material participation requirements (or "family members" of the income beneficiaries).

Perhaps the second sentence of §2057(e)(3)(C) referred to in ¶11.07 above also provides some support of the interpretation in the preceding paragraph, although it appears in a part of the statute titled "Rules Regarding Ownership". However, that part of the statute does provide that it is applicable for all purposes of §2057. Also see B(3)(e) above in this outline.

b. Disposition of QFOBI By Qualified Heir

§2057(f)(1)(B) imposes the §2057 recapture tax if "the qualified heir disposes of any portion of a QFOBI (other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under section 170(h))".

(1) Tricky Definition of "Family Members"

Great care must be taken to closely follow the family member definition in §2032A(e)(2) to determine whether a disposition is to a family member of the qualified heir. Not every family member of the decedent is a family member of every qualified heir. Not every qualified heir is a family member of all the other qualified heirs. A nephew is a family member of an uncle, but an uncle is not a family member of a nephew! See ¶1.07 for a complete analysis of the §2032A(e)(2) definition of "family member". Also see B(3)(c) above in this outline.

§2057(i)(3)(O) provides that rules similar to §6166(g)(1)(B), (C) and (D) (relating to acceleration of payment) shall apply for all purposes of §2057. The exact application of those provisions to §2057 will need to be clarified by regulations, and probably expanded by analogy to interests in entities other than corporations. Perhaps these provisions could also be applied to also permit pre-death tacking of periods of ownership and material participation for purposes of meeting the §2057 eligibility requirements.

(2) §1031 and §1033 Transactions

§2057(i)(3)(M) provides that rules similar to make §2032A(h) (relating to special rules for involuntary conversions of qualified real property) and §2032A(i) (relating to exchanges of qualified real property) shall apply for all purposes to §2057. This means that a qualified heir who disposes of a QFOBI in a transaction which qualifies for income tax purposes as a §1031 or §1033 transaction will not be deemed to have made a disposition for purposes of §2057(f)(1).

(3) Corporate, Partnership and Trust Transactions

§2057(i)(3)(L) provides that rules similar to Section 2032A(g) (relating to application to interests in partnerships, corporations and trusts) shall apply for all purposes of §2057. This should mean that the §2032A rulings which do not treat many such transactions as dispositions for §2032A purposes should be applied to also not treat such transactions as dispositions for §2057 purposes.

(4) Sales and Dispositions In Ordinary Course of Business

One of the two changes made to the Senate Report by the Joint Committee on Taxation when it drafted the Conference Agreement for the 1997 Act was to add the following exception to §2057 recapture tax treatment of a disposition of certain types of qualified family-owned business assets:

> The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g. the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.

While this statement in the Conference Agreement makes good sense, it also means that in some businesses where these types of assets make up a significant portion of the value of the QFOBI, there will be an opportunity over time to sell down the value of the business gradually without paying §2057 recapture tax.

It would seem wise for Treasury to permit partial §2057 elections, so that taxpayers could voluntarily exclude the value of these assets from the §2057 election, which would keep those assets free of the §2057 lien and would also protect the government's interests by having a full §2057 recapture tax liability and lien security apply to other types of "more permanent" assets for which §2057 would be elected.

(5) Cessation of Trade or Business Use of QFOBI Is a Disposition

§2057(f)(3) provides that "a qualified heir shall not be treated as disposing of an interest described in subsection (e)(1)(A) by reason of ceasing to be engaged in a trade or business so long as the property to which such interest relates is used in a trade or business by any member of such individual's family". §2057(e)(1)(A) describes a QFOBI which is "an interest as a proprietor in a trade or business carried on as a proprietorship". Presumably, the application of §2057(f)(3) is limited to proprietorships because a QFOBI which is an interest in an entity described in §2057(e)(1)(B) allows the activities of even non-family member employees of the entity to meet the trade or business requirement for the entity.

§2057(f)(3) is the only statutory provision which indicates that there is really a separate trade or business requirement which must be satisfied by qualified heirs during the 10 year period after the decedent's death, and cessation of trade or business use of the QFOBI constitutes what is really a fifth type of recapture even under §2057(f)(1), although technically §2057(f)(3) characterizes that cessation as one type of disposition under §2057(f)(1)(B). Even §2057(f)(3) imposes this fifth type of recapture event by implication, rather than by direct statement.

(A) Exception: Trade or Business Use of QFOBI in Proprietorship By Family Member of Qualified Heir and Not By Qualified Heir Is Not a Disposition

As explained above, §2057(f)(3) specifically provides that a family member's use of property in a trade or business is deemed to satisfy the trade or business requirement for a qualified heir if the property was owned by the decedent as a proprietor of a proprietorship. Therefore, the qualified heir's failure to use such property in a trade or business is not a disposition and not a §2057(f)(1) recapture event.

(B) Exception: Cessation of Trade or Business By Entity in Which Qualified Heir Has a QFOBI Is Not a Disposition (?)

Since §2057(f)(3) technically only applies to QFOBI's in proprietorships described in §2057(e)(1)(A), it can be argued that cessation of trade or business use is only a recapture event for QFOBI's in proprietorships, and not for QFOBI's in entities described in §2057(e)(1)(B). This would mean that an entity could cease to carry on a trade or business without causing imposition of recapture tax, as long as no §2057(f)(1) recapture event occurs.

This could be important if the qualified heirs receive QFOBI's in an entity from the decedent, and the entity cash rents its assets to a family member of the qualified heirs. §2057(f)(3) would not apply in this situation to allow attribution of the family member's trade or business use to the qualified heirs, so it would be important to interpret §2057(f)(3) as only implying a trade or business requirement for proprietorships and not for entities. As described above, the Conference Agreement for the 1997 Act would allow the family member tenant's activities to be attributed to the qualified heirs for purposes of the §2057(f)(1)(A) material participation requirement, even if the qualified heirs' QFOBI's were in an entity, so it would be inconsistent to impose recapture tax in those circumstances because the entity itself was not using the property to which the QFOBI relates in a trade or business.

(C) Exception: The 2 Year Grace Period

§2057(i)(3)(G) provides that rules similar to §2032A(c)(7) (relating to no tax if use begins within 2 years; active management by eligible qualified heirs treated as material participation) shall apply for all purposes of §2057. It is not completely clear how the 2 year grace period for commencing qualified use under §2032A is to be applied for purposes of §2057, since §2057 has no qualified use requirement. The Conference Agreement for the 1997 Act states that "as under present-law section 2032A, however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death". Apparently, this 2 year grace period relates to the trade or business requirement for qualified heirs which is implied by §2057(f)(3), as described above, and not to the material participation requirement (see C(4) in this outline below).

c. Qualified Heir Loses U.S. Citizenship

§2057(f)(1)(C) imposes the §2057 recapture tax if "the qualified heir loses United States citizenship (within the meaning of section 877) or with respect to whom an event described in subparagraph (A) or (B) of section 877(e)(1) occurs, and such heir does not comply with the requirements of" §2057(g). The Conference Agreement for the 1997 Act explains that "a qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a trust meeting requirements similar to a qualified domestic trust (as described in present law sec. 2056A(a), or through certain other security arrangements", which is basically what the statute provides in §2057(g).

d. Principal Place of Business Moves Outside U.S.

§2057(f)(1)(D) imposes the §2057 recapture tax if "the principal place of business of a trade or business" of the QFOBI ceases to be located in the United States. This suggests that if a QFOBI involves ownership of more than 1 trade or business, and the principal place of any 1 of the trades or businesses ceases to be located in the U.S., then recapture tax is imposed with respect to the entire QFOBI.

4. Computation of Amount of Recapture Tax

§2057(f)(2)(A) provides that the amount of the additional estate tax imposed by §2057(f)(1) shall be equal to -

(i) the "applicable percentage" of the adjusted tax difference attributable to the QFOBI, plus

(ii) interest on the amount determined under (i) at the underpayment rate established under §6621 for the period beginning on the date the estate tax liability was due under Chapter 11 and ending on the date such additional estate tax is due.

The "applicable percentage" referred to in §2057(f)(2)(A)(i) is determined under the §2057(f)(2)(B) table as follows:

If the event described in §2057(f)(1) occurs in the following year of material participation:	The applicable percentage is:
1 through 6	100
7	80
8	60
9	40
10	20

Apparently the "year of material participation" in the heading in the above table is a mistake, and should refer to "year after decedent's death", because the 2 year grace period which is incorporated by §2057(i)(3)(G)'s reference to §2032A(c)(7) does not apply to the §2032A material participation requirement, but instead applies to the §2032A qualified use requirement. The best analysis to use to apply §2032A(c)(7)(A) to §2057 is to say that the §2057(f)(3) implied trade or business requirement for proprietorships is more analogous to the §2032A qualified use requirement than is the §2057 material participation requirement, and therefore the 2 year grace period from §2032A(c)(7)(A) applies to the §2057(f)(3) trade or business requirement, and not to the §2057 material participation requirement.

Further, it would be better to follow the approach of §2032A(c)(7)(A)(ii) by saying that any part of the 2 year grace period actually used extends the §2057(f)(1) and §2057(f)(2)(B) year periods, rather than to try to state the basic year provisions in §2057(f)(2)(B) to refer to a grace period which may not even be applicable (the best interpretation appears to be that there is no §2057 2 year grace period for material participation and no §2057 2 year grace period for commencement of trade or business use by an entity if the QFOBI is in an entity, because there is no trade or business requirement for such an entity). Under this approach the heading in §2057(f)(2)(B) should be interpreted as meaning "If the event described in paragraph (1) occurs in the following year <u>after the date of the decedent's death</u>". This interpretation is also necessary to make §2057(f)(2)(B) consistent with the basic imposition of the recapture tax by §2057(f)(1), which describes the recapture period as being "within 10 years after the date of the decedent's death".

The "adjusted tax difference attributable to the QFOBI" referred to in §2057(f)(2)(A)(i) is defined in §2057(f)(2)(C).

§2057(f)(2)(C)(i) provides that the adjusted tax difference attributable to a "QFOBI" is the amount which bears the same ratio to the adjusted tax difference with respect to the estate (determined under clause (ii)) as the value of each interest bears to the value of all "QFOBI's" described in subsection (b)(2).

§2057(f)(2)(C)(ii) provides that "the term adjusted tax difference with respect to the estate" means "the excess of what would have been the estate tax liability but for the election under this section over the estate tax liability", and that "the term estate tax liability means the tax imposed by section 2001 reduced by the credits allowable against such tax."

The effect of the rules set forth in §2057(f)(2)(C) is that the apportionment of the §2057 recapture tax liability among qualified heirs is to be based on the value of the QFOBI's received by each qualified heir compared to the total value of all QFOBI's received by all qualified heirs.

It should be noted that there is apparently no provision similar to §2032A(c)(2)(A)(ii) applicable to computing the §2057 recapture tax, which means that the value of the QFOBI at the time a recapture event occurs does not enter into the computation of the amount of the §2057 recapture tax. At least the §2057 statute refers to no such provision.

5. <u>Computation of Amount of Partial Recapture Tax</u>

If there is a partial §2057 recapture event, meaning that the recapture event does not involve all of the QFOBI's for which §2057 was elected, then the method provided in §2057(f)(2)(C) is used to determine the amount of §2057 partial recapture tax. This is true whether the recapture event is "partial" in the sense that one of three qualified heirs disposes of all of their QFOBI's to a non-family member, or whether one qualified heir disposes of one-third of that heir's QFOBI's to a non-family member. Basically, the amount of §2057 recapture tax payable with respect to either such type of partial disposition is the same portion of the maximum potential §2057 recapture tax as the portion which the value of the QFOBI's disposed of (or otherwise subject to recapture) is of the total value of all of the QFOBI's for which §2057 was elected, using the estate tax values of the QFOBI's to determine such portion.

Since the §2057 recapture tax liability is apportioned pro rata to all of the QFOBI's for which §2057 is elected, based upon estate tax values of the QFOBI's, the §2057(f)(2)(C) partial recapture tax computation method is simpler than the §2032A partial recapture tax computation method in §2032A(c)(2)(B). Under §2032A, the total §2032A value reduction for an estate cannot be apportioned to the various §2032A properties just based on the estate tax value of those properties determined without §2032A, because the §2032A valuation method often produces a different proportion of value reduction for different properties being valued under §2032A in the same estate. Therefore, §2032A(c)(2)(B) requires the computation of the §2032A value reduction proportion to compute the partial §2032A recapture tax. The Form 706-A is defective because it ignores this aspect of computing the §2032A recapture tax.

However, the §2057 recapture tax liability is apportioned pro rata among the QFOBI's for which §2057 is elected based on the estate tax values of the QFOBI's, so it is really not necessary to compute the amount of §2057 deduction for each QFOBI. All that is necessary is to know the estate tax value of each QFOBI. In that respect, the Form 706-A is correct under §2057, even though it is incorrect for §2032A for which it was designed. See ¶6.02(3).

On the other hand, there will be difficulties in applying the §2057(f)(2)(C) method for computing the §2057 recapture tax, because it requires being able to determine the estate tax value of each QFOBI which is subject to §2057 recapture tax. That determination is not difficult in the §2032A context because only real estate can be valued under §2032A and the real estate which is subject to a §2032A recapture event can always be traced to real estate that was valued under §2032A on the estate tax return. However, §2057 can be elected for assets other than real estate, and it is going to be difficult in some cases to determine the estate tax value of the assets subject to a §2057 recapture event for purposes of computing the §2057 recapture tax.

§2057(i)(3)(C) provides that rules similar to §2032A(c)(2)(D) (relating to partial disposition) shall apply for all purposes of §2057. However, because §2057 has no provision comparable to §2032A(c)(2)(A)(ii), §2032A(c)(2)(D)(i) cannot be applied for purposes of §2057, and because §2032A(c)(2)(D)(ii) is really redundant and unnecessary if §2057(f)(2)(C) is applied correctly (a "portion of an interest" is no different than just using a smaller "interest" when applying §2057(f)(2)(C), the reference to §2032A(c)(2)(D) in §2057(i)(3)(C) is totally unnecessary for computing a partial recapture tax under §2057.

6. The Conference Agreement For The 1997 Act

The Conference Agreement for the 1997 Act provides the following explanation of how the §2057 recapture tax is to be computed:

> If a recapture even occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis. For example, if decedent's estate included $2 million in qualified family-owned business interests and $1 million of such interests received beneficial treatment under this proposal, one-half of the value of the interest disposed of is deemed to have received the benefits provided under this proposal.

This explanation is very confusing. It seems to suggest that a partial §2033A (now §2057) election is possible. Otherwise, how could only $1,000,000 out of $2,000,000 of QFOBI's in an estate "receive beneficial treatment" under §2033A? Apparently, this paragraph out of the Senate Report which was adopted in the Conference Agreement for the 1997 Act without revision should have been revised to reflect the Conference's reduction of the Senate's $1,000,000 §2033A maximum value exclusion down to $675,000. Apparently, the wording "receive beneficial treatment" was an unclear wording of what was intended to be said, which apparently was that "$1,000,000 of the $2,000,000 of QFOBI's was excluded from the value of the gross estate by the §2033A election".

In any event, apparently this statement in the Conference Agreement for the 1997 Act meant that in computing the amount of §2033A recapture tax payable when a QFOBI or an asset owned by the trade or business for which the §2033A election was made is subject to a recapture event (by disposition or otherwise), a fraction of that QFOBI or asset will be deemed to represent the §2033A value exclusion for purposes of computing the §2033A recapture tax payable as a result of that recapture event. The numerator of the fraction will be the total amount of value excluded from the decedent's gross estate by the §2033A election, and the denominator will be the estate tax value of all of the QFOBI's in the decedent's gross estate determined without §2033A.

In the example given in the Conference Agreement, if the decedent died in 1998, the fraction should have been $\frac{\$\ 675{,}000}{2{,}000{,}000} = 34\%$, instead of $\frac{\$1{,}000{,}000}{\$2{,}000{,}000} = 1/2$, if in fact the above explanation of that language in the Conference Agreement is correct.

This interpretation of the language in the Conference Agreement for the 1997 Act would have produced different results in computing the §2033A recapture tax than the method specified in the statute in §2033A(f)(2)(A)(i), which is the method used for computing the §2032A recapture tax under §2032A(c)(2)(B). Usually, when the statute and the Conference Agreement conflict, the statute prevails.

The only way to resolve this conflict between the §2033A statute and Conference Agreement is to follow the statute and say the Conference Agreement is just wrong, or to say that the Conference Agreement is actually, after all, describing how the §2033A recapture tax should be computed after a partial §2033A election is made. That is the only way to give meaning to both the statute and the Conference Agreement, without saying either one is wrong. The Blue Book contains the same example, which appears to strengthen the argument that it is not a mistake, but rather an explanation of how to compute the §2033A recapture tax after a partial election.

Even though the 1998 Act's conversion of the §2033A value exclusion into a §2057 deduction makes most of the above analysis inapplicable (the example in the Conference Agreement for the 1997 Act clearly is not applicable to computing the recapture tax for the §2057 deduction), the analysis is still relevant as to the Congressional intent in 1997 to allow §2033A partial elections, which still should be authority for allowing §2057 partial elections.

7. <u>Due Date for §2057 Recapture Tax</u>

§2057(i)(3)(E) provides that rules similar to §2032A(c)(4) (relating to due date) shall apply for all purposes of §2057.

§2032A(c)(4) provides that "the additional tax imposed by this subsection shall become due and payable on the date which is 6 months after the date of the disposition or cessation referred to in paragraph (1)".

This means that the §2057(f) additional estate tax ("recapture tax") becomes due and payable 6 months after the date the recapture event specified in §2057(f)(1) occurs.

8. Interest on §2057 Recapture Tax

The §2057 recapture tax principal amount includes interest from the due date of the estate tax (9 months after the decedent's death) to the due date of the recapture tax (6 months after the §2057 recapture event) computed at the underpayment rate established under §6621, as provided in §2057(f)(2)(A)(ii). Apparently, this means that even if the §2057 recapture tax is paid prior to its due date, the principal amount of that tax will be computed to include interest accrued to that due date.

Apparently, the reason for including this interest in the §2057 recapture tax principal amount is that §2057 gives qualified heirs a "full" basis for income tax purposes in the QFOBI (not reduced by any part of the §2057 deduction), whereas §1016(c) requires qualified heirs to pay such interest on the §2032A recapture tax in order to receive a "full" basis in the qualified real property (not reduced by the §2032A value reduction) after a §2032A recapture event.

As explained in Revenue Ruling 81-308, interest on the §2032A recapture tax accrues at the §6621 underpayment rate after the due date for the §2032A recapture tax. Presumably, interest on the §2057 recapture tax will also accrue at the §6621 underpayment rate after the due date of the §2057 recapture tax.

9. Statute of Limitations on Assessment of §2057 Recapture Tax

§2057(i)(3)(K) provides that rules similar to §2032A(f) (relating to statute of limitations) shall apply for all purposes of §2057.

§2032A(f) provides as follows:

> (F) STATUTE OF LIMITATIONS.- If qualified real property is disposed of or ceases to be used for a qualified use, then-
>
> > (1) The statutory period for the assessment of any additional tax under subsection [2032A](c) attributable to such disposition or cessation shall not expire before the expiration of 3 years from the date the Secretary is notified (in such manner as the Secretary may by regulations prescribe) of such disposition or cessation (or if later in the case of an involuntary conversion or exchange to which subsection [2032A](h) or (i) applies, 3 years from the date the Secretary is

notified of the replacement of the converted property or of an intention not to replace or of the exchange of property, and

(2) Such additional tax may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

The key concept here is that unless some notice of a recapture event is given to the IRS which a court deems to be sufficient to start the statute of limitations running against the IRS, the IRS can assert personal liability for §2032A recapture tax liability against the qualified heir, or perhaps even against the qualified heir's legal successors, 50 years or more after the original decedent's death!

Undoubtedly the IRS will publish a form similar to Form 706-A to use to report §2057 recapture events and file with payment of the §2057 recapture tax.

10. Special Lien For §2057 Recapture Tax

§2057(i)(3)(P) provides that rules similar to §6324B (relating to special lien for additional estate tax) shall apply for all purposes of §2057.

Letter Ruling 8228003 states that when a qualified heir dies and there can no longer be any §2032A(c) additional estate tax due, the District Director can exercise his discretion and issue a certificate of discharge of lien.

See also ¶14.04 for an explanation of how the amount of the lien is usually computed by the IRS.

Since §2057 can be elected for QFOBI's with respect to non-real estate assets, it remains to be seen how a §2057 lien will be imposed on such assets. The §2057 lien is not an inchoate lien like the general estate tax lien under §6324; instead, like the §2032A lien under §6324B(c)(1) which incorporates by reference the §6166 lien rule of §6324A(d)(1), the §2057 lien must be filed by the IRS. Presumably, the §2057 lien will be filed by the IRS just before it issues an estate tax closing letter which accepts a §2057 election made on Form 706, just like it has filed §2032A liens.

Hopefully, the IRS will only file a §2057 lien against non-real estate assets after prior consultation with the estate's representative and a determination that such filing is absolutely necessary to protect the government's legitimate security interest in being able to collect the §2057 recapture tax if a §2057 recapture event occurs. In this respect the §2057 lien procedure should be more similar to the §6166 lien procedure under §6324A than to the §2032A lien procedure under §6324B, which is to automatically file the §2032A lien against all real estate valued under §2032A.

The §6166 lien is only filed when an estate is closed prior to the making of the final tax payment under the §6166 election and the estate's representative wishes to be discharged from personal liability for the tax payments remaining due after the estate is closed. In that context the §6166 lien is negotiated between the IRS and the estate's representative as to the amount and the collateral, and under §6324A(d)(3)(C) the §6166 lien is subordinate to real property construction or improvement financing and even to a farm operating line of credit.

The §2057 lien should not have to be filed against all of the family-owned business property. Instead, it should be filed only against enough assets to secure the amount of the potential §2057 recapture tax, and such assets should be selected to assure the least commercial interruption of the family business.

When the QFOBI is an interest in an entity which owns the business assets, one might think that the lien would be on the interest in the entity, and not on the business assets owned by the entity. However, under §2032A when the qualified real property has been owned by an entity in which the decedent had an interest, the lien has been filed against the real estate owned by the entity and not against the decedent's interest in the entity.

D. "OTHER TAX CONSEQUENCES" OF §2057 ELECTION

The "other tax consequences" of a §2057 election are described in Chapter 15. A very brief summary of those other tax consequences is as follows:

1. Income Tax Basis Consequences of §2057 Election

The §2057 election does not reduce the qualified heir's income tax basis under §1014.

2. GST Tax Consequences of §2057 Election

The §2057 election will be disregarded for all purposes of Chapter 13, including the allocation of the decedent's GST exemption and the computation of any direct skip GST tax imposed at the decedent's death as to which the decedent is the transferor. This will greatly complicate tax formula drafting in estate plans for clients who may wish to utilize §2057, GST planning, and marital deduction formula planning (see H(8) in this outline below).

3. <u>§2032A Consequences of §2057 Election</u>

It is clear that an estate can elect to have both §2032A and §2057 apply if the estate meets the eligibility requirements for both sections.

In determining whether the §2032A 50% and 25% tests are met if §2057 is also elected, fair market values are to be used in the numerator and denominator of the fraction for each test (those tests are determined without applying either §2032A or §2057).

In determining whether the §2057 50% test is met if §2032A is also elected, the §2032A values of the QFOBI assets are to be used in the numerator of the fraction, and the denominator of the fraction is reduced by the §2032A value reduction for the estate.

If an estate is eligible for the elections under both sections and makes both elections, the §2032A value reductions are applied first, and then the §2057 deduction applies to the §2032A value of the QFOBI assets which are also §2032A qualified real property, as well as to the fair market value of other QFOBI assets.

4. <u>§6166 Consequences of §2057 Election</u>

The numerator and denominator of the §6166 fraction which determines both the eligibility for §6166 and the amount of estate tax payable under §6166 are not reduced by the §2057 deduction. Oddly, this means that the §2057 election does not decrease the percentage of the estate tax payable in installments, even though it reduces the estate tax value of the business assets!

5. <u>§303 Consequences of §2057 Election</u>

The numerator and denominator of the §303 fraction which determines eligibility for §303 is not reduced by the §2057 deduction.

6. <u>Marital Deduction Consequences of §2057 Election</u>

a. <u>In General</u>

(1) There are no adverse consequences of the §2057 election or the §2057 recapture tax as to the eligibility of QFOBI's for the marital deduction or the valuation of QFOBI's for purposes of the marital deduction.

(2) The valuation of QFOBI's for purposes of the marital deduction is not reduced by the §2057 deduction or the potential §2057 recapture tax.

(3) There are no adverse gift tax or eligibility for estate tax marital deduction consequences relating to the executor's discretion to make the §2057 election, even if the executor is the surviving spouse.

b. Most Marital Deduction Formula's Will Automatically Adjust to §2057

If §2057 is elected, it reduces the amount of the gross estate for purposes of computing the federal estate tax. Therefore, the §2057 deduction reduces dollar for dollar the amount of marital deduction which is needed to reduce the federal estate tax to zero or to whatever amount of tax is desired in the estate of the first spouse to die. This means that under any typical marital deduction formula which provides that the marital gift is to be the smallest amount necessary to produce the lowest possible total of federal estate tax and state death taxes computed by reference to the §2011 credit, the amount of the §2057 value exclusion will automatically be included in the "bypass" or non-marital deduction part of the disposition.

For example, if the fair market value of the gross estate is $1,500,000, which includes $800,000 of QFOBI's for which a §2057 election can be made, if there are no deductions available other than the marital deduction, if there have been no lifetime gifts which have "used up" unified credit, and if the will contains a typical pre-§2057 marital deduction formula gift of the type described in the preceding paragraph, then the following computations show the fair market value amounts allocable to the "marital" and "bypass" trusts with and without a §2057 election if the decedent dies in 1998:

	Without §2033A	With §2033A
Gross Estate	$1,500,000	$1,500,000*
Formula Allocation to Marital Trust or residue to Marital Trust	(875,000)	(200,000)
Residue or Formula Allocation to Bypass Trust	$ 625,000	$1,300,000*

* These fair market values are each reduced by $675,000 for tax purposes because of the $675,000 §2057 deduction, meaning that the estate tax value of the gross estate is $825,000 and of the Bypass Trust is $625,000. The applicable exclusion amount for estates of 1998 decedents is $625,000, so there are no estate taxes, whether §2057 is elected or not.

One observation to make about marital deduction formula's after 1997 is that they should not refer to any specific dollar amounts to be allocated to the bypass part of the estate, since the applicable exclusion amount increases in all but 2 years from 1998 to 2006. Another observation is that the formula needs to refer to state estate taxes computed with respect to the §2011 credit, in addition to federal estate taxes, or else the formula could result in some state estate taxes being payable, which is generally not intended. A final observation is that the formula should not refer to §2010 or the unified credit, the applicable credit or the applicable exclusion amount if §2057 might be elected.

As long as the above guidelines are followed, it does not matter, as far as the amounts allocated to the marital and bypass trusts with or without a §2057 election, what type of marital deduction formula is used; a pecuniary marital lead (true pecuniary or 64-19), a pecuniary exemption equivalent lead, or a fractional will each produce the above results. There is no taxable gain (with respect to the §2057 deduction) resulting from using a QFOBI to fund a pecuniary amount because the income tax basis of the QFOBI is not reduced by the §2057 election.

c. Non-Tax Considerations Arising From §2057 Reduction of Amount of Marital Deduction Needed For Tax Purposes

Finally, it should be noted that in estate plans where the bypass trust is not for the benefit of the surviving spouse there may be a non-tax concern about letting the §2057 deduction reduce the amount allocated to the marital trust in the manner shown in the above example. One way to address that concern would be to provide that to the extent the bypass trust exceeds a certain amount or a certain fraction of the fair market value of the gross estate, that excess amount would be held in a separate trust for the benefit of the surviving spouse.

E. DECIDING WHETHER TO MAKE THE §2057 ELECTION

If an estate includes one or more QFOBI's and the estate meets all of the §2057 eligibility requirements described in ¶10.02, then it must be decided whether the estate should make a §2057 election on Form 706 (as described in ¶10.06) if that election will save estate taxes. Before making this decision, several very important questions need to be seriously considered and discussed with the qualified heirs who will have to sign the §2057 agreement if the §2057 election is made. Those questions should include the following:

1. Are the qualified heirs fairly certain that they want to retain the QFOBI in family ownership for at least 10 years after the date of the decedent's death?

2. Will each of the qualified heirs be able to meet the material participation requirements for at least 7 years after the date of the decedent's death (5 years out of each 8 year period), either directly or through a family member of that qualified heir?

3. Will the QFOBI continue to be an interest in a "trade or business" with respect to each qualified heir, either directly through a family member of that qualified heir, for 10 years after the date of the decedent's death?

4. Is the estate tax savings which results from the §2057 election sufficient to justify any "cost" incurred by the qualified heirs or their family members for doing (or not doing) things in order to avoid the §2057 recapture tax?

5. Does the estate tax savings from the §2057 election benefit the same persons who are the qualified heirs who will be personally liable for pro rata portions of the §2057 recapture tax?

6. If the answer to 5 is "No", can some agreement be worked out after the decedent's death among the heirs to eliminate this "unfairness"?

7. Will the business be able to operate in "normal" fashion with its assets subject to the §2057 lien described in ¶14.11?

8. Are the consequences of the §2057 election on other tax provisions (as described in Chapter 15) acceptable?

If the answer to all of the above questions (or all except question 5) is "Yes", then the executor will probably want to make the §2057 election on Form 706 if the qualified heirs will sign the §2057 agreement.

F. MAKING THE §2057 ELECTION ON FORM 706

1. The Election

§2057(b)(1)(B) provides that §2057 will not apply to an estate unless "the executor elects the application of this section and files the agreement referred to in subsection (h)".

§2057(i)(3)(H) provides that rules similar to §2032A(d)(1) and (3) (relating to election; agreement) shall apply for purposes of §2057.

a. <u>Late Filing May Not Be Fatal, If Election Made on First Filed Return</u>

§2032A(d)(1) provides that "the election under this section shall be made on the return of tax imposed by section 2001" (Form 706). It goes on to provide that "such election shall be made in such manner as the Secretary shall by regulation prescribe. Such an election, once made, shall be irrevocable". Presumably, this means that the §2057 can be made on a late filed Form 706, as long as it is made on the first Form 706 filed on or after the due date (including any extension thereof), which is the rule for making §2032A elections.

Hopefully, the IRS will soon publish a new Form 706 which includes a new Schedule on which to make the §2057 election and detailed instructions related thereto. Hopefully, that Schedule will be even more complete and detailed with respect to the §2057 election than Schedule A-1 is for the §2032A election.

b. <u>Defective Elections Curable Under Newly Liberalized §2032A(d)(3)</u>

§2032A(d)(3) provides as follows:

> (3) MODIFICATION OF ELECTION AND AGREEMENT TO BE PERMITTED-The Secretary shall prescribe procedures which provide that in any case in which the executor makes an election under paragraph (1) (and submits the agreement referred to in paragraph (2)) within the time prescribed therefor, but -
>
> (A) the notice of election, as filed, does not contain all required information, or
>
> (B) signatures of 1 or more persons required to enter into the agreement described in paragraph (2) are not included on the agreement as filed, or the agreement does not contain all required information,
>
> the executor will have a reasonable period of time (not exceeding 90 days) after notification of such failures to provide such information or signatures.

Hopefully, this provision will make it possible for §2057 elections not to undergo the horrible history of defective §2032A elections, which could have been avoided if the above provisions had been enacted in the early years after 1976, instead of on August 5, 1997. It appears that especially prior to the publication of a comprehensive §2057 election schedule by the IRS as part of a revised Form 706, any reasonable attempt to make the §2057 election and file a §2057 agreement should be sufficient to enable the estate to take advantage of the opportunity to provide any supplemental information or signatures within a reasonable period after an IRS request therefor. Nevertheless, the §2057 election and agreement filed with Form 706 should be as complete as possible.

c. Once Made, Election is Irrevocable

§2032A(d)(1) provides that once the §2032A election is made, it is irrevocable. For this reason, it will usually not be a good idea to file the Form 706 making the §2057 election much before its due date, since §2032A(d)(1) is also applicable to §2057 elections.

d. What If More Than One Return Filed Before Due Date?

Although there is no regulation, case or ruling which specifically addresses this issue, it would appear by analogy to the temporary regulations under §2032 (Treas. Reg. §301.9100-6T(b)(1)), which are based on statutory language in §2032(d)(1) that is virtually identical to the statutory language in §2032A(d)(1), that if more than one tax return is filed before the due date, the last return filed on or before the due date will be considered the first and only return filed for purposes of the §2057 election. Although there is no explicit authority on this issue as to §2032A elections, it appears that the analogy to §2032 is a good one and it is understood that in practice this has been the position of the IRS. It is believed that the IRS will take the same position as to §2057 elections when more than one estate tax return is filed on or before the due date.

e. Filing The Return Late is Sometimes Not a Problem

If an estate does not owe any estate taxes, then there is no penalty or interest payable as a result of filing an estate tax return late. This means that if an executor is certain that no estate tax will be due under any circumstances, for example, because of a formula marital deduction provision in the decedent's will, then the executor can just wait until the documents necessary for the §2057 election are available and then file the first estate tax return late with the §2057 election.

f. Getting Extension of Time to File Return

If an executor does not want to file the estate tax return making the §2057 election late, and all of the §2057 election documents are not available by the due date for the estate tax return, then the executor has several alternative ways of applying for extensions of time to file from the IRS.

(1) Form 4768

One alternative is filing a Form 4768 asking for the maximum one time 6 month extension of time to file Form 706, which is routinely granted by the IRS. It is best to file this Form 4768 within five or six months after the decedent's death, but as long as it is filed on or prior to the 9 month due date, it will usually be granted. One disadvantage of this alternative is that the estimated amount of estate tax which will be payable on the Form 706 must be filed with Form 4768. Of course, if a §6166 election will be made, then only the estimated amount of estate tax not deferrable under §6166 has to be paid with Form 4768.

(2) Revenue Procedure 92-85

Another alternative is to carefully follow the procedure described in Revenue Procedure 92-85, 1992-2 C.B. 490, as modified by T.D. 8680 filed with the Federal Register on June 26, 1996, to obtain an automatic 12-month extension of time to file the §2057 election if an audit has not commenced. Although this technique does not specifically apply to §2057, it must be assumed that this technique will also be available for §2057 elections.

(3) Treas. Reg. §301.9100-1(a)

A third alternative would be to apply for an extension of time to file the §2057 election for reasonable cause under Treas. Reg. §301.9100-1(a), by carefully following all of the requirements under that regulation. Examples of this alternative for §2032A elections are described in Letter Ruling 9612010 and Technical Advice Memoranda 9204005 and 9215003, and it must be assumed that this technique will also be available for §2057 elections.

2. The Agreement

§2057(h) provides that "the agreement referred to in this subsection is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (f) with respect to such property". §2057(f) imposes the §2057 recapture tax. Presumably, the IRS will develop a form of the agreement it wishes to be used for this purpose, and that form will be published as part of the new Form 706 Schedule to be used to make the §2057 election, just as the form of the §2032A agreement is Part 3 of Schedule A-1 on pages 10 and 11 of Form 706.

a. Similar To §2032A Agreement

Presumably, the IRS will publish regulations as to who must sign the §2057 agreement which are similar to Treas. Reg. §20.2032A-8(c), except that the portions of that regulation which have been held invalid by the courts should be revised or deleted.

See ¶9.09 for a detailed explanation of the §2032A agreement, most of which will be equally applicable to the §2057 agreement.

b. Some Differences From §2032A Agreement

The §2057(h) agreement does appear to differ from the §2032A agreement in some respects.

(1) Property Must Be Designated in Agreement

§2057(h) requires that the property to which such agreement applies must be designated in the agreement, and states that when the qualified heir signs the agreement the consent to the application of the §2057(f) recapture tax will only apply to the property designated in the agreement. This suggests that a partial §2057 election can be made by only designating part of the decedent's QFOBI's in the agreement. Nothing in §2057 specifies what QFOBI's must be designated in the agreement. Further, the §2057 lien can only be recorded as to property designated in the agreement. For this purpose, it is not clear whether the decedent's interest in the business entity (the "QFOBI") should be designated in the agreement, or instead whether the particular business assets owned by the entity which are to be subject to the lien should be designated in the agreement.

(2) Not Clear Whether All Qualified Heirs Have to Sign Agreement

If only some of the heirs receiving fractional interests in the QFOBI from the decedent sign the agreement, perhaps that will result in another type of §2057 partial election. Alternatively, it appears literally possible under the §2057 statute for a business interest passing to a qualified heir to meet the QFOBI definition to qualify for the §2057 deduction even if the qualified heir does not sign the agreement.

(3) Regulations Needed

Obviously, the §2057 regulations will have to answer many questions about who must sign the §2057 agreement and what property must be designated in it.

3. Protective Election

§2057 does not make any mention of protective elections. Neither does §2032A. However, Treas. Reg. §20.2032A-8(b) establishes a very liberal protective elective procedure for §2032A election, although in the years since 1980 when the §2032A regulations were published, the IRS has shown signs of being much more restrictive in administering §2032A protective elections in several technical advice memoranda, and it may well be that in the process of considering whether to permit §2057 protective elections the Treasury Department will revise the §2032A protective election regulation. See ¶9.10 for a complete discussion of the §2032A protective election and the current status of that technique.

4. Partial Election

One of the most controversial and important issues under §2057 is whether the statute and the legislative history (Conference Agreement for the 1997 Act) will "permit" the Treasury Department to authorize partial §2057 elections. Policy considerations and administrative convenience and simplification considerations mitigate very heavily in favor of allowing partial §2057 elections, and there is a basis in both the statute and the Conference Agreement for finding that Congress intended that §2057 partial elections could be made. Hopefully, the Treasury Department in its initial published guidance on §2057 will determine that partial §2057 elections can be made and describe how to make a §2057 partial election.

a. Policy Considerations

The policy considerations are based on the purpose of §2057, which is to relieve qualified family-owned businesses from some of their estate tax burden, in other words to help qualified family-owned businesses survive. One consideration that flows from this purpose and favors the allowance of partial §2057 elections is to allow businesses to decide which of its assets should be encumbered with the §2057 recapture restrictions and lien and which assets should be free of those encumbrances. Allowing an estate to elect §2057 as to some assets and not as to others would be consistent with that policy consideration.

Another policy consideration which flows from the purpose of helping qualified family-owned businesses is to allow families to determine which family members should materially participate in the business in the next generation, rather than requiring all of them to materially participate because of the tax law. Because of the restrictive nature of the family member definition in §2032A(e)(2) which applies for purposes of §2057, it will be desirable in some estates not to elect §2057 on the business interests left to some heirs while electing it on the business interests left to other heirs. Again, allowing §2057 partial elections is consistent with this policy consideration.

Finally, it will help family businesses to be able to elect §2057 on only enough QFOBI to produce the optimal tax results, and allowing §2057 partial elections will do that.

b. <u>Administrative Convenience and Simplification</u>

The considerations of administrative convenience and simplification for both the government and taxpayers mitigate even more heavily in favor of allowing §2057 partial elections. For taxpayers the ability to elect §2057 on only the more fixed and permanent assets of the business will greatly simplify compliance with the §2057 recapture period requirements and living with the §2057 lien on those assets, instead of also having more transitory assets such as accounts receivable, inventory, small equipment and other assets also subject to those requirements and the lien. The government will also find it much easier to have the §2057 lien apply only to the more permanent assets, and it will also be able to more effectively collect the §2057 recapture tax from those assets, because the Conference Agreement for the 1997 Act states that "a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of " §2057. Unless estates are allowed to exclude these types of assets from the §2057 election, the government will have a terrible time trying to police transactions involving these assets for 10 years and to determine which transactions involving those assets are in the "ordinary course of business". Further, the government might even not be able to fully collect §2057 recapture tax with respect to these assets in some cases because of the language in the Conference Agreement for the 1997 Act and how the recapture tax is computed under the method of §2057(f)(2)(C).

It would also greatly simplify the compliance with §2057 for many families if §2057 could be elected only as to the business interests passing to the heirs who are actively involved in the business, and the government would certainly find it simpler to be involved with fewer qualified heirs.

c. <u>Statutory Basis</u>

Fortunately, given the high desirability of permitting §2057 partial elections, there is a basis in both the statute and the Conference Agreement for the 1997 Act for finding that Congress intended partial elections to be permissible. In the statute, §2057(h) states that the §2057 agreement must be signed by "each person in being who has an interest . . . in any property designated in such agreement". The words "any property" must refer to particular business assets and not to the interests of the qualified heirs in the business, in the context of that sentence in the statute. If it was not possible to exclude some of the business assets from the §2057 election, why would it be necessary to identify particular business property in the agreement? It should be possible to make a §2057 partial election just by not including some of the business property in the §2057 agreement, based on this reading of §2057(h).

d. The Conference Agreement

There is also a basis for finding that Congress intended for §2057 partial elections to be possible because of the last paragraph in the Senate Report in the Conference Agreement for the 1997 Act, which is analyzed in ¶14.06. Basically, either that paragraph is referring to a §2057 partial election or it is an incorrect explanation of how the §2057 recapture tax works. See C(6) above in this outline.

e. Treasury Should Allow Partial Elections Without Artificial Restrictions

Hopefully, the Treasury Department will publish procedures for making a §2057 partial election in the initial guidance it publishes under §2057, because there are strong reasons why such elections should be allowed and there is a basis in the statute and the Conference Agreement for finding that Congress intended §2057 partial elections to be allowed.

In considering §2057 partial elections, the Treasury Department should remember the reaction of the courts when it tried to be too restrictive in allowing §2032A partial elections. §20.2032A-8(a)(2) in the §2032A Final Regulations provides that if any of the decedent's property is to be valued under §2032A, the executor must elect §2032A valuation on sufficient property to satisfy §2032A(b)(1)(B) (the 25% test for qualifying for §2032A). However, in Miller v. U.S., 88-1 USTC ¶13,757 (March 9, 1988) the federal district court for the Central District of Illinois held that portion of the Final Regulations to be invalid, and the government did not appeal and has apparently acquiesced in that decision. The Service's analysis in Revenue Ruling 87-122 and General Counsel Memorandum 39680 are superseded and invalidated by the Miller case.

G. DRAFTING FOR §2057

Drafting for §2057 is sometimes inconsistent with otherwise good estate planning techniques. Thus, drafting for §2057 requires balancing other estate planning considerations against the requirements of §2057.

This balancing requires consideration of many factors: the particular clause in question, the client's desires, the likelihood that §2057 will be elected, the size of the client's estate, the percentage of the client's estate which consists of QFOBI for which §2057 might be elected, personal drafting preferences and other considerations.

The three special problem areas in §2057 drafting are:

1. Avoiding the §2057 recapture tax;

2. The successive interest rule; and

3. Tax payment clauses.

Besides the three special problem areas in §2057 drafting, there are other drafting considerations which are related to the §2057 election. For example, the drafting attorney should consider using a "bootstrap" clause providing that the document should be interpreted so as to permit the §2057 election and the avoidance of a recapture tax. Both of these aspects of the clause should explicitly permit the fiduciary to intentionally elect to incur a recapture tax or not to elect §2057 in the first instance.

The three special problem areas in §2057 drafting are extremely analogous to those same special problem areas in §2032A drafting, which are discussed in detail in ¶5.02, ¶5.04 and ¶5.05. The discussion of those problem areas in §2032A drafting in Chapter 5 is applicable by analogy to those same problem areas in §2057 drafting.

Chapter 16 provides a detailed discussion of various issues that arise when QFOBI's for which §2057 is elected pass from the decedent to a trust for the benefit of qualified heirs instead of outright to qualified heirs.

H. ESTATES WHICH MAY BE ELIGIBLE TO ELECT EITHER OR BOTH §2032A AND §2057

1. In General

There are many farm estates which should be able to qualify for both the §2032A value reduction and the §2057 deduction. There are several special concerns to consider when doing estate planning for such clients. Some of those special concerns are as follows:

a. Will Both Elections be Needed?

(1) If not, which one should be made?

(2) If so, how much estate tax can be saved by electing both?

b. Can The Percentage Eligibility Requirements be Met For Both Sections If Maximum Elections Are Made Under Both Sections?

(1) If not, can less than maximum elections be made under one or both sections to achieve a combined result which is better than just one of the maximums?

(2) If not, which section should be elected if the maximum election under one is the only thing possible or is as good as the best combined election?

c. Can The Other Pre-Death Eligibility Requirements Be Meet For Both Sections?

(1) Material Participation for both?

(2) Ownership for both?

(3) Qualified Use for §2032A?

(4) Trade or business for §2057?

d. Can The Recapture Taxes Be Avoided Under Both Sections?

(1) No dispositions to non-family members of qualified heirs under both sections?

(2) Material participation by qualified heirs or their family members under both sections?

(3) No cessation of qualified use by qualified heirs under §2032A?

(4) Continuance of trade or business by qualified heirs or their family members under §2057?

e. What Type of Marital Deduction Formula Should Be Used If Both Sections Might Be Elected?

f. What Type of GST Formula's Should Be Used If Both Sections Might Be Elected?

(1) For the client who is not married?

(2) For clients who are married?

g. Drafting concerns under both sections:

(1) "Successive interest" rule

(2) Avoiding recapture taxes

(3) Fairly balancing allocation of estate tax savings from both elections with recapture tax liability under both sections

The following portions of this outline will discuss most of the above special concerns.

2. Maximum Potential Estate Tax Savings From Combined Maximum Elections Under Both §2032A and §2057

a. For the Client Who Is Not Married

For a client who is not married, who dies in 1998, who has sufficient assets, and who can meet the eligibility requirements for both §2032A and §2057 even if maximum elections are made under both sections, the following fair market value amount of assets can be transferred at death without estate taxes if maximum elections are made under both §2032A and §2057:

Gross Estate	$2,050,000
§2032A Value Reduction	(750,000)
§2057 Value Deduction	(675,000)
Taxable Estate	$ 625,000
Tentative Tax	$ 202,050
Applicable Credit	(202,050)
Estate Taxes	0

If neither §2032A nor §2057 was elected, then the estate taxes would be computed as follows:

Gross Estate	$2,050,000
Tentative Tax	$ 805,300
Applicable Credit	(202,050)
Estate Taxes	$ 603,250

This is the amount of estate tax savings from the combined maximum election under both sections - $603,250!

b. For Clients Who Are Married

For married clients who can structure their asset ownership perfectly and have "perfect" tax formula will or trust documents, it will be possible to pass $4,100,000 of farm assets to succeeding generations without paying any estate taxes, thereby saving $1,206,500 of estate taxes by making maximum elections under both sections in both estates, if both spouses die in 1998.

Even larger farm estates can benefit from the new 2% interest rate under §6166 and pay the approximate $850,000 of estate taxes (if half is paid for each estate) on an additional

$2,000,000 of farm assets (if each spouse owns $3,050,000) over 14 years at a 2% interest rate.

It is fair to say that the 1997 Act has gone a long way toward eliminating the federal estate tax on all but the very largest farm estates. However, it is even more important than ever before that very sophisticated farm estate planning be done for every significant farm estate in order to take advantage of these very complicated estate tax savings provisions.

3. <u>The Marital Deduction Formula For Married Clients Whose Estates May Elect Either or Both §2032A and §2057</u>

As explained in ¶10.08, it does not matter too much which marital deduction formula is used for a §2057 estate, as long as the pecuniary marital lead 64-19 formula is not used. However, it is crucial that the pecuniary marital lead date of funding fair market value formula be used in estates for which a §2032A election may be made, so that same formula is the one formula that should <u>always</u> be used when both §2032A and §2057 may be elected. The reason that this formula must be used whenever a §2032A election may be made is explained in great detail in ¶5.03.

The marital deduction formula referred to in the preceding paragraph which should be used when either or both §2032A and §2057 may be elected is:

> As of the date of death, the trustee shall divide and allocate the trust property, including property to which the trustee may be entitled under my will or from any other source, remaining after providing for the allocations and payments contemplated above (referred to below as "net trust property") as follows:
>
> a. If my spouse is living at my death, the trustee shall establish out of "eligible marital deduction property" (defined below) a separate trust named for my spouse and shall allocate to that trust the smallest pecuniary amount, if any, which if allocated to that trust would result in the lowest possible total of federal estate tax and state death taxes (but only those state death taxes which are estate taxes computed by reference to the credit allowable under Internal Revenue Code §2011 or successor provisions) payable from all sources by reason of my death.
>
> b. After providing for the establishment of the trust named for my spouse, if any, the trustee shall allocate the balance of the net trust property to a separate trust named the "Family Trust".

c. "Eligible marital deduction property" means that part of the net trust property which is included in my gross estate for federal estate tax purposes and as to which, if so included, it is possible, by election or otherwise, to obtain a federal estate tax marital deduction with respect to such included property.

d. The "smallest pecuniary amount" described in subparagraph (a) above shall be determined as if a federal estate tax marital deduction is allowed for property allocated to the trust named for my spouse, is not allowed for property allocated to the Family Trust, and, in all other respects, after giving effect to the exercise or proposed exercise of tax elections. The words used to describe the smallest pecuniary amount shall not be construed as requiring any particular exercise of any tax election.

e. Each item of net trust property allocated in kind to the trust named for my spouse pursuant to subparagraph (a) above shall be valued for purposes of satisfying the pecuniary amount described in that subparagraph at the value of such item at the actual date of allocation to such trust.

4. §2032A Value Reduction Does Leverage $1,000,000 GST Exemption

The GST exemption available to each transferor (client) is $1,000,000. The exemption can be allocated to lifetime gifts or to transfers at the death of the transferor.

A very important issue concerning allocation of the GST exemption at the farm client's death is whether the $1,000,000 is allocated based on the §2032A value or the fair market value of the assets involved in the generation-skipping transfer. Internal Revenue Code §2642(b)(2)(A) specifies that Chapter 11 values shall be used in determining the applicable fraction (the mechanical way that the GST exemption is allocated by §2642(a)). If §2032A is elected, then the Chapter 11 value is the §2032A value.

Therefore, each farm client can leave as much as $1,750,000 in fair market value of §2032A farmland in a generation-skipping transfer fully sheltered from GST tax by the client's $1,000,000 (Chapter 11 §2032A value) GST exemption. A married couple could leave up to $3,500,000 in such transfers that would not be subject to estate tax or GST tax at the deaths of their children.

The GST final regulations published on December 27, 1995 have confirmed that §2032A valuation does leverage the GST exemption in this manner. See ¶8.02.

5. §2057 Value Deduction Does Not Leverage $1,000,000 GST Exemption

The §2057 value deduction is disregarded for all purposes of the generation-skipping transfer ("GST") tax under Chapter 13 of the Internal Revenue Code.

In particular, for purposes of allocating GST exemption at the transferor's death to QFOBI's subject to a §2057 election, the Chapter 11 value of the QFOBI determined without regard to §2057 has to be used. This creates some additional complexity in designing GST tax formula allocations in will and trust documents. It is also a disadvantage of electing §2057 compared to electing §2032A, because §2032A values can be used for purposes of allocating GST exemption.

§2057 also has no effect on the computation of GST tax payable as a result of a direct skip occurring at the death of the transferor, whereas §2032A values can be used in such computation.

6. §2032A-GST Tax Formula For the Unmarried Client

If a §2032A election may be made, the tax formula to use to allocate the largest possible amount of the unmarried client's assets to trusts sheltered from GST tax and estate tax at the deaths of the first generation beneficiaries (client's children, nieces, nephews, etc.) is as follows:

> The trustees (or executors) shall set apart out of the net trust property (or residue of my estate) a pecuniary amount equal to the excess, if any, of the value of the net trust property (or residue of my estate) as finally determined for federal estate tax purposes in my estate over the "GST exempt amount" defined below, and the trustees (executors) shall allocate said pecuniary amount to equal separate primary trusts named, respectively, for _____________. The trustees (executors) shall allocate the balance of the net trust property to equal separate exemption trusts named, respectively, for ________. Each item of net trust property (or of the residue of my estate) allocated in kind to the primary trusts created above shall be valued for purposes of satisfying the pecuniary amount described above at the value of such item at the actual date of allocation to any of such trusts. The "GST exempt amount" means the unused portion of my GST exemption (as described in Internal Revenue Code Section 2631) remaining after all allocations of such ex-

emption before or after my death other than to the exemption trusts created above.

The primary trusts referred to above are trusts over which the first generation beneficiaries (children, nieces, nephews, etc.) have inter vivos and/or testamentary general powers of appointment, making the primary trusts subject to estate tax and not GST tax at the deaths of those beneficiaries. If desired, outright gifts of the formula amount could be made to those beneficiaries, instead of allocating that amount to primary trusts.

By having the formula structured as above, the §2032A value reduction will all be allocated to the exemption trusts rather than the primary trusts, thereby making it possible to allocate as much as $1,750,000 of fair market value farmland with a §2032A value of $1,000,000 to the exemption trusts which will be wholly exempt from GST tax by allocation of the client's $1,000,000 GST exemption to those trusts.

Treas. Reg. §26.2642-2(b)(3) and (4) of the GST final regulations permit non-§2032A property to be allocated to the exemption trusts under this type of formula without losing the benefit of leveraging the GST exemption with §2032A values.

7. <u>GST Formula For Unmarried Client Whose Estate May Elect Either or Both §2032A and §2057</u>

For the unmarried client whose estate may elect either or both §2032A and §2057, the formula which should be used is as follows:

> The trustees (or executors) shall set apart out of the net trust property (or residue of my estate) a pecuniary amount equal to the excess, if any, of the value of the net trust property (or residue of my estate) as finally determined for federal estate tax purposes in my estate over the "GST exempt amount" defined below, and the trustees (executors) shall allocate said pecuniary amount to equal separate primary trusts named, respectively, for ______________. The trustees (executors) shall allocate the balance of the net trust property to equal separate exemption trusts named, respectively, for _________. Each item of net trust property (or of the residue of my estate) allocated in kind to the primary trusts created above shall be valued for purposes of satisfying the pecuniary amount described above at the value of such item at the actual date of allocation to any of such trusts. The "GST exempt amount" means the unused portion of my GST exemption (as described in Internal Revenue Code Section 2631) remaining after all allocations of such ex-

emption before or after my death other than to the exemption trusts created above.

If the estate of an unmarried client who dies in 1998 makes maximum elections under both §2032A and §2057 with such a GST formula in the will or trust document, the maximum fair market value which could be sheltered by such an estate in a GST exempt trust would be $1,750,000 ($750,000 + $1,000,000).

8. GST Formulas For Married Clients Whose Estates May Elect Either or Both §2032A and §2057

When doing estate planning for married clients who want to do GST planning and whose estate may elect either or both §2032A and §2057, it is necessary to include second formulas in both the marital deduction and the bypass parts of the estate so that whichever part needs to be divided into GST exempt and non-GST exempt shares or trusts (depending upon whether the §2057 election is made or not) can be so divided. If such clients may only elect §2032A and definitely will not elect §2057, then the type of GST formulas described and fully explained in ¶8.03(2) should be used. However, if the estates of such clients may elect either or both §2032A and §2057, then a second formula needs to be added to divide the bypass part of the estate (Family Trust) into GST exempt and non-GST exempt shares or trusts, or perhaps even more tailored formula provisions will be needed or desirable.

It appears that the following tax formula will produce the best possible results for married clients whose estates may elect either or both §2032A and §2057:

> As of the date of my death, the trustee shall divide and allocate the trust property, including property to which the trustee may be entitled under my will or from any other source, remaining after providing for the payments contemplated above (referred to below as "net trust property") as follows:
>
> (a) If my wife, ________________, is living at my death:
>
> (1) The trustee shall establish out of eligible marital deduction property a separate share referred to as the "marital share" and shall allocate to that share the smallest pecuniary amount, if any, which if allocated to the marital share would result in the lowest possible total of federal estate tax and those state death taxes computed by reference to the credit allowable under Internal Revenue Code Section 2011 pay-

able from all sources by reason of my death. The trustee shall establish the balance of the net trust property as a separate share named the "residuary share".

(2) The trustee shall set apart out of the residuary share a pecuniary amount equal to the excess, if any, of the value of the residuary share as finally determined for federal estate tax purposes in my estate over the "GST exempt amount" defined below, and the trustee shall allocate said pecuniary amount to a separate trust named "Family Trust B".

(3) The trustee shall allocate the balance of the residuary share to a separate trust named "Family Trust A".

(4) The trustee shall set apart out of the marital share a pecuniary amount equal to the excess, if any, of the smallest pecuniary amount described in (1) of this subparagraph over the amount, if any, of the "GST exempt amount" defined below which is not allocated to Family Trust A, and the trustee shall allocate said pecuniary amount to a separate trust named the "Primary Marital Trust".

(5) The trustee shall allocate the remaining balance of the marital share to a separate trust named the "GST Exempt Trust".

(b) If my wife, ____________________, predeceases me, the trustee shall set apart out of the net trust property a pecuniary amount equal to the excess, if any, of the value of the net trust property as finally determined for federal estate tax purposes in my estate over the GST exempt amount, and the trustee shall allocate said pecuniary amount to equal separate primary trusts named, respectively, for ____________________ ________________. The trustee shall allocate the balance of the net trust property to equal separate exemption trusts named, respectively, for ____ ____________________________________.

(c) If my wife is living at my death, I intend that the Primary Marital Trust and GST

Exempt Trust shall be eligible to qualify for the federal estate tax marital deduction in my estate, and the provisions of this instrument shall be construed liberally to effect my intent. Therefore, despite any other provisions of this instrument, (i) if necessary to be eligible to qualify for the federal estate tax marital deduction in my estate (without regard to whether an election to so qualify is made), on the death of my wife the trustee shall pay all accrued or undistributed income of such trusts to her estate, and (ii) no right, power or discretion granted to the trustee or any other person acting in a fiduciary capacity by the terms of this instrument or by law shall be exercised or exercisable in a manner which would cause such trusts (or any property allocated to such trusts) not to qualify or not to be eligible to elect to qualify for such deduction.

(d) The "smallest pecuniary amount" described in subparagraph (a)(1) above shall be determined as if a federal estate tax marital deduction is not allowed for property allocated to Family Trust A and Family Trust B and is allowed for property allocated to the Primary Marital Trust and the GST Exempt Trust and, in all other respects, after giving effect to the exercise or proposed exercise of tax elections. The words used to describe the smallest pecuniary amount shall not be construed as requiring any particular exercise of any tax election.

(e) Each item of net trust property allocated in kind to the marital share pursuant to subparagraph (a)(1) above shall be valued for purposes of satisfying the pecuniary amount described in that subparagraph at the value of such item at the actual date of allocation to such share.

(f) Each item of net trust property allocated in kind to Family Trust B pursuant to subparagraph (a)(2), to the Primary Marital Trust pursuant to subparagraph (a)(4) or to the primary trusts named for ________________ pursuant to subparagraph (b) above shall be valued for purposes of satisfying the pecuniary amounts described in those subparagraphs at the value of such item at the actual date of allocation to any of such trusts.

(g) For purposes of this instrument, the following definitions shall apply:

"Eligible marital deduction property" means that part of the net trust property with respect to which a federal estate tax marital deduction can be obtained by election or otherwise.

"GST exempt amount" means the unused portion of my GST exemption (as described in Internal Revenue Code Section 2631) remaining after all allocations of such exemption before or after my death other than to the GST Exempt Trust and Family Trust A. The trustee may rely conclusively on the certification of the executor as to the amount of such unused portion.

If both spouses die in 1998 leaving estates which make maximum §2032A and §2057 elections and will and trust documents that use the optimal formulas , then the maximum fair market value which they could shelter in GST exempt trusts would be $3,500,000 (2 x $1,750,000).

9. §2032A Consequences of §2057 Election

§2032A was not amended to refer in any way to a §2033A election when §2033A was enacted or when §2033A was converted to §2057.

The Conference Agreement regarding §2033A when it was enacted stated that §2033A was being "provided in addition to ... the special-use provisions of section 2032A".

Nothing in §2033A (new §2057) indicates that both §2032A and §2033A cannot be elected as to the same estate and even the same property.

Nothing in either §2032A or §2057 specifically refers to how the two elections relate to each other if both elections are made by the same estate.

§2032A(a) provides that if §2032A valuation of qualified real property is elected, then for all purposes of Chapter 11 the value of that property shall be its value determined under §2032A.

a. Effect of §2057 Election on §2032A 50% and 25% Requirements

(1) On Numerator of §2032A 50% and 25% Fractions

For purposes of the 50% and 25% qualification requirements under §2032A(b)(1)(A) and (B), §2032A(b)(3)(B) provides that the values to be used in computing the numerators of both fractions are to be the values determined for purposes of Chapter 11 without regard to §2032A. If §2057 is elected, then for purposes of the §2032A 50% and 25% requirements, the Chapter 11 values of the QFOBI's for which the §2057 value deduction is elected are determined without regard to the §2057 deduction.

(2) <u>On Denominator of §2032A 50% and 25% Fractions</u>

To determine the denominator of the fractions for both the 50% and 25% qualification requirements under §2032A(b)(1)(A) and (B) for an estate which also elects §2057, §2032A(b)(3)(A) provides that the value of the gross estate to be adjusted to determine the denominator is the value of the gross estate determined without regard to §2032A. The §2057 value deduction reduces the taxable estate, not the gross estate, so the §2057 election does not have any effect on the denominators of the fractions which determine whether the §2032A 50% and 25% qualification requirements are met.

b. <u>Effect of §2032A Election on §2057 50% Requirement</u>

(1) <u>On Numerator of §2057 50% Fraction</u>

In meeting the §2057 50% requirement, qualified real property which is valued under §2032A and which is also a QFOBI for purposes of §2057 is to be valued at its §2032A value. §2057(d) clearly states that the value of the QFOBI is its value for purposes of Chapter 11 determined without regard to §2057, meaning that it is determined with regard to §2032A.

(2) <u>On Denominator of §2057 50% Fraction</u>

To determine the denominator for purposes of the §2057 50% of adjusted gross estate requirement for an estate which also elects §2032A valuation, §2057(c) provides that the "adjusted gross estate" is to be determined by making adjustments to "the value of the gross estate" (the gross estate is reduced by the §2032A value reduction), so the §2032A value reduction of the denominator does "help" the estate to meet the §2057 50% requirement, but not as much as using the §2032A values in the numerator of the fraction "hurts" in trying to meet that requirement.

c. <u>Conclusions</u>

To carry out the clear intent of Congress, technical corrections legislation should be enacted which amends §2033A(c) and §2033A(d) so that the values to be used in both the numerator and denominator of the §2033A 50% requirement fraction are "values for purposes of Chapter 11 determined without regard to §2032A and without regard to §2057", since the Conference Agreement stated that an estate could make both elections, and it is hard to believe Congress intended that by making one of those elections the qualification requirements for the other election would not be met.

d. Examples

(1) Example 1 For example, if a farm estate (of a decedent who dies in 1998) which otherwise meets the requirements of both §2032A and §2057 consists of farmland with a fair market value of $1,750,000 and a §2032A value of $1,000,000, and $300,000 of non-farm assets, then under the above analysis the §2032A and §2057 percentage requirements would be computed as follows if both §2032A and §2057 are elected to the maximum extent possible (assuming no adjustments to any of the numerators or denominators are applicable):

(A) §2032A 50% Test

$$\frac{\text{Farm Assets (FMV)}}{\text{Gross Estate (FMV}} = \frac{1,750,000}{2,050,000} = 85\%$$

(B) §2032A 25% Test

The results of this test are the same as under the §2032A 50% test above.

(C) §2057 50% Test

$$\frac{\text{QFOBI (with §2032A)}}{\text{Gross Estate (with §2032A)}} = \frac{1,750,000 - 750,000}{2,050,000 - 750,000}$$

$$= \frac{1,000,000}{1,300,000} = 77\%$$

(D) Computation of Estate Taxes

The estate meets all the percentage requirements to elect both §2032A and §2057, and the estate taxes on this estate would be computed as follows:

Gross Estate	$2,050,000
§2032A Value Reduction	(750,000)
§2057 Value Deduction	(675,000)
Taxable Estate	$ 625,000
Tentative Tax	$ 202,050
Applicable Credit	(202,050)
Estate Taxes	0

(2) Example 2 If the facts in the preceding example are altered to be that the estate consists of farmland with a fair market value of $1,425,000 and a §2032A value of $675,000, and $625,000 of non-farm assets, then the percentage requirements would be computed as follows:

(A) <u>§2032A 50% Test</u>

$$\frac{\text{Farm Assets (FMV)}}{\text{Gross Estate (FMV}} = \frac{1{,}425{,}000}{2{,}050{,}000} = 70\%$$

(B) <u>§2032A 25% Test</u>

The results of this test are the same as under the §2032A 50% test above.

(C) <u>§2057 50% Test</u>

$$\frac{\text{QFOBI (with §2032A)}}{\text{Gross Estate (with §2032A)}} = \frac{1{,}425{,}000 - 750{,}000}{2{,}050{,}000 - 750{,}000}$$

$$= \frac{675{,}000}{1{,}300{,}000.} = 52\%$$

(D) <u>Computation of Estate Taxes</u>

The estate meets all the percentage requirements to elect both §2032A and §2057, and the estate taxes on this estate would be computed as follows:

Gross Estate	$2,050,000
§2032A Value Reduction	(750,000)
§2057 Value Deduction	(675,000)
Taxable Estate	$ 625,000
Tentative Tax	$ 202,050
Applicable Credit	(202,050)
Estate Taxes	0

(3) <u>Example 3</u> If the facts in the preceding example are altered to be that the estate consists of farmland with a fair market value of $1,325,000 and a §2032A value of $575,000, and $725,000 of non-farm assets, then the percentage requirements would be computed as follows:

(A) <u>§2032A 50% Test</u>

$$\frac{\text{Farm Assets (FMV)}}{\text{Gross Estate (FMV}} = \frac{1{,}325{,}000}{2{,}050{,}000} = 65\%$$

(B) <u>§2032A 25% Test</u>

The results of this test are the same as under the §2032A 50% test above.

(C) §2057 50% Test

OFOBI (with §2032A) / Gross Estate (with §2032A)	= (1,325,000 - 750,000) / (2,050,000 - 750,000)	
	= 575,000 / 1,300,000	= 44%

(D) Computation of Estate Taxes

In this example, the estate fails to meet the §2057 50% requirement because it made the maximum $750,000 value reduction election under §2032A. As a result the estate taxes on this farm estate would be computed as follows:

Gross Estate (FMV)	$2,050,000
§2032A Value Reduction	(750,000)
Taxable Estate	$1,300,000
Tentative Tax	$ 469,800
Applicable Credit	(202,050)
Estate Taxes	$ 267,750

(4) Example 4 If in the preceding example the estate had only elected §2032A valuation of enough farmland to reduce the §2032A value of the farmland from its $1,325,000 fair market value down to $725,000 (a $600,000 §2032A value reduction), then the estate could have met the percentage requirements for electing both §2032A and §2057, computed as follows:

(A) §2032A 50% Test

Farm Assets (FMV) / Gross Estate (FMV	= 1,325,000 / 2,050,000	= 65%

(B) §2032A 25% Test

The results of this test are the same as under the §2032A 50% test above.

(C) §2057 50% Test

OFOBI (with §2032A) / Gross Estate (with §2032A)	= (1,325,000 - 600,000) / (2,050,000 - 600,000)	
	= 725,000 / 1,450,000	= 50%

(D) Computation of Estate Taxes

In this last example, the estate meets all the percentage requirements to elect both §2032A and §2057, and the estate taxes on this estate would be computed as follows:

Gross Estate	$2,050,000
§2032A Value Reduction	(600,000)
§2057 Value Deduction	(675,000)
Taxable Estate	$ 775,000
Tentative Tax	$ 258,050
Applicable Credit	(202,050)
Estate Taxes	$ 56,000

Even though there are still $56,000 of estate taxes due on this farm estate, that is a large improvement over the $267,750 of estate taxes which would have been due if the maximum §2032A value reduction was elected, causing complete disqualification for the §2057 value exclusion.

10. Choosing Between §2032A and §2057

There will be some estates, in almost all cases farm estates, which can meet the eligibility requirements for both §2032A and §2057. Some estates will be able to meet all of those requirements even if both §2032A and §2057 are actually fully elected on Form 706, while other estates cannot elect both and still meet the percentage requirements of both, at least if a "maximum" election is attempted under both sections. The percentage requirements are very complicated and tricky if both sections are elected, as explained in ¶17.09.

If an election under only one section is possible because of the percentage requirements, or necessary to eliminate or sufficiently reduce the estate taxes, then which section should be elected? This is a much more difficult question than it might at first seem to be. The factors that should be considered in making this decision should include the following:

a. The §2057 recapture tax is much worse than the §2032A recapture tax, because §2057 requires interest to be paid on the recapture tax all the way back to the original estate tax due date, and §2032A does not. That interest cannot be computed with §6166 interest rates and is not deductible on any tax return.

b. The §2057 election will not reduce the basis of the QFOBI assets for income tax purposes by the amount of the §2057 value deduction, whereas the income tax basis of the qualified real property is reduced by the §2032A value reduction for that property.

c. The §2032A election can clearly be made on particular tracts of real estate and not on others, and does not apply to non-real estate business assets at all, whereas it appears that the "majority view" at this time is that a partial §2033A election is not possible, and that all business assets with respect to the QFOBI, including all real estate and all non-real estate assets of the business (except perhaps inventory or a piece of equipment used in the business which is sold in the ordinary course of business), will be subject to the §2057 recapture tax lien for 10 years after the date of the decedent's death.

d. At this point in time, the consequences of a §2032A election, while sometimes being onerous and complicated, are at least known with some certainty, whereas the consequences of a §2057 election are not only onerous and complicated, but they are also in many cases unknown or uncertain at this time. Many of the unknown or uncertain consequences should be clarified by further technical corrections legislation and regulations, but in the meantime there is a lot that is unknown or uncertain about the consequences of a §2057 election.

e. §2032A values can clearly be used for GST transfers which occur at the death of the decedent and of which the decedent is the GST transferor, both for purposes of allocating GST exemption (determining a trust's GST inclusion ratio) and for purposes of computing the GST direct skip tax on such transfers payable as a result of the decedent's death, whereas the §2057 value deduction cannot be taken into account for such GST purposes.

11. <u>Structuring Asset Ownership and Gifting Considerations in §2032A - §2057 - Marital Deduction - GST Planning</u>

a. <u>Effective Use of Unified Credits, §2032A Value Reductions, §2057 Value Deductions and GST Exemptions</u>

(1) <u>Unified Credits</u>

For the unmarried client, there is obviously no special asset ownership consideration.

For married clients, it is important for each spouse (or the spouse's trust) to separately own sufficient assets to use all of that spouse's available unified credit if that spouse is the first to die, or at least enough of that credit so that the surviving spouse's taxable estate will be less than the unified credit exemption equivalent. It is desirable to be sure that each spouse has enough assets for this purpose taking into account §2032A valuation and/or §2057 value deduction, which should be elected on the first estate to maximize use of the first spouse's unified credit.

(2) §2032A Value Reductions and §2057 Value Deductions

There is not much to do with an unmarried client's asset ownership here, other than to retain assets for which §2032A and/or §2057 can be elected and gift other assets if any lifetime gifts are to be made.

For married clients who own substantial amounts of assets for which §2032A and/or §2057 can be elected, the §2057 value deduction amount and the $750,000 §2032A value reduction for each spouse should be effectively used, no matter which spouse dies first. This will require each spouse to separately own enough farmland to use the full $750,000 §2032A value reduction and/or the maximum §2057 value deduction, or at least enough so that the other spouse's $750,000 §2032A value reduction limit and/or §2057 value deduction limit will not be exceeded if the other spouse is the second to die. In dividing farmland between the spouses, the §2032A and §2057 percentage requirements mentioned in ¶17.11(2) must be remembered.

(3) GST Exemptions

There is not much planning to do with an unmarried client's asset ownership, other than to retain §2032A assets if lifetime gifts are being made, so that §2032A valuation at the client's death will maximize the amount of property covered by the client's GST exemption. §2057 will not leverage the GST exemption, as explained in ¶17.05.

For married clients, it is desirable to have each spouse own enough assets to fully use each spouse's GST exemption (taking into account §2032A values if applicable) no matter which spouse dies first, or at least to be sure that the surviving spouse's assets will not exceed the surviving spouse's GST exemption unless the first spouse's assets also equal or exceed the first spouse's GST exemption.

(4) Inter Vivos QTIP Trust

An inter vivos QTIP trust may be a helpful solution to accommodate the non-tax concerns of a spouse who owns most of the property in a farm family and is reluctant to transfer assets outright to the other spouse to achieve the tax benefits described above.

To create an inter vivos QTIP trust, the donor spouse transfers assets to an irrevocable trust for the benefit of the donee spouse with a child or independent third party as trustee. A gift tax return is filed by the donor spouse for the calendar year in which the trust is created to elect QTIP treatment so that the property transferred to the trust qualifies for the gift tax marital deduction.

The donee spouse is the income beneficiary of the QTIP trust for life, and at the death of the donee spouse the property passes to the beneficiaries of the donor spouse as designated in the trust with little or no power given to the donee spouse to alter that disposition.

Until fairly recently it has appeared that there was a significant disadvantage of using the inter vivos QTIP trust because it was thought that the donor spouse could not retain the right to receive any benefits from the trust property if the donor spouse survived the donee spouse, which would mean that none of the trust would qualify for marital deduction on the donee spouse's Form 706 if the donee spouse dies first. However, Treasury regulations now specifically indicate that it is permissible for the donor spouse to receive at least an income interest after the donee spouse's death, without causing §2036 inclusion of all of the trust on the donor spouse's Form 706. Treas. Reg. §25.2523(d) and (f) Examples 9, 10 and 11.

At the death of the donee spouse, all of the trust property is included on that spouse's federal estate tax return pursuant to the QTIP election made on the gift tax return filed by the donor spouse when the trust was created. Thus, if the donee spouse dies before the donor spouse, the property in the trust can effectively utilize the donee spouse's unified credit, §2032A value reduction, §2057 value deduction and GST exemption.

b. Meeting §2032A And/Or §2057 Percentage Requirements

In structuring asset ownership between married clients and advising on gifting for married and unmarried clients, the §2032A and §2057 percentage requirements must be understood and remembered.

For an unmarried client, the only available techniques to help meet the §2032A and §2057 percentage requirements are to gift away non-farm assets (perhaps even using unified credit) and/or to buy farm assets. While property cannot be valued under §2032A or be a QFOBI under §2057 unless it has been owned by the decedent's family for at least 5 years prior to the decedent's death, it can immediately help to meet the §2032A 50% test so that other assets can be valued under §2032A.

For married clients, the same techniques mentioned above for the unmarried client are available, plus by shifting asset ownership between the spouses it may be possible to qualify both estates or one estate for §2032A and/or §2057 elections, instead of having only one estate or neither estate qualify for §2032A and/or §2057 elections. However, §2057 has a special 10 year rule applicable to transfers between spouses which must be remembered when doing this type of planning for married clients.

c. Making Annual Exclusion Gifts

To the extent other assets are available for making annual exclusion gifts, interests in assets for which §2032A and/or §2057 can be elected should not be used for such gifts. However, if no other assets are available for making such gifts, then interests in those assets should be gifted as long as no problems are thereby created for meeting the §2032A and/or §2057 50% and the §2032A 25% requirements later at the donor's death.

WORKSHEET TO DETERMINE VALUE OF A QFOBI UNDER §2057(e)

One of these worksheets must be completed for each separate business in which the decedent had an interest to determine if that interest can be characterized as a QFOBI under §2057.

1. Is the principal place of business outside U.S.? ________

2. Has stock or debt of business been a "marketable security" within 3 years prior to decedent's death? ________

3. If the business is not a bank described in §581 or a building and loan association described in §7701(a)(19), did more than 35% of the adjusted gross income of the business in its tax year during which decedent died consist of income of the type defined as "personal holding company income" under §543(a)? ________

4. Is the business a "trade or business" as required under §2057(e)? ________

5. Did the decedent and members of the decedent's family own at least 50% of all classes of equity ownership of the business at the decedent's death and at least 5 of the 8 years prior thereto? ________

6. If the decedent and members of the decedent's family owned at least 30% but did not own 50% of all classes of equity ownership of the business at the decedent's death and for at least 5 of the 8 years prior thereto, did the members of 2 families own at least 70% of all such classes or did the members of 3 families own at least 90% of all such classes? ________

If the answer to any of questions 1, 2 or 3 above is "Yes", then the decedent's interest in the business cannot be a QFOBI.

If the answer to question 4 above is "No", then the decedent's interest in the business cannot be a QFOBI.

If the answers to both of questions 5 and 6 above is "No", then the decedent's interest in the business cannot be a QFOBI.

7. Value of Decedent's Interest In Business Which Is Not Denied QFOBI Characterization From Answers To Six Preceding Questions (Determined With Discounts and With §2032A) $________

8. Percentage of Business Assets Which Consist of Cash and Marketable Securities in Excess of Reasonable Day to Day Working Capital Needs and Assets Which Produce Income of the Type Defined as "Personal Holding Company Income" under §543(a) or "Foreign Personal Holding Company Income" under §954(c) ________%

9. Percentage Equal to 100% Minus Percentage on Line 8 ________%

10. Line 7 Value Multiplied By Line 9 Percentage (QFOBI Value of Decedent's Interest In Business For §2057 Deduction Purposes) $________

WORKSHEET TO DETERMINE FACTOR A IN NUMERATOR OF FRACTION FOR 50% OF ESTATE REQUIREMENT

Aggregate Value of QFOBI's included in the gross estate and acquired by or passing to qualified heirs (sum of portions of amounts on lines 10 of Appendix A worksheets which were acquired by or passed to qualified heirs): ________

Minus

The Excess of:

All amounts deductible under §2053(a)(3) and (4) [Schedule K debts and liens on Form 706]: ________

over the sum of:

(A) All indebtedness on any qualified residence of decedent for which interest was deductible under §163(h)(3): (________)

(B) All indebtedness for which proceeds used to pay educational or medical expenses of decedent, decedent's spouse or decedent's dependents as defined in §152: (________)

(C) All indebtedness of decedent not described in A or B, but not in excess of $10,000: (________)

Excess of Schedule K Debts and Liens over (A + B + C) (________)

Adjusted Value of QFOBI (Factor A in Numerator) ________

WORKSHEET TO DETERMINE FACTOR B IN NUMERATOR OF FRACTION FOR 50% OF ESTATE REQUIREMENT

The sum of

(i) Amount of all gifts of QFOBI from decedent to members of decedent's family (other than decedent's spouse) continuously held by decedent's family members from date of gift to date of decedent's death and included as taxable gifts on line 4 of Form 706, valued at date of gift ______________

Plus

(ii) Amount of all gifts described above not included on line 4 of Form 706 because of §2503(b) gift tax annual exclusion, valued at date of gift ______________

Amount of Gifts of QFOBI Includable In Numerator (Factor B in Numerator) (i + ii) ______________

WORKSHEET TO DETERMINE DENOMINATOR OF FRACTION FOR 50% OF ESTATE REQUIREMENT

Value of Gross Estate (Form 706, page 1, line 1)	________
Minus	
All amounts deductible under §2053(a)(3) and (4) [Schedule K debts and liens on Form 706]	(________)
Plus	
The Excess of	
(A) The sum of	
(i) The amount of gifts of QFOBI includable in numerator (Factor B)	________
plus	
(ii) The amount of transfers of non-QFOBI assets from decedent to decedent's spouse within 10 years prior to decedent's date of death (other than de minimis (?) transfers), valued at date of transfer	________
plus	
(iii) The amount of gifts not included in (i) or (ii) from decedent within 3 years prior to decedent's death (other than gifts to decedent's family excluded by §2503(b)), valued at date of gift	________
Over	
(B) The sum of the amounts described in (i), (ii) and (iii) which are otherwise includable in gross estate, valued at date of gift or transfer	(________)
Adjusted Gross Estate For §2057 (Denominator)	________

SECTION 2033A (2057) AS AMENDED BY SECTION 6007(b) OF H.R. 2676 (INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998) PER CONFERENCE REPORT RELEASED ON JUNE 24, 1998

(Deletions are ~~struck through~~; additions are double-underlined.)

SEC. ~~2033A~~ 2057. FAMILY-OWNED BUSINESS ~~EXCLUSION~~ INTERESTS.

~~(a) IN GENERAL.—In the case of an estate of a decedent to which this section applies, the value of the gross estate shall not include the lesser of—~~

~~(1) the adjusted value of the qualified family-owned business interests of the decedent otherwise includible in the estate, or~~

~~(2) the excess of $1,300,000 over the applicable exclusion amount under section 2010(c) with respect to such estate.~~

(a) GENERAL RULE.—

(1) ALLOWANCE OF DEDUCTION.—For purposes of the tax imposed by section 2001, in the case of an estate of a decedent to which this section applies, the value of the taxable estate shall be determined by deducting from the value of the gross estate the adjusted value of the qualified family-owned business interests of the decedent which are described in subsection (b)(2).

(2) MAXIMUM DEDUCTION.—The deduction allowed by this section shall not exceed $675,000.

(3) COORDINATION WITH UNIFIED CREDIT.—

(A) IN GENERAL.—Except as provided in subparagraph (B), if this section applies to an estate, the applicable exclusion amount under section 2010 shall be $625,000.

(B) INCREASE IN UNIFIED CREDIT IF DEDUCTION IS LESS THAN $675,000.—If the deduction allowed by this section is less that $675,000, the amount of the applicable exclusion amount under section 2010 shall be increased (but not above the amount which would apply to the estate without regard to this section) by the excess of $675,000 over the amount of the deduction allowed.

(b) ESTATES TO WHICH SECTION APPLIES.—

(1) IN GENERAL.—This section shall apply to an estate if—

(A) the decedent was (at the date of the decedent's death) a citizen or resident of the United States,

(B) the executor elects the application of this section and files the agreement referred to in subsection (h),

(C) the sum of—

(i) the adjusted value of the qualified family-owned business interests described in paragraph (2), plus

(ii) the amount of the gifts of such interests determined under paragraph (3),

exceeds 50 percent of the adjusted gross estate, and

(D) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—

(i) such interests were owned by the decedent or a member of the decedent's family, and

(ii) there was material participation (within the meaning of section 2032A(e)(6)) by the decedent or a member of the decedent's family in the operation of the business to which such interests relate.

(2) INCLUDIBLE QUALIFIED FAMILY-OWNED BUSINESS INTERESTS.—The qualified family-owned business interests described in this paragraph are the interests which—

(A) are included in determining the value of the gross estate ~~(without regard to this section)~~, and

(B) are acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of section 2032A(e)(9)).

(3) INCLUDIBLE GIFTS OF INTERESTS.—The amount of the gifts of qualified family-owned business interests determined under this paragraph is the ~~excess of~~—

~~(A) the~~ sum of—

~~(i)~~ (A) the amount of such gifts from the decedent to members of the decedent's family taken into account under ~~sub~~section 2001(b)(1)(B), plus

~~(ii)~~ (B) the amount of such gifts otherwise excluded under section 2503(b),

to the extent such interests are continuously held by members of such family (other than the decedent's spouse) between the date of the gift and the date of the decedent's death~~, over~~

~~(B) the amount of such gifts from the decedent to members of the decedent's family otherwise included in the gross estate.~~

(c) ADJUSTED GROSS ESTATE.—For purposes of this section, the term "adjusted gross estate" means the value of the gross estate ~~(determined without regard to this section)~~—

(1) reduced by any amount deductible under paragraph (3) or (4) of section 2053(a), and

(2) increased by the excess of—

(A) the sum of—

(i) the amount of gifts determined under subsection (b)(3), plus

(ii) the amount (if more than de minimis) of other transfers from the decedent to the decedent's spouse (at the time of the transfer) within 10 years of the date of the decedent's death, plus

(iii) the amount of other gifts (not included under clause (i) or (ii)) from the decedent within 3 years of such date, other than gifts to members of the decedent's family otherwise excluded under section 2503(b), over

(B) the sum of the amounts described in clauses (i), (ii), and (iii) of subparagraph (A) which are otherwise includible in the gross estate.

For purposes of the preceding sentence, the Secretary may provide that de minimis gifts to persons other than members of the decedent's family shall not be taken into account.

(d) ADJUSTED VALUE OF THE QUALIFIED FAMILY-OWNED BUSINESS INTERESTS.—For purposes of this section, the adjusted value of any qualified family-owned business interest is the value of such interest for purposes of this chapter (determined without regard to this section), reduced by the excess of—

(1) any amount deductible under paragraph (3) or (4) of section 2053(a), over

(2) the sum of—

(A) any indebtedness on any qualified residence of the decedent the interest on which is deductible under section 163(h)(3), plus

(B) any indebtedness to the extent the taxpayer establishes that the proceeds of such indebtedness were used for the payment of educational and medical expenses of the decedent, the decedent's spouse, or the decedent's dependents (within the meaning of section 152), plus

(C) any indebtedness not described in subparagraph (A) or (B), to the extent such indebtedness does not exceed 10,000.

(e) QUALIFIED FAMILY-OWNED BUSINESS INTEREST.—

(1) IN GENERAL.—For purposes of this section, the term "qualified family-owned business interest" means—

(A) an interest as a proprietor in a trade or business carried on as a proprietorship, or

(B) an interest in an entity carrying on a trade or business, if—

(i) at least—

(I) 50 percent of such entity is owned (directly or indirectly) by the decedent and members of the decedent's family,

(II) 70 percent of such entity is so owned by members of 2 families, or

(III) 90 percent of such entity is so owned by members of 3 families, and

(ii) for purposes of subclause (II) or (III) of clause (i), at least 30 percent of such entity is so owned by the decedent and members of the decedent's family.

For purposes of the preceding sentence, a decedent shall be treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business.

(2) LIMITATION.—Such term shall not include—

(A) any interest in a trade or business the principal place of business of which is not located in the United States,

(B) any interest in an entity, if the stock or debt of such entity or a controlled group (as defined in section 267(f)(1)) of which such entity was a member was readily tradable on an established securities market or secondary market (as defined by the Secretary) at any time within 3 years of the date of the decedent's death,

(C) any interest in a trade or business not described in section 542(c)(2) , if more than 35 percent of the adjusted ordinary gross income of such trade or business for the taxable year which includes the date of the decedent's death would qualify as personal holding company income (as defined in section 543(a) without regard to paragraph (2)(B) thereof) if such trade or business were a corporation,

(D) that portion of an interest in a trade or business that is attributable to—

(i) cash or marketable securities, or both, in excess of the reasonably expected day-to-day working capital needs of such trade or business, and

(ii) any other assets of the trade or business (other than assets used in the active conduct of a trade or business described in section 542(c)(2)), which produce, or are held for the production of, personal holding company income ~~of which is described in section 543(a)~~ (as defined in subparagraph (C)) or income described in section 954(c)(1) (determined without regard to subparagraph (A) thereof and by substituting "trade or business" for "controlled foreign corporation").

In the case of a lease of property on a net cash basis by the decedent to a member of the decedent's family, income from such lease shall not be treated as personal holding company income for purposes of subparagraph (C), and such property shall not be treated as an asset described in subparagraph (D)(ii), if such income and property would not be so treated if the lessor had engaged directly in the activities engaged in by the lessee with respect to such property.

(3) RULES REGARDING OWNERSHIP.—

(A) OWNERSHIP OF ENTITIES.—For purposes of paragraph (1)(B)—

(i) CORPORATIONS.—Ownership of a corporation shall be determined by the holding of stock possessing the appropriate percentage of the total combined voting power of all classes of stock entitled to vote and the appropriate percentage of the total value of shares of all classes of stock.

(ii) PARTNERSHIPS.—Ownership of a partnership shall be determined by the owning of the appropriate percentage of the capital interest in such partnership.

(B) OWNERSHIP OF TIERED ENTITIES.—For purposes of this section, if by reason of holding an interest in a trade or business, a decedent, any member of the decedent's family, any qualified heir, or any member of any qualified heir's family is treated as holding an interest in any other trade or business—

(i) such ownership interest in the other trade or business shall be disregarded in determining if the ownership interest in the first trade or business is a qualified family-owned business interest, and

(ii) this section shall be applied separately in determining if such interest in any other trade or business is a qualified family-owned business interest.

(C) INDIVIDUAL OWNERSHIP RULES.—For purposes of this section, an interest owned, directly or indirectly, by or for an entity described in paragraph (1)(B) shall be considered as being owned proportionately by or for the entity's shareholders, partners, or beneficiaries. A person shall be treated as a beneficiary of any trust only if such person has a present interest in such trust.

(f) TAX TREATMENT OF FAILURE TO MATERIALLY PARTICIPATE IN BUSINESS OR DISPOSITIONS OF INTERESTS.—

(1) IN GENERAL.—There is imposed an additional estate tax if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death—

(A) the material participation requirements described in section 2032A(c)(6)(B) are not met with respect to the qualified family-owned business interest which was acquired (or passed) from the decedent,

(B) the qualified heir disposes of any portion of a qualified family-owned business interest (other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under section 170(h)),

(C) the qualified heir loses United States citizenship (within the meaning of section 877) or with respect to whom an event described in subparagraph (A) or (B) of section 877(e)(1) occurs, and such heir does not comply with the requirements of subsection (g), or

(D) the principal place of business of a trade or business of the qualified family-owned business interest ceases to be located in the United States.

(2) ADDITIONAL ESTATE TAX.—

(A) IN GENERAL.—The amount of the additional estate tax imposed by paragraph (1) shall be equal to—

(i) the applicable percentage of the adjusted tax difference attributable to the qualified family-owned business interest ~~(as determined under rules similar to the rules of section 2032A(c)(2)(B)~~, plus

(ii) interest on the amount determined under clause (i) at the underpayment rate established under section 6621 for the period beginning on the date the estate tax liability was due under this chapter and ending on the date such additional estate tax is due.

(B) APPLICABLE PERCENTAGE.—For purposes of this paragraph, the applicable percentage shall be determined under the following table:

If the event described in paragraph (1) occurs in the following year of material participation:	*The applicable percentage is:*
1 through 6	100
7	80
8	60
9	40
10	20

(C) ADJUSTED TAX DIFFERENCE.—For purposes of subparagraph (A)—

(i) IN GENERAL.—The adjusted tax difference attributable to a qualified family-owned business interest is the amount which bears the same ratio to the adjusted tax difference with respect to the estate (determined under clause (ii)) as the value of such interest bears to the value of all qualified family-owned business interests described in subsection (b)(2).

(ii) ADJUSTED TAX DIFFERENCE WITH RESPECT TO THE ESTATE.—For purposes of clause (i), the term "adjusted tax difference with respect to the estate" means the excess of what would have been the estate tax liability but for the election under this section over the estate tax liability. For purposes of this clause, the term "estate tax liability" means the tax imposed by section 2001 reduced by the credits allowable against such tax.

(3) USE IN TRADE OR BUSINESS BY FAMILY MEMBERS.—A qualified heir shall not be treated as disposing of an interest described in subsection (e)(1)(A) by reason of ceasing to be engaged in a trade or business so long as the property to which such interest relates is used in a trade or business by any member of such individual's family.

(g) SECURITY REQUIREMENTS FOR NONCITIZEN QUALIFIED HEIRS.—

(1) IN GENERAL.—Except upon the application of subparagraph (F) ~~or (M)~~ of subsection (i)(3), if a qualified heir is not a citizen of the United States, any interest under this section passing to or acquired by such heir (including any interest held by such heir at a time described in subsection (f)(1)(C)) shall be treated as a qualified family-owned business interest only if the interest passes or is acquired (or is held) in a qualified trust.

(2) QUALIFIED TRUST.—The term "qualified trust" means a trust—

(A) which is organized under, and governed by, the laws of the United States or a State, and

(B) except as otherwise provided in regulations, with respect to which the trust instrument requires that at least 1 trustee of the trust be an individual citizen of the United States or a domestic corporation.

(h) AGREEMENT.—The agreement referred to in this subsection is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (f) with respect to such property.

(i) OTHER DEFINITIONS AND APPLICABLE RULES.—For purposes of this section—

(1) QUALIFIED HEIR.—The term "qualified heir"—

(A) has the meaning given to such term by section 2032A(e)(1), and

(B) includes any active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business for a period of at least 10 years before the date of the decedent's death.

(2) MEMBER OF THE FAMILY.—The term "member of the family" has the meaning given to such term by section 2032A(e)(2).

(3) APPLICABLE RULES.—Rules similar to the following rules shall apply:

(A) Section 2032A(b)(4) (relating to decedents who are retired or disabled).

(B) Section 2032A(b)(5) (relating to special rules for surviving spouses).

(C) Section 2032A(c)(2)(D) (relating to partial dispositions).

(D) Section 2032A(c)(3) (relating to only 1 additional tax imposed with respect to any 1 portion).

(E) Section 2032A(c)(4) (relating to due date).

(F) Section 2032A(c)(5) (relating to liability for tax; furnishing of bond).

(G) Section 2032A(c)(7) (relating to no tax if use begins within 2 years; active management by eligible qualified heir treated as material participation).

(H) Paragraphs (1) and (3) of section 2032A(d) (relating to election; agreement).

(I) Section 2032A(e)(10) (relating to community property).

(J) Section 2032A(e)(14) (relating to treatment of replacement property acquired in section 1031 or 1033 transactions).

(K) Section 2032A(f) (relating to statute of limitations).

(L) Section 2032A(g) (relating to application to interests in partnerships, corporations, and trusts).

(M) Subsections (h) and (i) of section 2032A.

~~(L)~~ (N) Section 6166(b)(3) (relating to farmhouses and certain other structures taken into account).

~~(M)~~ (O) Subparagraphs (B), (C), and (D) of section 6166(g)(1) (relating to acceleration of payment).

~~(N)~~ (P) Section 6324B (relating to special lien for additional estate tax).

CONFERENCE AGREEMENT ON SECTION 2033A (2057) AMENDMENTS IN INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998

TITLE VI. TAX TECHNICAL CORRECTIONS

House Bill

The House bill contains technical, clerical and conforming amendments to the Taxpayer Relief Act of 1997 (the "1997 Act") and other recently enacted legislation. The provisions generally are effective as if enacted in the original legislation to which each provision relates.[1]

Senate Amendment

The Senate amendment is the same as the House bill, with the following modifications, additions, and deletion:

6. Estate and Gift Tax Provisions of the 1997 Act

The Senate amendment modifies the provisions of the House bill to: (1) clarify the effective date for the generation-skipping exemption; (2) coordinate the unified credit and the qualified family-owned business exclusion; and (3) clarify the rules governing revaluation of gifts. The Senate amendment also adds provisions that: (1) clarify the phaseout range for the 5-percent surtax to phase out the benefits of the unified credit and graduated rates; (2) clarify that interests eligible for the family-owned business exclusion must be passed to a qualified heir; (3) clarify the "trade or business" requirement for the family-owned business exclusion; (4) convert the family-owned business exclusion into a deduction; (5) make other technical changes to items cross-referenced in the family-owned business provision; and (6) clarify the treatment of post-mortem conservation contributions.

CONFERENCE AGREEMENT

3. Estate and Gift Tax Provisions of the 1997 Act

Phaseout range for the 5-percent surtax to phase out the benefits of the unified credit and graduated rates.–The conference agreement does not include the provision in the Senate amendment clarifying the phaseout range for the 5-percent surtax to phase out the benefits of the unified credit and graduated rates.

Qualification for an estate tax deduction for qualified family-owned business interest in the case of cash leases by decedent to family member.--The conference agreement clarifies that an interest in property will not be disqualified, in whole or in part, as an interest in a family-owned business where the decedent leases that interest on a net cash basis to a member of the decedent's family who uses the leased property in an active business. The rental income derived by the decedent from the net cash lease in those circumstances is not treated as personal holding company income for purposes of Code section 2057.

SENATE FINANCE COMMITTEE REPORT ON SECTION 2033A AMENDMENTS IN H.R. 2676 AS RELEASED ON APRIL 22, 1998

3. Conversion of qualified family-owned business exclusion into a deduction (sec. 6007(b)(1)(A) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

Present Law

The qualified family-owned business provision in the 1997 Act provides an exclusion from estate taxes for certain qualified family-owned business interests. It is unclear whether the provision provides an exclusion of value or an exclusion of property from the estate, and thus it is unclear how the new provision interacts with other provisions in the Internal Revenue Code (e.g., secs. 1014, 2032A, 2056, 2612, and 6166).

Explanation of Provision

The provision converts the qualified family-owned business exclusion into a deduction, and redesignates section 2033A as section 2057. Except as provided below, the requirements of the qualified family-owned business provision otherwise remain unchanged. The qualified family-owned business deduction is not available for generation-skipping transfer tax purposes.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

4. Coordination between unified credit and family-owned business provision (sec. 6007(b)(1)(B) and 6007(b)(4) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057(a) of the Code)

Present Law

The 1997 Act effectively increased the amount of lifetime gifts and transfers at death that are exempt from unified estate and gift tax from $600,000 to $1,000,000 over the period 1997 to 2006, through increases in an individual's unified credit. In addition, the 1997 Act provided a limited exclusion for certain family-owned business interests. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million. As a result, for years after 1998, the maximum amount of exclusion for family-owned business interests is reduced by increases in the dollar amount of transfers effectively exempted through the unified credit.

Because the structure of the 1997 Act increases the unified credit over time (until 2006) while decreasing over the same period the benefit of the closely-held business exclusion, the estate tax on estates with family-owned businesses increases over time until 2006. This increase in estate tax results from the fact that increases in the unified credit provide a benefit at the decedent's lowest estate tax brackets, while the exclusion for family-owned businesses provides a benefit at the decedent's highest estate tax brackets.

Explanation of Provision

Under the provision, if an executor elects to utilize the qualified family-owned business deduction, the estate tax liability is calculated as if the estate were allowed a maximum qualified family-owned business deduction of $675,000 and an applicable exclusion amount under section 2010 (i.e., the amount exempted by the unified credit) of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

For example, assume the decedent dies in 2005, when the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued at $675,000 or more, the estate tax liability is calculated as if the estate were allowed a qualified family-owned business deduction of $675,000, and the applicable exclusion amount under section 2010 is limited to $625,000. If the estate includes qualified family-owned business interests of $500,000 or less, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued between $500,000 and $675,000, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is calculated as the excess of $1.3 million over the amount of qualified family-owned business interests. (For example, if the qualified family-owned business interests were valued at $600,000, the applicable exclusion amount under section 2010 is $700,000.)

If a recapture event occurs with respect to any qualified family-owned business interest, the total amount of estate taxes potentially subject to recapture is calculated as the difference between the actual amount of estate tax liability for the estate, and the amount of estate taxes that would have been owed had the qualified family-owned business election not been made.

Effective Date

The provision is effective for decedents dying after December 31, 1997.

5. Clarification of businesses eligible for family-owned business provision (sec. 6007(b)(2) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057(b)(3) of the Code)

Present Law

In order to be eligible to exclude from the gross estate a portion of the value of a family-owned business, the sum of (1) the adjusted value of family-owned business interests includible in the decedent's estate, and (2) the amount of gifts of family-owned business interests to family members of the decedent that are not included in the decedent's gross estate, must exceed 50 percent of the decedent's adjusted gross estate.

Explanation of Provision

The provision clarifies the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate.

Effective Date

The provision is effective with respect to decedents dying after December 31, 1997.

6. Clarification of "trade or business" requirement for family-owned business provision (sec. 6007(b)(5) of the bill, sec. 502 of the Act, and redesignated secs. 2057(e)(1) and 2057(f) of the Code)

Present Law

A qualified family-owned business interest is defined as any interest in a trade or business that meets certain requirements—e.g., the decedent and members of his family must own certain percentages of the trade or business, the decedent or members of his family must have materially participated in the trade or business for five of the eight years preceding the decedent's death, and the qualified heir or members of his family must materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death.

Explanation of Provision

The provision clarifies that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business provision as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cash-leases her portion to her brother, who is engaged in the trade or business of farming, the "trade or business" requirement is satisfied with respect to both the brother and the sister. Similarly, if a father cash-leases farmland to his son, and the son materially participates in the trade or business of farming the land for at least five of the eight years preceding his father's death, the pre-death material participation and "trade or business" requirements are satisfied with respect to the father's interest in the farm.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

7. Clarification that interests eligible for family-owned business provision must be passed to a qualified heir (secs. 6007(b)(1)(B) of the bill, sec. 502 of the Act, and redesignated sec. 2057(a)(1) of the Code)

Present Law

The 1997 Act provided a new exclusion for qualified family-owned business interests. One of the requirements for the exclusion is that such interests must pass to a "qualified heir," which includes members of the decedent's family and any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death.

Explanation of Provision

The provision clarifies that qualified family-owned business interests must pass to a qualified heir in order to qualify for the deduction. For this purpose, if all beneficiaries of a trust are qualified heirs (and in such other circumstances as the Secretary of the Treasury may provide), property passing to the trust may be treated as having passed to a qualified heir.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

8. Other modifications to the qualified family-owned business provision (secs. 6007(b)(3), 6007(b)(6), and 6007(b)(7) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

Present Law

The qualified family-owned business provision incorporates by cross-reference several other provisions of the Code, including a number of provisions in section 2032A and the personal holding company rules of section 543(a).

Explanation of Provision

The provision modifies section 2033A(g) (relating to the security requirements for noncitizen qualified heirs) by deleting the cross-reference to section 2033A(i)(3)(M), which does not appear to be appropriate. The provision also makes rules similar to those set forth in section 2032A(h) and (i) (relating to conversions and exchanges of property under sections 1031 and 1033) applicable for purposes of section 2033A. Finally, the provision clarifies that, in identifying assets that produce (or are held for the production of) income of a type described in section 543(a), section 543(a) is applied without regard to section 543(a)(2)(B) (the dividend requirement for corporate entities).

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

CONFERENCE AGREEMENT ON SECTION 2033A AS ENACTED BY THE TAXPAYER RELIEF ACT OF 1997

3. Estate tax exclusion for qualified family-owned businesses (sec. 402 of the Senate amendment)

Present Law

There are no special estate tax rules for qualified family-owned businesses. All taxpayers are allowed a unified credit in computing the taxpayer's estate and gift tax, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax (sec. 2010). An executor also may elect, under section 2032A, to value certain qualified real property used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value (up to a maximum reduction of $750,000). In addition, an executor may elect to pay the Federal estate tax attributable to a qualified closely-held business in installments over, at most, a 14-year period (sec. 6166). The tax attributable to the first $1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

House Bill

No provision.

Senate Amendment

The Senate amendment allows an executor to elect special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. In general, the provision excludes the first $1 million of value in qualified family-owned business interests from a decedent's taxable estate.

This new exclusion for qualified family-owned business interests is provided in addition to the unified credit (which currently effectively exempts $600,000 of taxable transfers from the estate and gift tax, and will be increased to an effective exemption of $1,000,000 of taxable transfers under other provisions of the Senate amendment), the special-use provisions of section 2032A (which permit the exclusion of up to $750,000 in value of a qualifying farm or other closely-held business from a decedent's estate), and the provisions of section 6166 (which provide for the installment payment of estate taxes attributable to closely held businesses).

Qualified family-owned business interests

For purposes of the provision, a qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. Under the provision, members of an individual's family are defined using the same definition as is used for the special-use valuation rules of section 2032A, and thus include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants. For purposes of applying the ownership tests in the case of a corporation, the decedent and members of the decedent's family are required to own the requisite percentage of the total combined voting power of all classes of stock entitled to vote and the requisite percentage of the total value of all shares of all classes of stock of the corporation. In the case of a partnership, the decedent and members of the decedent's family are required to own the requisite percentage of the capital interest, and the requisite percentage of the profits interest, in the partnership.

In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. Each trade or business owned (directly or indirectly) by the decedent and members of the decedent's family is separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest. In applying these tests, any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest. The value of any qualified family-owned business interest held by an entity is treated as being proportionately owned by or for the entity's partners, shareholders, or beneficiaries. In the case of a multi-tiered entity, such rules are sequentially applied to look through each separate tier of the entity.

For example, if a holding company owns interests in two other companies, each of the three entities will be separately tested under the qualified family-owned business interest rules. In determining whether the holding company is a qualified family-owned business interest, its ownership interest in the other two companies is disregarded. Even if the holding company itself does not qualify as a family-owned business interest, the other two companies still may qualify if the direct and indirect interests held by the decedent and his or her family members satisfy the requisite ownership percentages and other requirements of a qualified family-owned business interest. If either (or both) of the lower-tier entities qualify, the value of the qualified family-owned business interests owned by the holding company are treated as proportionately owned by the holding company's shareholders.

An interest in a trade or business does not qualify if the business's (or a related entity's) stock or securities were publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in section 543). This personal holding company restriction does not apply to banks or domestic building and loan associations.

The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities. Under the provision, the value of qualified family-owned business interests does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. For this purpose, it is intended that day-to-day working capital needs be determined based on a historical average of the business's working capital needs in the past, using an analysis similar to that set forth in Bardahl Mfg. Corp., 24 T.C.M. 1030 (1965). It is further intended that accumulations for capital acquisitions not be considered "working capital" for this purpose. The value of the qualified family-owned business interests also does not include certain other passive assets. For this purpose, passive assets include any assets that: (1) produce dividends, interest, rents, royalties, annuities and certain other types of passive income (as described in sec. 543(a)); (2) are an interest in a trust, partnership or REMIC (as described in sec. 954(c)(1)(B)(ii)); (3) produce no income (as described in sec. 954(c)(1)(B)(iii)); (4) give rise to income from commodities transactions or foreign currency gains (as described in sec. 954(c)(1)(C) and (D)); (5) produce income equivalent to interest (as described in sec.

954(c)(1)(E)); or (6) produce income from notional principal contracts or payments in lieu of dividends (as described in new secs. 954(c)(1)(F) and (G), added elsewhere in the Senate amendment). In the case of a regular dealer in property, such property is not considered to produce passive income under these rules, and thus, is not considered to be a passive asset.

<u>Qualifying estates</u>

A decedent's estate qualifies for the special treatment only if the decedent was a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate (the "50-percent liquidity test"). For this purpose, qualified heirs include any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family. If a qualified heir is not a citizen of the United States, any qualified family-owned business interest acquired by that heir must be held in a trust meeting requirements similar to those imposed on qualified domestic trusts (under present-law sec. 2056A(a)), or through certain other security arrangements that meet the satisfaction of the Treasury Secretary. The 50-percent liquidity test generally is applied by adding all transfers of qualified family-owned business interests made by the decedent to qualified heirs at the time of the decedent's death, plus certain lifetime gifts of qualified family-owned business interests made to members of the decedent's family, and comparing this total to the decedent's adjusted gross estate. To the extent that a decedent held qualified family-owned business interests in more than one trade or business, all such interests are aggregated for purposes of applying the 50-percent liquidity test.

The 50-percent liquidity test is calculated using a ratio, the numerator and denominator of which are described below.

The numerator is determined by aggregating the value of all qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of qualified business interests that are made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family and were not otherwise includible in the decedent's gross estate. For this purpose, qualified business interests transferred to members of the decedent's family during the decedent's lifetime are valued as of the date of such transfer. This amount is then reduced by all indebtedness of the estate, except for the following: (1) indebtedness on a qualified residence of the decedent (determined in accordance with the requirements for deductibility of mortgage interest set forth in section 163(h)(3)); (2) indebtedness incurred to pay the educational or medical expenses of the decedent, the decedent's spouse or the decedent's dependents; and (3) other indebtedness of up to $10,000.

The denominator is equal to the decedent's gross estate, reduced by any indebtedness of the estate, and increased by the amount of the following transfers, to the extent not already included in the decedent's gross estate: (1) any lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family, plus (2) any other transfers from the decedent to the decedent's spouse that were made within 10 years of the date of the decedent's death, plus (3) any other transfers made by the decedent within three years of the decedent's death, except non-taxable transfers made to members of the decedent's family. The Secretary of Treasury is granted authority to disregard de minimis gifts. In determining the amount of gifts made by the decedent, any gift that the donor and the donor's spouse elected to have treated as a split gift (pursuant to sec. 2513) is treated as made one-half by each spouse for purposes of this provision.

Participation requirements

To qualify for the beneficial treatment provided under the Senate amendment, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) is required to materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death. For this purpose, "material participation" is defined as under present-law section 2032A (special use valuation) and the regulations promulgated thereunder. See, e.g., Treas. Reg. sec. 20.2032A-3. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) must be considered. Physical work and participation in management decisions are the principal factors to be considered. For example, an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.

Recapture provisions

The benefit of the exclusions for qualified family-owned business interests are subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements (i.e., if neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least five years of any eight-year period); (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution under section 170(h); (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. A qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a trust meeting requirements similar to a qualified domestic trust (as described in present law sec. 2056A(a)), or through certain other security arrangements.

If one of the above recapture events occurs, an additional tax is imposed on the date of such event. As under section 2032A, each qualified heir is personally liable for the portion of the recapture tax that is imposed with respect to his or her interest in the qualified family-owned business. Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test. If she ceases to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the recapture tax; that is, each would be liable for the recapture tax attributable to his or her interest.

The portion of the reduction in estate taxes that is recaptured would be dependent upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis. For example, if the decedent's estate included $2 million in qualified family-owned business interests and $1 million of such interests received beneficial treatment under this proposal, one-half of the value of the interest disposed of is deemed to have received the benefits provided under this proposal.

<u>Effective date</u>

The provision is effective with respect to the estates of decedents dying after December 31, 1997.

<u>Conference Agreement</u>

The conference agreement follows the Senate amendment, except that the exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million.

The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.

IS IT POSSIBLE TO PROVIDE A FAIR RETURN TO BOTH CURRENT AND FUTURE TRUST BENEFICIARIES?

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SECTION C

IS IT POSSIBLE TO PROVIDE A FAIR RETURN TO BOTH CURRENT AND FUTURE TRUST BENEFICIARIES?

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II. CONTROLLING PRINCIPLES.

A. **A Trustee is subject to a number of duties including:**

1. Duty to make the trust property productive. Restatement (Third) of Trusts § 181 (1990). Where a trustee fails to make any investment, he or she is chargeable with interest at the usual rate of return on trust investments. III Scott on Trusts § 288 (4th ed. 1988).

2. Duty to pay net income to beneficiary. Restatement (Second) of Trusts § 182 (1957).

3. Duty to deal impartially with beneficiaries. Restatement (Third) of Trusts § 183 (1990). Ordinarily, this duty arises where there are successive beneficiaries. IIA Scott on Trusts 558 (4th ed. 1988). If a trust is created for beneficiaries in succession, the trustee is under a duty to the successive beneficiaries to act with due regard to their respective interests. Restatement (Third) of Trusts § 232 (1990).

   a. "If by the terms of a trust the trustee is directed to pay the income to a beneficiary during a designated period and on the expiration of the period to pay the principal to other beneficiaries, the trustee is under a duty to the income beneficiary to exercise care not merely to preserve the trust property but to make it productive of trust income so that a reasonable amount of income will be available for the beneficiary. The trustee is also under a duty to the remainder beneficiaries to exercise reasonable care in an effort to preserve the trust property, and this duty ordinarily includes a goal of protecting the property's purchasing power. In some trust situations the trustee may invest with a goal of increasing the real value of the principal. It is important to note that protection or growth of the purchasing power of principal also tends to preserve or enhance the purchasing power of the income flow over the duration of the trust. This effect would also be of importance in implementing a comparable duty of impartiality that would exist if there were successive income beneficiaries.

Even with best efforts and prudent action by the trustee, however, the combined objectives with respect to income and principal may not be accomplished, particularly over any given time frame. Tradeoffs inevitably exist in these matters, and a need to generate and distribute significant amounts of income can be expected to impair the trustee's ability to preserve the real value of corpus in periods of serious inflation or other difficult market conditions.

The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time. For example, the trust's risk tolerance and expected duration are factors to be considered, as are distribution requirements and the time horizons these factors may impose on the trust's investment strategy. On investment standards generally, see § 227 [General Standard of Property Investment.]

The terms of a trust, as expressed or interpreted, may influence the balancing of competing interests and affect a particular trustee's duty of impartiality. See Comment e, below. Thus, although a trustee is ordinarily not to endanger the safety of principal in order to produce a large income, the purposes and needs of a particular trust may require the trustee to pursue a high income yield at an increased risk to principal, especially at the risk of failing to maintain its purchasing power. Accordingly, it may be appropriate for the trustee to invest heavily in bonds and other fixed-income securities. Conversely, in the circumstances of a given trust it may be appropriate for the trustee to seek a modest yield for the income beneficiary and a high level of capital appreciation. Trust terms granting the trustee authority to invade principal or to accumulate income tend to alleviate investment inhibitions or pressures based on the duty of impartiality. See § 227, Comment i.

In short, trustees have a duty of impartiality with respect to the diverse beneficial interests they serve. Thus, a trustee has a duty to seek to balance the income and principal elements of total investment return. This balance is to be achieved in a manner that is fair to all beneficiaries as a reflection of the trust's purposes, terms, and obligations and in light of the circumstances of the trust and the relevant circumstances of its beneficiaries.

One result of this (see § 240) is that a trustee has a duty to the income beneficiary not to retain or purchase unproductive or under-productive property to an extent that jeopardizes the proper entitlements of that beneficiary through a low income yield from the trust estate as a whole. This is so even though it could be expected that the trust corpus would significantly appreciate in value as a result of those investments. The presence of a power to invade principal, however, may affect the trustee's duty in this respect, although it would not eliminate the income beneficiary's right to an income yield that is reasonable in light of the objectives and circumstances of the trust. See § 227, Comment i.

On the other hand, the beneficiaries of various forms of future interests are also entitled to have reasonable consideration given to their concerns over protection of the purchasing power of trust principal. Thus, if there are subsequent income beneficiaries, they as well as remainder beneficiaries have a right to see that their interests are not disregarded as a result of efforts to provide what might amount to a higher than appropriate yield for the current income beneficiary.

Ultimately these matters may be affected not only by applicable provisions of the trust (see Comment e, below) but also indirectly yet importantly by principles of state law governing principal and income accounting. See §§ 223 through 241, containing specific applications of the rule stated in this Section. Also, on matters of investment policy, see § 227, particularly Comments e and i." Restatement (Third) of Trusts §232 (1990) Comment b.

b. A related commentary supports the original premise. "In short, only when beneficial rights do not turn on a distinction between income and principal is the trustee allowed to focus on total return...without regard to the income component of that return. In other trust situations there exists a fiduciary duty to make the trust estate productive of trust accounting income. The trustee then has a duty to consider two aspects of the productivity question. First, what is an appropriate level or range of income productivity for the particular trust? ...[T]his is a matter for interpretation and fiduciary judgment... Second, how should that productivity objective be incorporated into an overall portfolio strategy? In resolving the latter question the trustee is not governed by the productivity standard in the selection and retention of each individual investment. The standard applies to the portfolio as a whole." Restatement (Third) of Trusts § 227 (1990) Comment i.

B. The Prudent Investor Rule.

1. The Old "Prudent-Man" Standard.

   a. Duty to preserve principal value at all costs.

   b. Each investment was considered on its own merits without regard to the rest of the portfolio.

   c. Broad categories of investments were considered imprudent per se.

d. Delegation of investment authority was generally prohibited.

2. Influence of Modern Portfolio Theory.

a. The capital markets offer bigger rewards and risks for the unknown than for predictability.

b. Assumes that all investors desire the highest possible level of return while bearing the lowest amount of risk.

c. Assumed baseline for risk-free investors - the return on U.S. government securities: the only way to participate in a market returning greater than the baseline is to assume risk beyond treasury risk.

d. Concerns the relationship between risk and reward - investors will search for those opportunities that offer the greatest reward relative to the risk assumed.

e. Diversification reduces the overall variability of the performance of an investment portfolio - investments selected to minimize covariance, i.e., the tendency of certain investments to behave the same.

f. Focus is on portfolio selection rather than individual asset selection - risk can be judged only within the context of the whole portfolio.

g. See generally, Jonathan R. Macey, "An Introduction to Modern Financial Theory", (1991) (American College of Trust & Estate Counsel Foundation) and R.A. Brealey, "An Introduction to Risk and Return from Common Stocks," (2d ed. 1983).

3. The New Standard.

a. The "Standard of Prudence" in investing is applied to the trust portfolio as a whole, rather than to individual investments.

b. The fiduciary's central consideration in investing is the tradeoff between risk and return as applied to risk and reward objectives suitable for the specific trust.

(1) The investment strategy must protect real (as opposed to historic) value, while providing for a suitable return for any income beneficiary.

(2) Trustees have a Duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer.

c. There are no categoric restrictions on types of investments.

d. Prudent investing generally requires diversification.

e. Delegation of investment functions is permitted.

f. A trustee with special skills or expertise has a duty to use those special skills or expertise.

g. The Rule is a standard of conduct. The focus is on process, not results. Liability is not based on the performance of investments if the fiduciary follows the right process.

h. The new standard appears as section 227 of the Restatement (Third) of Trusts (1990) and the Uniform Prudent Investor Act (1994). Uniform Prudent Investor Act, 7B U.L.A. 21 (West Supp. 1997).

C. **Current Uniform Principal and Income Acts.**

1. The 1931 Act is in effect in eight states.

2. The 1962 Revised Act is in effect in 34 states.

D. **The Uniform Principal and Income Act (1997).**

1. Approved by the National Conference of Commissioners on Uniform Laws on July 21, 1997.

2. Primary objectives of the 1997 Act.

a. To revise the 1962 Act.

b. To add provisions to the Act that will facilitate adoption by trustees of investment techniques associated with modern portfolio theory and permitted by legislation such as the Uniform Prudent Investor Act.

3. To facilitate a trustee adopting a total return approach to investing, Section 104 of the 1997 Act provides the trustee with broad authority to make adjustments between principal and income.

4. Section 104 provides a power to adjust total return between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine that he or she is unable to comply with the duty to administer the trust impartially by applying the terms of the trust and the provisions in other sections of the Act. Comment to section 104.

5. Examples.

   a. If trust property does not produce sufficient income, the trustee can transfer funds from principal to income.

   b. If trust property produces significant income, a portion can be transferred to principal.

   c. If the character of an investment's return is unclear, the trustee can adjust to produce a fair and reasonable result.

III. A BRIEF HISTORICAL LOOK AT THE PERFORMANCE OF THE FINANCIAL MARKETS.

A. Fixed Income Investments Versus the Domestic Equity Market.

1. It is well recognized that, at least for the last 75 years, equity out performs debt over time. Illustration I is based on data from Ibbotson Associates and tracks the growth of one dollar from 1926 to 1996. Inflation alone would cause one dollar to grow to nine over this period while Treasury Bills would grow to only \$14 and Bonds to only \$37. During the same period equities increased to <u>\$1,371</u>.

2. Despite historic trends, investors generally prefer income to capital appreciation and debt rather than equity. Joel C. Dobris, "Why Trustee Investors Often Prefer Dividends To Capital Gain And Debt

Investments to Equity - A Daunting Principal and Income Problem" 32 REAL PROP. PROB. & TR. J. 2 (1997).

B. **Which Approach Provides the Best Balance of Risk and Return Over the Long Term?**

1. An analytical model of growth in wealth should take into account the effects of inflation, taxes and spending over time.

2. The "miracle" of compounding is balanced by the "need" to spend.

3. Given that equity grows faster than debt and capital gains are taxed only when incurred and at preferential rates, the more a portfolio is weighted toward equity, the more effectively the investor can maintain real spending power while preserving real wealth.

4. The "Garland Rule" posits that the most reliable way to provide a steady spending rate which adjusts for inflation is to invest entirely in equity and spend all dividends. James P. Garland, "A Market-Yield Spending Rule for Endowments and Trusts." 45 FINANCIAL ANALYSTS JOURNAL, (July/August, 1989) at 50.

5. For a good discussion of how various economic models perform over time see Roger Hertog and David A. Levine, "Income Versus Wealth: Making The Trade-Off," 5-1 THE JOURNAL OF INVESTING 1 (Spring, 1996).

IV. WHAT CAN A TRUSTEE DO TO BETTER BALANCE THE INTERESTS OF THE CURRENT BENEFICIARY AND THE REMAINDERMAN?

A. **The Litigator's Solution.**

1. In general, the remedies of a beneficiary against a trustee are equitable. The beneficiary of a trust can maintain a suit:

   a. To compel the trustee to perform his duties as trustee;

   b. To enjoin the trustee from committing a breach of trust;

   c. To compel the trustee to redress a breach of trust;

   d. To appoint a receiver to take possession of the trust property and administer the trust;

e. To remove the trustee. Restatement (Second) of Trusts § 199 (1957).

2. If the Trustee has committed a breach of trust, the beneficiary can maintain a suit to compel the trustee to redress the breach of trust. A breach of trust is a violation by the trustee of any duty which as trustee he owes to the beneficiary. Restatement (Second) of Trusts § 201 (1957). "Ordinarily a trustee does not commit a breach of trust if he does not intentionally or negligently do what he ought not to do or fail to do what he ought to do. In other words, he does not commit a breach of trust unless he is personally at fault. He may, however, commit a breach of trust where is not personally at fault, as where he acts under a mistake of law or fact, ..." Comment a.

3. If the trustee commits a breach of trust, he is chargeable with (i) any loss or depreciation in value of the trust estate resulting from the breach; (ii) any profit that was made as a result of the breach; or (iii) any profit which would have accrued to the trust estate if there had not been a breach. Restatement (Second) of Trusts § 205 (1957).

4. Nature of the action.

B. **Changing The Mix of Trust Assets**

1. Trust assets heavily weighted towards growth can be rebalanced to produce more interest and dividends.

2. The risk of increasing conventional "income" is that it reduces the ability to keep pace with inflation. Additionally, in the case of bonds, it can be argued that interest payments include some distribution (depletion) of principal.

3. The "drag" of rebalancing includes taxes on capital gains as well as transactional costs.

4. Ideal market conditions for rebalancing may not coincide with pressures from current and future beneficiaries to change the asset mix.

C. **Section 104 Adjustments - Examples from the Official Comment.**

1. "T is the trustee of a trust that provides income to A for life, remainder to B. T received from the settlor a portfolio of financial

assets invested 20% in stocks and 80% in bonds. In response to the Uniform Prudent Investor Act, T determines that the suitable risk and return objectives for this portfolio indicate that it should be invested 50% in stocks and 50% in bonds. As a result, the dividend and interest income is decreased. T is authorized, after considering the factors in subsection (b), to adjust between principal and income to the extent T considers it necessary to increase the amount paid to the income beneficiary."

2. "T is the trustee of a trust that requires the income to be paid to the settlor's son C for his life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double digit interest and determines that a portion of the interest, which is allocated to income under the other provisions of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer a portion of the interest to principal."

3. "T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. E's income from her social security, retirement pension, and savings is more than the amount required to provide for her accustomed standard of living. Applying prudent investor standards, T determines that the trust assets should be invested entirely in growth stocks that produce virtually no dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T is authorized to adjust from principal to income to provide her with that degree of enjoyment."

4. "T is the trustee of a trust whose situs is State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H. The trust agreement gives T the power to invade principal for the benefit of G for "dire emergencies only," and limits the amount that can be distributed from principal over the lifetime of the trust to an aggregate amount that does not exceed 6% of the

trust's value at its inception. The trust's portfolio is invested 50% in stocks and 50% in bonds. After State X adopts the prudent investor rule, T determines that, to achieve the suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds, which increases the total return from the portfolio and decreases the dividend and interest income. In a year in which G does not experience a dire emergency T may nevertheless exercise the power to adjust in Section 104(a) to the extent that T determines that the adjustment is exclusively from the portion of capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981)."

D. Bringing Together All Parties at Interest.

1. Identifying all parties at interest and assessing the ability for them to enter into a legally binding agreement.

   a. dealing with minors and unborn beneficiaries.

   b. dealing with beneficiaries who have significantly different goals and needs.

2. Agreements with respect to:

   a. investment strategy

   b. distribution patterns:

      (1) definition of income

      (2) authority to make discretionary payments of principal and income and applicable limitations

      (3) application of rule 104 type adjustments

3. Is the IRS a party at interest? The transfer tax implications of proposed agreements.

4. Let's take it to the Judge.

V. WHAT CAN A PLANNER DO TO BETTER ASSURE A BALANCE BETWEEN THE CURRENT BENEFICIARY AND THE REMAINDERMAN?

A. Drafting Options.

Professor Joel C. Dobris addressed this issue in his paper "New Forms of Private Trusts For the Twenty-First Century - Principal and Income." 31 REAL PROP., PROB. & TR. J (Spring 1995) at 1. He summarizes the planning options as follows:

1. Traditional fiduciary income allocation rules with authority in the fiduciary to determine a beneficiary's return based on asset allocation.

2. Empower the fiduciary to distribute income and principal on a discretionary basis.

3. Authorize the fiduciary to allocate receipts and expenditures between income and principal.

4. Authorize the fiduciary to reallocate receipts to improve fairness.

5. Create a noncharitable unitrust.

6. Rely upon a formula based on real return for the allocation of trust receipts.

7. Rely upon a formula based on asset values that is essentially a modified unitrust for the allocation of trust receipts.

8. Rely upon a hybrid formula based on asset values and traditional trust accounting income for the allocation of trust receipts.

B. Variations On the Non-Charitable Unitrust Theme.

1. It is suggested a private, noncharitable unitrust:

   a. creates realistic expectations;

   b. replaces the inherited conflict between current and future beneficiaries with a common purpose to provide maximum return given the risk tolerance of the beneficiaries and the trust's probable duration; and

c. addresses the trustee's duty of impartiality. Robert B. Wolf, "Defeating the Duty to Disappoint Equally - The Total Return Trust" 32 REAL PROP., PROB. & TR. J. 1 (1997) at 45.

2. The Simple Illustration: "The Trustee shall pay to the beneficiary X percent of the value trust estate as of the end of each year of A's life and shall distribute the balance as of A's death to B."

3. Additional considerations:

a. Fluctuating Needs:

(1) Will the current beneficiary need all of the unitrust amount each year?

(2) Will the current beneficiary have predictable extra needs, such as tuition?

(3) Should emergencies be addressed such as extraordinary medical expenses?

(4) Should life events i.e., marriage, children, employment status, be taken into account?

(5) Each consideration can be addressed with caps, minimums and powers of invasion.

b. Fluctuating Markets:

(1) Does annual valuation produce a reliable payment?

(2) To smooth fluctuations consider payments based on valuations averaged over 3 to 5 years.

4. Sample trust clauses to define a non-charitable unitrust amount.

* * *

ARTICLE I. DISPOSITION OF TRUST ESTATE

* * *

1. The Trustees shall pay the "Unitrust Amount" to the beneficiary [together with whatever other amounts of income or principal they deem proper for his welfare]. Upon his death, the beneficiary may appoint the balance of the Trust to or for the benefit of anyone, [including his estate or the creditors of his estate] [other than himself, his estate, his creditors or the creditors of his estate]. Any part of the Trust which the beneficiary does not so appoint, for any reason, shall be divided among and held in separate trusts under the following paragraph for his or her lineal descendants, then living, per stirpes.

* * *

ARTICLE II. GENERAL

* * *

5. Definitions. In this Agreement:

* * *

a. Needs and Welfare. A person's "needs" include such amounts as the Trustees deem proper for such person's support, health (including lifetime residential or nursing home care) and education (at all levels). A person's welfare includes such amounts as the Trustees deem proper for such person's "needs" and also for his advancement in life (including assistance in the purchase of a home or the establishment or development of any business or professional enterprise which the Trustees believe to be reasonably sound), happiness and general well-being.

* * *

b. Unitrust Amount. The Unitrust Amount shall be paid in equal quarterly installments on the last day of March, June, September and December. The Unitrust Amount for any taxable year shall be an amount equal to three percent (3.0%) of the net fair market value of the trust assets valued as of the first day of such taxable year, decreased prorata in the case where the taxable year is a short taxable year or is the taxable year in which the beneficiary dies; and increased prorata in the case where there are additional contributions in the taxable year. Any income of the trust which is in excess of the Unitrust Amount shall be added to principal. If any additional contributions are made to the trust, the Unitrust Amount for the taxable year in which the assets are so added to the trust shall be equal to three percent (3.0%) of the sum of (i) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any income from, or appreciation on, such assets) and (ii) that proportion of the fair market value of the assets so added that was excluded under (i) that the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year or the date of the death of the beneficiary bears to the number of days in the period which begins on the first day of such taxable year and ends with the earlier of the last day in such taxable year or the date of the death of the beneficiary. The assets so added shall be valued at the time of contribution. The trust assets, including additional contributions, shall be valued on the first business day of each taxable year. If no valuation date occurs before the end of any taxable year of the trust, the trust assets shall be valued as of the last day of the taxable year of the trust and, if no valuation date occurs before the date of the death of the beneficiary, the trust assets shall be valued as of the date of the death of the beneficiary. If the net fair market value of the trust assets is incorrectly determined by the Trustees as of the first business day of any taxable year, within a reasonable period after the final determination of the correct value, the Trustees shall pay to the beneficiary in the case of an undervaluation, or shall receive from the beneficiary in the case of an overvaluation, an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.

* * *

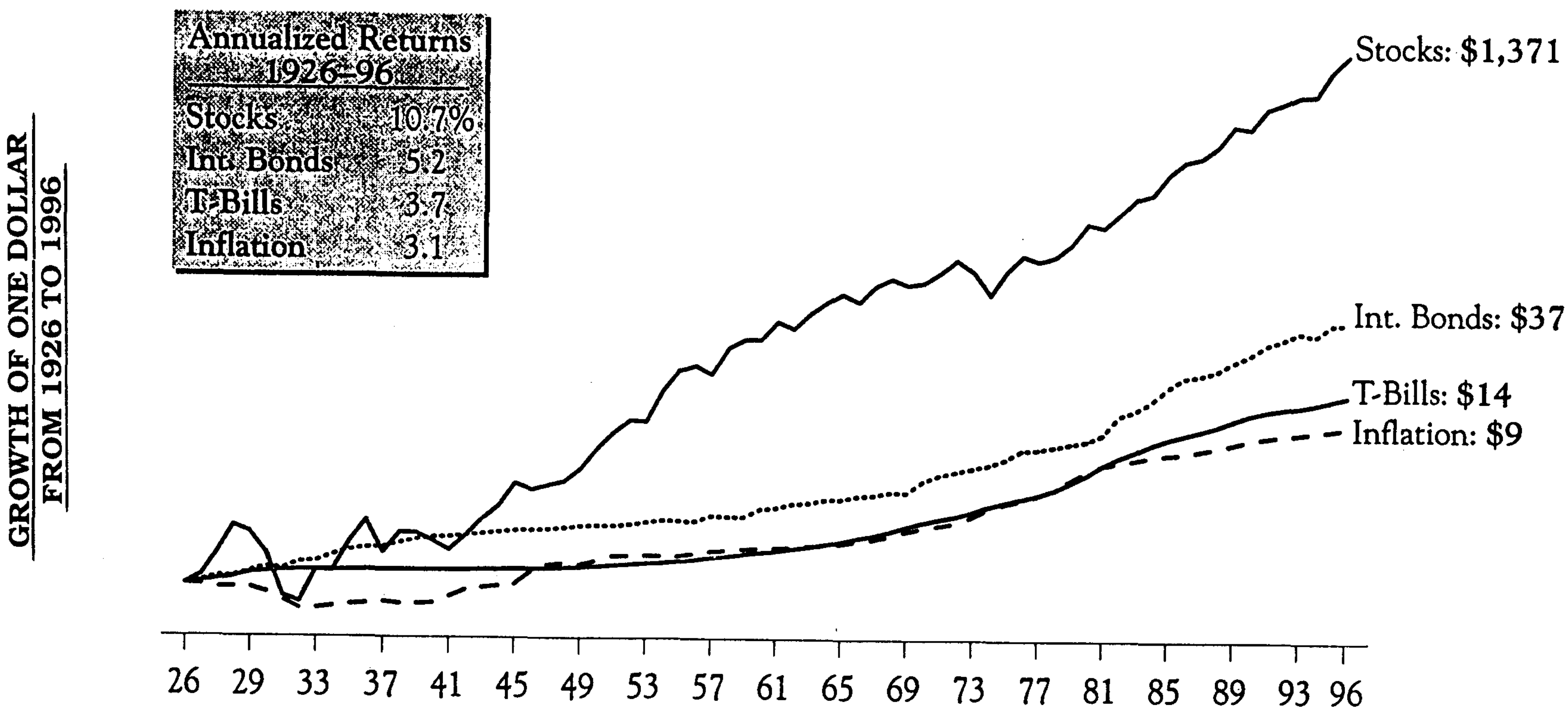
ARTICLE III. FIDUCIARIES

* * *

ARTICLE IV. LIMITATIONS ON RIGHTS AND DUTIES

ILLUSTRATION I

GROWTH OF $1



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THE USE OF DISCRETIONARY TRUSTS

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SECTION D

THE USE OF DISCRETIONARY TRUSTS

TABLE OF CONTENTS

I. INTRODUCTION

A. Most persons drafting wills and trust agreements recognize the desirability of giving the trustee as much flexibility as possible regarding distributions of income or principal to a beneficiary or a class of beneficiaries. Trusts giving the trustee such a discretionary power are referred to in this outline as "discretionary trusts."

B. Discretionary provisions are favored to give the trustee as much flexibility as possible in:

1. providing for a beneficiary's, or class of beneficiaries', well-being, including all of the reasons of health, education, support, capital needs for a home or a business or otherwise, and differences in income. Such provisions have also been used for "family control", e.g., to discipline beneficiaries for family abandonment, matrimonial problems, divorce, use of abusive substances, and other non-pecuniary situations.

2. providing protection for spendthrifts, i.e., giving beneficiaries protection from claims by creditors by prohibiting the voluntary or involuntary assignment or alienation of a beneficiary's beneficial interests.

3. providing for minors.

4. providing tax savings or tax deferral through a plan of favoring or bypassing individual beneficiaries or generations based on need (the corollary is favoring or bypassing based upon comparative tax brackets).

5. insulating trust assets from being countable assets that would disqualify a beneficiary from receiving governmental benefits.

Much of the material in this outline is discussed at greater length in quarterly commentaries of Practical Drafting, Copyright by United States Trust Company of New York and is used here with permission See, particularly, April 1985 and July 1985 issues, "Discretionary Payments of Income or Principal" updated through July 1998. References are to the Internal Revenue Code of 1986.

II. TAX CONSEQUENCES

A. Trust income in a discretionary trust may be taxed to the beneficiary, the trustee, the grantor or another (non-grantor).

1. The beneficiary is taxed on amounts distributed to him to the extent of the trust's distributable net income and in accordance with the "tier" distribution rules. I.R.C. §662.

2. The trust is taxed on accumulated income and these accumulations are no longer subject to the "throwback rule" (which was repealed by Section 507 of The Taxpayer Relief Act of 1997 (P.L. 105-34)). I.R.C. §665-667. The trust is also taxed on capital gains.

3. The grantor is treated as the owner of any portion of trust property and taxed on trust income to the extent that beneficial enjoyment of income or principal is subject to a power of disposition exercisable by a nonadverse party without the consent of an adverse party. I.R.C. §674(a). (This rule, obviously, does not apply to testamentary trusts.) There are exceptions to this general rule. Thus, if a grantor creates a discretionary trust (and he is not the trustee), trust income will not be taxed to the grantor if one of the exceptions in I.R.C. §674(c), 674(b)(5), 674(b)(5)(A) or 674(d) is satisfied.

a. The grantor is not taxed on income of a discretionary trust if the grantor is not a trustee and no more than half the trustees are related or subordinate parties [a term defined in I.R.C. §672(c) as any nonadverse party who is the grantor's spouse (if living with the grantor), the grantor's father, mother, issue, brother or sister and certain other persons]. I.R.C. §674(c).

b. When the trustee is a related or subordinate party and has discretion to distribute <u>corpus</u>, the grantor is not taxed on trust income provided the trustee's power is limited by a "reasonably definite standard" in the will or trust agreement. I.R.C. §674(b)(5) and I.R.C. §674(b)(5)(A).

c. When the trustee is a related or subordinate party (other than the grantor or grantor's spouse living with the grantor) and has discretion to distribute or accumulate income, the grantor is not taxed on trust income provided the trustee's power is limited by a "reasonably definite external standard" in the trust instrument. I.R.C. §674(d) and Reg. §674(d)-1 and Reg. §1.674(d)-1.

4. The grantor is taxed on trust income if it may be used for the benefit of grantor or grantor's spouse. I.R.C. §677(a).

   a. This includes possible use of income to discharge a legal obligation of grantor or grantor's spouse.

   b. If the legal obligation is the obligation of support, the grantor is taxed only if income actually is used to discharge the support obligation. I.R.C. §677(b).

5. The non-grantor will be treated as the owner of any portion of a trust with respect to which the non-grantor has a power, exercisable solely by himself or herself, to vest the income or corpus from the trust in himself or herself. I.R.C. §678. The section does not state that an exception applies for a power subject to an ascertainable standard. Nevertheless, if the non-grantor, who is serving as trustee of a trust for his or her benefit, has discretion to distribute income or principal limited to an ascertainable standard, cases hold that the trustee will not be taxed on the trust income under I.R.C. §678 (a). See, e.g., De Bonchamps v. U.S., 278 F. 2d 127, 130 (9th Cir. 1960). The non-grantor is taxed on trust income which is expended for a beneficiary whom the non-grantor has a legal obligation to support if the non-grantor has the power as trustee to so apply the income. I.R.C. §678. The Internal Revenue Service takes the position that trust income applied to discharge a non-grantor's support obligation is taxable to the non-grantor, even when the non-grantor is not a trustee. Reg. 1.662(a)-4.

6. Cases on the subject of whether college expenses of a child fall within the support obligation of a parent are numerous, and the determination must be made under applicable state law.

   a. After 1968 the general rule in New York appeared to be that a father is not obligated to provide a private school education for his minor child without "special circumstances" and the factors to be considered include: (1) the educational background of the parents, (2) the child's academic abilities and (3) the father's financial ability to provide the necessary funds. Kaplan v. Wallshein, 57 A.D. 2d 828, 394 N.Y.S. 2d 439 (2nd Dept. 1977). See Frankel v. Frankel, 82 A.D.2d 796, 439 N.Y.S. 2d 218 (2d Dept. 1981) ordering a very wealthy parent to pay his children's college expenses. In 1989 the Child Support Standards Act (CSSA) was enacted and a court, within its discretion, could determine to award educational expenses where it was in the "best interests" of the children and appropriate to the circumstances. Cohen v. Cohen, NYLJ April 22, 1994, p. 25 col. 5, Romans v. Romans, NYLJ May 3, 1994, p. 27 col. 2 and Cassano v. Cassano, NYLJ May 2, 1994, p. 32 col. 2.

b. In Frederick C. Braun, Jr., 48 TCM 210 (1984), the Tax Court held that under New Jersey law a parent has a legal obligation to pay (l) college expenses of a child age 18 and over and (2) private school expenses of a child under age 18.

c. The Supreme Court in Florida held that a parent has no legal duty to provide a college education for an adult child (a child over 17). Grapin v. Grapin, 450 So.2d 853 (1984).

d. The Pennsylvania Court concluded in Griffin v. Griffin, 558 A.2d 75 (Pa. Super. 1989) that (1) in determining the support obligation for a child over age 18, the child's own resources may be taken into account but he or she may not necessarily be required to contribute as much as possible or required to attend a state institution rather than a more expensive private college, and (2) only in exceptional cases, will the parent's obligation to pay college expenses continue after the child becomes 23.

e. Does payment of college expenses of a child over age 17 paid from trust income result in a parent being taxed on such income in California? Section 196 of the California Civil Code states that a father and mother have an equal responsibility to support and educate their child and §241(d) defines a child as a daughter or son under the age of 18 or incapacitated. See Jones v. Jones, 225 Cal. App. 3d 1011 (Cal. App. 2 Dist. 1986) and

Christopher Stone, 54 TCM 462 (1987), aff'd. without published opinion 867 F. 2d. 613 (9th Cir. 1989), and Joanne L. Sharon, 57 TCM 1562.

B. The estate tax consequences should be considered when a beneficiary, trustee, or grantor is given a discretionary power to distribute income or principal.

1. The trust property will be included in the estate of a beneficiary or power holder if he has an unrestricted power to consume trust property. I.R.C. §2041(b).

a. If the beneficiary or power holder has a power limited by an ascertainable standard related to health, education, maintenance or support, the trust property will not be included in the gross estate. I.R.C. §2041(b)(1)(A) and Reg. §20.2041-1(c)(2). See also I.R.C. §2514(c)(i) and Reg. §25.2514-1(c)(2).

i. The Regulations state that "support in his accustomed manner of living" is an ascertainable standard. Yet the IRS ruled that a power to invade corpus "to continue the donee's accustomed mode of living" is a general power of appointment. Rev. Rul. 77-60, 1977-1 CB 282 (See quote at iii infra).

ii. To avoid adverse tax consequences, statutes in some states prohibit a beneficiary-power holder from participating in the exercise of the power (Wis. Stat. Ann. §701.20(12)(dm), New York's EPTL 10-10.1, Missouri's Mo. Rev. Stat. §456.540.4, North Carolina's N.C. Gen. Stat.632-29) and Connecticut, P.A. No. 95-315 and other statutes restrict the exercise of certain powers (Florida's F.S.A. 737.402(4), Ohio Rev. Code §1340.22, Virginia's Va. Code §55-78, California Civil Code §2269, Montana Code Annotated §72-34-130, New Jersey, NJSA 3B:11-4.1, New Hampshire, N.H. RSA §564-A:3 and Colorado, CRS §15-1-1401). Similarly, Garfield v. United States, 80-2 USTC 13,381 (D.C. Mass. 1980) holds that the common law in Massachusetts prohibits the beneficiary-power holder from participating in the exercise of the power and Armington v. Meyer, 103 R.I. 211, 236 A.2d 450

(1967) holds that in Rhode Island the beneficiary-holder must obtain court approval of the exercise of the power for his benefit. An Indiana statute requires the power holder to secure court approval of the exercise of the power (Ind. Code Ann. §30-4-3-5).

iii. The scope of the principal invasion language is determined under applicable state law and the words used may or may not create an ascertainable standard. The courts held ascertainable standards were created in: Estate of Wood v. Comm'r, 398 T.C. 919 (1963): "support, maintenance, welfare and comfort"; Estate of Bell vs. Comm'r, 66 T.C. 729 (1976): "well-being and maintenance in health and comfort"; Estate of Gokey v. Comm'r, 72 T.C. 721 (1979): "support, care, welfare and education." The courts have held ascertainable standards were not authorized in Miller v. United States, 387 F2d 866 (3rd Cir. 1968): "comfort and well-being"; Lehman v. United States, 448 F.2d 1318 (5th Cir. 1971): "comfort and welfare;" and in Strite v. McGinnes, 300 F.2d 234 (3rd Cir. 1964): "benefit". See also Rev.Rul. 77-60, 1977-1 Cum. Bull. 282 where the I.R.S. said, "A power to use property to enable the donee to continue an accustomed mode of living, without further limitation, although predictable and measurable on the basis of past expenditures, does not come within the ascertainable standard prescribed in §2041(b)(A)...."

iv. the potential tax problem exists only when a person may exercise the power (or participate in the exercise) for his own benefit.

b. If a trustee-beneficiary has a legal obligation to support another beneficiary, and the support obligation may be satisfied by a distribution from the trust in the trustee's discretion, the power of the trustee to participate in a decision to distribute, even if measured by an ascertainable standard, is a general power. Reg. 20.2041-1(c)(1) and Reg. 25.2514-1(c)(1).

2. A power of appointment includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used. Reg. §20.20401-1 (b)(1). These powers may include the power in a donee to remove or discharge a trustee and appoint a successor trustee.

   a. In Rev. Rul 79-353, 1979-2 C.B. 325 the decedent-grantor's unrestricted power to replace a corporate trustee of an irrevocable trust with another independent trustee caused the powers of that trustee to be attributed to the grantor for estate tax purposes. The Tax Court, in Estate of Wall v. Comm'r., 101 T.C. 300 (1993), rejected the holding of the Revenue Ruling. (After this decision, the estate brought a proceeding under IRC §7430(a) for its reasonable litigation costs. To succeed it had to show that the IRS position was not "substantially justified," a difficult task with a case of first impression. The Tax Court held the test was not met. 102 T.C. 13 (1994).) In Rev. Rul. 95-58 the Service reconsidered its position and revoked Rev. Rul. 79-353 and Rev. Rul. 81-51, holding that if the grantor possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate (for purposes of §672(c)), the grantor has not retained a trustee's discretionary control over trust income.

   b. In LTR 8916032, the IRS extended the principle of Rev. Rul. 79-353 (regarding grantor powers) to a beneficiary's power to remove a trustee and appoint a successor. The Ruling's position was that if the trustee has a discretionary power (unlimited by an ascertainable standard) to distribute principal to the beneficiary, then the beneficiary will be deemed to have a general power of appointment causing the trust property to be taxed in the beneficiary's estate under §2041(a)(2). Also, a release or lapse of the power to remove and appoint successor trustees causes the trust property to be taxed in the beneficiary's estate if the beneficiary has an interest in the trust such that if the property had been transferred to the trust by the beneficiary, the property would be includable in the beneficiary's estate under §2035 to §2038, inclusive.

      In LTR 8922003, a National Office Technical Advice Memorandum, the IRS employs the rationale of Rev.

Rul. 79-353 to attribute the incidents of ownership of insurance in an insurance trust to the grantor, who retained the right to remove the trustee. On April 23, 1979, the decedent created an irrevocable insurance trust and designated a corporate fiduciary as initial trustee. The decedent grantor reserved the right for his life to remove any trustee and appoint anyone other than himself as successor trustee. In 1986, the decedent removed the corporate trustee and appointed his two siblings as successor trustees. The decedent died in 1987. The insurance, however, was held not includable in the decedent's gross estate because the policy was irrevocably transferred to the trust before October 29, 1979, the grandfather date Rev. Rul. 81-51 established for Rev. Rul. 79-353.

The letter ruling was issued on February 24, 1989. On August 7, 1989, the Tax Court decided Estate of Headrick v. Commissioner, 93 T. C. 171 (1989), aff'd, 918 F. 2d 1263 (6th Cir. 1990). The decedent died within three years of creating an irrevocable insurance trust under which the corporate trustee purchased insurance on the decedent's life. The Tax Court held that the decedent never possessed incidents of ownership in the life insurance policy within the meaning of §2042. However, the trust agreement reserved to the decedent the right to remove any trustee at will and appoint a successor bank trustee. This power was not discussed in the opinion.

In LTR 9607008 the IRS, citing Rev. Rul. 95-58, ruled that beneficiaries of irrevocable trusts could be appointed co-trustees but would not be deemed to have a general power of appointment over the income and principal of their respective trusts by virtue of their power to remove and replace the corporate trustee of their respective trusts. (The trust will also be reformed to provide that any successor corporate trustee may not be related or subordinate to the individual trustees under §642(c)).

c. Consideration should be given to imposing restrictions on the removal right. Letter ruling 9303018 relates to the proposed construction and modification of a 1978 trust as to which additions were made through 1983. The trust authorizes certain family trustees who are beneficiaries to remove and replace any other trustee and states that no fiduciary power (including the removal and replacement power) be exercised to benefit the trustee. The trustees proposed to construe and modify by court order certain provisions of the trust. The family trustee's removal and replacement power could only be exercised for "cause." The trust agreement listed 13 grounds for removal.

i. The legal incapacity of a trustee.

ii. The willful or negligent mismanagement by the trustee of the trust's assets.

iii. The abuse or abandonment of, or inattention to, the trust by the trustee.

iv. A federal or state charge against the trustee involving the commission of a felony or serious misdemeanor.

v. An act of stealing, dishonesty, fraud, embezzlement, moral turpitude, or moral degeneration by the trustee.

vi. The use of narcotics or excessive use of alcohol by the trustee.

vii. The poor health of the trustee such that the trustee is physically, mentally, or emotionally unable to devote sufficient time to administer the trust.

viii. The failure by the trustee to comply with a written fee agreement or other written agreement in the operation of the Trust.

ix. The failure of a corporate trustee to appoint a senior officer with at least five (5) years of experience in the administration of trusts to handle the trust account.

x. Changes by a corporate trustee in the account officer responsible for handling the trust account more frequently than every five (5) years (unless such change is made at the request of or with the acquiescence of the other trustee).

xi. The relocation by a trustee away from the location where the trust operates so as to interfere with the administration of the trust.

xii. A demand from the trustee for unreasonable compensation for such trustee's services.

xiii. Any other reason for which a [state] court of competent jurisdiction would remove a trustee.

The IRS ruled the family trustee did not have or release a general power of appointment either before or after the construction.

d. Consideration should be given to giving the removal right to:

i. the spouse-beneficiary of a marital deduction trust;

ii. a beneficiary to whom the trustee cannot currently distribute principal; or

iii. an individual who is not a beneficiary

3. The trust property will be included in the estate of a decedent-grantor if income from a discretionary trust is used by the trustee to discharge the support obligation of the grantor. Reg. §20.2036-1(b)(2). But if distributions from the trust for the support of a dependent were discretionary (with independent trustees), the Regulation does not apply. Ltr. Rul. 8504011.

C. When there is a splitting of trust benefits among younger generation beneficiaries assigned to two or more generations, tax payment under Chapter 13 may arise in a discretionary trust with power to pay income or principal among a class of beneficiaries. In general, a distribution of income or principal to a grandchild or more remote descendant will be a taxable distribution under Chapter 13 unless if made by an individual it would not be treated as a taxable gift under I.R.C. §2503(e). See I.R.C. §2611(b)(2).

III. PROPERTY LAW CONSIDERATIONS

A. In creating a discretionary trust to distribute income and principal, what standard is the trustee to apply in making distributions? The clause in Appendix A gives the trustee as much flexibility as possible regarding the exercise of the power.

1. A trustee acting under a simple discretion should be judged by a standard of reasonableness. Restatement (second) of Trusts §187, comment j (1959).

2. A trustee having "absolute," "uncontrolled," or "unlimited" discretion should be judged by a standard based on his state of mind. Restatement (Second) of Trusts §187, comment j (1959). This is commonly referred to as the good faith test. Even though the Restatement interpretation does not appear to be supported by the cases, use of the words "absolute" or "sole" should provide some additional discretion.

   a. In re Ledyard's Estate, 21 N.Y.S. 2d 860 (1939) aff'd., 259 App. Div. 892, leave to appeal denied 284 N.Y. 819, the Trustee had "absolute discretion" to distribute income to wife and decendants. In an accounting proceeding objections were filed because income was distributed to the wife (who had sufficient income from other sources). The court held that the trustee's exercise of discretion would not be subject to review.

   b. Similarly, See Matter of Payson, NYLJ June 20, 1989, p.26, in which the scope of the invasion language set forth in Appendix A of this outline was discussed and the opinion found no abuse of discretion by the trustee.

   c. Compare the somewhat inconsistent interpretation found in Matter of Stillman, 107 Misc.2d 102, 433 N.Y.S. 2d 701 (1980), where the trustees, who had "absolute and uncontrolled" discretion to invade principal for testator's grandsons, refused to invade principal and were later compelled to do so by the Surrogate.

B. It is important to know whether the terms "support and maintenance", "use", "benefit," "emergency," and "need" are to be interpreted liberally or conservatively in the applicable jurisdiction. The use of these words may cause uncertainty regarding the circumstances under which the power to invade principal may be exercised.

1. When the language allows for an invasion due to an "emergency" and the beneficiary is a trustee, the I.R.S. takes the position that the trustee/beneficiary has a general power of appointment. However, the courts have not found "emergency" to be broadening language in Warner v. Trust Co. Bank, 250 Ga. 204, 296 S.E. 2d 553 (1982), Estate of Ira Maude Sowell, 74 T.C. 1001 (1980), rev'd, 708 F. 2d 1565 (10th cir. 1983) (where the opinion stated: "The key characteristic of the meaning of "emergency" is that of need. The Tax Court also erred in concluding that the concept of an "emergency" included broader uses than for support or maintenance.") and Hunter v. United States, 597 F. Supp. 1293 (D.C. Pa. 1984) (where the opinion, referring to Reg. §20.2041-1(c)(4) stated: "allowing invasion in order to support the beneficiary in his accustomed manner of living [as does the regulation] is surely a more liberal standard than that embodied in the term 'emergency.' We can envision no emergency which would not be reasonably measurable in terms of health or to support a beneficiary's standard of living".)

2. The terms "support" and "maintenance" mean different things to different people. Depending upon the governing jurisdiction, it may or may not be helpful to use modifiers such as "comfortable" or "generous".

    a. The terms are interpreted to mean more than the bare necessities of life. Hartford-Connecticut Trust Co. v. Eaton, 36 F. 2d 710 (2d Cir. 1929). The terms may be exercised taking into account the beneficiary's station in life. Hill v. Comm'r, 88 F.2d 941 (8th Cir. 1937), In re Levinson's Will, 5 Misc. 2d 979, 162 N.Y.S. 2d 287 (Surr. Ct. 1957) and Equitable Trust Co. v. Montgomery, 44 A.2d 420 (Del. Ch. 1945).

    b. When a trustee is authorized to invade principal for the support of the beneficiary, most jurisdictions hold that the trustee is also authorized to invade for expenses of the beneficiary's dependents, including spouse and children. In re Sullivan, 144 Neb. 36, 12 N.W. 2d 148 (1943); Robinson v. Robinson, 173 Misc 985, 19 N.Y.S. 2d 44 (Surr. Ct. 1940); and Seattle-First National Bank v. Crosby, 42 Wash. 2d 234, 254 P.2d 732 (1953). But see Cavett v. Buck, 397 P. 2d 901 (Okla. 1964) where the court limited distributions for the support of the beneficiary alone, and not for the support of his wife and dependent children.

3. It is often uncertain whether the trustee has the authority to invade principal to enable the income beneficiary to make gifts.

   a. The court refused to permit such an invasion in a marital deduction trust where the will authorized an invasion "for the spouse or for her use" Matter of Mandel, 46 Misc. 2d 850, 261 N.Y. 2d 110 (1965). Similarly, the court denied an invasion to enable the wife to make gifts to her children pursuant to a clause which authorized "in the absolute discretion of my Trustee [an encroachment on corpus as] shall be appropriate and to the best interest of my wife...." In re Estate of Howard, 236 S.E. 2d 423 (1977).

   b. In Estate of Hartzell v. Comm'r, the IRS took the position that the exercise of an invasion power over property held in an IRC §2056(b)(5) trust was invalid and the surviving spouse's gifts of property should not be recognized. The will authorized invasions of principal as follows:

      > "In addition thereto, the trustees are given the right, in their sole and absolute discretion, to use the principal of Trust A or any part thereof, even to the exhaustion thereof, for the comfort, maintenance, support and general well being of said Miriam H. Hartzell, or to continue the standard of living to which she is accustomed, or to aid her in the event of any accident, injury, illness or other emergency affecting her."

      The Tax Court rejected the IRS contention. 68 TCM 1243 (1994).

      In Estate of Halpern v. Comm'r., the invasion language for the spouse was more limited than in Hartzell. Invasions could be made if the surviving spouse had an illness or other emergency requiring a distribution of principal to ensure her maintenance and welfare. The trustee of the marital trust made distributions of principal to the spouse pursuant to an invasion power and the spouse then made gifts with the distributed property. The IRS asserted that the invasions were not authorized and that the gift property should be included in the spouse's estate. The Tax Court held that distributions made to the spouse from the trust before her incompetency were not subject to estate tax, but that post-incompetency distributions were taxable. 70 TCM 229 (1995).

Similar facts were involved in letter ruling 9337001, a National Office Technical Advice Memorandum.

c. Often the spouse desires to make gifts to descendants and, particularly, to children. This should be possible if the trustee is given absolute discretion to make discretionary payments (See language in Appendix A), rather than having discretion to make invasions for the "benefit" of or in the "best interest" of the spouse.

C. Whether or not the trustee must consider other income or resources available to the beneficiary before exercising discretion to invade principal is a frequently litigated issue.

1. The general rule is that a beneficiary should be supported by the trust regardless of the beneficiary's outside resources. "It is a question of interpretation whether the beneficiary is entitled to support out of the trust fund even though he has other resources. The inference is that he is so entitled." Restatement (Second) of Trusts, §128, comment e (1959).

2. In New York the standard is based on whether the testator/grantor created a trust to provide for the support of the beneficiary (i.e., a support trust is an absolute gift without regard to the beneficiary's outside resources) or whether the instrument authorizes the trustee to invade principal for the beneficiary's support if the income is insufficient for the beneficiary's needs. In re Martin's Will, 269 N.Y. 305, 129 N.E. 491 (1936). Courts disagree on the application of the New York rule, and use of the words "need," "insufficiency," or "necessary" may or may not be determinative, so that prior cases may have minimal precedential value.

a. Where the will authorized the trustees "...to apply the net income and so much of the principal as my said trustees in their discretion shall deem necessary or desirable for the support, maintenance and treatment of my beloved sister...," and trust income was not sufficient to provide for the beneficiary's maintenance, the Court held the trustees were authorized to use trust principal and to disregard the beneficiary's (substantial) personal income because an absolute gift to support was intended by the testator. Estate of Fannie Brundage, New York Law Journal, April 28, 1975, P. 16. But see Matter of Flyer, 23 N.Y 2d 579, 245 N.E. 2d 718 (1969).

b. Where the will provided for discretionary monthly income to the widow, "always keeping mind [sic] her necessities in the way of medical expenses, food, shelter, clothing and other incidentals which would be necessary to maintain the same standard of living to which she is accustomed," the Court held the trustees were not to consider the (private) income of the beneficiary in reaching decisions regarding discretionary distributions of trust income. Hamilton National Bank v. Childers, 233 Ga. 427, 211 S.E.2d 723 (1975).

c. Where the will provided for all income to be paid to the widow and "in addition if such net income should be insufficient to provide for her comfortable maintenance, support and medical care, the trustee in its discretion may from time to time use such part of principal as it deems necessary therefor," the Court held that other resources were to be considered before invading principal to pay for nursing home expenses which exceeded income. Boston Safe Deposit & Trust Co. v. Boynton, 15 Mass. App. 103, 443 N.E.2d 1344 (1983).

d. Where the will created a trust of the residuary estate for the surviving spouse, with income payable to her, and the will provides, "in addition, my trustee may expend such amounts of principal as my trustee, in her sole discretion determines necessary for the support and maintenance of my wife," the Trial Court held that no invasion should be made after the trustee refused to recommend an invasion. In re Estate of Tahjian, 544 A.2d 67 (PA. Super. 1988). The opinion contains an extensive discussion of Pennsylvania law.

3. The term "other resources" is ambiguous and gives little guidance to the trustee as to what resources must be considered.

a. must the trustee consider only the beneficiary's other sources of income or should the beneficiary's separate estate also be considered?

b. must the beneficiary sell appreciated property, incurring a capital gains tax?

c. must the trustee consider the beneficiary's non-liquid assets?

d. must the trustee consider the equity in a beneficiary's home?

e. what kind of an investigation must the trustee undertake?

D. If a beneficiary is eligible for or receiving public benefits or residing in a state institution, it may or may not be possible to insulate income and corpus from claims of governmental agencies for the cost of the benefits or other services furnished to the beneficiary.

1. Where the trustee has been given broad discretion as to payments and the trustee did not invade principal to pay for costs incurred while the beneficiary was receiving benefits from the state, some courts have not intervened on the ground that there was no abuse of discretion. Matter of Escher, 94 Misc. 2d 952, 407 N.Y.S. 2d 106 (1978), aff'd 75 A.D. 2d 531, 426 N.Y.S. 2d 1008 (1st Dept. 1980), aff'd 52 N.Y. 2d 1006, 420 N.E.2d 91 (1982), Matter of Roberts, 61 N.Y. 2d 782, 461 N.E. 2d 300 (1984), and First National Bank of Md. v. Dept. of Health, 399 A. 2d 891 (Md. App. 1979).

2. If a beneficiary is denied needed care because of the trustee's exercise of discretion to withhold payments, the court may find an abuse of discretion and intervene. Restatement of Trusts, 2d, §187 and comments. Some courts have also required payments be made even though the trustee has complete discretion. See Estate of Lackman, 156 Cal. App. 674, 320 P. 2d 186 (1958); Bureau of Support in Dept. of Ment. H. & C. v. Krietzer, 16 Ohio St. 2d 147, 243 N.E. 2d 83 (1968); and Stroudt v. Pennsylvania, 454 A. 2d 665 (Pa. 1983).

3. In 1986 the Social Security Act was amended to prevent a grantor from creating a discretionary trust so the trust property would not be considered as his resources for purposes of determining his Medicaid eligibility. 42 U.S. Code §1396a(k). And, of course, OBRA '93 containing major revisions of the Federal Medical Assistance (Medicaid) program became law on August 9, 1993 and affects planning in this area.

4. See Cali. Probate Code §15306 and Ohio Rev. Code §1340.22.

E. In general, courts will not interfere with a trustee's exercise of discretion nor will they instruct the trustee how to exercise his discretion. Matter of Emmons, 165 Misc. 192, 300 N.Y. Supp. 580 (Surr. Ct. 1937); People's National Bank v. Jarvis, 58 Wash. 2d 627, 364 P.2d 436 (1961).

IV. PLANNING CONSIDERATIONS

A. When two or more trusts are created for the same beneficiary, the will or trust agreement should state how invasions are to be made (e.g., if there are two trusts for the spouse, marital and non-marital, any power of invasion of principal in the spouse's favor should be made first from the marital trust).

B. When multiple generations will participate in benefits from one trust, consider creating a single discretionary trust for each child and his descendants because:

1. It is likely that each family branch will have different needs, necessitating different investment strategies and

2. Each branch of the family will expect "equal" distributions, barring the occurrence of an unforeseen and very unusual situation.

C. Test the administrative predictability of the language to be selected with the trustee who will administer the provisions. The current trend is away from words which limit the powers in favor of broad "absolute" powers. But when a trustee may benefit from the exercise, the power should be restricted by an ascertainable standard.

D. The will or trust agreement should provide that the trustee in exercising a discretionary power may but need not consider any other resources of any beneficiary.

APPENDIX A

"Sprinkle" Trust for Wife and Descendants

If my wife, Mary Doe ("my spouse"), survives me, I give and devise my residuary estate to my trustees In Trust, to pay out of the net income or principal or both such amount or amounts (whether equal or unequal, and whether the whole or a lesser amount) as my trustees (other than any current beneficiary) in their sole discretion determine to such one or more of my spouse and my descendants, of whatever degree and whether or not born during my life, as my trustees (other than any current beneficiary) in their sole discretion select. In exercising this discretionary power, my trustees (other than any current beneficiary) may but need not consider any other resources of any beneficiary and shall give primary consideration to the needs and desires of my spouse and the needs of my children who are under age 21 or have not completed their education. Any net income not so paid shall be added to principal.

(If no current beneficiary can be a trustee, omit the words "(other than any current beneficiary)" in the first and second sentences. If the testator does not desire to create a preference in favor of his spouse and certain of his children, omit everything after "other resources of any beneficiary" in the second sentence. If none of the testator's children is under 21 and all have completed their education, omit everything after "my spouse" in the second sentence.)

(A distribution of income or principal to a grandchild or more remote descendant will be a taxable distribution under Chapter 13 unless if made by an individual it would not be treated as a taxable gift under IRC §2503(e). See IRC §2611(b)(1).)

APPENDIX B

A. *Payments to Beneficiaries.* The trustee shall pay any one or more persons in the group consisting of my spouse, Jane Doe ("Jane"), and my descendants as much of the net income and principal, even to the extent of all or none, as the trustee determines in his discretion. [In determining whether to make payments to Jane, the trustee shall disregard the interests of any other beneficiary.] [In determining whether to make payments to Jane, the interests of any other beneficiary shall be subordinate to Jane's interests.]

* * * *

K. *Restrictions on Trustees.* No individual trustee shall participate in the exercise of any discretionary power relating to:

1. A payment of trust property or grant of a power to himself as a beneficiary except to the extent governed by and made pursuant to an ascertainable standard within the meaning of Sections 2041 and 2514 of the Code.

2. A distribution of trust property that would discharge or satisfy any of his or my legal obligations.

3. A distribution of trust property that would constitute a taxable gift from him personally if he were to so participate.

4. A distribution of, or grant of a power with respect to, trust property, if, as to such property, he, in his individual capacity, previously made a Qualified Disclaimer, except to the extent the distribution or grant is governed by and made pursuant to an ascertainable standard within the meaning of Sections 2041 and 2514 of the Code.

5. The determination to grant or withhold consent to the exercise of a general power of appointment if he has a substantial interest in the trust property adverse to the exercise of the power in favor of the holder of the power or his estate within the meaning of Section 2041 (b).

RESTRICTIONS ON POWERS OF FIDUCIARIES

Notwithstanding any other provision of this Agreement to the contrary, no person or entity acting in any fiduciary capacity hereunder shall participate in the exercise of a power conferred hereunder:

A. that the fiduciary would either be entirely prohibited from exercising, or prohibited from exercising in the manner desired, if he were serving as trustee in place of the acting trustee,

B. to vote shares of stock in a company controlled by the fiduciary (in an individual capacity) (within the meaning of Section 2036 (b)(2)) that were transferred to the trust by the fiduciary (in an individual capacity),

C. that would constitute an "incident of ownership" (within the meaning of Section 2042) with respect to insurance on the fiduciary's life, or

D. that would render any portion of the trust property includible in his gross estate, and any such purported exercise shall be void and of no effect.

* * * *

4. "*As the trustee determines in his discretion*" shall, except as may be specifically provided, be construed liberally so as to confer upon the trustee the greatest amount of power to determine if, when, and for what purposes payments will be made, and the amount of such payments, and the trustee's determination to make or refrain from making payments shall be conclusive on all persons interested in the trust.

* * * *

C. *My Legal Obligations.* Notwithstanding any provision of this Agreement, no payment shall be made to or for the benefit of a beneficiary that would discharge any of my legal obligations.

D. *Payments to One or More Beneficiaries.* If the trustee of a trust is authorized to make payments to one or more persons in a specified group, the trustee may make equal or unequal payments to such persons, without any duty to make equalizing payments, and the trustee's determination with respect to such payments shall be conclusive on all persons interested in the trust.

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APPENDIX C

Credit Trust - - Invasions

4.10 Distribution: Trustee shall hold, administer, and distribute all other property, including separate asset accounts, as follows:

4.11 Income: Trustee may accumulate income or may pay all or part of the net income to one or more of Settlor's spouse and Settlor's descendants as Trustee deems appropriate under the circumstances existing at each date of distribution, taking into account the potential recipients' economic needs, best interest, and welfare, income tax brackets, availability of other resources, and the guidelines provided below relative to invasions of principal. Income distributions may be in unequal amounts and may exclude members of the class to be benefited.

4.12 Invasion of Principal for Spouse: Trustee may pay principal to Settlor's spouse from time to time (even to the exhaustion of the trust) as in Trustee's discretion is adequate and appropriate after looking to other resources available to maintain the standard of living to which the spouse was accustomed during Settlor's lifetime.

4.13 Invasion for Descendants: Trustee may pay principal to benefit one or more of Settlor's descendants (if it will not impair Settlor's spouse's security) when, in Trustee's discretion, payment is necessary in order to (1) provide proper care and support for any who is not self-supporting, through no fault of his or her own, (2) provide an education (including courses in an accredited college or university, or graduate and professional training), (3) meet extraordinary requirements caused by illness or other misfortune. These payments shall not be taken into consideration when allocating the principal upon termination of the Credit Trust.

4.14 Invasion for Children: Trustee also may pay principal (if it will not impair Settlor's spouse's security) to provide any of Settlor's children with a home of the child's own or to enable a child to embark upon or to pursue a business or professional venture. In exercising this judgment, however, Trustee shall determine the wisdom of the proposed disbursement and shall consider any other income or resources available to the child, including the child's earnings or potential earnings. Whenever principal is invaded for these purposes, the amount shall be treated as an advancement to the child (or the child's issue) when Trustee allocates the principal upon termination of the Credit Trust.

4.15 Intent: Settlor's spouse is the primary object of Settlor's bounty. The other beneficiaries are the secondary objects. Therefore, if there is a conflict between the interests of the spouse and other beneficiaries, Trustee shall favor the spouse.

APPENDIX D

Discretionary trust to pay income and/or principal to a child with precatory advice to the trustee.

Each share of the trust property set apart for a child of the grantor shall be held by the trustee IN FURTHER TRUST, to pay to the child so much of the net income or principal, or both, whether the whole or a lesser amount, as the trustee in its sole discretion determines. Any net income not so paid shall be added to the principal of the trust

In exercising this discretionary power, the trustee may, but need not, consider any other resources of the child and shall give primary consideration to the health, education and welfare of the child. The grantor desires, but does not direct, that the trustee take into consideration when exercising its discretion to distribute principal to the child after he reaches majority, the uses to which such property will be applied by the child, and to favorably consider distributions for such purposes as the child's continued education, purchase of an appropriate residence, an appropriate business investment or payment of appropriate family expenses that the child cannot reasonably meet. The grantor's expression of his desires does not in any way limit the trustee's discretion hereunder.

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DISCLAIMERS AND DISCLAIMER TRUSTS

IN POST-MORTEM ESTATE PLANNING

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SECTION E

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DISCLAIMERS AND DISCLAIMER TRUSTS IN POST-MORTEM ESTATE PLANNING

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DISCLAIMERS AND DISCLAIMER TRUSTS IN POST-MORTEM ESTATE PLANNING

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INTRODUCTION

The Disclaimer is a crucial estate planning tool. The disclaimer is a limited exception to the general rules that impose tax on transfers of property. The effective use of disclaimers can provide the post-mortem planner with a flexibility and an agility that can be invaluable in circumventing the potential land mines which can arise in post-mortem administration. When properly anticipated in the estate planning process, disclaimers can provide beneficiaries with an array of tax-planning and dispositive options which otherwise would not be available to them.

1. Disclaimers - The Kentucky Perspective

1.1 Common Law Rule

Under the common law rule, a testate share (inherited under a will) could be disclaimed by the beneficiary within a reasonable period of time after the testator/decedent's death; however, an intestate share could not be disclaimed or renounced by its recipient. See Thomas E. Atkinson, Law of Wills, 30 (2nd Ed. 1953). Title to testate property passed to the intestate taker immediately at and upon the decedent's death. On the other hand, a gift by will had to be accepted by the donee recipient before title actually devolved to the donee. While a disclaimer by a beneficiary under a will prevented title from passing to the intended beneficiary, a disclaimer by an intestate taker divested the intestate taker of title to the property renounced. Atkinson, supra at 774-776. This distinction between disclaimers by testate and intestate beneficiaries meant that with respect to intestate beneficiary's disclaimers there was a gratuitous transfer of title by the disclaimant to another (i.e. federal gift tax implications).

1.2 Kentucky's Uniform Disclaimer Act

Kentucky has adopted the Uniform Disclaimer of Transfers by Will, intestacy or appointment act (hereinafter the "Disclaimer Act"). Kentucky Revised Statutes ("KRS") 394.610 - 394-680. The Disclaimer Act eliminates the Common Law Rule discussed above and further eliminates any conceptual difference between the two acts of renunciation by permitting disclaimers by both intestate and testate takers. KRS 394.610. Both types of disclaimer are not treated as a gratuitous transfer of the disclaimant's interest in the property (assuming that the federal disclaimer requirements are also met).

1.3 Other Matters

A beneficiary under a will who is given a future interest (rather than a present interest) in property of either illegal or equitable nature may disclaim such property. KRS 394.610.

Testamentary beneficiaries of interests such as a power to consume or to appoint or to apply property for any purpose also have the right to disclaim such interest. Uniform Probate Code Section 2-801(8) Comment, 8 ULA 161 (1991). The act extends the right to disclaim to representatives of incapacitated or protected persons and to appointees under a power of appointment exercised by a testamentary instrument. KRS 394.610. Successive disclaimers are permitted under the act since persons succeeding to a disclaimed interest also have the power to disclaim. KRS 394.610. Since the amendment of the act in 1980, the right to disclaim survives the death of the person having the right to do so. Such right may be exercised by the personal representative of the person within the time period stipulated in the act. KRS 394.610.

The disclaimant must file the disclaimer in District Court in the county in which the probate proceedings have been commenced (or could be commenced if not yet commenced) for the administration of the decedent's estate. KRS 394.620(3). A copy of the disclaimer is required to be delivered in person or mailed by registered or certified mail, to the personal representative or other fiduciary of the decedent or donee of the power. KRS 394.620(3). If disclaiming real property or an interest in real property, the disclaimant may record a copy of the disclaimer in the office of the county clerk of the county in which the real property is located. KRS 394.620(3). (Obviously from a real estate attorney's prospective, this provision should be mandatory even though it's not.)

2. Disclaimers - The Federal Perspective

2.1 Disclaimer Defined

Section 2518(b) of the Internal Revenue Code ("Code" or "IRC") defines a qualified disclaimer as "an irrevocable and unqualified refusal by a person to accept an interest in property" and sets forth the requirement for a qualified disclaimer. The disclaimer must:

(1) be irrevocable and unqualified;
(2) be written;
(3) be received by the transferor of the interest (or his or her legal representative) no later than nine months after the date on which the transfer creating the interest is made or the date on which the claimant attains age 21;
(4) be made before the disclaimant has accepted the interest or any of its benefits; and
(5) result in the passing of the disclaimed interest without any direction on the part of the disclaimant to either the decedent's spouse or a person other than the disclaimant.

3. Tax Consequences of Disclaimers

3.1 Transfer Tax Treatment

For gift, estate, and generation-skipping transfer tax purposes, property which has been disclaimed in a qualified manner is treated as if it had never been transferred to the disclaimant.

IRC§2518(a). A qualified disclaimer is not a gift for federal gift tax purposes. Treas. Reg.§25.2518-1(b). If a qualified disclaimer is made with respect to a transfer at death, the federal estate tax provisions apply with respect to the property interest transferred as if the interest had never been transferred to the person making the disclaimer. Treas. Reg. 20.2046-1. Similarly, the generation-skipping transfer tax (GSTT) provisions apply with respect to a property interest transferred under a qualified disclaimer as if the interest had never been transferred to the person making the disclaimer. IRC§2654(c).

Disclaimed property is considered to pass directly from the transferor to the person (or persons) entitled to receive the property as a result of the disclaimer. Thus, the federal gift, estate, and GSTT that otherwise would be imposed on the passage of property from the disclaimant to the ultimate recipient of the property is avoided. The governing instrument (usually, the decedent's will and/or trust), as interpreted under Kentucky law, will determine to whom the property passes as a result of a disclaimer. If there is no governing instrument or if it cannot be determined from that instrument to whom disclaimed property should pass, Kentucky law will determine to whom the property passes. In such cases, Kentucky intestacy laws generally will apply.

3.2 Income Tax Treatment

IRC 2518 is a transfer tax provision. There is no corollary provision under Subtitle A of the Code, governing income taxation, which extends disclaimer principles to the income tax area generally. Rev. Rul. 64-62, 1964-1 C.B. 221. Nevertheless, disclaimers often have been recognized to have effect in the income tax context.

3.2.1 Future Income Not Taxable to Disclaimant

If a disclaimer is qualified, the disclaimant will not be required to include in his or her taxable income future income on disclaimed property. This rule also applies if the disclaimer is not effective for transfer tax purposes, but results in a transfer under Kentucky law. Private Letter Ruling ("PLR") 7933066.

3.2.2 Income Earned Prior to Disclaimer

If the disclaimant had the right to receive or control income after the date of the transfer with respect to which the disclaimer is made, income earned from that date and prior to the disclaimer may be taxed to the disclaimant. See, Grant v. Comm'r., 197 F.2d 891 (5th Cir. 1949); Mildred Cleary, 34 T.C. 728 (1960).

More often, however, income earned from the date of the transfer is attributed to the taker of the disclaimed property. In particular, where income is earned on property which is subject to an estate or trust proceeding and that income is subject to administration, a disclaimer of that property should be effective for income tax purposes. PLR 8215056. With respect to qualified plan benefits and individual retirement accounts (IRAs), the Internal Revenue Service (IRS) has ruled that the recipient of the disclaimed benefits, and not the disclaimant, will be subject to income tax on those benefits. GCM 39858 (1991); PLR 9319029, 9303027.

3.2.3 Disclaimers Recognized With Respect to Various Income Tax Provisions

IRC 678 contains specific statutory authority recognizing disclaimers with respect to the application of that provision. IRC 678(d) provides that Code Section 678(a) will not apply with respect to a power which has been "renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence." Note that a disclaimer need not be qualified under IRC 2518 to be effective under IRC 678(d).

Despite the lack of additional statutory authority, disclaimers have been recognized with respect to a wide variety of other income tax provisions as well. For example, a qualified disclaimer of income in respect of a decedent did not constitute a "transfer" under IRC 691(c)(2) such that recognition of the income would be accelerated as a result of the disclaimer. PLR 7830022; PLR 8215056.

The IRS has ruled that a disclaimer of qualified plan benefits that satisfies the requirements of state law and IRC 2518(b) is neither a prohibited assignment or alienation of plan benefits contrary to IRC 401(a)(13) and Section 206(d) of ERISA, nor is it an assignment of income. GCM 39858 (1991). Similarly, the IRS has ruled that a disclaimer of benefits from an IRA that satisfies the requirements of state law and IRC 2518(b) is not an assignment of income, nor is the disclaimer contrary to IRC 408(a)(4) and 408(b)(1). Id. As noted above, the IRS has determined that income earned on disclaimed qualified plan or IRA benefits will be taxed to the taker of those benefits under the disclaimer. Id.

> **[Ironic Note:** It is unfortunate that the IRS has limited its rulings to disclaimers which satisfy the requirements of state law. The primary purpose of IRC 2518 (as I recall) was to provide a uniform scheme for disclaimers which was not dependent on the differences in state law. HR Rep. No. 1380, 94th Cong., 2d Sess. (1976) While that goal was not fully accomplished, it is not desirable to perpetuate a reliance on state law to determine the validity of disclaimers.]

Disclaimers may be utilized to permit redemptions under IRC 302 and 303. PLR 9041005, 9014015, 8323027, 8149050. Disclaimers also may be utilized to permit qualification of a trust as a shareholder in an S corporation. PLR 8825055, 8621057. In one recent ruling, takers of disclaimed stock were treated as owning the stock during the period in which it was owned by the decedent under IRC 382(l)(3)(B)(i)(I). PLR 9222041.

Takers of disclaimed property have been permitted to make a IRC 1033(a)(2) election not to recognize gain on disclaimed property that was sold during probate to the county under threat of condemnation. TAM 9232004. A disclaimer also has been recognized under IRC 613A(c)(9) with the result that takers under a disclaimer were considered to be heirs and not transferees for purposes of avoiding disallowance of the percentage depletion allowance under IRC 613A(c)(9)(A) (as in effect at that time). PLR 8741073.

One United States District Court has indicated its inclination to recognize disclaimers for income tax purposes. In dicta, the Court rebuffed the argument put forth by the government that the disclaimer provision of IRC 2055(a) was applicable only to estates and would not be valid for purposes of determining the charitable income tax deduction. The Court stated it was "of the opinion that the same principles apply to an income tax deduction as well as to an estate." Simmons v. U.S., 80-1 USTC ¶9,287 (D. Ariz. 1980).

There appears to be a trend towards extending the recognition of disclaimer principles from the transfer tax arena to the income tax realm. [Specific authority from the IRS on this point would be quite helpful.]

4. Technical Requirements for Qualified Disclaimer

4.1 Irrevocable and Unqualified

4.1.1 General

A qualified disclaimer must be irrevocable and unqualified. IRC 2518(b); Treas. Reg. 25.2518-2(a)(1). These requirements are self-explanatory and generate few disputes or controversies. A disclaimer which is conditioned on the receipt of a favorable ruling by the IRS will not be qualified. GCM 32625 (1963); GCM 32894 (1964). Such a disclaimer may be effective for state (Kentucky) law purposes, however, causing disclaimed property to be transferred under state law. Palmer v. White, 784 P.2d 449 (1989); Wilmington Trust Company v. Carpenter, 315 A.2d 625 (De. Ch.), aff'd 328 A.2d 141(Del. 1974).

4.1.2 Revoking the Irrevocable

Under the general rule regarding irrevocability, even a disclaimer based on mistake may not be rescinded. Webb v. Webb, 301 S.E.2d 570 (W.Va. 1983); Estate of Munch, 480 N.Y.S.2d 95 (1984). A Texas case, however, illustrates one way in which this rule may be stretched. Upon the death of her husband, a surviving spouse executed and filed with the Probate Court a document entitled "Partial Disclaimer". This instrument purported to disclaim certain interests passing to the spouse as a result of her husband's death. The disclaimant-spouse had been advised by her attorney and her accountant that the disclaimer would cause the disclaimed property to pass to her children, The deceased husband's children by a prior marriage sued, claiming that a portion of the disclaimed property passed to them under the Texas laws of intestacy. The trial court granted the motion for summary judgment filed by the children of the decedent's prior marriage, awarding them interests in the disclaimed property. Disclaimant appealed, arguing that the disclaimer was ineffective because she had accepted the benefits of the disclaimed property prior to making the disclaimer and further arguing that the filing of the "Partial Disclaimer" was simply a means of making a gift to her own children. The Court of Appeals reversed and remanded, finding that issues of fact had been raised as to (1) whether the disclaimer was effective and, if not, (2) whether the ineffective disclaimer was nevertheless an assignment of the disclaimed property under state law and whether disclaimant had the requisite intent to make a gift to the plaintiffs (decedent's children by a prior marriage).

This case suggests an interesting strategy for "revoking" an otherwise irrevocable disclaimer. The Court noted,

"'We point out that Paragraph (d) of Section 37A which provides that 'any disclaimer filed and served under this section shall be irrevocable' applies only to a 'disclaimer' and not to an ineffective disclaimer which passes the property 'as an assignment."

By arguing that the disclaimer was invalid, the purported disclaimant hoped to prevent the property from passing to the persons who would be entitled to take under a qualified disclaimer. In a situation in which a disclaimer causes property to pass to unintended recipients, it may be worthwhile to carefully examine the facts and circumstances to determine whether an argument can be made that the disclaimer was not qualified. If so, it would then be necessary to determine that the unqualified disclaimer had not caused the disclaimed property to pass to the purported takers under state law.

4.1.3 <u>The Estate of Monroe Case</u> (1997)

<u>Estate of Monroe</u>, 124 F. 3rd 699 (5th Cir 1997) is a very recent and interesting case.

4.1.3.1 Facts

Louise Monroe died in 1989 at age 91, married but with no children. Her husband (92 years old) was appointed Executor of her estate (multi million dollars). Mrs. Monroe in her will made 31 specific cash bequests to family members and friends and some employees and some bequests to certain corporations. She also set up some trusts with $500,000 of Treasury Bonds for some grandnieces and grandnephews and provided that each bequest would bear its fair share of death taxes (rather than having all the taxes paid out of the residuary estate). Some of the bequests were subject to GST tax and in some cases resulting in 75% or 80% of the gift being used to pay the taxes. Mr. Monroe was obviously concerned about the high tax bite and sought the advice of Touche, Ross, Accountants. The accountants recommended and Mr. Monroe asked 29 of the legatees to disclaim their bequest. All of them agreed and executed disclaimers on December, 1989. The disclaimed assets totaled $892,800. These assets passed to Mr. Monroe and were eligible for the marital deduction. Also in December, 1989, and in January, 1990 (surprise, surprise) Mr. Monroe sent each disclaimant a check with the notation "gift" on it for an amount similar to the amount disclaimed. Mr. Monroe died in May, 1990. Gift tax returns for 1989 and 1990 were filed in 1991. The IRS (surprise, surprise) audited Mr. Monroe's estate tax return and determined that the disclaimers did not satisfy the requirements the qualified disclaimer requirements under Code

Section 2518(b). The IRS disallowed the related marital deduction (i.e. the $892,800) and applied a fraud penalty. The IRS and estate went to tax court which ruled in the IRS' favor disallowing 28 of the 29 disclaimers but only imposing a negligence penalty not a fraud penalty.

4.1.3.2 General Law of the Case

The disclaimers in questions would be invalid under Code Section 2518 if they were "irrevocable and unqualified", or if the disclaimant "accepted the interest or any of its benefits". "Acceptance" of an interest includes the receipt of consideration in exchange for executing the disclaimer as well as the explicit (or implicit) acceptance of the interest or any of its benefits. Treas. Reg. 25.2518-1(d)(1).

4.1.3.3 Holding And Opinion of Fifth Circuit Court

- The Fifth Circuit Court of Appeals in Monroe, supra., stated that an "irrevocable and unqualified" disclaimer is "a relinquishment of a legal right that is incapable of being retracted or revoked by the disclaimant and is not modified by reservations or restrictions that limit its forceability". The Court determined that all of the disclaimers made by the Monroe beneficiaries were prima facie irrevocable and unqualified. Accordingly, the IRS could not support the contention that the disclaimers were irrevocable or subject to some condition (Query: Even with the use of something like the step transaction doctrine?) The fact that Mr. Monroe gave gifts to the disclaimants after the disclaimers were executed, did not change the disclaimers' irrevocability, and the acceptance of the gifts did not revoke the disclaimers.

- The real issue was whether the disclaimers were "unqualified" and whether "unqualified" has broader meanings than those stated in the regulations (no qualifications were specifically stated in the disclaimers.

- The IRS and the Tax Court held that the disclaimers were made subject to a qualification because the disclaimants "expected" eventually to receive the amount disclaimed through a gift or bequest from Mr. Monroe. The Tax Court reasoned that a disclaimer is not "unqualified" if it was executed as a result of an "implied promise" that the beneficiary would "be better off executing the disclaimer than not doing so". An "implied promise" could be found even though there was no negotiating or bargaining between the parties.

- The Fifth Circuit disagreed with the Tax Court's interpretation of the term "unqualified." The Fifth Circuit Court found that it was "inconsistent with a holistic reading of section 2518(b), contrary to the governing Treasury Regulations and the Service's letter rulings, and intolerably, unnecessarily vague." The appellate court believed that a disclaimer could be subject to a qualification only if there was a tangible receipt or retention of the property disclaimed.

- The position of the IRS and the Tax Court would greatly increase the changes of a disclaimer being disqualified, and would create an "incomprehensible subjective standard" against which to judge disclaimers. As several letter rulings on this issue indicate, "a primary purpose of the law authorizing qualified disclaimers is to facilitate post-mortem estate tax planning and to increase family wealth on the 'expectation' that there will thus remain more wealth to pass on to disclaimants in the future." See PLR 9509003, 9427030 and 8701001. The Tax Court's subjective interpretation of the term "unqualified" was at odds with this purpose. It could also cause most disclaims to be subject to litigation since, realistically, heirs or legatees rarely make disclaimers for tax reasons without some expectation of future benefit.

- The Tax Court's "expectation" or "implied promise" theory was incompatible with the Regulations as well as the Code. The Regulations specify two situations in which a disclaimer expresses a mere qualified refusal to accept an interest in property. Treas. Reg. 25.2518-2(d)(1). The first occurs when the disclaimant accepts, expressly or impliedly, the property or any of its benefits. The second situation happens when the disclaimant is given something as consideration for disclaiming.

- The court noted that the term "implied" is found only in the first situation (above). An implied acceptance of the property or its benefits occurs when one takes an action inconsistent with the disclaimer, such as pledging as security for a loan the assets that are to be disclaimed. When determining if consideration is received, as in the second situation in the Regulations, there must be actual receipt of the consideration.

- The Fifth Circuit determined, therefore, that a mere expectation of a future benefits is not consideration and will not disqualify a disclaimer. The circuit court cited two Supreme Court cases, namely Philpot v. Gruninger [81 U.S. 570 (S. Ct. 1872)] and Fire Ins. Ass'n v. Wickham [141 U.S. 564 (S. Ct. 1891)] which provide guidance in defining the term "consideration." The estate had relied on these cases for support of its argument that a disclaimant's motive or expectation are not the same as consideration. According to Fire Ins. Ass'n, consideration is present when a promise has "been offered by one party and accepted by the other, as one element of the contract."

- The Fifth Circuit also discussed the private letter rulings referred to earlier (PLR 9509003, 9427030, and 8701001), in which disclaimers were ruled valid even though it was obvious that the disclaimants expected that agreeing to disclaim would ultimately benefit them. In each instance, it was clearly stated that the disclaimers were being executed by children and grandchild in order to reduce death taxes, and it could by assumed that such beneficiaries would ultimately receive a comparable gift or bequest from the surviving spouse. The IRS approved the disclaimers, however, because there was no express or implied agreement between the disclaimant and the ultimate taker regarding the disposition of the disclaimed property. The court in *Monroe* determined that the private letter rulings were "properly cited as evidence of how the Commissioner has interpreted the law in the past."

- The Fifth Circuit concluded that the question that must be raised regarding each disclaimer is whether the person's decision to disclaim resulted from mutually bargained for consideration, or whether it was due to an unenforceable hope of future benefit. The court agreed with the estate that each disclaimer required a separate evaluation. After reviewing testimony from many of the disclaimants, the Fifth Circuit found that nothing inappropriate was said during the majority of the presentations in which the beneficiaries were asked to disclaim. Statements about the generous nature of the decedent's husband (Mr. Monroe), without going further and promising consideration, did not invalidate the disclaimers.

- The Appellate court noted that many of the beneficiaries had personal reasons for complying with the executor's request that he or she disclaim. The decedent and her husband had been generous people who had taken care of family and friends, and it was expected that the decedent's husband would continue to do so. Some disclaimants simply wanted to comply with his wishes to make him happy because he had been kind to them in the past, and not from a particular expectation of future benefit. Other beneficiaries expected to receive future gifts from him, during his lifetime or under his will, and did not want to anger him.

- The Appellate court concluded that, although questionable statements (stronger indications of future benefit) may have been made to a few beneficiaries, in the rest of the situations there was no agreement between the parties. The Fifth Circuit reversed the Tax Court's ruling as to the majority of the disclaimers, and remanded the six questionable cases to the Tax Court for further consideration.

- The Fifth Circuit also voided the negligence penalty. "Negligence" is found if there is "any failure to may a reasonable attempt to comply with the provisions of this title . . . " IRC 6662(c). Although the decedent's husband had sought the advice of CPAs on the correctness of requesting the disclaimers from the disclaimant, the Tax Court believed that he had been negligent because he had not informed the accountants of his intent to make gifts to the disclaimant after the disclaimers were made. The accountants testified that their advice would not have differed if they had known of his gift giving intentions, but they would have advised him that such gifts would probably result in greater scrutiny by the IRS. The Court found that this would not have mattered to the decedent's husband. At age 93 and in questionable health, he would probably have decided that it was best to make any gifts sooner rather than later. In fact, he did die just five months later.

4.2 Qualified Disclaimer Must Be Written

A qualified disclaimer must be in writing which must specifically identify the interest in property which is being disclaimed. Treas. Reg. 25.2518-2(b)(1).

4.2.1 Disclaimer Must Be Signed by Disclaimant or Legal Representative

A disclaimer must be signed by the disclaimant or his or her legal representative. Id. A disclaimer may be made by an agent of the disclaimant. The following kinds of legal representatives have been authorized to execute disclaimers:

(1) an agent acting under a durable power of attorney (PLR 9015017);
(2) an attorney acting as agent on oral instructions from the disclaimant Allen v. Comm'r., T.C.Memo 1989-111;
(3) under certain circumstances, the executor or administrator of a decedent's estate (Rolin v. Comm'r., 588 F.2d 368 (2nd Cir. 1978); Estate of Kravis, 584 F.2d 274 (1992);
(4) trustees, in some cases but not in others (see Section 7, infra, for further discussion of disclaimers by trustees);
(5) the conservator of the disclaimant (PLR 9318020); and
(6) a guardian ad litem for a minor disclaimant (PLR 9310020; PLR 9251019; and 9203028).

Note: Certain states require that disclaimers for minors or other incompetent persons be approved by the court (i.e. California and New York are two). To my knowledge, Kentucky has no such requirement.

Some courts will not allow disclaimers to be made on behalf of a minor unless it can be demonstrated that the disclaimer is in the best interest of the minor as an individual (as opposed to the family as a whole). It is often difficult to argue that a disclaimer will result in personal benefit to a minor, as disclaimed property must pass to another and the minor cannot receive consideration for the disclaimed property. In re: Estate of DeDomenico, 418 N.Y. S.2d 1012 (1979). It is important to be aware of the Kentucky law notice requirements for such actions. The nine month disclaimer period will not be extended even if a petition requesting authorization to make a disclaimer is pending.

While a disclaimer by a duly appointed guardian ad litem has been approved in numerous cases, purported disclaimers by a parent "on behalf of himself and as natural guardian for his minor children" were not qualified with respect to the minor children. PLR 7947008. The IRS ruled that the minor children could only disclaim through a guardian ad litem under applicable state law (Georgia). This ruling contained troubling language implying that, because a minor, upon reaching majority, could attack disclaimers made on his behalf even by a guardian ad litem, a disclaimer made on behalf of a minor would not be irrevocable as would be required for a qualified disclaimer. The implication that a qualified disclaimer could not be made on behalf of a minor because it potentially could be subject to revocation upon the minor's attaining the age of majority is clearly wrong. Numerous rulings since have approved disclaimers made on behalf of minors. PLR 9310020, 9251019, 9203028, 9051007 and 9003007.

4.2.2 Delivery to Transferor or Legal Representative

The writing must be delivered to the transferor of the interest, his or her legal representative (usually the decedent's executor, administrator, or trustee in a post-mortem situation), the person who holds legal title to the property to which the interest relates or the person in possession of that property. Treas. Reg. 25.2518-2(b)(2). Note that IRC 2518(b)(2) requires that the writing be received by the appropriate party within the allowable time period. The Regulations have liberalized that requirement by allowing delivery within that period. Id.

A timely mailing of a disclaimer is treated as a timely delivery. Treas. Reg. 25.2518-2(c)(2). For this purpose, the mailing requirements under paragraphs (c)(1), (c)(2), and (d) of Section 301.7502-1 of the Treasury Regulations must be met. If the last day of the period within which the disclaimer must be made falls on a Saturday, Sunday, or legal holiday, delivery will be considered to be timely if it is made on the first succeeding day which is not a Saturday, Sunday, or legal holiday. Id.

4.3 Disclaimer Must Be Made Within Nine Months

A qualified disclaimer must be delivered to the transferor of the interest (or any of the persons designated in Treas. Reg. Section 25.2518-2(b)(2) no later than nine months after the later of the date on which the transfer creating the interest is made or the date on which the disclaimant attains age 21. Treas. Reg. 25.2518-2(c)(1).

4.3.1 Disclaimer Period Begins on Date of Taxable Transfer

4.3.1.1 General

The nine month period within which a disclaimer can be made is determined with reference to the date of the taxable transfer creating the interest. Treas. Reg. 25.2518-2(c)(3).

4.3.1.2 Inter Vivos Transfers

The period within which an inter vivos transfer can be disclaimed begins on the date on which the transfer becomes a completed gift for gift tax purposes (regardless of whether a gift tax actually is imposed). If a gift is not complete, there is no "taxable" transfer for disclaimer purposes until the gift becomes complete. PLR 9001062. In the case of certain transfers which remain revocable during the life of the transferor, the taxable transfer will not be deemed to occur until the date of the transferor's death. For example:

- U.S. savings bonds held in pay-on-death form may be disclaimed within nine months of the date of death of the owner of the bond (PLR 9017026; Rev. Rul. 68-269, 1968-1 C.B. 399);

- life insurance policies could be disclaimed within nine months of the death of the insured (PLR 9012053);

- the beneficiary under "totten" or tentative trust bank accounts could disclaim within nine months of the death of the account holder (PLR 8648070); and

- certificates of deposit that were held in "pay on death" form could be disclaimed within nine months of the death of the owner (PLR 9336011).

4.3.1.3 Testamentary Transfers

The period within which a testamentary transfer can be disclaimed begins on the transferor's date of death, and not the date on which a decedent's will is admitted to probate. Estate of Fleming v. U.S., 974 F.2d 894 (7th Cir. 1992).

4.3.1.4 Interest in Irrevocable Trusts

In the case of an irrevocable trust, the date on which an interest in the trust must be disclaimed is determined with reference to the date on which the trust is created (or becomes irrevocable, if that is later), even when that interest will not vest for many years. For example, the remainder beneficiaries of a testamentary qualified terminable interest (QTIP) trust must disclaim their interests within nine months after the death of the spouse creating the trust and not the death of the surviving spouse. Treas. Reg. 25.25189-2(c)(3). The IRS has ruled that a beneficiary could not disclaim her interest in an irrevocable trust that had been created 20 years earlier, even though the beneficiary had never received distributions from the trust. PLR 9027026.

4.3.1.5 Earliest Taxable Transfer

Where there is a taxable transfer of an interest for gift tax purposes and that interest later is included in the transferor's gross estate for estate tax purposes, the nine month period within which a qualified disclaimer can be made is determined with reference to the date of the earlier taxable transfer. Treas. Reg. 25.2518-2(c)(3); PLR 8617011. For example, in the case of a grantor retained interest trust (such as a grantor retained annuity or unitrust or a qualified personal residence trust) which later is included in the transferor's estate because he or she died during the trust term, the disclaimer period generally will run from the date on which the trust was created, and not the date of the transferor's later death. Where, however, the transferor retained a contingent "general" power to appoint the trust corpus to anyone, including the transferor's estate, exercisable if the transferor died within five years after the creation of a grantor retained interest trust, and the transferor did die within five years, the IRS held that the disclaimer period ran from the date of the transferor's death and not the date on which the irrevocable trust was created. PLR 9340052. See Section 4.3.3., infra, for discussion of the rules pertaining to the time limits governing disclaimers of powers of appointment.

4.3.1.6 No Extenstions

The rules with respect to the timely exercise of disclaimers are strictly enforced. No extensions may be granted. An extension to file the gift or estate tax return reporting the taxable transfer which is the subject of the disclaimer does not extend the time within which the recipient of the interest can make a qualified disclaimer. See PLR 90223051. If the last day of the disclaimer period falls on a Saturday, Sunday, or defined legal holiday, the period will be extended to the next succeeding day which is not a Saturday, Sunday or legal holiday. Treas. Reg. 25.2518-2(c)(3).

Interests passing as a result of a qualified disclaimer must be disclaimed within nine months after the date of the original transfer. Thus, multiple or successive disclaimers all must be made within nine months of the date of the original transfer. Treas. Reg. 25.2518-2(c)(3).

4.3.2 The "Under 21" Rules

A recipient of property who is under 21 years of age has until nine months after his or her 21st birthday within which to disclaim property. IRC 2518(b)(2)(b). This is true regardless of the age of majority in the state in which the beneficiary resides. Thus, a beneficiary can receive a gift at age 15, attain the age of majority at age 18, receive an inheritance at age 19, and disclaim an interest in either or both of the gift and the inheritance within nine months after he or she attains age 21. Treas. Reg. 25.2518-2(d)(4), Example (11). More surprisingly, this rule applies whether or not the beneficiary (or any individual acting on his or her behalf, such as a parent or guardian) has taken any action that otherwise would be considered an acceptance of the property. PLR 9046035; See also, Estate of Kravis, 584 N.Y. S.2d 274 (1992).

Although a beneficiary under the age of 21 cannot accept an interest in property, the beneficiary apparently can disclaim such an interest after attaining the age of majority in his or her state. PLR 8825101, 8622018. In one recent case, a 17 year old beneficiary who was legally emancipate under state law was permitted to disclaim an inheritance 15 months after the date of the transferor's death. PLR 9223051. A disclaimer can also be executed on behalf of a minor by a legal guardian, conservator, or guardian ad litem. See Section 4.2.1., supra.

4.3.3 Powers of Appointment

4.3.3.1 General Powers of Appointment

The holder of a general power of appointment must disclaim that power within nine months after the power is created. Treas. Reg. 25.2518-2(c)(3) An interest passing as the result of the exercise or lapse of a general power of appointment must be disclaimed within nine months after the date on which the power is exercised or lapses. Id. A beneficiary taking in default of the exercise of a general testamentary power of appointment must disclaim within nine months of the death of the holder of the power. Treas. Reg. 25.2518-2(c)(3); PLR 8911028. Beneficiaries taking as a result of the lapse or release of a pre-1942 general power of appointment have nine months from the date of the lapse or release within which to disclaim, even though the lapse or release will not be treated as an exercise of a general power of appointment for federal estate and gift tax purposes and will not give rise to estate or gift tax liability. PLR 9318020, 9340053, 9245011.

4.3.3.2 Special Powers of Appointment

The rules with respect to disclaiming interests relating to special or non-general powers of appointment are harsh. The holder of a special power of appointment, any permissible appointee under such a power, and potential takers in default of the exercise of that power all are required to disclaim their interests within nine months of the creation of the power. Treas. Reg. 25.2518-2(c)(3), 25.2518-2(c)(5), Example (1). As a practical matter, this rule means that potential takers under broad special powers of appointment often cannot disclaim. Treas. Reg. 25.2518-2(c)(3).

- **Example 1**: Bill creates an irrevocable trust for the benefit of his daughter, Chelsea, to be held for Sue's benefit during her lifetime. Upon Chelsea's death, the trust terminates and is distributed by right of representation to her descendants. Chelsea's descendants have until nine months after the date on which the trust is created (or they attain age 21, whichever is later) within which to disclaim their remainder interests in the trust.

- **Example 2.** Hillary has a testamentary special power to appoint the trust property to anyone except her estate, her creditors, or the creditors of er estate. All potential takers under the power must disclaim within nine months of the creation of the trust.

- **Example 3.** Hillary has a testamentary general power of appointment. Now, takers of the property have nine months from the date on which the general power is exercised or the date on which that power lapses or is released within which to disclaim.

4.3.4 Joint property

4.3.4.1 Disclaimer Regulations Generally

The disclaimer regulations provide a general rule that a qualified disclaimer of any interest or any portion of an interest in a joint tenancy or a tenancy by the entirety must be made no later than nine months after the transfer creating the tenancy. In the case of residential property held in joint tenancy by some or all of the residents, the regulations provide that a joint tenant will not be considered to have accepted the survivorship interest merely because the tenant resided on the property prior to disclaiming his interest in the property. Treas. Reg. 25.2518-2(d)(1). In addition, the service has ruled that a surviving spouse may make a qualified disclaimer of her survivorship interest in the residence held as joint tenants even if the surviving spouse furnished all the funds for the down payment, the mortgage payments, the real estate taxes and other expenses. PLR 9135043.

4.3.4.2 Invalidity of Former Disclaimer Regulations

Several federal circuit courts held that former disclaimer regulations were invalid to the extent that they require a survivorship interest in a unilaterally severable joint tenancy to be disclaimed within nine months of the creation of the tenancy. See Estate of Dancy, 872 F.2d 84 (4th Cir. 1989); McDonald v. Comm'r, 853 F.2d 1494 (8th Cir. 1988) and Kennedy v. Comm'r, 804 F.2d 1332 (7th Cir. 1986). If a joint interest is unilaterally severable by either joint owner, then at any time prior to a deceased joint owner's death, the decedent can sever the tenancy and defeat the other owners survivorship interest. Therefore, the Court concluded that a surviving joint owner survivorship interest is created at the deceased owner's death. The IRS announced that it would follow the circuit court decision [AOD CC-1990-06 (2/7/90)], and Proposed Regulations (and now final Regulations) were issued to replace the invalidated Regulations.

4.3.4.3 Proposed and Final Disclaimer Regulations

Proposed Disclaimer Regulations were published in the Federal Register on August 21, 1996. Reg. 208215-91, 61 Fed. Reg. 43197. The proposed regulations created a distinction between joint interests that are unilaterally severable under local law and joint interests that are not unilaterally severable. In response to comments from practitioners and the public, the recently issued Final Regulations eliminate this distinction. The proposed regulations also contain special rules with respect to (a) certain tenancies in real property between spouses and (b) joint bank and brokerage accounts. The final regulations retain these rules and extend the rules of governing bank and brokerage accounts and other investment accounts such as mutual funds. The final regulations were issued on December 30, 1997, and were published in the Federal Registered and are effective on December 31, 1997. TD 8744.

4.3.4.4 Unilaterally Severable Interests under the Proposed Regulations

Under the Proposed Regulations, in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety the either joint tenant could sever unilaterally under local law, a qualified disclaimer of the interest to which the disclaimant succeeded as donee upon creation o the tenancy had to be made no later than nine months after the creation of the tenancy. A qualified disclaimer of the survivorship interest to which the survivor succeeded by operation of law upon the death of the first joint tenant to die had to be made no later than nine months after the date of death. A surviving joint tenant could disclaim the interest to which he succeeded by right of survivorship, regardless of (1) how much of the property was attributable to consideration furnished by the disclaimant, (2) how much of the property was included in the decedent's gross estate under Section 2040, or (3) whether the joint owners were married. Prop. Reg. 25.2518-2(c)(4)(i), and 25.2518-2(c)(5), Example (7).

- Although state law varies, a joint tenancy with right of survivorship generally is unilaterally severable. Therefore, the proposed rules described above would have applied to such joint tenancies. On the other hand, those rules usually would not have applied to tenancies by the entirety because such tenancies generally are not unilaterally severable.

4.3.4.5 Interests That Are Not Unilaterally Severable Under the Proposed Regulations

Under the Proposed Regulations, if an interest in joint property with right of survivorship or an interest held as a tenant by the entirety was not unilaterally severable under local law, a qualified disclaimer of any portion of the interest had to be made no later than nine months after the transaction creating the tenancy. A tenant by the entirety or a joint tenant who could not unilaterally sever the interest under local law could not make a qualified disclaimer of any portion of the joint interest to the extent attributable to consideration furnished by that tenant even if the disclaimer was made within nine months of the creation of tenancy. Prop. Reg. 25.2518-2(c)(4)(ii).

- As noted above, a tenancy by the entirety typically is not unilaterally severable. Thus, under the Proposed Regulations, an interest in a tenancy by the entirety generally had to be disclaimed no later than nine months after the transaction creating the tenancy by the entirety. Nevertheless, in the preamble to the Proposed Regulations, the Service requested comments on whether or under what circumstances (e.g., tenancy by the entirety ownership of a personal residence) the rules applicable to unilaterally severable interests should apply to interests that are not unilaterally severable.

4.3.4.6 Joint Interests under the Final Regulations

According to the preamble to the final Regulations, the comments unanimously suggested that a surviving joint owner should be able to disclaim his survivorship interest in a tenancy within nine months of the date of death of the first joint owner to die, whether or not the tenancy is unilaterally severable. Consequently, the final Regulations eliminate the distinction based on whether a tenancy is unilaterally severable.

- Final Reg. 25.2518-2(c)(4) provides a general rule that in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds as donee upon creation of the tenancy must be made n o later than nine months after the creation of the tenancy. A qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint owner to die must be made no late than nine months after the date of death. Except as provided below with respect to certain tenancies in real property created on or after 7/14/88, such interest in the property. This is the case regardless of: (1) how much of the property is attributable to consideration furnished by the disclaimant; (2) how much of the property is included in the decedent's gross estate under Section 2040: (3) whether the joint owners are married; and (4) whether the interest can be unilaterally severed under local law. Regs. 25.2518-2(c)(4)(i), and 25.2518-2(c)(5), Examples (7) and (8).

4.3.4.7 Disclaimer of Certain Tenancies in Real Property

The Proposed Regulations extended the rule in the former Regulations that applied to joint interests between spouses in real property created after 1976 and before 1982. Under the Proposed Regulations, in the case of a joint tenancy between spouses or a tenancy by the entirety in real property created after 1954 and before 1982 with respect to which no election was made under former Section 2515, the surviving spouse had to make a qualified disclaimer no later than nine months after the death of the first spouse to die. The surviving spouse could disclaim any portion of the joint interest that was includable in the decedent's gross estate under Section 2040. Prop. Reg. 25.2518-2(c)(4)(iii). For purposes of this rule, it did not matter whether the tenancy was unilaterally severally under state law. Prop. Reg. 25.2518-2(c)(5), Example (9). The preamble to the final Regulations indicates that, for purposes of simplification, these special rules dependent on the application of former Section 2515 were eliminated from the final Regulations.

- The Proposed Regulations also provided that with respect to a joint tenancy between spouses or a tenancy by the entirety in real property created on or after 7/14/88, to which IRC 2523(i)(3) (relating to the creation of a tenancy as to which the spouse of the donor is not a U.S. citizen) applied the surviving spouse had to make a qualified disclaimer no later than nine months after the death of the first spouse to die. Moreover, the surviving spouse could disclaim any portion of the joint interest that was includable in the decedent's gross estate under Section 2040. Prop. Regs. 25.2518-2(c)(4)(iii) and 25.2518-2(c)(5), Example (10). These provisions are retained in the new final Regulations. Regs. 25.2518-2(c)(4)(ii), and 25.2518-2(c)(5), Example (9).

4.3.4.8 Disclaimer of Joint Bank, Brokerage, and Other Investment Accounts

Under the Proposed Regulations, in the case of a transfer to a joint bank account or a joint brokerage account, if a transferor could unilaterally withdraw the transferor's own contributions from the account without the consent of the other cotenant, the transfer creating the survivor's interest in a decedent's share of the account occurred on the death of the deceased cotenant. Therefore, a surviving joint tenant had to make a qualified disclaimer with respect to funds contributed by the deceased cotenant within nine months of the cotenant's death. The surviving joint tenant could not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. Prop. Reg. 25.2518-2(c)(4)(iv). The final Regulations retain these provisions and extend them to other investment accounts (e.g., accounts held at mutual funds). Regs. 25.2518-2(c)(4)(iii).

- If one joint owner transfers his own funds into a joint bank account with another joint owner, and the contributing owner dies first, the surviving owner may disclaim the entire account within nine months of the decedent's death. The entire account is includable in the decedent's estate under Section 2033. The result is the same regardless of whether the joint owners are spouses. Reg. 25.2518-2(c)(5), Example (12).

- If, on the other hand, the non-contributing owner dies first, the contributing owner cannot disclaim any portion of the joint account. Because the contributing owner furnished all the funds, he did not relinquish dominion and control over the funds. A surviving joint owner cannot disclaim funds that he has always owned and never transferred. Reg. 25.2518-2(c)(5), Example (13).

- If the contributing owner dies first and the noncontributing owner disclaims only a portion of the account, the disclaimed portion is included in the decedent's estate to the extent required by Section 2040. If the joint owners are spouses, half of the nondisclaimed portion is included in the decedent's estate under Section 2040(a) because the decedent furnished all the funds in the account. Reg. 25.2518-2(c)(5), Example (14).

4.4 Acceptance of Benefits

A disclaimer may not accept an interest in property or any of its benefits prior to making a disclaimer of that property. IRC 2518(b)(3).

4.4.1 "Acceptance" Defined

4.4.1.1 Generally

Acceptance is manifested by "an affirmative act which is consistent with ownership of the interest in property". Treas. Reg. 25.2518-2(d)(1). The receipt of dividends, rent, or interest is considered to be an acceptance of the underlying property, as is use of the property, pledging the property as security for a loan, and directing others to act with respect to the property. Treas. Reg. 25.2518-2(d)(4), Examples (1), (4) and (5). The acceptance of any consideration by the disclaimant in exchange for the disclaimer is considered to be an acceptance of the entire interest being disclaimed. Treas. Reg. 25.2518-2(d)(1), 25.2518-2(d)(4), Example (2); <u>Estate of Thompson v. Comm'r</u>, 89 T.C. 619 (1987); PLR 8225096, 7809043.

4.4.1.2 Loan as "Acceptance"

The use of estate funds to pay personal income taxes due under joint returns filed on behalf of a decedent and the disclaimant-surviving spouse was an acceptance of benefits even where the spouse agreed at the time of the tax payments to reimburse the estate for any portion of the payments which later were deemed attributable to her personal income tax liability. PLR 9244012. The disclaimant-surviving spouse also agreed to pay interest on any such amounts at market rate, and executed an interest-bearing promissory note which she repaid in full a short time later. In finding the spouse had accepted the benefits of the loaned funds, the IRS ruled,

"In the instant case, the surviving spouse's borrowing of $7,469 from the residuary estate of which the spouse is the beneficiary provided the spouse with the use of the estate funds until the loan was repaid. Although the loan was negotiated at arm's-length and the interest rate was set at market rate, the loan nevertheless enabled the surviving spouse to use the bequest for a period of time before deciding to disclaim the property. Thus, the surviving spouse has accepted the benefits with respect to $7,469 in dividend income to which she would not otherwise be entitled as a beneficiary of the residuary estate. She, therefore, may not disclaim this income and the share to which this dividend income relates." Id.; See also PLR 8405003.

4.4.1.3 Exercise of Power of Appointment as "Acceptance"

The exercise to any degree of a power of appointment by the donee of the power is an acceptance of the benefits of that power. Treas. Reg. 25.2518-2(d)(1). Where, for example, a decedent exercised a general power of appointment over a marital trust to the extent necessary to pay estate taxes, the decedent's executor could not subsequently disclaim the decedent's interest in that trust. PLR 8142008. This was true even though the power of appointment had been exercised only with respect to a portion of the trust.

The Regulations clarify, however, that an intended exercise of a power of appointment which is not yet effective will not constitute an acceptance. Treas. Reg. 25.2518-2(d)(4), Example (7). In one example, the donee of a general testamentary power of appointment executed a will which exercised the power. Shortly thereafter, and within nine months after the power was created, the donee disclaimed the testamentary power of appointment. Assuming all other requirements for a qualified disclaimer were met, the example approved the disclaimer. Id.; See also, Pennsylvania Bank and Trust Co. v. U.S., 78-2 USTC ¶13, 248 (W.D. Pa., 1978).

4.4.1.4 "Acceptance" of Life Insurance

A beneficiary under an insurance policy who filed a claim and received checks from the insurance company enabling her to draw on an account funded with the proceeds of the policy had accepted the benefits of the policy and could not disclaim, even though no withdrawals were made from the account. PLR 8702024.

4.4.2 Actions Which Do Not Constitute "Acceptance"

4.4.2.1 Generally

Certain actions, in and of themselves, do not constitute an acceptance that will invalidate a disclaimer. The acceptance of one interest in property will not necessarily be considered an acceptance of all other interests in that same property. Treas. Reg. 25.2518-2(d)(1). For example, acceptance of one asset in a joint brokerage account did not prevent (or invalidate) the disclaimer of other assets. PLR 8922060, 9214022, 9218015.

4.4.2.2 "Vesting" of Title; Renunciation

The mere vesting of title in the disclaimant at the death of the transferor, (as in the case of joint tenancy property vesting at the moment of death in the surviving joint tenant), will not preclude a qualified disclaimer. Treas. Reg. 25.2518-2(d)(4), Example (6). Extending this "vesting of title" reasoning, the IRS has ruled that a surviving spouse's election of a statutory share against the decedent's will would not constitute an acceptance that would preclude a subsequent disclaimer by the spouse of a portion of the elected interest. Rev. Rul. 90-45, 1990-1 C.B. 175. [For Kentucky's renunciation statutes, see KRS 391.030 and 392.080].

Actions taken by the disclaimant which are required under local law merely to divest ownership from the disclaimant and transfer it to another, in and of themselves, will not constitute an acceptance that will preclude the exercise of a qualified disclaimer. IRC 2518(c)(3); Treas. Reg. 25.2518-1(c)(1)(i).

4.4.2.3 Deposit of Dividend Check

A disclaimant did not accept the benefits of shares of stock when a dividend check issued to the decedent was deposited, without disclaimant's knowledge, into an account held jointly by the decedent and the disclaimant. The disclaimer of 250 shares of corporate stock, together with a proportionate share of the dividend which had been deposited into the joint account, could be disclaimed. PLR 9243024.

4.4.2.4 Premature QTIP Election

A surviving spouse's timely disclaimer of the life interest in a trust was qualified, even though the executor of the decedent's estate already had filed a federal estate tax return on which he had a IRC 2056(b)(7) "QTIP" election with respect to the property in which spouse disclaimed the life interest. Rev. Rul. 83-26, 1983-1 C.B. 234. [Perhaps the most remarkable aspect of this ruling is that the federal estate tax return in this matter was filed only six months after the decedent's death!]

4.4.2.5 Disclaimer Regarding Residences

A number of issues arise with respect to the acceptance of benefits when residential real property is disclaimed. In the case of such property held in joint tenancy, community property, or as a tenancy by the entirety, a beneficiary will not be considered to have accepted an interest in the property merely became he or she continued to reside in the residence prior to disclaiming his or her interest in it. Treas. Reg. 25.2518-2(d)(1); PLR 9135043.

- Despite the permissive approach of the Regulations, practitioners should proceed cautiously when counseling disclaimants who intend to continue to reside in a residence after disclaiming an interest in that property. Kentucky law should be consulted concerning the rights of co-tenants if the disclaimant retains an interest in the property, as will most often be true if that property formerly was owned as community property, joint tenancy, or tenancy by the entirety property. Unless the disclaimant is a surviving spouse and the disclaimed interest passes to a trust of which the spouse is a beneficiary (and the terms of the trust or state law authorize a beneficiary to reside in trust property without paying rent), in most cases, the disclaimant should plan to pay fair market rent to the taker of the disclaimed interest. While there is no direct authority on this point, presumably the rent would be a proportionate amount of the fair market rent that would be charged on the entire residence, although a strong argument can be made that the rental value of a portion of a residence is significantly less than a proportionate amount of the rental value of the entire residence.

- It is helpful to note that, in many cases, payment of rent to the taker of disclaimed property will have desirable transfer tax consequences, as the rental payments will pass wealth from the disclaimant to the taker of the property on a transfer tax-free basis. Of course, the income ta payable by the taker of the property will reduce those benefits. Still, to the extent the disclaimant's marginal federal estate tax rate is likely to exceed the marginal income tax rate of the taker of the disclaimed property, the payment of rent will "convert,"in effect, a transfer tax payable at a higher rate to an income tax payable at a lower rate. An explanation of these consequences may help mitigate the initial reluctance a disclaimant may demonstrate at having to pay rent on a portion of his or her family home to a child or other taker of the disclaimed interest in that home.

- The payment of real property taxes, even when payment is made by the beneficiary of that property out of personal funds, will not preclude the beneficiary from subsequently making a qualified disclaimer of that property. Treas. Reg. 25.2518-2(d)(4), Example (3); PLR 9135043. The IRS has ruled that, with respect to residential real property that had been owned in joint tenancy, payments of mortgage principal and interest and other expenses related to the residence prior to and after the disclaimer of a survivorship interest in that property were a "natural consequence of the use and occupancy of the residence and, thus, were not an acceptance of the benefits". PLR 9135043; 8143022. In the case of a"transfer" disclaimer under IRC 2518(c)(3), the IRS implied that, after delivery of the deed of transfer, one-half of such payments would be gifts to the taker of the disclaimed property, which gifts might qualify for the gift tax annual exclusion. Rev. Rul. 83-26, 1983-1 C.B. 234. This reasoning, if correct, should not be limited to the transfer disclaimer context, but should be relevant in any disclaimer situation. See Section 6, infra., for a discussion of transfer disclaimers.

4.4.2.6 Community Property Issues

A surviving spouse did not accept the benefits of the deceased spouse's community property interest in various assets when she segregated and took control of her one-half community property interest in those assets. PLR 9232014, 9218015.

4.4.2.7 Joint Property

In several rulings which arguably are related in concept to the segregation of community property rulings cited in the preceding paragraph, the IRS has allocated the entire amount of a withdrawal or other acceptance from a jointly owned asset to the disclaimant's personal interest in that asset. PLR 9218015, 9214022. If the withdrawal did not exceed the value of the disclaimant's own interest in the property, no acceptance of the decedent's interest was deemed to have occurred. In one such instance, payments on a credit card issued by a brokerage firm were made, with the permission of the surviving spouse, from a brokerage account that had been owned by the decedent and the surviving spouse as community property. Where the payments were less than the surviving spouse's community one-half interest in the account at the date of the decedent's death and where the surviving spouse had given the brokerage firm no other instructions regarding the account and its disposition, there was no acceptance by the surviving spouse of the decedent's interest in the account. PLR 9218015. In another such case, where the balance in a cash account that had been owned in joint tenancy exceeded the value of the decedent's one-half interest in the account at all times after the decedent's death, withdrawals by the surviving spouse during the period preceding her disclaimer were deemed attributable to her interest in the account and were not an acceptance of any portion of the decedent's interest in that account. PLR 9214022.

- In other cases, withdrawals or other "acceptances" have been allocated one-half to the decedent's interest and one-half to the surviving joint tenant's interest. PLR 9012053, 9214022. In one ruling, the decedent and his spouse had owned a brokerage account in joint tenancy. After the decedent's death, the spouse on two occasions, used a credit card issued in connection with the money fund portion of the account. She promptly repaid from her separate funds the amounts charged to the account. The amounts charged were allocated equally between the spouse's and the decedent's shares of the account. The spouse was deemed to have accepted the benefits of that portion of the credit card charges that was attributable to the decedent's share of the account, together with a proportionate share of the income earned by that account. PLR 9012053. In a second ruling, a portion of stock held in a jointly owned brokerage account was "accepted" when it was sold and reinvested with the permission of the surviving spouse. One-half of the stock was allocated to the surviving spouse's interest in the account, and one-half was attributed to the decedent's interest in the account. The surviving spouse could not disclaim that portion of the decedent's interest in the account which was attributable to the accepted stock, nor could she disclaim dividends or income attributable to that portion of the account. PLR 9214022. This ruling is of particular interest because the cash and stock accounts were treated differently, with no explanation why this is so.

- Certainly, a clear and consistent position from the IRS on this question would be helpful. Given a joint owner's right to take the proportionate interest attributable to his or her share of jointly owned property, it seems reasonable to adopt the position taken by the IRS in those rulings which have charged withdrawals or "acceptances" during the administrative period first, to the disclaimant's interest in that property. PLR 9218015. Only when the disclaimant's own interest in the property is exhausted should acceptances be deemed to have occurred with respect to the decedent's interest in the property.

4.4.3 Actions Taken by Fiduciaries

4.4.3.1 Generally

Generally, actions taken by an individual in his or her fiduciary capacity with respect to property do not preclude that individual from making a qualified disclaimer of that property. Treas. Reg. 25.2518-2(d)(2); PLR 7821045. For example, the executor of an estate may, in his or her fiduciary capacity, take steps to protect or preserve property which is an asset of that estate and may collect income with respect to the property without jeopardizing the ability of that same person, in his or her capacity as the beneficiary of an interest in that property, to disclaim. Treas. Reg. 25.2518-2(d)(2). Moreover, the IRS has ruled that taking executor's fees on disclaimed property was not an "acceptance" of that property that would disqualify the disclaimer. PLR 9051007, 8921083.

4.4.3.2 Disclaimant as Fiduciary For Disclaimed Property

An individual may not disclaim, however, where that individual, in a fiduciary capacity, has exercised or will retain a discretionary power to direct the enjoyment of the disclaimed interest. Treas. Reg. 25.2518-2(d)(2). Assume, for example, that a beneficiary wished to disclaim property which then would pass to a trust for her children. Such a disclaimer would not be qualified if the beneficiary served as trustee of the children's trust and held an unrestricted discretionary power to sprinkle trust income or principal among the children.

- A disclaimant can act as a fiduciary with respect to disclaimed property where the disclaimant's fiduciary powers are limited by an ascertainable standard. Treas. Reg. 25.2518-2(e)(1)(I). Thus, if the hypothetical trust described in the preceding paragraph provided for the distribution of income and principal only for the health, support, maintenance, or education of the children, the disclaimant could disclaim property which then would pass to the trust and she also could serve a trustee of the trust. PLR 9320015. If the fiduciary powers were not so limited, the disclaimer would be qualified if the disclaimant also disclaimed the right to act a trustee. PLR 9244012, 9236018. In either case, disclaimed property would have to pass to the children's trust without direction by the disclaimant, presumably under the terms of the decedent's will or trust.

- Under certain circumstances, a disclaimant can continue to manage disclaimed property in a partnership or a corporation when the disclaimant holds a fiduciary or management position in the business. Where, for example, a disclaimant continued to manage partnership property in her capacity as a partner after disclaiming a portion of a partnership interest, the IRS ruled that management of the partnership was not ac acceptance of the underlying partnership interest so long as (1) the compensation to the disclaimant-partner was reasonable and not based on the value of the partnership or its profits, and (2) there was no control over the distribution of income and profits of the partnership. PLR 8922082. Where, however, an executor exercised the estate's voting rights, together with her own votes, to elect herself, in her individual capacity, as the general partner of two partnerships in which the estate held interests, thereby initiating a major recapitalization of the partnership accounts, the executor could not later disclaim the partnership interests in her individual capacity because she had accepted the benefits of the interest by exercising incidents of ownership intrinsic to the decedent's partnership interests. TAM 9123003.

4.5 Disclaimed Property Must Pass Without Direction to Either Decedent's Spouse or Person Other Than Disclaimant

4.5.1 Property Must Pass Without Direction

4.5.1.1 Generally

Property passing under a qualified disclaimer must pass without direction on the part of the disclaimant. IRC 2518(b)(4); See Dipole v. Comm'r, TC Memo 1993-577. Any agreement, whether express or implied, that the property will be distributed as specified by the disclaimant will be considered a direction on the part of the disclaimant and will invalidate the disclaimer. Treas. Reg. 25.2518-2(e)(1).

- The disclaimant may neither direct the transfer or redistribution of the disclaimed property to another person nor have the power to do so. Id. See Treas. Reg. 25.2518-2(e)(5), Examples (11) and (12). This is true even if the direction may be made or the power exercised only in conjunction with another. Treas. Reg. 25.2518-2(e)(1)(i). Where, however, a fiduciary power to distribute to designated beneficiaries is limited by an ascertainable standard, the fact that the disclaimant will hold such a power with respect to an interest in disclaimed property will not disqualify the disclaimer. Treas. Reg. 25.2518-2(e)(5), Example (12).

- A disclaimer of a power of appointment will meet the requirements of this section only if the disclaimant does not direct either the transfer of the interest subject to the power or the power itself to another. Treas. Reg. 25.2518-2(e)(1).

4.5.1.2 Two IRS Examples

The Regulations offer the following interesting example of an anticipated abuse of the disclaimer statute:

"C died testate on January 1, 1979. According to C's will, D was to receive 1/3 of the residuary estate with any disclaimed property going to E. D was also to receive a second 1/3 of the residuary estate with any disclaimed property going to F. Finally, D was to receive a final 1/3 of the residuary estate with any disclaimed property going to G. D specifically states that he is disclaiming the interest in which the disclaimed property is designated to pass to E. D has effectively directed that the disclaimed property will pass to E and therefore D's disclaimer is not a qualified disclaimer under Section 2518(a)." Treas. Reg. 25.2518-2(e)(5), Example (9).

The next example goes on to approve the situation where D receives a bequest of Whiteacre which, if disclaimed, will pass to F and a bequest of Blackacre which, if disclaimed, will pass. to D. Treas. Reg. 25.2518-2(e)(5), Example (10). Under the second example, a disclaimer of either property or an undivided interest in each property would be valid, assuming all other requirements for a qualified disclaimer are met. These examples deal with estate planning situations where the use of a disclaimer is contemplated. The latter illustrates some of the flexibility that can be incorporated into an estate plan through the use of disclaimers.

4.5.1.3 Probate Activities By Disclaimant To Control Disclaimed Property

A recent private letter ruling suggests an interesting and creative planning possibility with respect to disclaimers which cause property to pass to minor beneficiaries. The beneficiary proposed to disclaim shares of stock out of an irrevocable trust. She petitioned the court for a determination that, under the terms of the trust, her minor children would receive any property disclaimed by her. The disclaimant-beneficiary also petitioned the court for the appointment of a conservator for her minor children. The conservator was not related to the disclaimant. The conservator planned to petition the court to establish trusts for the benefit of the minor children to hold the disclaimed property. Without specifically addressing the proposed creation of trusts to hold the disclaimed property (which was the portion of the fact pattern that arguably crossed the "passage without direction" line), the IRS ruled that the actions by the disclaimant to have the terms of the trust construed and to get a conservator appointment for her minor children were not "directions" by the disclaimant. The proposed disclaimer would be qualified, assuming all other requirements for a qualified disclaimer were met. PLR 9226013.

- This ruling suggests an intriguing planning strategy when disclaimers in favor of minor beneficiaries are considered. One of the concerns that arises when disclaimers are contemplated that will result in the passage of disclaimed property to minor beneficiaries in the administration of that property during the period of minority (and, in some cases, beyond). When the disclaimer has not been anticipated in the estate plan and the disclaimed property is not directed by the growing instrument to trusts for the minor beneficiaries, most often state law will require that a conservationship or guardianship be established to manage the property on behalf of the minor. This result can be undesirable for several reasons. The disclaimant may prefer to avoid the expense, inconvenience, and reporting requirements of a court-supervised proceeding. Moreover, the age at which the guardianship or conservator can petition the court to establish a trust to hold the disclaimed property, these concerns may be avoided, or at least mitigated to some degree.

- If the IRS does, in fact, take the position implied in this ruling, practitioners should examine the relevant state law to determine whether a guardian or conservator in that state would be permitted to create a trust to hold disclaimed property passing to a minor, and , if so, what restrictions might pertain to such a trust. If this approach is pursued, the disclaimant should not be appointed as the fiduciary who will create the trust on behalf of the minor beneficiary. Caution is advised, however. Private letter rulings did not even address the issue directly, but merely implied, by the *absence* of discussion, that such a procedure would not disqualify the disclaimer. Counsel should consider obtaining a ruling if the creation of a trust by a court-appointed fiduciary to hold disclaimed property is contemplated.

4.5.1.4 Disclaimed Property Passing To Charity

A number of rulings have been issued allowing disclaimers of property which then pass to a charitable organization or trust. PLR 9350033, 9350032, 9320008, 9319022, 9317039. Disclaimers have been utilized in conjunction with reformation proceedings to qualify the resulting transfer for a charitable deduction for federal estate tax purposes. PLR 9347013, 9341003.

- When property passes as a result of a disclaimer to a charitable organization, the disclaimant cannot have the power to direct the enjoyment of the disclaimed funds after the charity receives them. PLR 9350033. When the disclaimant is an officer of director of the recipient charity, or otherwise is in a position to influence the disposition of the disclaimed funds, this issue must be addressed.

- Under the facts of recent companion rulings, the decedent had three children. Prior to the decedent's death, each child established a private foundation. At the decedent's death, her revocable trust provided that her estate pass in equal shares to her children. If any child disclaimed, that child's share would pass to the private foundation created by him or her. Disclaimers by the children were qualified when the appropriate sections of the By-Laws of each foundation would be amended to require that any funds received as a result of a disclaimer made by any director of the foundation would be held as a separate and segregated fund over which only the independent (non-disclaiming directors) would have authority to distribute income and principal. In addition, the By-Laws would be further amended to provide that no disclaiming director could control the selection of persons who could hold the position of independent director. PLR 9320008, 9317039.

- Another ruling approves a rather elaborate mechanism established under a decedent's revocable trust agreement which provided the family with a great deal of flexibility concerning the disposition of the disclaimed funds. The IRS ruled that disclaimers would be qualified and a federal estate tax charitable deduction would be available if children of the decedent executed disclaimers which would, under the decedent's revocable trust agreement, cause disclaimed property to pass to one or more charitable organizations to be selected by the *spouses* of the disclaimant within six months after the disclaimers were executed. If a "selector" died before completing the selection of the recipient organizations, the surviving selectors could name a successor selector. If no successor was named, the trustee would be required to petition the court for the appointment of up to three individuals who were lineal descendants of the decedent, none of whom could be a disclaimant, to act as selectors. The recipient charities could include a foundation created by decedent (the Foundation). The potential disclaimant sat on the Board of Directors of the Foundation. If the Foundation were to be selected as a recipient charity, the By-Laws of that Foundation would have to be amended *prior to* the execution of the disclaimers to require that all funds received as a result of a disclaimer by a member of the Board be administered in a separate and segregated fund to be administered by the Separate Fund Committee. Neither the Separate Fund Committee nor the directors who selected that committee could include a person disclaiming funds to the Foundation. PLR 9235022.

- It is interesting to note that, in effect, these charitable disclaimer rulings are permitting post-death reformations to qualify an anticipated disclaimer. In these instances, however, the "reformations" are not of governing instruments, but rather of the organizational structure of the charitable organizations that will take the disclaimed property. When disclaimed property is to pass to charity, it is common for that charity to be an organization with respect to which the disclaimant has significant ties. (Otherwise, the disclaimant is less likely to disclaim in favor of that charity.) Frequently, the charitable organization will be an entity created by the disclaimant's family, or perhaps by the disclaimant him or herself, and in many cases, the disclaimant will hold a position of authority within the organization. In earlier rulings, the disclaimant would resign from the Board of Directors or from his or her office in the charity to qualify the disclaimer. PLR 9008011, 9350032. Certainly, it is more desirable from the disclaimant's standpoint to fashion an arrangement which allows him or her to remain involved with the charity, isolating him or her only from the administration of the disclaimed property.

- When considering disclaimers in favor of charities, practitioners must be conversant with the issues addressed in the rulings cited above and must be careful to ensure that disclaimed property will be segregated in a manner that will afford the disclaimant no opportunity to influence the disposition of that property. Several of the rulings go so far as to prohibit the disclaimant from even being in a position to select those persons who will have authority to distribute disclaimed funds. Several of the more recent rulings appear to require that any amendment to the recipient organization's Articles and By-Laws which are necessary to accomplish this result must be made *before* the disclaimer is executed. PLR 9350033, 9235022. While such disclaimers require careful analysis, and often additional expense because of the planning that must be done with respect to the recipient charitable organization, they also afford the opportunity for significant transfer tax benefits, as well as personal satisfaction to the disclaimant.

4.5.2 Disclaimed Property Must Pass to Either the Surviving Spouse of the Decedent or a Person Other Than the Disclaimant

4.5.2.1 Disclaimant is Not Transferor's Spouse

If the disclaimant is anyone other than the surviving spouse of the transferor, the disclaimed property must pass in its entirety to a person other than the disclaimant, the disclaimer will not be effective unless the portion of the disclaimed property in which the disclaimant retains an interest is severable from the rest of the disclaimed property or constitutes an undivided interest in the property. Id. See Section 5 *infra*, for discussion of partial interests in property.

A beneficiary who is not the spouse of the transferor may not disclaim property which then will pass to a trust in which then will pass to a trust in which the beneficiary holds an interest, even if the interest is merely a contingent remainder interest or an interest is merely a contingent remainder interest or an interest that would pass to the beneficiary under Kentucky intestacy laws. Treas. Reg. 25.2518-2(e)(3)(ii). In one instance, for example a child was bequeathed certain shares of stock. The residue of the estate was to be distributed to a family trust, which was to be divided into a marital and a non-marital share. The marital share would be held for the benefit of the surviving spouse during her lifetime and could pass, upon her death, to the children (including the disclaimant) and the heirs of any deceased children. the non-marital share would pass directly to the children and the heirs of any deceased children. The IRS approved the child's proposed disclaimer of his entire interest in the shares specifically bequeathed to him and him entire interest in shares that otherwise would be distributable to him under either the marital or non-marital share of the family trust. PLR 8831032, PLR 8705029. This ruling illustrates the necessity to determine whether disclaimed property will pass, as a result of the disclaimer, in a manner that affords that disclaimant any kind of continuing interest in the disclaimed property and, if so, the requirement that the secondary interest or interests also must be disclaimed.

- **Note:** When planning disclaimers, it is critical to determine in advance to whom the disclaimed property will pass. When, under the relevant documents or Kentucky (or other state) law, disclaimed property will pass in a manner such that a non-spouse beneficiary will continue to have an interest in that property, the beneficiary must further disclaim the interests that arise under the initial disclaimer in a manner that will cause the property to pass, without direction, to someone other than the disclaimant. In other words, the property must be disclaimed "down the line" until it will pass to another beneficiary.

4.5.2.2 Disclaimant is Transferor's Spouse

A special exception is made for spousal disclaimers. A spouse may disclaim property passing from a descendent and still receive beneficial enjoyment from that property. Treas. Reg. 25.2518-2(e)(2). For example, a spouse may disclaim an outright bequest which, under the terms of the descendent's will, passes either to a trust for the exclusive benefit of the spouse or to a discretionary trust of which the spouse is a permissible beneficiary. When spouses prefer to leave their estates outright to one another, disclaimer planning can be utilized to provide the surviving spouse with the option to preserve all or a portion of the deceased spouse's unified credit by providing for the disposition of disclaimed assets to an appropriately structured trust or to other beneficiaries. Similar flexibility with respect to planning for the use of the GSTT exemption can be obtained through the use of disclaimers in the estate planning process.

Property disclaimed by a surviving spouse must pass without any direction on the part of the surviving spouse to that spouse or another person. Treas. Reg. 25.2518-2(e)(2); Treas. Reg. 25.2518-2(e)(5), Examples (5) and (6). This rule is applied differently with respect to a disclaimant who is the surviving spouse of the transferor, however, than it is with respect to other disclaimant. A surviving spouse will be treated as directing the beneficial enjoyment of the disclaimed property in a transfer that is not subject to federal estate or gift tax (whether as trustee or otherwise) *unless* that power is limited by an ascertainable standard. Treas. Reg. 25.2518-2(e)(2). It is unclear whether the disclaimant spouse can retain a general power to appoint or direct beneficial enjoyment to *anyone*, or whether that power must be limited to a "5 and 5" power or a general power of distribution which would permit the disclaimant spouse to invade corpus for his or her benefit alone. In other words, it is not clear whether the disclaimant spouse can retain a general power to appoint disclaimed property to anyone other than the disclaimant spouse. Treas. Reg. 25.2518-2(e)(5), Example (5); PLR 9329025.

5. Disclaimers of Partial Interests

5.1 Disclaimer May be Made of All or Undivided Portion of Any Separate Interest in Property

A disclaimer may be made with respect to an undivided portion of an interest is all other requirement for a qualified disclaimer are met. IRC 2518(c)(1).

5.1.1 "Undivided portion"

An undivided portion of a disclaimant's separate interest in property must consist of:

"a *fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property* and must extend over the entire term of the disclaimant's interest in such property and in other property into which such property is converted." Treas. Reg. 25.2518-3(b) (Emphasis Added).

If, for instance, a beneficiary were the devisee of a life estate in certain property, he could disclaim the entire life estate or a fraction or percentage of that life estate, assuming all other requirements for a qualified disclaimer were met. He could not, however, disclaim a portion of the life estate measured by a term of years. Treas. Reg. 25.2518-3(a)(1)(i) and (d), Example (4). Such a disclaimer also would violate the requirement that the disclaimed interest be separately created by the transferor. (See Section 5.1.2, *infra.*) These two requirements are closely related, and often overlap.

5.1.2 The "Separate Interest" Rule

Generally, any interest which is separately created by the transferor will be regarded as a separate interest for disclaimer purposes. If, for instance, a decedent left shares of stock to his daughter, Jane, Jane could disclaim all or any number of the share bequeathed to her, assuming all other requirements for a qualified disclaimer were met. Jane could not, however, disclaim a remainder interest in the shares and retain a life estate in them, as the remainder interest was not a separate interest, separately created by the decedent. Treas. Reg. 25.2518-3(d), Example (2).

The inability to disclaim a temporal interest that was not separately created by the transferor was illustrated by the facts of a Technical Advice Memorandum. The decedent's will directed that his spouse be entitled to occupy a residence for so long as she continued to use it and did not remarry. The residue of the estate passed to the decedent's children. The children disclaimed all interests in the residence which might arise during the spouse's lifetime, either through reversion or intestacy, but retained the right to receive the property at the spouse's death. The IRS ruled that the children were attempting to disclaim a "temporal part" of the remainder which was not separately created by the decedent and was not an undivided portion of the interest. the disclaimers were not qualified for the marital deduction. TAM 9140004. This rule illustrates again the desirability of planning in advance for the use of disclaimer, as the creation of separate interests in anticipation of disclaimers can greatly increase the planning opportunities available to the beneficiaries.

5.1.3 Merger of Interests Under Kentucky (Or Other State) Law

There is a significant caveat to the "separate interest" rule. If, under Kentucky (or other state) law, interests that are separately created by the transferor are merged, all or a portion of the entire merged interest must disclaimed if the disclaimer is to valid. Treas. Reg. 25.2518-3(a)(1)(i).

> **Example:** Ann receives life estate in a farm and is the sole beneficiary of the residuary estate. The remainder interest in the farm passes to the residuary estate under the decedent's will. Under state law, Ann's interests merge to give her a fee simple interest in the farm. Under these circumstances, Ann cannot make qualified disclaimer of her interest in the life estate. Treas. Reg. 25.2518-3(d), Example (12).

When merger would occur under state law but for the creation by the transferor of a nominal interest in the property, a disclaimer must be made of all or an undivided portion of the interests which would have merged but for the nominal interest. Treas. Reg. 25.2518-3(a)(1). A nominal interest is an interest in property created by the transferor that;

(1) has an actuarial value of less than 5% of the total value of the property at the time of the taxable transfer creating the interest;

(2) prevents the merger under local law of two or more other interests created by the transferor; and

(3) can be clearly shown from all the facts and circumstances to have been created primarily for the purpose of preventing the merger of the other interests. Treas. Reg. 25.2518-3(a)(1)(iv).

Factors to be considered in determining whether an interest is created primarily for the purpose of preventing merger include, but are not limited to the following:

(1) the relationship between the transferor and the interest holder;

(2) the age difference between the interest holder and the beneficiary whose interests would have merged;

(3) the interest holder's state of health at the time of the taxable transfer; and

(4) in the case of a contingent remainder, any other factors which indicate that the possibility of the interest vesting as a fee simple is so remote as to be negligible. Id.

5.2 Disclaimers of Pecuniary Amounts

5.2.1 Generally

Disclaimers can be made of pecuniary amounts. PLR 9338010, 9245021, 8539004. A pecuniary amount can be expressed as a specific dollar amount or by formula. For example, a spouse was permitted to disclaim that pecuniary amount which, when added to a child's intestate share, would result in full utilization of the decedent's unified credit. PLR 9338010. Disclaimers also can be made of reverse pecuniary amounts, and the use of such disclaimers has become increasingly popular. PLR 9319022, 9310020, 9115062, 9014005, 9009007, 8708069; Estate of Henry Stanley McInnes, TC Memo 1992-558. A reverse pecuniary disclaimer might be described as an "all but" disclaimer. A child might disclaim, for example, all but the amount of the bequest to him or her that can pass free of tax by reason of the unified credit. Such a disclaimer could be particularly useful where a decedent's estate passes to a child, and a disclaimer by the child will cause property to pass to the surviving spouse and thus qualify for the marital deduction. PLR 8708069.

5.2.2 "Separate Fund" Protection

A disclaimer of a specific pecuniary (or reverse pecuniary) amount can be made out of either a pecuniary or non-pecuniary bequest or gift if no income or other benefit of the disclaimed amount inures to the benefit of the disclaimant, either before or after the disclaimer. Treas. Reg. 25.2518-3(c). Thus, following the disclaimer of a pecuniary amount, the disclaimed amount and any income attributable to it must be segregated from portion of the gift or bequest that was not disclaimed. Id. While there is no specific guidance as to the nature and degree of segregation that is required, the Regulations approve an example in which the executor set aside a disclaimed amount after the disclaimer into a "separate fund." Treas. Reg. 25.2518-3(d), Example (19). Presumably, the establishment by an executor or trustee of a separate bank account to hold such funds would satisfy this requirement. PLR 9232014. While some practitioners rely solely on separate accounting entries to segregate disclaimed pecuniary amount, this approach is not recommended unless and until there is some indication from the IRS that it will be sufficient.

5.2.3 Post-Disclaimer Asset Allocation

The segregation of assets in satisfaction of a disclaimer of a pecuniary amount must be made on the basis of the fair market value of the assets on the date of the disclaimer or on a basis that is fairly representative of appreciation and depreciation that has occurred between the date of transfer and the date of the disclaimer. Treas. Reg. 25.2518-3(c). A disclaimer of a pecuniary amount, which, by its terms, was based on date of death values was qualified when the disclaimed amount would be satisfied using date of distribution values. PLR 8539004.

5.2.4 Determination of Share of Income

Any amount distributed to the disclaimant from the gift or bequest prior to the disclaimer is treated as distribution of corpus from that gift, and an acceptance by the disclaimant of the amount distributed as well as a proportionate amount of the income earned by the gift or bequest between the date of transfer and the date of the disclaimer. Treas. Reg. 25.2518-3(c). The Regulations provide a formula under which the proportionate share of income is to be determined. Id.; Treas. Reg. 25.2518-3(d), Example (17).

5.3 Powers of Appointment

5.3.1 Generally

A power of appointment is treated as a separate interest in property and may be disclaimed independently from any other interests in that same property which are separately created by the transferor. Treas. Reg. 25.2518-3(a)(1)(iii); PLR 9318020. Thus, a "5 and 5" power is a separate interest which can be disclaimed. PLR 8824014. A qualified disclaimer of a general power of appointment is not a release of the power under IRC 2041. Treas. Reg. 20.2041-3(d)(6)(I); PLR 9236018.

5.3.2 What A Trust Beneficiary Can Disclaim

A beneficiary can disclaim the right to receive trust corpus upon distribution of a trust, while retaining the right to discretionary distributions of income during the trust term. PLR 8825101, 8824014. Similarly, a beneficiary can disclaim the right to receive discretionary distributions of principal during the trust term, retaining the right to receive all income from the trust. PLR 9329025. A beneficiary also can disclaim inter vivos and testamentary powers to appoint trust property, and retain the right to all income from the property. PLR 9236018. The IRS has ruled that the disclaimer by surviving spouse of a lifetime power to appoint trust property to descendants, while retaining the right to all income from the trust, the right to discretionary distributions of the corpus, and a testamentary general power of appointment, was qualified when all other requirements for a qualified disclaimer were met. PLR 9329025. Note that a similar disclaimer by a beneficiary who was not the spouse of the transferor would not be qualified, as the retention of the general power of appointment would violate the "passage without direction" rule. See discussion at Section 4.5.2.2., *supra.*

5.3.3 What a Trust Beneficiary Cannot Disclaim

A disclaimant may not, however, retain a power or right to direct the beneficial enjoyment of disclaimed property unless that right is limited by an ascertainable standard. Treas. Reg. 25.2518-3(a)(1)(iii), 25.2518-3(d), Example (9). In the facts presented in one ruling, beneficiaries disclaimed property which passed to a trust in which neither disclaimant retained beneficial interests, but of which the disclaimant were named to serve as co-trustees. The trust permitted the trustees to made distributions to provide for the beneficiaries' "support, education, and comfort." Concurrently with the execution of their disclaimers, the disclaimant proposed to resign as trustees. Noting that the trustees' power to distribute from the trust was not limited by an ascertainable standard, the IRS nevertheless ruled that the proposed disclaimers would be qualified if the disclaimant resigned as trustees concurrently with the execution of their disclaimers.

- **Example:** A trust is created for the benefit of Bob which provides for the payment of all income to Bob, for invasions of principal for Bob's benefit, and which gives Bob a testamentary general power of appointment over the trust corpus. Bob can disclaim the testamentary power to appoint all or an undivided portion of the trust corpus and retain his beneficial interest in the trust income and principal. Treas. Reg. 25.2518-3(d), Example (21). Unless Bob were the spouse of the transferor, however, Bob could not retain the right to direct the beneficial enjoyment of the trust property unless that right were limited by an ascertainable standard. Treas. Reg. 25.2518-3(a)(1)(iii); 25.2518-3(d), Example (9). Thus, if Bob were the trustee of the trust, Bob's disclaimer of his power of appointment would be qualified only if Bob's ability as trustee to distribute principal were limited by an ascertainable standard. If, however, Bob were the surviving spouse of the transferor, the power to distribute principal to himself need not be limited by an ascertainable standard, and there is some authority which seems to indicate that the power to distribute even to others need not be limited by such a standard so long as a transfer under the power would be subject to estate or gift tax. PLR 9329025.

- A general testamentary power of appointment can not be "pared down" by the beneficiary. There is no statutory or regulatory authority which permits this kind of pruning or shaping of a general power. To ensure that the trust assets would not be subject to estate tax at the death of the beneficiary, the appropriate course of action would have been to disclaim the general power in its entirety.

- An interesting question arises in a related area, however. Could a partial disclaimer be make of a general power to distribute corpus (or of the right to have corpus distributed) for the comfort or happiness of a beneficiary if the trustee had the power to distribute trust principal for the "health, support, comfort, and happiness" of the beneficiary? The Proposed Regulations included an example disallowing a disclaimer where a trustee/ beneficiary had the power to invade trust principal for his own "health, maintenance and happiness" and attempted to disclaim the power to invade for happiness. Prop. Reg. 25.2518-3, Example (15). The disclaimer was disallowed because the trustee did not disclaim *all* powers to invade principal. (Under the Proposed Regulations, a disclaimer of an interest in principal only could be valid if all other interests in principal were disclaimed. This concept was not carried forward in the Final Regulations.)

Although the Final Regulations do not address this issue, it has been suggested that such a disclaimer should be permissible under the present rules. It can be argued that the transferor has separately created a general power (the power to invade principal for comfort (the power to invade principal for comfort or happiness) and also has separately created a special power (the power to invade for health and maintenance). Because the general power was separately created and because, after the disclaimer, the remaining special power to invade principal for health and maintenance is a power limited by an ascertainable standard, the general power of appointment should be able to be disclaimed independently. This argument is persuasive and should be the correct result for a policy standpoint. Practitioners should be aware, however, that there is no authority ratifying this conclusion and should proceed cautiously.

5.4 Severable Property

5.4.1 Generally

Severable property is defined as "property which can be divided into separate parts each of which, after severance, maintains a complete and independent existence." Treas. Reg. 25.2518-3(a)(1)(ii).

5.4.2 Shares of Stock

The classic example of severable property is shares of stock. The recipient of 100 shares of stock in a corporation may disclaim any specific number of those shares as long as the other requirements for a qualified disclaimer are met. Treas. Reg. 25.2518-3(a)(1)(ii), 25.2518-3(d), Example (1). Similarly, any stated dollar amount of a cash gift may be disclaimed. Treas. Reg. 25.2518-3(d), Example (16). Identifiable parcels of real property, such as individual acres, also are severable, as are separate paintings. Treas. Reg. 25.2518-3(d), Examples (1) and (3). Surface estate and mineral estate interests have been held to be severable as well. PLR 8212061.

5.4.3 Other Assets/Interests

Various other rights and interests have been hold to be severable for disclaimer purposes. For example, a spouse's right to remove the trustee was considered to be separate from all other interests. The spouse was permitted to disclaim that right, while retaining all other interests in a trust for her benefit. PLR 9329025, 8122075. The right to receive loans from a trust "on terms determined by the trustee" also was a separate interest which could be disclaimed by beneficiaries. PLR 8815038.

5.4.4 Sole Interest Of Decedent/Transferor

Property that is severable but that ordinarily would not constitute an undivided portion can be disclaimed if that property is the only property in which the decedent had an interest. Treas. Reg. 25.2518-3(a)(1)(ii). If, for example, a spouse is given the right to live in a residence until his remarriage, he should be able to disclaim all or an undivided portion of that right. On the other hand, had the spouse been given a life estate or fee interest in the residence, the right to live in the residence until remarriage would not be severable and would not constitute an undivided portion of the spouse's interest that could be disclaimed.

5.5 Specific Asset

Specific assets can be disclaimed from an outright bequest. Treas. Reg. 25.2518-3(d), Example (1); PLR 9243024, 8705029. Specific assets also can be disclaimed out of a trust. Treas. Reg. 25.2518-3(a)(2), 25.2518-3(d), Example (6); PLR 9014005, 8719014, 8705029. An asset disclaimed from a trust must be removed from the trust and must pass, without direction on the part of the disclaimant, to someone other than the disclaimant or the decedent's spouse. Id.; PLR 9244012, 9038031. If the disclaimed asset remains in the trust and the disclaimant retains an interest in that trust, the disclaimer will not be qualified. Treas. Reg. 25.2518-3(d), Examples (5) and (7).

6. Transfer Disclaimers

6.1 Generally

IRC 2518 was enacted primarily to create a uniform federal disclaimer law that would eliminate the inconsistencies and confusion that arose from the need to satisfy divergent state law disclaimer requirements. See, Estate of O. W. Newman, Jr., T.C. Memo 1979-223. Even after the passage of IRC 2518, however, the impact of state law on the qualification of a disclaimer for federal tax purposes remained unclear. The IRS initially took the position that, in order for a disclaimer to be qualified under IRC 2518, it must be effective under state law to transfer the disclaimed property from the disclaimant to another. Prop. Reg. 25.2518-1(c)(1). Fortunately, the IRS reversed this position in the Final Regulations, which state that a disclaimer may be qualified even when it is not effective under local law. Treas. Reg. 25.2518-1(c)(1)(i). Unfortunately, the language of the Regulations is limited to disclaimers of interests created in transfers prior to 1982. Id.. With respect to all other transfers, the Regulations continue to require that disclaimed property pass, as a result of the disclaimer, without direction on the part of the disclaimant to someone other that the disclaimant or to the surviving spouse of the transferor. Treas. Reg. 25.2518-2(e).

6.2 IRC 2518

In 1981, responding to continuing concern over the state law issue, Congress expanded the scope of IRC 2518 by enacting IRC 2518 (c) (3). IRC 2518(c)(3) provides that a written transfer of the transferor's entire interest in property will be a qualified disclaimer if the transfer is to the person or persons who would have received the property if the transferor had made a qualified disclaimer and if the transfer meets all of the requirements for a qualified disclaimer *except* the requirement that disclaimed property pass without direction on the part of the disclaimant. Thus, a disclaimer that does not meet the requirements for a valid disclaimer under Kentucky law nevertheless will be qualified for federal tax purposes if it is effective under Kentucky law to cause the disclaimed property to pass without direction on the part of the disclaimant to someone other than the disclaimant. Treas. Reg. 25.2518-1(c)(3), Example (1). If, however, the attempted disclaimer does not cause the requisite transfer under Kentucky law, it will not be qualified for federal tax purposes unless the requirements of IRC 2518(c)(3) are met.

6.3 Some Questions/Unresolved Issues

Although IRC 2518(c)(3) was intended to provide a uniform alternative when state law disclaimer requirements cannot or have not been satisfied, a number of issues remain. For example, IRC 2518(c)(3) requires the transfer of the disclaimant's "entire" interest in property. IRC 2518(c)(3). While arguably and "entire interest" should include any severable or undivided portion of an interest, there is no authority on this point on which to rely. It is unclear whether a spouse can retain an interest in property disclaimed by transfer under IRC 2518 (c)(3), as he or she can under IRC 2518 (b)(4)(A). Moreover, if a disclaimer is not effective to transfer property under state law, state law may not establish to whom the property would have passed if the disclaimer had been effective. To whom should the property be transferred under these circumstances? The IRS has promised to issue regulations explaining the requirements of IRC 2518 (c)(3), and IRC 25.2518-1(c)(1)(ii) of the Regulations has been reserved for this purpose. However, given the more pressing need for guidance from the IRS in higher-profile areas such as GSTT tax, qualified domestic trusts, and Chapter 14, it is unlikely such regulations will be issued anytime soon.

6.4 Approvals Of Transfer Disclaimers

Despite the continuing lack of clarity surrounding their use, transfer disclaimers have been approved in a number of instances. See PLR 9228003, 9135043. In some cases, taxpayers have attempted to "save" disclaimers which were attempted under the general provisions of IRC 2518(b), but which were found to be unqualified, by arguing that such disclaimers should be recognized under IRC 2518(c)(3). This approach generally has been unsuccessful, and one court recently scolded:

> "Section 2518(c)(3) should not be viewed as a catch-all provision to save defective or unqualified disclaimers but an entirely new relief provision under which, after a disclaimer has been disqualified, the would be disclaimant makes an actual written transfer to the person who otherwise would have received the property had the disclaimer been valid under local law. The relief of section (sic) 2518 (c)(3) was designed to eliminate the gift tax consequences for the beneficiary who had made a disclaimer that was disqualified and who then made an actual written transfer to another individual. Estate of Bennett v. Comm'r., supra.

On the other hand, a recent ruling allowed an agreement not to probate a will to qualify as a disclaimer under IRC 2518(c) (3). PLR 9228004. In this extremely lenient ruling, the IRS reasoned that, because the taxpayer could have obtained the same result by disclaiming, and because an agreement not to probate a will caused a transfer to occur under applicable state law (Texas), and finally, because the agreement was executed within nine months of the date of the decedent's death and the "disclaimant" spouse had not accepted the benefits of the disclaimed property, the spouse was considered to have made a qualified disclaimer under IRC 2518(c)(3). It appears that a critical factoring this ruling was a provision of stat law which held that a transfer occurred when that will. This should be considered when evaluating the holding of this ruling. Nevertheless, if faced with a disclaimer which is determined to be invalid under IRC 2518 (b), it is worth analyzing whether an argument can be made that the purported disclaimer should be qualified under IRC 2518(c)(3).

7. Disclaimers by Trustees

Disclaimers by trustees have had mixed reception. In some cases, disclaimers by trustees have been recognized. See Cleaveland v. U.S., 88-1 USTC ¶13,766 (C.D. Ill.,1988); McClintock v. Scahill, 530 N.E. 2d 164 (1988). In other instances, such disclaimer have not been effective, particular when the disclaimer purports to disclaim a beneficial interest in a trust, the beneficiary has not executed a simultaneous disclaimer (or, at minimum, consented to the disclaimer by the trustee), and/or the trustee is not authorized to disclaim under either state law or the operative instrument. Estate of Bennett v. Comm'r., supra.; Rev Rul 90-110, 1990-2 C.B. 209; Matter of Martin, 549 N.Y. S.2d 592 (1989); In re. Witz, 406 N.Y. S.2d 671 (1978).

In a number of cases in which a trustee has attempted to disclaim a fiduciary power, it has been held that the disclaimer was effective with respect to the *disclaiming* trustee, but not with respect to successor trustees. See PLR 8729002, 8605004, 8527009. In other words, the trustee's disclaimer was not effective to remove the disclaimed power from the trust. Thus, the disclaimed power would be exercisable by successor trustees, even though it was no longer exercisable by the disclaiming trustee.

If it is desirable to eliminate a fiduciary power by disclaimer (where, for example, a trustee has the power to made distributions to children from a trust for which the marital deduction is desired), it would be a good idea to obtain disclaimers from the beneficiaries who could benefit from the exercise of the offending power in lieu of, or at least in addition to, obtaining a disclaimer from the trustee.

8. Conclusion

The disclaimer is a valuable planning tool. Through the effective and creative use of disclaimer, the estate planner can accomplish a wide variety of objectives for his or her clients, particularly when disclaimers are anticipated in the estate planning process.

PROFESSIONAL RESPONSIBILITY ISSUES FOR TRUST AND ESTATE LAWYERS

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SECTION F

PROFESSIONAL RESPONSIBILITY ISSUES
FOR
TRUST & ESTATE LAWYERS

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PROFESSIONAL RESPONSIBILITY ISSUES FOR TRUST & ESTATE LAWYERS

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1. INTRODUCTION TO ISSUES.

1.1 Review of Fundamental Issue: "Who does the lawyer represent?"

1.1(a) Does the lawyer represent the fiduciary? If the lawyer represents the fiduciary, then does the lawyer represent the fiduciary in a fiduciary capacity or an individual (corporate) capacity?

1.1(b) Does the lawyer represent the beneficiaries?

1.1(c) Does the lawyer represent the estate/trust as an entity?

1.1(d) Does the lawyer represent the beneficiaries *and* the fiduciary?

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

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

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

1.5 Review of Questions Presented By KBA E-401.

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

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

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

1.5(d) Question 4: May the lawyer for the fiduciary also represent the beneficiaries of the decedent's trust or estate?

2. REVIEW OF PROFESSIONAL RULES.

2.1 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.

2.2 Comments To Rule 1.7. *Other Conflict Situations*

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

[11] For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.

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

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

2.4 Rule 1.2: Scope of Representation.

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

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

(c) A lawyer may limit the objectives of the representation if the client consents after consultation.

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

(e) *When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall inform the client regarding the relevant limitations on the lawyer's conduct.*

2.5 Comment to Rule 1.2.

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

2.6 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 a court order.

2.7 Comments to Rule 1.6.

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

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

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

[4] A fundamental principle in the client-lawyer relationship is that the lawyer maintain confidentiality of information relating to the representation. The client is thereby encouraged to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter.

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

Disclosure Adverse to Client

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

[10] Several situations must be distinguished.

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

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

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

Withdrawal

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

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

3. REVIEW OF STATE CHOICES.

3.1 Representation of Fiduciary. Florida Law.

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

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

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

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

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

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

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

4. DUTIES TO BENEFICIARIES.

4.1 Review Rule 1.2.

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

5. ABA FORMAL OPINION 94-380 & KBA E-401.

5.1 Review of Majority Rule - Lawyer Represents Fiduciary.

5.2 Review of KBA Opinion Citing ABA Opinion.

6. CONCLUSION OF KBA OPINION.

6.1 Review of Five Points.

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

6.1(b) The fact that a fiduciary has obligations to the beneficiaries of the trust or estate does not in itself either expand or limit the lawyer's obligations to the fiduciary under the Rules of Professional Conduct, nor impose on the lawyer obligations toward the beneficiaries that the lawyer would not have toward other third parties.

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

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

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

6.2 Recommendations.

6.2(a) *Get It In Writing*

6.2(b) *You Do Not Represent Trusts - Estates*

6.2(c) *Use The Hot Line*

7. PROCESS OF OPINION.

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

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

8. MISCELLANEOUS ETHICAL ISSUES FOR THE ESTATE PLANNER.

8.1 Joint Representation of Spouses

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8.3 Will Provision Requiring Appointment as Fiduciary's Lawyer

8.4 Lawyer Representation of Fiduciary & Beneficiaries

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8.6 Lawyer Serving as Fiduciary

8.7 Lawyer Disclosure of Information After Client's Death

9. QUESTIONS FOR REVIEW.

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

#1 Is there any ethical reason why I should or should not share with him the events surrounding preparation of mother's documents, as well as letters, drafts and notes in my file?

#2 Do I owe the mother a continuing duty of confidentiality after her death?

#3 Should I tell the disgruntled child that I will share information with him if he gives me written consent from all other legatees?

#4 If the child attempts to obtain a court order to have me disclose the information do I have an affirmative obligation to oppose the child's efforts?

KENTUCKY BAR ASSOCIATION ETHICS OPINION E-401

The Committee has been asked to address the applicability of the Kentucky Rules of Professional Conduct with respect to a lawyer's representation of the fiduciary of a decedent's estate or trust, and the lawyer's responsibilities to the beneficiaries of estates and trusts. In order to provide the requested advice, explain the Committee's position on these issues, and to give insight into the applicable Rules of Professional Conduct, the following questions are presented for response and discussion.

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

Answer: **No.**

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

Answer: **No.**

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

Answer: **No.**

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

Answer: **Qualified Yes.**

References:
ABA Formal Op. 94-380 (1994); Privilege and Confidentiality Issues When a Lawyer Represents a Fiduciary, 30 Real Property, Probate and Trust Journal 541 (1996); ACTEC Commentaries on the Model Rules of Professional Conduct, 28 Real Property, Probate and Trust Journal 865 (1994); Developments Regarding the Professional Responsibility of the Estate Administration Lawyer: The Effect of the Model Rules of Professional Conduct, 26 Real Property, Probate and Trust

Journal 1 (1991); When Loyalties Collide: Courts Resolve Conflicting Duties, 135 Trusts & Estates 22 (1996); Professional Responsibility Issues Keep Practitioners on Their Toes, 135 Trusts & Estates 22 (1996); and The Fiduciary, His Counsel And The Attorney - Client Privilege, 136 Trusts & Estates 29 (1997); §73, Duty to Certain Non-Clients, Restatement, The Law Governing Lawyers.

OPINION

From time to time Kentucky lawyers have requested advice from the Committee regarding a lawyer's responsibilities in the context of the administration of trusts and estates. The primary problem in answering such questions arises from the fundamental question: Whom does the lawyer represent? Does the lawyer represent the beneficiaries of the estate or trust; does the lawyer represent the estate or trust entity or does the lawyer represent the fiduciary? The complexity of this problem is acknowledged in Comment 12 to Rule 1.7, which states:

> 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.

By issuing this Opinion it is the Committee's intent to clarify a Kentucky lawyer's obligations under the Rules of Professional Conduct. The examination of these issues must focus on Rule 1.7, Conflict of Interest: General Rule, and the problems generated by a lawyer's multiple representation of clients. The American College of Trust and Estate Counsel, hereafter referred to as "ACTEC," adopted Commentaries to the Model Rules of Professional Conduct in October 1993, and their Commentaries and the Reporter's Notes on the ACTEC Commentaries are helpful to this analysis. The Reporter's Notes contained the following statements:

> Lawyer for Fiduciary.
> Under the majority view, a lawyer who represents a fiduciary ... stands in a lawyer-client relationship with the fiduciary and not with respect to the fiduciary estate or the beneficiaries.
> Duties to Beneficiaries.
> The lawyer who represents a fiduciary generally is not usually considered also to represent the beneficiaries. However, most courts have concluded that the lawyer owes some duties to them. Some courts subject the lawyer to the duties because the beneficiaries are characterized as the lawyer's "joint," "derivative" or "secondary" clients. Other courts do so because the lawyer stands in a fiduciary relationship with respect to the fiduciary, who, in turn, owes fiduciary duties to the beneficiaries. The duties, commonly called "fiduciary duties," arise largely because of the nature of the representation and the relative positions of the lawyer, fiduciary, and beneficiaries. However, note that the existence and nature of the duties may be affected by the nature

and extent of the representation that a lawyer provides to a fiduciary. Thus, a lawyer who represents a fiduciary individually regarding a fiduciary estate may owe few, if any, duties to the beneficiaries apart from the duties that the lawyer owes to other nonclients.

In addition to the Reporter's Notes, this Committee finds the following comments from the ACTEC Commentaries on Model Rule 1.7 instructive for purposes of clarifying the lawyer's obligations to the fiduciary, to the beneficiaries of an estate or trust, and the problems of multiple representation.

> General Nonadversary Character of Estates and Trusts Practice: Representation of Multiple Clients. It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plans, more than one beneficiary with common interests in an estate or trust administration matter....
> In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. ... Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. ...
> Disclosures to Multiple Clients.
> Before, or within a reasonable time after, commencing the representation, a lawyer who is consulted by multiple parties with related interests should discuss with them the implications of a joint representation (or a separate representation if the lawyer believes that mode of representation to be more appropriate and separate representation is permissible under the applicable local rules). In particular, the prospective clients and the lawyer should discuss the extent to which material information imparted by either client would be shared with the other and the possibility that the lawyer would be required to withdraw if a conflict in their interests developed to the degree that the lawyer could not effectively represent both of them. The information may be best understood by the clients if it is discussed with them in person and also provided to them in written form, as in an engagement letter or brochure.

This Committee adopts the ACTEC Commentaries because the Commentaries properly set forth a lawyer's ethical obligations. Further, this Committee agrees with ABA Formal Opinion 94-380, and adopts the majority view; that is, that a lawyer who represents a fiduciary does not also represent the beneficiaries. We reject the view that a lawyer who represents a fiduciary also owes fiduciary obligations to the beneficiaries that in some circumstances will override obligations otherwise owed by the lawyer to the fiduciary, such as the obligation of confidentiality. We also reject the view that when a lawyer represents a fiduciary in a trust or estate matter, the client is not the fiduciary, but is the trust estate. We adopt the following comments made in the ABA's Formal Opinion:

> When the fiduciary is the lawyer's client all of the Model Rules prescribing a lawyer's duties to a client apply. The scope of the lawyer's representation is defined by and limited by Model Rule 1.2. The lawyer must diligently represent the fiduciary, see Model Rule 1.3, preserve in confidence communications between the lawyer and the fiduciary, see Model Rule 4.1(a). The fact that the fiduciary client has obligations toward the beneficiaries does not impose parallel obligations on the lawyer, or otherwise expand or supersede the lawyer's responsibilities under the Model Rules of Professional Conduct. A lawyer's duty of confidentiality to a client is not lessened by the fact that the client is a fiduciary. Although the Model Rules prohibit the lawyer from actively participating in criminal or fraudulent activity or active concealment of a client's wrongdoing, they do not authorize the lawyer to breach confidences to prevent such wrongdoing.

The ABA's Opinion, in Footnote 6, included the following important caveats:

> 6. The Model Rules impose a number of limitations on a lawyer representing a fiduciary. For example, a lawyer may not participate in a breach of fiduciary duty by the fiduciary that involves fraud or criminal activity because the lawyer's conduct is limited by Model Rule 1.2(d), which provides that a lawyer may not actively participate in a client's criminal or fraudulent activity. This rule applies to all lawyers, not just those representing fiduciaries. Lawyers are also prohibited from actively concealing client breaches of fiduciary duty, or actively assisting in such concealment, by Model Rules 4.1(a) (a lawyer shall not lie to third parties) and 3.3(a)(1) and (2) (a lawyer shall not lie to or conceal information from a tribunal).
> If a lawyer knows that a breach of fiduciary duty has occurred, and that an accounting is misleading in that it hides wrongdoing committed by the fiduciary, the lawyer is expressly prohibited by Model Rule 3.3(a) from presenting the accounting to the court. Further, the lawyer is prohibited by Model Rule 4.1(a) from representing to the beneficiaries that a false accounting is accurate. These rules apply to a lawyer with a fiduciary client to the same extent as, but no farther than, they apply in any other lawyer/tribunal/third party scenario.

Continuing in the text of the Opinion, the ABA Ethics Committee then made the following comments:

> Although a lawyer may not disclose confidences of the fiduciary, if the fiduciary insists on continuing a course of fraudulent or criminal conduct, the lawyer may be required to terminate the representation because the lawyer's services will be involved in that conduct, so as to invoke Rule 1.16(a)(1), or may have the option of a voluntary withdrawal under Rule 1.16(b)(1).
> If either of these provisions of Rule 1.16 applies, this will be not because the client is a fiduciary, but because the client is acting in the manner described by the Rule. The client's status is irrelevant.

Based upon the instructive comments of the ACTEC Commentaries and the ABA Formal Opinion, this Committee concludes with the following advice for Kentucky lawyers.

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

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

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

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

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

9/97

PLANNING FOR DISTRIBUTION OF RETIREMENT BENEFITS

**** IRA and Qualified Plan Distributions and Roth IRAs ****
**** Minimizing Multiple Taxation ****

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SECTION G

PLANNING IN DISTRIBUTION OF RETIREMENT BENEFITS

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UPDATE IN PLANNING FOR DISTRIBUTION OF RETIREMENT BENEFITS
* IRA and Qualified Plan Distributions and Roth IRAs
* Minimizing Multiple Taxation

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I GENERAL COMMENTS

As we approach the beginning of the 21th Century, we are finding quite frequently that the largest single asset in our clients' estates are the total of their qualified plan and IRA accounts. These assets have very unique tax implications and are extremely hard to deal with in adopting practical estate planning for our clients. We will address some of these problems and choices, including the new Roth IRA and other provisions of the 1997 Tax Reform Act, that directly affect this area in my presentation and this outline. The interplay of the various income, excise and transfer taxes creates a bewildering array of possibilities, some of which without careful planning, can be catastrophic.

II ROLLOVERS

A. A participant in a qualified retirement plan may avoid current taxation on a distribution by rolling the distribution over into another qualified retirement plan or into an individual retirement plan.

B. There are five types of rollovers:

1. Amounts may be transferred from one IRA to another.

2. Amounts may be transferred from a qualified retirement plan to an IRA.

3. A rollover from one qualified retirement plan to another.

4. A rollover to a qualified retirement plan from an IRA if all amounts in the IRA are attributable to an earlier rollover contribution from a qualified retirement plan.

5. A Roth IRA can only be rolled over to another Roth IRA.

C. An eligible rollover distribution is subject to automatic 20 percent withholding unless the distribution is transferred by a direct rollover to an eligible retirement plan that permits the acceptance of rollover distributions. A direct rollover is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee (i.e., the distribution is made in the form of a direct trustee-to-trustee transfer from a qualified retirement plan to the eligible retirement plan). § 401(a)(31); Reg. § 1.401(a)(31)-1.

D. With regard to a rollover from a qualified retirement plan to an IRA, the payout must be transferred into one or more IRAs within 60 days after receipt. It is not necessary, however, to transfer the entire amount into the IRA; but the portion not rolled over is taxed as ordinary income in the year received. However, unless the distribution is transferred by a direct rollover to the IRA, the distribution is subject to automatic 20 percent withholding. Reg. § 1.402(c)-2. In addition, don't buy stock or other property with any cash distribution without first putting the cash back into the rollover IRA. Reinvesting cash distributions from IRA and Keogh accounts into other property before depositing the property into a rollover IRA, even within the 60 day rollover period, does not qualify as a rollover contribution and instead, subjects the taxpayer to tax on the entire amount of distribution. Lemishow v. Comr 110 TC IN011 (1998).

E. The spouse of an employee who receives an eligible rollover distribution from a qualified retirement plan or is the beneficiary of an IRA at the death of the employee, is permitted to roll over all or part of the distribution to an IRA of his or her own.

   1. IRS has also ruled that, if the deceased spouse's qualified retirement plan benefits are paid to a trust and the trust distributes the benefits to the surviving spouse, the surviving spouse may roll over the distribution. PLRs 9633-43, 9633042, 9533042, 9509028 and 9234032.

   2. If the deceased spouse's qualified retirement plan benefits are paid to the decedent's estate and the surviving spouse is the sole beneficiary of the decedent's residuary estate, IRS has ruled that the surviving spouse may roll over the distribution to an IRA. PLRs 9402023, 9351041, 9229022 and 9138067.

   3. The surviving spouse was permitted to roll over the benefit to an IRA when the deceased spouse named a trust as the beneficiary of the death benefit payable from a qualified retirement plan, the trust beneficiaries

disclaimed the benefit, and, as a result of the disclaimer, the benefit was paid to the surviving spouse. PLRs 9450041 and 9247026.

4. The spouse may establish an IRA rollover account even if the spouse would not be eligible to establish a regular IRA. However, the surviving spouse may not roll over the distribution to another qualified retirement plan or from the rollover IRA to another qualified retirement plan in which the spouse is a participant. § 402(c)(9).

5. Generally, a rollover by the surviving spouse is permitted where there is no discretion on the part of someone other than the surviving spouse. PLRs 9721028, 9710034, 9703036, 9626049, 9623064, 9623056 and 9620038.

F. An IRA acquired by a beneficiary upon the death of a nonspouse is an inherited IRA and does not qualify for rollover treatment.

G. The following distributions are not eligible as rollovers to an IRA: (Reg. 1.402(c)-2 [Q & A 4}

1. ESOP Dividends. Deductible dividends paid to participants by an ESOP.

2. Life insurance policies.

3. A participant's loan that is treated as a distribution is therefore not eligible for rollover. (Reg. 1.402(c)-2 {Q & A 4(d)}.

III LUMP SUM DISTRIBUTIONS

A. A lump-sum distribution is a distribution from a qualified retirement plan made within one taxable year of the recipient, represents the balance to the credit of the employee and is payable:

1. On account of the employee's death;

2. On or after the attainment of age 59-1/2 by the employee;

3. On account of separation from service in the case of a common-law employee; or

4. On account of disability in the case of a self-employed individual.

B. "One taxable year" will usually be the calendar year.

C. To satisfy the requirement that the distribution be the "balance to the credit" of the employee, all pension plans are aggregated and all profit sharing plans are aggregated. An employee may receive a lump-sum distribution from a pension plan in one year and a lump-sum distribution from a profit sharing plan in a later year. However, special income averaging can only be elected one time. A money purchase pension plan is aggregated with a defined benefit pension plan.

D. The taxable amount of a lump-sum distribution is the total distribution reduced by the employee's basis, unrealized appreciation on employer securities (unless an election is made to include such unrealized appreciation) and accumulated deductible employee contributions plus income attributable to such contributions.

E. The employee may elect five-year income averaging if the employee had five years of participation in the plan prior to the year in which the distribution is made. Since this does not include the year of distribution, if the distribution is received in 1998, the employee must have commenced participation in the plan in 1993 or earlier. In order for five-year averaging to apply, the lump-sum distribution must be received after the employee has attained age 59-1/2.

1. To calculate the five-year averaging tax, a tax is computed on one-fifth of the total taxable amount after reduction for the minimum distribution allowance using the single taxpayer rate table and then such amount is multiplied by five.

2. Five-year income averaging can be elected only once, and the election must apply to all lump-sum distributions received during the same taxable year. § 402(d)(4)(B)(ii); Prop. Reg. § 1.402(e)-3(a).

3. Five-year income averaging are repealed for taxable years beginning on or after January 1, 2000. SBA'96, Act §§ 1401(a), 1401(b)(2).

F. Prior to the enactment of Tax Reform Act of 1986 (TRA'86), other favorable income tax elections were available with regard to the receipt of a lump-sum distribution. These elections are subject to transition rules.

1. If the employee was age 50 on January 1, 1986, the recipient may elect ten-year averaging in lieu of five-year averaging.

2. In calculating the ten-year averaging tax on a lump-sum distribution, the 1986 tax rates are used. Therefore, ten-year income averaging is not always more favorable than five-year income averaging.

3. Based upon the tax rates in effect for 1998, ten-year averaging is more favorable than five-year averaging until the adjusted taxable amount exceeds approximately $350,000. Above that amount, five-year averaging is more favorable.

4. Even though five-year income averaging will be repealed in 2000, ten-year income averaging will remain available for those individuals who are over age 62 years of age in 1998.

5. If the employee was age 50 on January 1, 1986, and commenced participation in the plan prior to 1974, then a portion of the distribution may be taxed as long-term capital gain at the old 20 percent capital gain rate and not the current rate. TRA'86, Act § 1122(h)(3). With the recent changes to the capital gain tax rates under the TRA'97 § 311, this transition rule is no longer beneficial. TRA'97, Act §311.

G. The special tax treatment of a lump-sum distribution is not available to IRA's or if any part of the distribution is rolled over either to another qualified retirement plan or an individual retirement plan.

IV REPEAL OF THE EXCESS DISTRIBUTION AND EXCESS ACCUMULATION TAXES

A. Even though TRA'97 repealed the excess distribution and excess accumulation taxes retroactive to January 1, 1997, TRA'97, Act § 1073, there are some tax refund opportunities still available in this area:

1. A 15 percent excise tax was imposed on excess distributions made after 1986 from qualified retirement plans and IRAs.

2. An individual whose total benefits in all qualified employer plans and individual retirement plans on August 1, 1986 had a value in excess of $562,500 was eligible to elect a special grandfather rule.

3. Under the discretionary method, ten percent of the total distributions that the individual received during a calendar year was treated as a recovery of the grandfather amount. The individual was permitted to elect to accelerate the rate of recovery from ten percent

to 100 percent of the total aggregate distributions received during a calendar year commencing with any calendar year (acceleration election).

4. To have made this special grandfather election, an individual had to attach Form 5329 to the individual's 1987 or 1988 federal income tax return, which return had to be timely filed. In addition to electing the special grandfather rule, the individual was required to set forth the initial grandfather amount and also elect one of the two alternative methods of recovery. In addition, a copy of such Form 5329 was also required to be filed with Schedule S of Form 706 in the event of the individual's death.

5. The acceleration election was also made on Form 5329 and can be made or revoked on a timely filed amended return. However, the acceleration election may not be made after the individual's death other than with his final income tax return or with a return for a prior year which was not filed before the individual's death. The acceleration election may not be made on an amended return after the individual's death for a year for which a return was filed before the date of death.

   Example of possible refund: - Let us assume that, in 1995, P received distributions of $200,000, elected not to make an acceleration election, and paid the excess distribution tax of $7,500 [15% x ($200,000 - $150,000)]. Further assuming that P is still alive, P can now make the acceleration election on an amended return for 1995 and receive a refund of the $7,500.

B. Taxable excess accumulation for estate tax purposes:

1. The estate tax imposed by Chapter 11 with respect to the estate of a decedent was increased by an amount equal to 15 percent of the decedent's excess accumulation. A decedent's excess accumulation was the excess of the aggregate value of the decedent's interests in all qualified employer plans and individual retirement plans (decedent's aggregate interest) as of the date of deaths over an amount equal to the present value of a hypothetical life annuity.

2. The excess accumulation tax was added to the Code by TRA '86 but was amended by TAMRA to permit a spousal election. If the surviving spouse was the beneficiary of all of the decedent's retirement accumulations (qualified employer plans, individual retirement plan, etc.), the surviving spouse was permitted to elect to have such interests and any retirement distribution attributable to

such interests treated as those of the surviving spouse. § 4980A(d)(5)(A).

3. The spousal election was made on Form 706 filed on behalf of the decedent's estate.

<u>Example of possible refund</u>: - Let us assume that P died in 1995 with a small excess accumulation. Even though P's surviving spouse was the beneficiary of all of P's retirement accumulation, the spousal election was not made, and P's estate paid the excess accumulation tax. The spousal election can now be made on an amended estate tax return and the excess accumulation tax recovered.

V ROTH IRA

A. For taxable years beginning after 1997, TRA'97 creates a new nondeductible IRA called the Roth IRA. The income and appreciation inside the Roth IRA is not taxable upon a qualified distribution, if made after five years of Roth IRA participation. However, a Roth IRA, like all other IRA's, is taxable for Federal estate tax purposes.

B. Qualified distributions from a Roth IRA are not included in the taxpayer's gross income and are not subject to the additional 10% early withdrawal tax. To be a qualified distribution, the distribution must satisfy the five-year holding period and must meet one of four requirements, which are:

1. made on or after the date on which individual attains age 59-1/2; or

2. made to a beneficiary (or the individual's estate) on or after the individual's death; or

3. attributable to the individual being disabled; or

4. a distribution to pay for "qualified first-time homebuyer expenses.

C. Roth IRA's are subject to income limits. The maximum yearly contribution that can be made to an IRA is phased out for single taxpayers with adjusted gross income (AGI) between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000. (Code Section 408A(6)(3).

D. Taxpayer and his or her spouse may contribute a maximum of $2,000 each per year to all IRA's (deductible, non-deductible and Roth IRA's). The $2,000 annual limit does not include rollover contributions. Excess contributions to a Roth IRA are subject to a 6% tax under Code Sec 4973). Roth IRA contributions are not deductible for Federal income tax purposes.

E. Distribution from one Roth IRA may only be rolled over tax-free to another Roth IRA.

F. There is no rule requiring any distribution to a Roth IRA beneficiary before his or her death.

G. Commencing in 1998, amounts distributed from an IRA may only be rolled over to a Roth IRA; or, alternatively, an IRA may be converted into a Roth IRA. However, income taxes on the distribution or conversion will have to be paid. Qualified retirement plan distributions, even eligible rollover distributions, could not be rolled over to a Roth IRA. Therefore, you will have to rollover the qualified plan benefits to an IRA first, then rollover the regular IRA to a Roth IRA. § 408A, as added by TRA'97, Act § 302.

<u>Example</u>: In 1998, F rolls over a $60,000 IRA distribution to a Roth IRA. The amount of $15,000 will be includible in F's gross income in 1998, 1999, 2000, and 2001.

However, the ability to roll over or convert an IRA into a Roth IRA is not available to an individual or joint return taxpayer whose adjusted gross income (determined before any amount includible in income as a result of the rollover or conversion) exceeds $100,000. (Code Sec 408A(c)(3)(B)(8). If the taxpayer is a married individual, filing a separate return, then no rollover is allowed regardless of how low the adjusted gross income is. During 1998 only, if an IRA is rolled over or converted into a Roth IRA, the amount otherwise includible in gross income due to the IRA distribution or conversion is includible in gross income ratably over a four-taxable-year period beginning with the taxable year in which the distribution or conversion is made. After 1998, the entire IRA rollover or conversion will be includible in gross income in the year of the distribution or conversion.

H. You can contribute to a Roth IRA even if you are over 70-1/2 years old. However, contributions can only be made if the taxpayer has employment income and his or her adjusted gross income is below the limits discussed above.

I. The deadline for a contribution to a Roth IRA (like a deductible IRA) is the due date for filing the individual's tax return for the year (without regard to extensions). Code Sec 408A(c)(7). Further, the 5-year holding period begins to run with the tax year to which the contribution relates, not the year in which the contribution is actually made.

VI PREMATURE DISTRIBUTIONS

A. A ten percent additional tax is imposed on withdrawals from an IRA or from a qualified retirement plan before attainment of age 59-1/2.

1. The most noted exceptions to this penalty tax are distributions prior to age 59-1/2 made because of the death or disability of the IRA account holder or qualified retirement plan participant.

2. There are a number of other exceptions to the imposition of this penalty tax.

a. One of those exceptions relates to distributions of substantially equal periodic payments over the life or life expectancy of the IRA account holder or plan participant or over the joint lives or joint life expectancies of the IRA account holder or plan participant and his or her beneficiary.

b. For this exception to apply to distributions from a qualified retirement plan, the plan participant must have terminated employment.

c. This termination-of-employment requirement, however, does not apply to distributions from the IRA. § 72(t).

3. If the payment method changes before the later of five years after payments commence or attainment of age 59-1/2, there is a ten percent recapture tax -- the ten percent premature penalty tax is applied retroactively to payments that were previously exempt. An individual who has multiple IRAs can use the equal payment exception for one IRA without having to take distributions from any other IRA. § 72(t)(4); PLRs 9243054, 9050030 and 8946045.

VII REQUIRED BEGINNING DATE

A. The required beginning date is the date on which periodic payments have to be paid to the qualified plan recipient or IRA owner. The required beginning date is normally April 1 immediately following the year in which the participant or IRA owner reaches age 70-1/2.

B. The exception is if the participant of a qualified plan is still employed at age 70-1/2 and owns less than a 5% equity interest in the employer, then he or she can postpone the mandatory pay out period until April 1 immediately following the date of retirement. (Small Business Protection Act of 1996)

VIII FUNDING TRUSTS WITH QUALIFIED RETIREMENT PLAN AND IRA DEATH BENEFITS

A. As a general rule, it is advisable to make the surviving spouse the beneficiary of all benefits from qualified retirement plans and IRAs. Such payment will provide the surviving spouse with more flexibility since the surviving spouse could then make a spousal rollover into his or her own IRA and therefore defer income taxable distributions until the spouse reaches his or her required beginning date. The spouse can also elect instead to keep the benefits in the deceased participant's IRA and not be required to take out benefits until the deceased spouse would have reached his or her required beginning date (70-1/2). However, there may be compelling reasons not to pay such death benefits directly to the surviving spouse.

B. IRA or qualified plan benefits left to a trust is income in respect of decedent (IRD) and thus the Estate receives no step-up in basis upon the participant's death.

C. The decedent could create a trust for the benefit of the surviving spouse and have such benefits payable in a single sum payment to the trust. However, such payment will cause the immediate income taxation of all such benefits. If such death benefits can be paid in installments to a trust for the benefit of the surviving spouse, there will be a deferral of income taxes and the funds remaining in the qualified retirement plan or IRA will be able to continue to generate more tax-free income.

D. QTIP is a type of martial deduction trust where the surviving spouse has an income interest for life. § 2056(b)(7)(B)(i); Prop. Reg. § 20.2056(b)-7(b). The surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all of the income from the property, payable at least annually, and no person has the power to appoint any part of the property (income or principal) to any person other than the surviving spouse during the surviving spouse's lifetime. However, the deceased spouse can determine where the trust principal is left following the death of the surviving spouse. § 2056(b)(7)(B)(ii).

1. In Revenue Ruling 89-89 (1982-2 C.B. 231), IRS held that the payment of the death benefit under an IRA in installments to a trust for the benefit of the surviving spouse could qualify for the marital deduction.

2. In Private Letter Ruling 9038015, IRS expanded upon the payment method approved in Revenue Ruling 89-89 by holding that an IRA can qualify as QTIP if it annually distributes to the QTIP trust the greater of (1) all IRA income or (2) the required minimum distribution amount. § 401(a)(9). The approach approved in the Private Letter Ruling is potentially more advantageous than the approach approved in Revenue Ruling 89-89 because the method of payment approved in the Private Letter Ruling will require a smaller annual distribution.

3. In both Revenue Ruling 89-89 and Private Letter Ruling 9038015, the basic payout from the IRA to the testamentary trust was over the life expectancy of the surviving spouse.

4. However, as clarification, under the new proposed regulations, a trust must have the following characteristics:

   a. Whether the participant dies before or after his or her required beginning date, the trust must be valid under state law.

   b. The trust is irrevocable or will by its terms become irrevocable upon the death of the employee. The timing of the irrevocability requirement is now tied firmly to the settlor's death and not the RBD (as in the old proposed regulations). It therefore does not matter whether the participant dies before or after his or her required beginning date.

   c. The beneficiaries of the trust who are beneficiaries with respect to the trust interest in the employee benefit must be identifiable from the trust instrument.

   d. The documentation described in D-7 of this Section has to be provided to the plan administrator. Prop Reg Sec 1-401(a)(9)-1 {Q & A D-5b}.

E. If the two Rulings, 89-89 and Private Rule 9038015, had ruled that the irrevocability requirement was not satisfied, then the surviving spouse would not have been considered a designated beneficiary; and, without a designated beneficiary, the post-death distributions must be completed no later than the end of the fifth year after the testator's death or, possibly, no later than the end of the year following the year in which the testator's death occurred, if death occurred after the required beginning date. Prop. Reg. § 1.401(a)(9)-1.

F. Payment of death benefits in a credit shelter or trust for other beneficiaries can also qualify for the extended payment benefits.

   1. In these type trusts, there must be current income beneficiary or beneficiaries.

   2. The minimum distribution requirement must be paid under the trust terms outright to or for the benefit of the said beneficiary of the trust income at least annually by the Trustee.

G. The provisions outlined above should be drafted in both the trust agreement, as well as, in the beneficiary designation.

IX CONCLUSION:

All qualified plan and IRA assets are included in the decedent's estate, for Federal Estate Tax purposes and in some states for State Inheritance Tax purposes as well. In addition, the following penalty taxes may also be applicable: A 10% penalty for taking out the benefits when the Participant is too young; a 50% penalty if the minimum annual distribution is not distributed when the Participant reaches his or her required beginning date. In addition, a Generation Skipping Penalty tax of 55% can also be assessed if too much of the Participant's total assets, which includes all qualified plan and IRA benefits, skip a generation which is usually grandchildren, but not always.

The Roth IRA has some sizable benefits over the years but is not available to many of our clients because of the adjusted gross income requirements. Very careful overall tax planning is required if taxable IRAs are transferred to a Roth IRA.

The use of trusts as beneficiary of qualified plan and IRA benefits can substantially increase the pay out period of benefits and result in the long run in paying out more total benefits by increasing the life of the qualified plan or IRA. However, to accomplish this benefit, careful drafting of both the trust and the beneficiary designation is required.

If careful planning relative to qualified plan and IRA benefits is not done, it is possible for the total taxes, at death, and income taxes thereafter, can take up to 91% of the total benefits left by the Participant to the family.

There is no substitute for proper and careful estate planning during the lifetime of the Participant relative to all of his or her ownership of qualified and IRA plans. These plan benefits are frequently becoming a very sizable asset in most of our clients' estates as we approach the 21st Century.

BASIC GENERATION SKIPPING RULES, STRATEGIES AND TECHNIQUES

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SECTION H

BASIC GENERATION-SKIPPING RULES, STRATEGIES AND TECHNIQUES

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BASIC GENERATION–SKIPPING RULES, STRATEGIES AND TECHNIQUES

By
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I. INTRODUCTION

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, estate tax, or income tax which may also be payable.

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).

Two important sets of proposed regulations were issued on December 24, 1992 and were revised and finalized on December 27, 1995 (60 Fed.Reg. 66898). Corrections were made to the final regulations on June 12, 1996 (61 Fed.Reg. 29653). On May 1, 1997, one of the new regulations, Treas.Reg. §26.2652-1(a)(4), and two related examples, were deleted (62 Fed.Reg. 27496). One set 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 regulations 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. Generally, the new substantive GST regulations apply to generation-skipping transfers made on or after December 27, 1995.

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.

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.

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.

It is easy to understand why generation-skipping trusts have been popular. Imagine a wealthy client in a top 55% transfer tax bracket, and whose descendants are all likely to be in a similar top 55% bracket. Each dollar our wealthy client has will net the client's child only 45 cents after being estate taxed at the client's death, will net the client's grandchild only 20.25 cents after the estate tax imposed at the child's death, and will net the great grandchild 9.11 cents after the estate tax imposed again at the grandchild's death.

Instead, assume that same property is tied up in trust for successive generations. The initial estate tax of 55% would be paid, leaving 45 cents on the dollar left in trust to benefit the child, then the grandchild, and to ultimately benefit (or be distributed outright to) the great grandchild. Needless to say, having 45 cents on the dollar left is better than having only 9.11 cents on the dollar left. Additional benefits of tying up property in trust include the protection afforded such assets from the beneficiary's creditors, divorces, or mismanagement.

The terms of the trust for the benefit of the client's descendants needn't be repugnant. Trust benefits which can be granted to each successive beneficiary are so broad as to be tantamount to ownership of the trust assets for most purposes. They included:

A. The right to receive all trust income;

B. The right to receive discretionary distributions of trust principal (self-determination of needs is possible if the beneficiary was acting as his or her own trustee pursuant to a so-called "ascertainable standard" for making distributions to himself or herself, such as the authority to make distributions for "health, education, support, and maintenance");

C. The right to exercise a five-by-five right of withdrawal to withdraw from the trust each calendar year, without the showing of any need for such funds, assets having a value equal to the greater of $5,000 or 5% of the trust's fair market value.

D. The right to possess a broad inter vivos (i.e., during lifetime) and/or testamentary (i.e., at death) special power of appointment to direct the trust's assets to be distributed to such other persons or institutions as the beneficiary sees fit (which must only exclude the beneficiary himself or herself, the beneficiary's creditors, the beneficiary's estate, and the creditor's of the beneficiary's estate as objects of the power);

E. The right to direct trust investments and vote trust securities;

F. The right to occupy one or more homes owned by the trust; and

G. The right to hire and fire trustees, at least when the trustee has an ascertainable standard concerning discretionary distributions.

These rights (except to the mere extent that a five-by-five withdrawal right was unexercised at the time of death) do not give the beneficiary holding such rights ownership of the property for estate tax purposes. 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). The GST tax does not eliminate such planning techniques — it does, however, put a cap on the amount that can be put into such multi-generational tax savings trust arrangements.

II. THE GST TAX RULES

A detailed analysis of Chapter 13 is beyond the scope of these materials. However, it is necessary to understand several key definitions and concepts in order for GST tax planning strategies to make sense.

A. 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".

1. **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.

2. **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. Treas. Reg. §26.2612-1(b)(1)(i).

3. **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. However, if federal estate or gift tax is imposed on an individual with respect to a property interest in trust, that property interest is deemed to have been distributed to the individual to the extent its value is subject to federal estate or gift tax. This often happens with respect to a lapse of a power of appointment. Treas. Reg. §26.2612-1(c).

4. **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. Only one direct skip occurs where a single transfer of property skips more than one generation. Treas. Reg. §26.2612-1(a)(1).

   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 "predeceased child" exception, "sometimes also called the "predeceased parent exception," also applies to transfers to generations below that of a grandchild if all lineal persons between the transferor's and transferee's generations are deceased. Also, if the child dies no later than ninety days after the transfer, the child will be deemed to be a predeceased child for purposes of the transfer if the governing instrument or local law so provides. Beginning in 1998, the predeceased child exception is extended to transfers to collateral heirs assigned to at least one generation below that of a child of the grantor, provided that the grantor has no lineal descendants living at the time of the transfer. The predeceased child exception only applies to transfers in trust that are direct skips. If the transferor's child, or the ancestor of the beneficiary who is in a generation below the transferor's, survives the transferor and is a beneficiary of a trust, a taxable termination will occur at the child's or ancestor's subsequent death when the trust assets pass to (or are held in further trust for the benefit of) the ultimate beneficiaries. A disclaimer cannot be used to cause a living descendant to be deemed to have predeceased the grantor or donor. Treas. Reg. §26.2612-1(a)(2).

5. **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.

B. Excluded Transfers

1. **Subject to Estate 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. Further, the determination as to whether an occurrence is a GST is made by reference to the most recent transfer which is subject to estate or gift tax, as this establishes the identities of the actual transferor and the skip and nonskip persons. Treas. Reg. §26.2611-1.

2. **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).

3. **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.

4. **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 GST taxation, even if they do not exceed the $10,000 annual exclusion amount. IRC §2642(c)(2) provides that annual exclusion gifts made to a Crummey trust are subject to GST tax, unless (1) 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 and (2) 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.

   Sometimes, the advantage of doing GST planning is to have none of the GST trust included in the beneficiary's estate at death, which means that many gifts to trusts (especially gifts to irrevocable life insurance trusts) that involve annually less than $10,000 per beneficiary (and require no gift tax return to be filed by reason of the Crummey clause in the trust) will still need to have a Form 709 filed --- in order to allocate GST exemption to the gift that otherwise would not have required the filing of a gift tax return. <u>See</u> below for planning considerations for Crummey trusts, in light of the fact that properly structured annual exclusion gifts to such trusts are not subject to estate or gift taxation but are subject to GST tax.

   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. Treas. Reg. 26.2652-1(a)(6), Example 5. Further, if the Crummey beneficiary is a skip person, he or she will be considered to have received a taxable distribution to the extent the amount exceeds the 5 and 5 limitations. Treas.Reg. §26.2612-1(c)(1).

C. Available Exemptions

1. **$1 Million 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. Beginning in 1998, the $1 million GST exemption will be indexed annually for inflation, to the nearest $10,000. 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. 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. However, formula allocations with respect to charitable lead annuity trusts are not valid except to the extent they depend on values finally determined for federal estate and gift tax purposes. 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. 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. IRC 2642(b)(3)(A); Treas. Reg. §26.2642-2(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 it is made. 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. 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. This allows the division of a large trust into two separate trusts, one totally GST taxable and one totally GST tax exempt. Treas. Reg. §26.2632-1(d)(1).

2. <u>Gallo Amendment Transfers</u>. 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.

D. Computation of Tax

1. <u>Overview</u>. 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).

2. <u>Applicable Definitions</u>. 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 in the event of IRC §2032A recapture). 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. Treas. Reg. §26.2642-2(b)(2).

Complex 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. Treas. Reg. §26.2642-2(b).

3. **<u>Examples</u>.** 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.

E. 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. Treas. Reg. §26.2662-1(c)(2)(iii).

F. GST Reporting Requirements

1. <u>Reporting During Life by Donor.</u> 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.

   In E. Norman Peterson Marital Trust v. C.I.R., 73 F.3d 795 (2nd Cir. 1996), the lapse of a surviving spouse's testamentary general power of appointment upon the surviving spouse's death in 1987 was deemed to be a "constructive addition" to a marital trust established in 1974 when the first spouse died. The entire trust was thus subjected to GST tax as a taxable termination, because skip persons - grandchildren - were the remainder beneficiaries in default of the power of appointment.

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.

G. 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. PLANNING STRATEGIES

A. **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.

B. **Use of Multiple Trusts.** As a general rule, it will be beneficial to structure an estate plan so that only trusts which are wholly GST tax exempt (i.e., with an applicable fraction of 1 and an inclusion ratio of zero) or wholly GST taxable (i.e., with an applicable fraction of zero and an inclusion ratio of 1) result. Such a strategy may require the use of two separate trusts where one partially GST taxable trust could otherwise have been established, but a great deal of GST tax planning flexibility ensues. The GST tax exempt trust could be maximized for the eventual benefit of skip-persons (such as the transferor's grandchildren or great-grandchildren) by an aggressive investment growth policy and the making of minimal distributions, while at the same time the wholly GST taxable trust was being invested more conservatively and making GST tax exempt distributions to non-skip persons (such as the grantor's children).

A single trust included in the grantor's gross estate may be divided into separate trusts (i.e., so that one can have an inclusion ratio of 1.0 and the other an inclusion ratio of zero) if: (a) expressly permitted by local law or the governing instrument; (b) the terms of the new trusts provide for the same succession of interests and beneficiaries as the old one did; (c) the severance occurs (or the reformation begins) prior to the due date for the Form 706 (including extensions); and (d) the severance results in a fractional or pecuniary division which is an appropriate amount. Treas. Reg. §26.2654-1(b).

C. Taking Advantage of Grandfathering

1. **Overview.** Trusts which are grandfathered from GST taxabilitybythe 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.

2. **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.

3. **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.

4. **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.

D. Maximizing Excluded Transfers

1. **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.

2. **Education and Medical Expenses.** 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.

E. Making Optimal Use of Exemptions

1. **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.

2. **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.

3. **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. Treas. Reg. §26.2652-1(a)(3); §26.2652-1(a)(6), Example 8.

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. Treas. Reg. §26.2652-2(c); 26.2654-1(a).

F. Other Planning Considerations

1. **Subject Assets to Estate or Gift Tax.** It may be advantageoustocause 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.

2. **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.

3. **Estate Tax Inclusion Period.** Before the final regulations were issued, it was thought that the creation of a concept called the "Estate Tax Inclusion Period", or "ETIP", might make it unwise to grant the grantor's spouse a Crummey withdrawal right or to allow any distributions to be made to the grantor's spouse from an irrevocable life insurance trust until after the grantor's death. This is because no effective allocation of GST exemption is possible during the ETIP, which is the period during which the trust would still be deemed owned by the grantor for estate tax purposes, and, under the proposed regulations, any interest in the trust held by the grantor's spouse is deemed to be held by the grantor.

However, the spousal attribution rules were eliminated from the final regulations. Treas. Reg. §26.2642-1. Hence, estate plans which grant powers and beneficial interests in a trust to a spouse will not prevent allocation of the grantor's GST exemption to the trust.

4. Crummey Trusts. It may be wise to consider giving a Crummey trust beneficiary who is a non-skip person a testamentary general power of appointment over his or her portion of the trust remainder if allocation of GST exemption to annual exclusion gifts to the trust is not desired. See above for a discussion of special GST tax rules applying to Crummey trusts.

5. 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 (which may be accomplished, for example, under the authority of the document or local law, and the use of a special QTIP trust to prevent a transferor's GST exemption from being wasted create new and unresolved drafting problems.

IV. CONCLUSION

A significant additional transfer tax burden is now imposed on gifts, estates and trusts to which the GST tax law applies. Careful planning will allow such potential GST tax liability to be eliminated, minimized or deferred if the appropriate steps are taken. It is essential that estate planning professionals become familiar with the GST law and that clients be counseled to make the appropriate modifications to their estate plans. Tax return preparers need to be aware of the fact that it may also be necessary to report GST tax consequences by reason of the same event necessitating the filing of an estate, gift, or fiduciary income tax return.

WHAT CURRENT TECHNOLOGY CAN DO TO ASSIST THE ESTATE PLANNING ATTORNEY

**** Estate Planning Software ****

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WHAT CURRENT TECHNOLOGY CAN DO
TO ASSIST
THE ESTATE PLANNING ATTORNEY

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ESTATE PLANNING SOFTWARE

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Like many areas of the law - and indeed the world - the advancements in, and proliferation of, estate planning software and assistance feels mind-boggling. Just several years ago there were relatively few software systems available for the estate planner to review and evaluate, leaving the planner wanting more; much more. Well, like most things in life, this is another example where one might have been better off to heed the advice of an unknown sage to "be careful what you ask for, because you just may get it!"

Truly the estate planning software arena is a place where that maxim has proved prophetic. Attached to this introduction is a listing of some of the products which are presently available on the market for assisting the estate planner. Surely there are more, but the attached materials should give the seminar attendee adequate references to begin researching which products are best for his, her or their firm's practice. Likewise, the panel members will provide their input as to the products they have tried and prefer.

Attached are the following:

A. Copy of "SOHO Consumer: Software for the Estate Planning Law Office." A web page designed to list software that is particularly useful in an estate planning, trust and probate law practice. Last updated February, 1998.

B. Copy of Cover to Wills, Trusts, and Technology: An Estate Lawyer's Guide to Automation, Daniel B. Evans, ABA Section of Real Property, Probate and Trust Law Section and Law Practice Management, American Bar Association, 1996. Series Foreword reads:

> "The first in Law Practice Management's planned series of books for applying document assembly and substantive systems tools to particular types of law practices. Evans' book shows you how to harness the power of database and case management systems to automate and manage an estate planning and estate administration practice.
>
> In concise, user-friendly chapters, Evans walks you through the basics of understanding and choosing the necessary hardware and software; helps you plan for implementation of and training on your new

system; demonstrates how to apply your system to managing client information, will and trust inventories, generating and managing documents and performing estate planning (including generation-skipping, charitable giving, and estate tax planning); reviews the available fiduciary accounting, valuation, automated asset transfer, and estate, death, gift and income tax return programs; and gives tips on preparing probate court pleadings. Evans also guides you through the ethical considerations and other management problems that can arise from automating tasks where Murphy's famous Law applies that 'anything that can go wrong, will go wrong.'"

While this publication is highly recommended for general information, because it is now two years old, many of the specific applications are somewhat dated. Nonetheless, this is still and **excellent publication** from which to start assembling a technologically efficient estate planning practice.

C. Miscellaneous E-mail postings and advertisements concerning certain software applications (many of which were listed in the directory under (A) above. Note how quickly the products are updated when comparing the advertisements with the reviews from SOHO published just several months ago.

D. Copy of "A Small Firm's Perspective on Document Assembly Software," Ebenal, Evans, Violette and Hompesch, Trusts & Estates, November, 1997.

> "Utilizing document assembly software will be imperative for every estate planning attorney who practices in the 21st Century. This article surveys all of the popular document assembly software programs for Will and trust drafting that are on the market today. The authors explore the strengths and weaknesses of the best programs as well as offer analysis as to what programs would work better for different office structures."

E. Copy of "How to Avoid Losing Your License on the Information Superhighway," Metzmeier and Esposito, Kentucky Bench & Bar, Vol. 62, No. 2, Spring 1998, Kentucky Bar Association, May, 1998.

SMALL OFFICE / HOME OFFICE (SOHO) CONSUMER:
Software For The Estate Planning Attorney

SOHO Consumer: Software for the Estate Planning Law Office

by Mark J. Welch - last update February 13, 1998

What is this page? This page is designed to list software that is particularly useful in an estate planning, trust, and probate law practice. That's it. No hidden agenda, no overwhelming biases, just a list intended to provide a starting point for evaluating and researching tools for estate planning attorneys. **Please** send email to legal_sw@sohoconsumer.com with any web links for any products or companies that belong on this page!

It is my intention, as I get more experience with some of these programs, to include brief descriptions and discussions of some or all of the programs listed on this page, but only if written by myself or another estate planning attorney (or law office staff member). Send your comments to legal_sw@sohoconsumer.com and I'll include your name & an email or web link to you, if I include your comments on this page (or let me know if you don't want public credit). (Many thanks to John Brentin for sharing his list of estate planning and probate software, and thus allowing me to add many more links on 3/20/97.

Software to Assist in Planning, Number-Crunching, or to Create Client Presentations

These are in a single category because they overlap so much.

- ViewPlan: Vista ($849), Data+, Factuary, and BeneQuick (for Windows); Estate Forecast Model (EFM) and Progeny (both for DOS only). There is no price information available online, but you can download fully-functional demos of Vista & Factuary [800-826-2127]

Mark J. Welch says (after using the downloaded demo version): "ViewPlan's Vista is excellent at showing in flowchart form the flow of assets into trusts to implement basic tax planning, the benefits of transferring life insurance out of the estate, the effects of annual gifting, and the effect of growth on estate taxes. Unfortunately, it does *not* show income tax effects (such as capital gains taxes on assets in a bypass trust, or ordinary income taxes on tax-deferred retirement accounts)."

- Estate Plan Plus from ProBATE Software - 17 reports, 7 graphs ($495) [800-288-9169]

- Penn D'Calc "complex calculations for IRAs, 401Ks, pensions, life insurance policies, defined benefit plans and other assets flowing through retirement to the estate" - downloadable demo available

- zCalc from Lexite Development - "zCalc is a set of formulas that perform estate and financial planning calculations within your own spreadsheet or program" - downloadable 30-day demo available. [$399]

- BNA Estate Tax Planner ($995-$1495) [800-372-1033]

- Kettley Publishing: Back Room Technician, Estate Cost Estimator; Estate Quick-Plan; Charitable Quick Plan; and Retirement Quick Plan [800-777-3162]

  See an ABA-PTL posting about this software (10/8/97).

- PROFILES+ - from Financial Profiles, Inc. ("Presentation software for the financial services profession") [800-237-6335]

- Master Plan [800-229-5080]

- Clark Boardman Callaghan [800-336-6365]:

  - Estate Planning Explorer (software designed to be used by the client)

  - Estate Planning Concepts

  - Estate Practice Assistant by Donald Kelley - projects estate taxes; also includes worksheets to facilitate 706 preparation and 1041 (IRD) Computations

- FREE Estate Tax Calculator (updated for TRA'97) from BeachWalk Financial (Sean O'Riordan) [800-613-2273]

- Brentmark Software's "Estate Planning Tools" and "Charitable Financial Planner" [800-879-6665]

- Inter-Est: Interrelated Estate Tax Calculator from Cammack Computations - DOS ($595) or Windows ($695) [800-594-5826]

- Essential Software - software to assist in business valuations [414-475-3450]
- InsMark software designed to help agents sell life insurance [800-422 6644]
- Leimberg & LeClair (NumberCruncher & more) (select *browse catalog* then *software*) [610-527-5216]

  See an email posting (10/8/97) by Dan Evans to the ABA-PTL list about this software.

- Impact Technologies' Estate Tax Analysis for Windows (ETAW) [800-438-6017]

  See praise for this product by John L. Olson (10/8/97) posted to the ABA-PTL mailing list

- EZ Gift Planner distributed by Jane Schuck & Associates - free demo [800-694-7624]
- Charitable Scenario Deduction Calculator / Remainder Trust Marketing Systems - from PhilanthroTec - They are offering free software that calculates the optimum payout rate to achieve the new 10% remainder. Click on Free Planned Giving Software for information on downloading. [800-332-7832]
- CIRCALC [717-299-1181]
- Crescendo Planned Gifts Software - from Comdel, Inc. [800-858-9154] *the web site is missing!*
- EP Expert Spreadsheet - from Eidelman Associates [800-775-2786]
- EPLAN - from U. S. Trust Company of New York [212-852-3564]
- ES: The Estate Plan Analyzer - from Superior Software, Inc. $495 ["slide-show" demo *(poorly designed demo, impossible to exit once started, automatically prints reports at end)*] [800-421-3264]
- Estate Resource - from Benefit Analysis, Inc. [800-223-3601]
- Planned Giving Manager, $1,795 plus $575 annual service contract (required); Mini Manager, $895 plus $425 annual service contract (required). - from PG Calc Inc. [888-497-4970]
- Tax Facts Calculator - from National Underwriter Co. [800-543-0874]
- Tiger Tables - TSP Software [314-231-2800]
- TAXPLAN - from Daniel B. Evans [215-233-0988/215-233-1887]

- LifeNet's Online Estate Tax & Probate Fee Estimator

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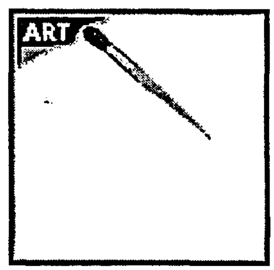
Soup to Nuts: Complete Software Solutions for the Estate Planning Law Office

Each of these companies promises to meet your needs for every aspect of an estate planning law practice, from marketing through drafting.

- Cowles Legal Systems [800-366-1730]
- National Network of Estate Planning Attorneys
- American Academy of Estate Planning Attorneys
- Estate Practice Systems from Clark Boardman Callaghan [800-336-6365]
-

Software to Create Client Correspondence



- ElderLaw Forms Manual on disk - Harry S. Margolis' software (Little, Brown & Co.)
- *See also: Mark J. Welch's Sample "Opening Letter" to new clients (sent after first meeting)*
- *See also:* InTrust (in the "Asset Transfer" section, below)
-

Software to Draft Wills and Trusts

- Drafting Wills and Trusts (Robert Wilkins) (CAPS) - distributed by Clark Boardman Callaghan [800-336-6365]
- CAPS Practice System Series - California Wills and Trusts Software (John Hartog) - offered by Matthew Bender, whose web site is incredibly difficult to navigate

  Mark J. Welch says: "When I interviewed attorneys for an associate position with my firm, more than half had experience with the Matthew Bender/CAPS California Wills and Trusts software. But when I tried to buy it from Matthew Bender, I was quoted five different prices in five inquries. Finally, I spoke with the product manager, who told me that the product was not adaptable enough to be useful to me.""

- California Continuing Education of the Bar (CEB) - many of their books (including *California Will Drafting*, *Drafting California Revocable Living Trusts*, and *California Durable Powers of Attorney*) come with forms on disk, or you can buy all their estate planning, trust & probate books on one CD-ROM (with Folio software) for $600-$750 (plus $300/year for updates). They do not provide document assembly software, just their book forms on disk in WordPerfect format. [800-232-3444]

- Cowles Legal Systems (TrustPlus, Will-Do-It, Trust Plus Life Insurance, and TrustTerminator) - downloadable demos [800-366-1730]

- Drafting Libraries - Blumberg, NYC [800-LAW-MART]

- Automated Legal Systems, Inc: ProDoc; Lipman's Wills and Trusts; Probate Forms; and Guardianships [800-659-1973]

- Wealth Transfer Planning system - The Technology Group, Inc. [410-576-2040]

- EP Expert (for Microsoft Word) from Eidelman Associates [800-775-2786] [review by Vince Wilk]

- Provisions Plus Estate Document Generation System - from Legal Works, Inc. [203-232-7030]

- Wills and Trusts Expert / WillDraft - from ExperText Systems, Inc. [800-387-2625]

- WillBuilder from Easy Soft, Inc. [800-905-7638]

- DL Drafting Libraries $200 per library (separate libraries for "wills" and "inter vivos trusts") - Attorney's Computer Network, Inc. [610-347-1500] - *sample client questionnaire for New York Wills module and for inter vivos trust module*

  John D. Etheriedge (web) writes: "I use several of the DL Drafting Libraries by Attorneys Computer Network, Inc. The question & answer format is quick and produces a substantial draft in a fraction of the time I used to spend using WP macro's. With DL, I am able to streamline the drafting process and focus more attention on refining and editing specific clauses. Of course, DL does have limitations. In most instances, however, I find the documents produced by DL to be a good starting point in the drafting process."

- Texas Probate Library with State Bar of Texas Forms - from Lawyer's Cooperative Publishing (LCP) [800-711-4503]

- Legal Ease Auto Systems from Microcomputer Concepts, Inc. - includes Guardianship and Probate modules ($295 each) and "Wills and Trusts 2000" module ($395) (requires WordPerfect) [800-232-1321]

- Living Trust Maker and Will Maker - from Nolo Press (for consumers) [510-549-1976]

- Will Builder - from Easy Soft, Inc. [908-754-7638]

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Document Assembly Software

- HotDocs and CAPS from Matthew Bender's Capsoft division (free 30-day demo of HotDocs) [800-500-DOC]

  Mark J. Welch says (after using the downloaded demo version): "I was very impressed with this software, but when I first tried to use version 4.0, there were bugs; the company promised an upgrade, which finally arrived after I made several calls, but the upgrade didn't fix the bugs. To its credit, the company gave me a *complete* refund. In November 1997, I decided to try again, and ordered HotDocs 4.1, despite a large price increase (from $69 to $149 for HotDocs, and from "free" to $149 for the Judicial Council Forms set). Unfortunately, the company refused to accept my order because I refused to tell them my *home address*. Then, in January, I decided to try again, and I mailed them a check. Although I have already received the cleared check ($283.42) back from my bank, Matthew Bender's computer system has no record of my order (as of February 13); apparently they delayed entering my order because I ordered both the Judicial Council Forms ($149) and the Northern California County Forms ($99) -- which were advertised as "Now Available" but a month later were still **not** actually available. **Clearly, Matthew Bender just doesn't want me as a customer.**"

  - HotDocs Toolbox (Newsletter from RPW Publishing) [803-359-9941]

  - HotDocs Internet email Mailing List discussion groups

- FastDraft from InterActive Professional Software ($495 DOS, $595 Windows) [800-364-2419]

  Doug Duncan writes: "I'm delighted that you list the "FastDraft" program in your software summary. I'd suggest, however, that it should be included in the more generic "document assembly" category. While the folks at InterActive Professional Software have offered my Will and trust forms in conjunction with FastDraft, the FastDraft engine is really generic and is intended to facilitate the user's employing it with any forms he or she may choose."

- Agility from RealWorld Solutions Inc. - "document assembly for the law office" (apparently for WordPerfect or ASCII only) $695 [617-621-7099]

- PowerTXT [800-422-3880]

- Scrivener for Windows [215-592-2630]
- WinDraft from Eidelman Associates [800-775-2786]
- General Counsel [410-576-2040]
-

Software to Transfer Assets

Henson's software prepares Schedule A and all transfer documents, including deeds and state-specific forms (e.g. PCOR for California), and includes a comprehensive nationwide database of county recorders, life insurance companies, stock transfer agents, etc.; it can also export to fiduciary accounting and 706-preparation software. In contrast, the cheaper InTrust software is more of a "do it yourself" document assembly system. (I'd like to see a system that also incorporates a checklist and follow-up letters to clients, to verify the status of asset transfers.)

- Henson's Transfers - *developed by Richard W. Henson* - (you can download a tutorial, but it's not a functioning demo) - distributed by Jane Schuck & Associates ($695/year) [800-694-7624]
- InTrust for Windows - from AtLaw Software ($99-$168) [800-828-5154]
-

CD-ROM Trusts & Estates Libraries

- Tax Analysts OneDisc and related titles
- Kleinrock Tax Library [800-678-2315]
- Estate Planning Advisor - from Research Institute of America [800-431-9025]
-

Software to Prepare Probate & Trust Accountings

- ProBATE Plus ($495) [800-288-9169]
- Fiduciary Accounting for Trusts and Estates from Clark Boardman Callaghan [800-336-6365]
- TEdec

- Zane Fiduciary Accounting System (FAS) - facilitates preparation of Probate Court accounting as well as 706 and 1041, plus Fiduciary Calendar; more products in development alt.link Demos [800-331-2533]

-

Software to Value Assets

- Software distributed by Jane Schuck & Associates [800-694-7624]:
  - EZ Bond - Calculate value of U.S. Savings Bonds
  - Wallace Pricing (see next item)
- Wallace Pricing by Financial Data Service - CD-ROM and online pricing of securities for estate & gift tax reporting [800-762-5468]
- EPScom software to obtain securities pricing information online, for import to fiduciary accounting and 706 software - from Clark Boardman Callaghan [800-336-6365]
- Investools' historical stock prices
-

Software to Prepare the 706 Estate Tax Return

- BNA 706 Preparer for Windows ($795-$995) demo available [800-372-1033]
- ProBATE 706 Plus ($495) also offers 706 and 1041 products [800-288-9169]
- Rock Creek FormsXPERT for Windows or DOS includes 706, 709, 1041, and most other federal and state tax forms ($195-$598) free evaluation CD available [800-296-2621]
- UST 706/709 System from U.S. Trust Co. of NY
- from Clark Boardman Callaghan [800-336-6365]:
  - Federal Estate Tax Returns: Calculation & Preparation (Form 706) (also 709 and 1041 modules)software

- o Estate Practice Assistant by Donald Kelley - projects estate taxes; also includes worksheets to facilitate 706 preparation and 1041 (IRD) computations

- TEdec
- Zane/706 [800-331-2533]
- LaCerte Software - complete tax prep software for accountants, including 706/709/1041 preparation. [800-876-6672]
- Faster Tax System - from Faster Software Products [908-846-5511]
- Form 709 Program - from Dunphy Systems, Inc. [614-431-0846]
- QUIK 706, QUIK 709 and QUIK 1041 - Lackner Group, Inc. [800- 709-1041]
- Taxtime 706 - from Austin Scientific [415-323-6338]
-

Database and Case/Client Management Systems

- The Will Tracker - from The Lackner Group, Inc. [412-279-2121]
- Wills Manager - from Canterbury Systems Corp. [416-977-8434]
- Agency Assistant - from Client Marketing Systems "client management software for insurance agents, agencies, and financial planners"
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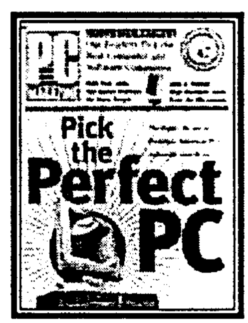
Time & Billing Software



- TimeSlips (and TimeSheet)
- TimeSlice for Macintosh and Windows
- BillQuick/TimeCard 800-BILL-NOW
-

Word Processing Software

- Microsoft Word / Microsoft Office '97
    - What's in Office '97 for You? (draft article by James Eidelman)
    - Microsoft Word for Windows 95 v. WordPerfect 6.1 for Windows (LexTech Inc.)
- Lotus WordPro (formerly AmiPro) / SmartSuite
- Corel WordPerfect / Suite
    - Mark Welch's unpleasant experience with Corel WordPerfect Suite 7 (June 1996)
    - The Perfect Lawyer Newsletter from RPW Publishing [803-359-9941]
    - MicroCounsel (WordPerfect consulting, macro design, and training for law firms - San Francisco)

Other Useful Sites Regarding Law Office Computing & Technology

- Law Office Technology Homepage (Dana Shultz & Associates, Oakland CA) - includes many useful articles
- LexTech Inc. (NJ) - includes useful articles
- Microsoft's Legal Industry News Page (apparently updated twice per month)
- Law Technology Product News *This monthly magazine publishes "new product" announcements from vendors - pricing information is never included*
-

Books and Publications

- *Wills, Trusts, and Technology: An Estate Lawyer's Guide to Automation*, by Daniel B. Evans (published by the ABA) - lists more than 100 vendors in the appendix.
- RPW Publishing: Publishes several newsletters for attorneys, including *The Lawyer's PC, The Perfect Lawyer, HotDocs Toolbox,* and *Mediator's Toolbox*
- Technology Update by G. Burgess Allison (column in *LPM*, the ABA Law Practice Management section's magazine)

- *The Lawyer's Guide to the Internet* by G. Burgess Allison
- *Net Law: How Lawyers Use the Internet* by Paul Jacobsen
- Creating a Lawyer's Web Site: Results of My Web Site, by Mark J. Welch
-

Some Related Sites:

California Estate Planning, Probate & Trust Law [Mark Welch's Home Page]

Estate Planning Newsletter Articles

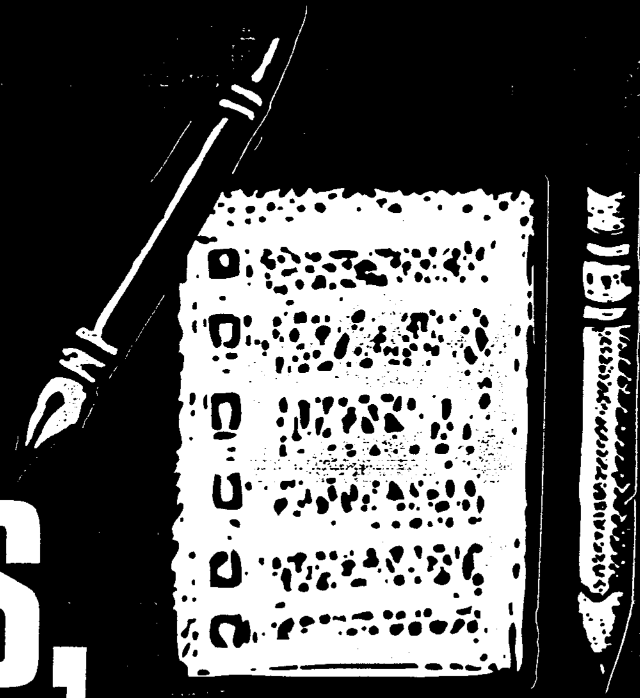
Wills on the Web [Celebrity & Historical Wills]

Complete List of U.S. Estate Planning & Probate Attorneys with Web Sites

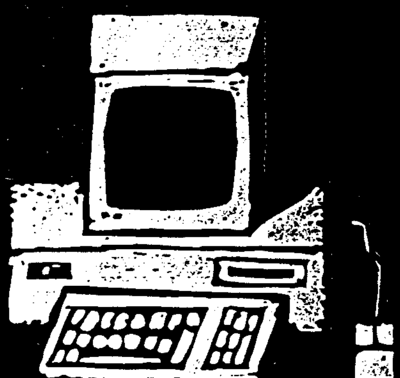
If you want an e-mail update notice from NetMind whenever this page is updated, please **enter your complete e-mail address:**

Press Here to Register

You are viewing web page: http://www.ca-probate.com/legal_sw.htm



Wills, Trusts, and Technology



An Estate Lawyer's Guide to Automation

Daniel B. Evans

SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
SECTION OF LAW PRACTICE MANAGEMENT
AMERICAN BAR ASSOCIATION

MISCELLANEOUS E-MAIL POSTINGS AND ADVERTISEMENTS CONCERNING SOFTWARE APPLICATIONS

From: Joseph G.Hodges Jr. <jghodges@usa.net>
To: LOUISVILLE.SMTP("aba-ptl@home.ease.lsoft.com","cba...
Date: Thursday, June 18, 1998 1:30 am
Subject: Fwd: Release of HotDocs 5 and HotDocs Pro 5

The follow important official news from Capsoft Corporation about the new
Version 5.0 upgrades to the popular HotDocs and HotDocs Pro
document assembly programs was finally posted today on the
hotdocs-dist list by Bob
Manning, the Product Manager for Capsoft Corporation.

The Moderators, ABA-PTL List

>From: "Bob Manning" <bobm@capsoft.com>
>To: <hotdocs-dist@capsoft.com>
>Subject: Release of HotDocs 5 and HotDocs Pro 5
>Date: Wed, 17 Jun 1998 18:12:07 -0600
>X-Mailer: Microsoft Outlook Express 4.72.3110.5
>Sender: owner-hotdocs-dist@capsoft.com
>Reply-To: "Bob Manning" <bobm@capsoft.com>
>
>Capsoft Development is pleased to announce the release of
HotDocs version 5
>and HotDocs Pro version 5. A few of the new features added
include (for more
>detailed information, see www.capsoft.com):
>
>HotDocs 5
>-- Direct filling of form template fields
>-- URL's in the HotDocs library
>-- Ability to use auto-assemble and auto-install files
>-- Better overflow control in filling form templates
>
>HotDocs Pro 5
>-- All things listed above (and more) in HotDocs 5
>-- New publishing options for creating auto-assemble and
auto-install files
>-- Ability to attach field wizards to form template fields
>-- Create templates that upload the answer file data back to a
server
>-- Attach post assembly macros to document templates
>-- Create detailed helps for users that reference infobases and
Windows help
>files
>
>You should have received an upgrade notice in the mail by now,
but if you
>haven't received one, you can order upgrades by calling
800-500-3627 (in
>U.S.) and 801-354-8000 from anywhere else. Upgrade pricing is
per licensed
>user and is as follows (all prices quoted in $US):
>

>Upgrade from HotDocs 4.x to HotDocs 5
>$79 ea 1 - 4 copies
>$74 ea 5 - 9 copies
>$68 ea 10 - 24 copies
>$58 ea 25 - 49 copies
>$47 ea 50 - 199 copies
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>Upgrade from HotDocs 1.x, 2.x, 3.x to HotDocs 5
>$149 ea 1 - 4 copies
>$139 ea 5 - 9 copies
>$129 ea 10 - 24 copies
>$109 ea 25 - 49 copies
>$89 ea 50 - 199 copies
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>Upgrade from HotDocs 4.x to HotDocs Pro 5
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>Upgrade from HotDocs Pro 4.x to HotDocs Pro 5
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>For more than 200 copies, please call 800-500-3627 (in U.S.). Maintenance
>customers (more than 25 copies with a maintenance contract) will receive the
>upgrade automatically. If you have more than 25 copies and have no
>maintenance contract, please call 800-500-3627 (in U.S.) to discuss options.
>
>Bob Manning
>Product Manager
>Capsoft Development
>
>---
>This message came by way of your subscription to the hotdocs-dist list.
>To unsubscribe, go to this web page in your browser:
>http://www.capsoft.com/cgi-bin/mlgate/HOTDOCS-DIST/unsubscribe.html
>You can also unsubscribe by sending an e-mail message to
>majordomo@capsoft.com with no subject line and this in the body:
>unsubscribe hotdocs-dist
>

CC: LOUISVILLE.SMTP("lpm-counselors@abanet.org","rppt-...

From: Vaughn W Henry <VWHenry@AOL.COM>
To: LOUISVILLE.SMTP("VWHenry@AOL.COM")
Date: Friday, June 19, 1998 5:48 am
Subject: Re: Estate & Charitable Planning Software

John Oler writes:

>Do any of you have suggestions on other software that can illustrate Estate
>and Charitable plans?

Actually, for "quick and dirty" calculations, flowcharts and client education pieces, Kettley Publishing out in California has a pretty good charitable quick plan that integrates with their estate cost estimator module. They offer it as an inexpensive option to other estate planning software and I usually have handouts and literature from several publishers and developers when I do my seminars, and Kettley has been nice enough to discount it heavily as a courtesy to my workshop attendees. I make zip, nada, zilch on their products, but using my corp. discount you'd have a hard time beating their price.

Vaughn W Henry
Springfield, IL http://members.aol.com/CRTrust/CRT.html

ROTH IRA Conversion Kit Available

Clients with IRAs need to know whether to contribute to a ROTH IRA or convert funds from traditional IRAs into a ROTH IRA. Clients with no present IRAs should also determine whether they are eligible for a ROTH IRA and whether annual contributions make sense.

CCH's new *ROTH IRA Conversion Kit* is an all-in-one package that will help the practitioner capitalize on this urgent, new planning opportunity. Each kit includes:

- *IRAs After the Taxpayer Relief Act of 1997*, a detailed reference book to help you understand the application of the new IRA rules;
- *25 copies of New IRA Opportunities*, a handy booklet for client distribution;
- *Sample Client Letters*, to help you alert clients to ROTH IRA opportunities and to assist you in providing follow-up information;
- *ROTH IRA Conversion Calculations CD-ROM*, a CD containing ROTH IRA conversion calculations to help you determine the best IRA strategies for your clients by plugging in the specifics on a client-by-client basis; and
- *A CPE Quizzer*, to help you earn valuable CPE credit.

With CCH's ROTH IRA Conversion Kit you'll have all the tools you need to work more effectively. To order, for only $99, please call 1-800-248-3248, priority code GC 44634, Prod. #05358101.

Windows Estate Planning

Intuitive Estate Planner from West Group analyzes myriad estate plan development options and saves users time in collecting and organizing client information, performing estate tax calculations and preparing illustrative presentations for clients.

Authors Donald H. Kelley and Konrad Schmidt III created the Intuitive Estate Planner with features that help identify the present ownership and estate tax consequences of different assets for both the first and second estate of spouses, display the effect of the estate tax in both tabular and graphic form, and plan and demonstrate estate tax techniques for the client. The user can select different scenarios with specific assets, deductions, tax adjustments and other choices, such as split-interest gift calculation, choices for the marital deduction and generation skipping, and how the tax burden is allocated among different legacies. In addition, adjustment options are included for adjusted taxable gifts, gift taxes payable, property previously taxed, foreign tax credits and the amount of any state death tax that might be payable.

The program contains many display formats and performs many calculations, including calculation of the death tax on first estates and second estates of spouses, split-interest trusts, estate liquidity, IRS annuity and life interest calculations for valuation of annuities, life estates and remainders, as well as calculation of growth in value of estate assets by asset or overall average. The results of all calculations can be viewed in flow chart, comparative bar graph or table format, with the detailed calculations in columns. And every screen, calculation, flow chart and graph can be printed. The Intuitive Estate Planner also contains a predefined slide show of information, pictures and charts that can be used to present options to clients and help convince them of the significance of estate planning.

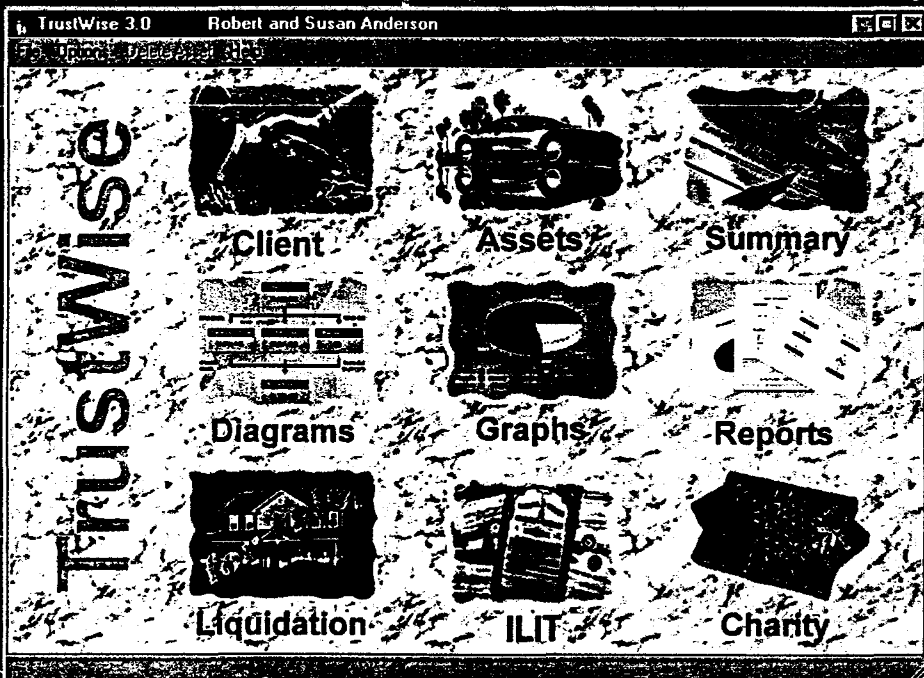
The Intuitive Estate Planner is a Windows program and requires a laser printer. The current edition covers changes made by the Taxpayer Relief Act of 1997 and costs $795 for a one-year subscription.

TRUSTWISE 3.0

ESTATE PLANNING PRESENTATION SOFTWARE

The simple and effective presentation tool for estate planning professionals...

The market is wide open. Thousands of people need your professional services as an estate planner. They need to understand estate planning. TrustWise gives you a powerful means of providing that understanding. And while your clients get the crystal clear picture, your estate practice grows. Take a moment and see what TrustWise can do for your practice.



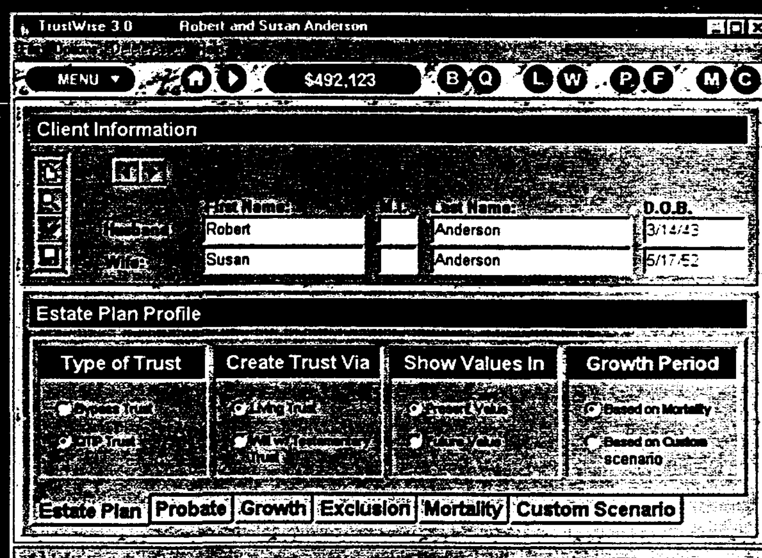
TrustWise is one of the simplest software packages you will ever use. The data entry screens are intuitive and easy to use. Just enter the relevant data in the appropriate fields and the ***results appear almost immediately.***

It's really that simple. Click on the appropriate options (see sample screen below) to customize the estate plan for your client. Define the type of trust and how it should be created. Choose how probate fees will be calculated, and decide how the estate will grow over time. Illustrate the results in present value, or project the estate's value into the future.

Entering a client's assets and liabilities is equally simple. Just select the asset category, choose the asset type, and enter its value. You can specify who owns each asset, and project growth by asset category or individual asset.

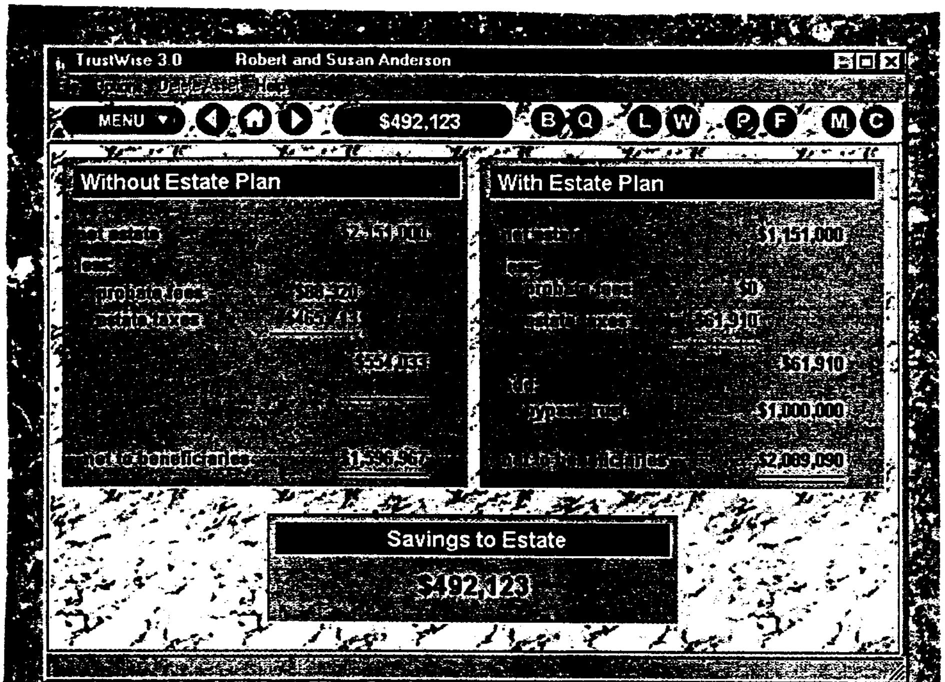
Quickly and easily show your client the benefits of estate planning while obtaining detailed information about their estate in a non-threatening and unobtrusive way.

After you have entered the client and asset information, the savings to the estate generated by your estate plan are just a mouse-click away.

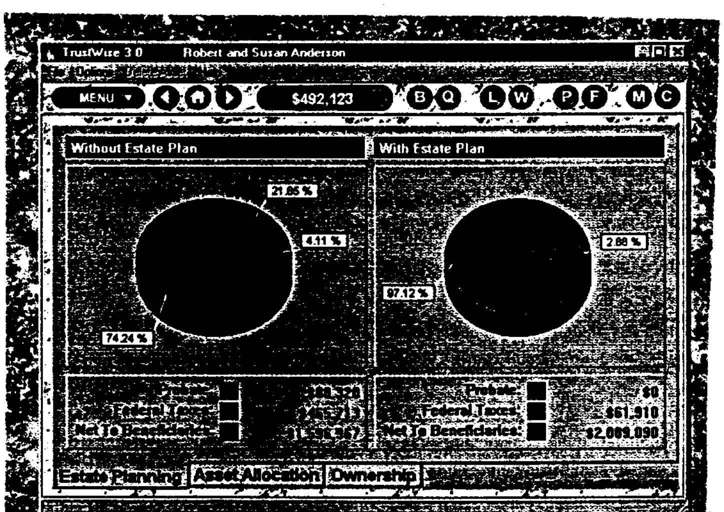


OSI Software

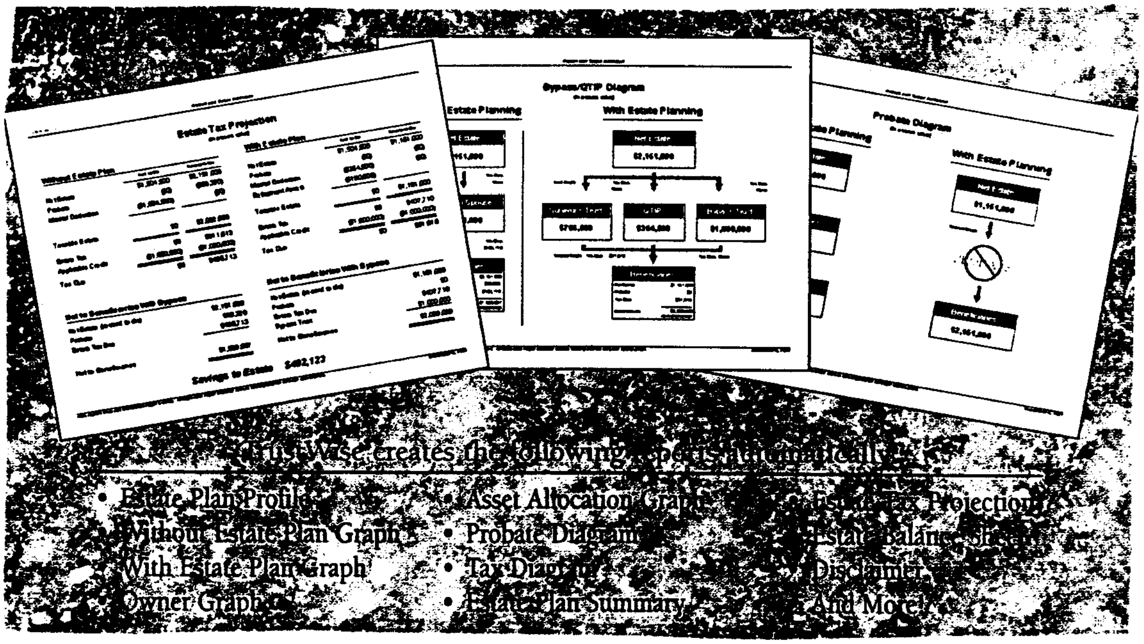
Call 1-800-432-6947 Now!

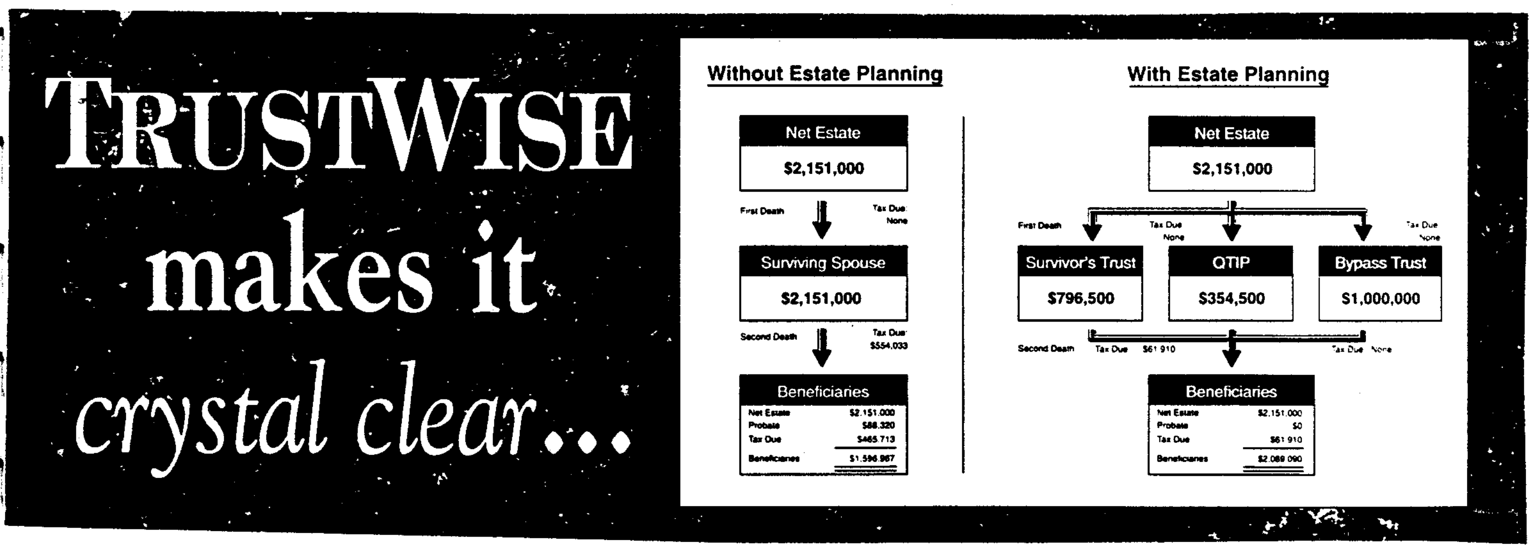


The estate summary screen shows the savings to your [illegible] estate— perhaps the most important reason your client [illegible] your services as [illegible] planning counselor.



Generate [illegible] comparisons [illegible] exhibits.


TrustWise creates the following reports automatically:
• Estate Plan Profile
• Without Estate Plan Graph
• With Estate Plan Graph
• Owner Graph
• Asset Allocation Graph
• Probate Diagram
• Tax Diagram
• Estate Plan Summary
• Estate Tax Projection
• Estate Balance Sheet
• Disclaimer
• And More!
Savings to Estate $482,123


TRUSTWISE
makes it
crystal clear...
Without Estate Planning
Net Estate
$2,151,000
First Death
Tax Due None
Surviving Spouse
$2,151,000
Second Death
Tax Due $554,033
Beneficiaries
Net Estate $2,151,000
Probate $88,320
Tax Due $465,713
Beneficiaries $1,596,967
With Estate Planning
Net Estate
$2,151,000
First Death
Tax Due None
Tax Due None
Survivor's Trust
$796,500
QTIP
$354,500
Bypass Trust
$1,000,000
Second Death
Tax Due $61,910
Tax Due None
Beneficiaries
Net Estate $2,151,000
Probate $0
Tax Due $61,910
Beneficiaries $2,089,090

Includes 1997 Estate Tax Law Changes

OSI Software

Dear Estate Counselor,

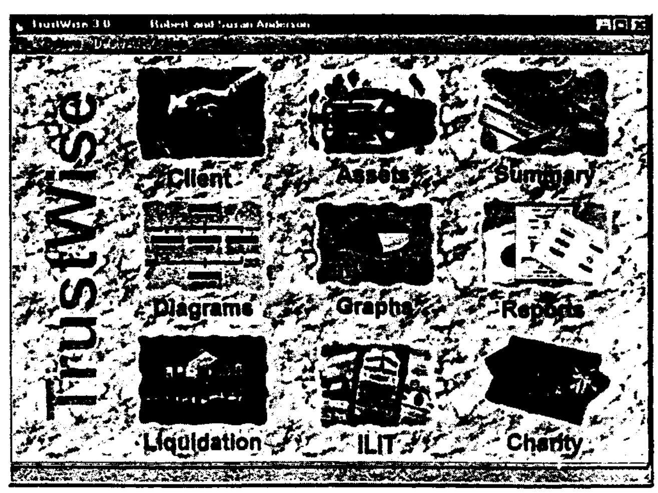
In the next ten years, over **TEN TRILLION DOLLARS** will pass from one generation to the next. Portions of that amount will end up in the hands of accountants, attorneys, estate planners and federal, state, and local governments. The estate planning market is growing rapidly and is probably one that you are watching very closely.

The estate planning market will see trillions of dollars change hands over the next decade.

You are also on the lookout for new technologies to help you provide breakthrough services for your clients.

Thousands of estate planning professionals are calling TrustWise Estate Planning Presentation Software just such a breakthrough. They no longer rely on calculators and pencil sketches on a yellow legal pad. They use TrustWise, a time-saving tool for showing clients a crystal clear picture of their estate planning options. They are providing their clients with highly professional, full-color reports with very useful and provocative information.

TrustWise allows you, as a trained and experienced professional, to simply and quickly put quality information in your clients' hands. Your client can see the clear and simple information on the reports you provide, and the decision is almost made!



Navigation through TrustWise is intuitive and simple. Point and click at the information you want, and TrustWise takes you there.

Many people realize the need for an estate plan. However, many times they either lack information or are too confused to take action. TrustWise makes that information crystal clear by

OSI Software • 9460 Union Square • Suite 249 • Sandy, Utah 84070 • 801-495-3100 • 1-800-432-6947 showing the projected savings to your client's estate, in real dollars, based on their assets. **Your effectiveness in moving clients to take action on estate plans will increase dramatically — OSI absolutely guarantees it or your money back.**

The process is **very, very simple**. In just five minutes, you can gather vital information about your client's estate in a very non-threatening, unobtrusive way. In another moment, the client sees a detailed comparison of savings to the estate — with and without an estate plan. The bottom line is crystal clear.

> **TrustWise is the best tool you have to ensure your clients follow through on estate planning.**

What's more, TrustWise allows you to show your clients variations of estate planning using a living trust or testamentary will, and a bypass or QTIP trust. And all of these options take place in a matter of moments. Your clients will be well equipped and feel confident about making decisions concerning their estate.

The benefits of TrustWise are numerous:

- You spend LESS time giving your clients MORE and better information.
- The actual cost of TrustWise software is returned in a single successful presentation.
- You don't need to be a computer wizard to make TrustWise work. It's very simple, intuitive, and easy to use.
- TrustWise is the most certain way to motivate clients to action on an estate plan.
- TrustWise generates professional looking reports, charts, and graphs for your clients rather than pencil sketches on a yellow legal pad.
- OSI Software keeps you up to date on any changes in the tax code affecting the formation and maintenance of wills, trusts, etc. Timely upgrades ensure that your presentations are accurate and current.
- Technical support is completely **FREE** for one full year from the time you purchase TrustWise.
- Spend less time crunching numbers and more time actually planning you clients estate.
- Show your clients results in just minutes.

60-Day Money-Back Guarantee

TrustWise is fully guaranteed. If, for any reason, you are dissatisfied with TrustWise, simply return it within 60 days of purchase for a full refund— no questions asked. (Note: Shipping & handling charges are not refundable.)

Also, when you purchase TrustWise, you can download interim releases of TrustWise 3.0 via the internet free of charge. In addition, you will be given special discounted pricing on future upgrades of TrustWise, which will further enhance the capabilities of your software.

These additional modules, such as the Irrevocable Life Insurance Module, the Liquidation module, and the Charitable Contribution module are available now. The Liquidation module shows your client how his estate might be liquidated to pay probate fees and estate taxes. It powerfully illustrates any need for estate liquidity tools such as a second-to-die life insurance policy. The Irrevocable Life Insurance module allows you to illustrate how a such a life insurance trust can provide liquidity to the estate, preventing the need for a wholesale estate sale. The Charitable Trust module enables your clients see the effects of charitable giving on estate and income taxes. These modules further enhance your ability to make your clients confident and sure about the decisions they make concerning their estates.

It's simple— Your practice grows as TrustWise makes you a more effective estate planner.

If you order TrustWise before July 31, 1998, you will automatically receive the Liquidation and Irrevocable Life Insurance modules at no additional cost. Regularly priced at $99 each, you save $198. Also, you have the option to purchase the Charitable Contribution module, also regularly priced at $99 for only $49.

The hardware and software requirements to run TrustWise are a 486 66-MHz DX, IBM-compatible or better computer with at least 16 MB RAM, 10 MB of free disk space, and Windows 3.1, Windows 95, or Windows NT.

The benefits of TrustWise 3.0 to an estate planner are clear. Those with the foresight to take advantage of these benefits will have a significant competitive advantage. Don't get left behind. Order today.

There is nothing to lose. Your small investment today will mean large returns in the near future as your estate practice grows. Get TrustWise 3.0 at a special, limited-time-only price if you act before July 31,1998. TrustWise regularly retails for $189.95, but if you order before July 31,1998, you can get the base module (which includes the AB Trust and QTIP Trust modules) for **only $99**. Also, as part of this special offer, you will get the Life Insurance and Liquidation modules (each valued at $99) absolutely **FREE**, AND have the opportunity to purchase the newly released Charitable Contributions module (regularly priced at $99) for only $49! If you take advantage of the full offer, you get over $485.00 worth of valuable software for only $148! (plus shipping.)

To order TrustWise, **call 1-800-432-6947**. Have your VISA or MasterCard number and expiration date ready. Or, to order by mail, simply enclose a check or money order for the appropriate amount in the postage-paid envelope along with the enclosed order card. Your order will be processed promptly and you will be running TrustWise 3.0 in a matter of days.

Sincerely,

Craig Osterloh
President, OSI Software

Call Now!
1-800-432-6947
Order your copy of TrustWise 3.0 today!

OSI Software

FINANCIAL & ESTATE PLANNING

P R O D U C T S

INHERITANCE, ESTATE AND GIFT TAX REPORTER—STATE

With the ***CCH Inheritance, Estate and Gift Tax Reporter — State***, you get the big picture with all-state and home-state coverage of inheritance, estate and gift tax laws. This six-volume reference combines the full background of the laws affecting these taxes — in *all* states, the District of Columbia and Puerto Rico.

- Valuable, time-saving tools such as charts and checklists provide a snapshot of the various state laws.
- CCH Explanations clarify pertinent laws, regulations and decisions — showing you what they mean and how they may be applied.
- The full text of relevant state laws and annotations to court decisions, Attorney General's opinions, and administrative releases are included in identical format — for your state only or for all 50 states, the District of Columbia and Puerto Rico. The choice is yours.
- All-State Compendiums summarize each state's law and tax rates, while the All-State Treatise offers a quick picture of the entire field.

CCH Inheritance, Estate and Gift Tax Reporter — State is the perfect complement to the *Federal Estate and Gift Tax Reporter*.

PRINT

6 Loose-leaf Volumes
Monthly Updates

ESTATE PLANNING REVIEW

Stay on top of the latest financial and estate planning trends with this invaluable monthly newsletter edited by CCH editors in consultation with renowned expert Sidney Kess. ***Estate Planning Review*** reports and interprets the meaning and planning implications of legislative, judicial and administrative changes.

Each monthly issue, covering a wide range of topics, keeps you in touch with current planning techniques and key financial and estate planning developments. Other helpful features, including a Table of Contents on the front page of every issue, along with annual indexing, make this newsletter perfect to retain for future reference.

NEWSLETTER

Monthly Newsletter

This valuable newsletter is also included as part of a print or CD-ROM ***CCH Financial & Estate Planning*** subscription. (See SmartPLANNER on page 23.)

NEW YORK ESTATES, WILLS AND TRUSTS

The interrelated statutes of New York probate law affect practitioners with clients who live or own property in New York and serve as an important reference source for practitioners around the country. Many professionals will find this loose-leaf reporter an indispensable addition to their research libraries.

- Essential statutory provisions for trust and estate practice in New York are published in full text and effectively organized for easy access.
- Monthly reports offer the latest coverage of important new law provisions and amendments, plus current court decisions back referenced by paragraph number to pertinent law sections, to ensure that you're working with only the most up-to-date information.

Topics Include:

- Guardianships
- Intestate Succession
- Trusts and Estates
- Fiduciaries—Rights, Powers, Duties and Limitations
- Will Interpretation and Construction
- Estate and Trust Administration

PRINT

1 Loose-leaf Volume
Monthly Updates

CCH® SMARTPLANNER™

When it comes to complete, comprehensive coverage of financial and estate planning issues, CCH® SmartPLANNER™ is unbeatable. It's an all-in-one productivity tool that enables you to offer more to your clients and affords more time for *you.* We provide the superior content you deserve, giving you the most accurate, comprehensive coverage you won't find anywhere else. CCH SmartPLANNER is comprised of four unique products, which together provide a complete estate and financial planning library on one CD-ROM.

CD-ROM
Monthly Updates

CCH FINANCIAL & ESTATE PLANNING

This all-encompassing guide covers all stages of the estate plan — from development to administration — and at the same time allows you to improve your financial and estate planning expertise.

- Includes productivity tools that are designed to assist you in the research process. Includes detailed explanations, strategies and planning aids that target these major areas: *income, estate and gift tax planning, general investment planning, insurance planning, pension, and retirement planning* and *estate administration.*
- You'll get answers to the real issues you face because this guide is written by tax professionals for tax professionals. CCH editors provide you with cutting-edge guidance on the latest financial and estate planning trends.
- You'll also be provided with timely advice offered by Sidney Kess, Consulting Editor, and an Advisory Board of leading practitioners representing law, accounting, insurance, investment and financial, and retirement planning.
- You'll have access to forms, client communication letters, checklists and sample documents designed by experts and used in practice.
- Subscription includes *Estate Planning Review* and *Ideas & Trends* newsletters.

CD-ROM — Monthly Updates

PRINT — 4 Loose-leaf Volumes
Monthly Updates

FEDERAL ESTATE & GIFT TAX REPORTS

This reliable reference guide contains the full-text of the Internal Revenue Code and IRS regulations on federal estate, gift and generation-skipping taxes, which allows you to make informed, accurate decisions.

- You'll have full text reporting on these provisions at your fingertips, along with applicable final, temporary and proposed regulations and related income tax provisions.
- We also include full-text reporting of federal court decisions and IRS rulings, including selected private letter rulings, and pending legislation — keeping you current with the latest information.
- To simplify your research, CCH explanations are integrated within the official material to provide you with the law, what it means and how to apply it — and best yet, it's all in one place.

CD-ROM — Monthly Updates

ONLINE — Monthly Updates

PRINT — 3 Loose-leaf Volumes
Weekly Updates

FEDERAL ESTATE & GIFT TAXES EXPLAINED

If you're searching for a source for quick, concise answers to your federal estate and gift tax questions, look no further. This timely reference has it all.

- Clear, comprehensive explanations of the laws relating to federal estate, gift and generation-skipping transfer taxes provides you with the practical guidance you need.
- Timely discussions of recent law and regulation changes, court decisions and IRS rulings give you quick answers to support your research.

BOOK

CCH® FinEst Calcs™

This electronic productivity tool is designed exclusively for professionals who perform estate planning and related functions. It automates and consolidates financial and estate planning calculations and provides graphical representation — in one product!

- More than 20 separate calculations covering *Split Interest Transfers, Retirement, Financial* and *Tax.*
- These calculators may be modified to accommodate a variety of computational options — so you're not locked into default settings.
- Each calculation has three different scenarios displayed side-by-side — allowing for "what-if" planning.
- A graphing capability is built right into this program, allowing you to display or print the results.

CD-ROM DISK

THE CCH MEXICAN TAX LIBRARY

MEXICAN TAX GUIDE

Turn to this one-of-a-kind guide for practical analysis of Mexican tax laws. You won't find another service with this level of detail...not even in Mexico! Authored by Jaime González-Bendiksen and other experts in the Mexico offices of Baker & McKenzie, the Guide includes:

- Complete explanatory coverage of income, asset and value-added tax laws and Mexico's administration of its tax system.
- Discussions of recent tax reform packages and historical trends.
- Step-by-step examples of complex calculations including:
  - Inflationary adjustments
  - CUFIN balance and dividend distributions
  - Income, asset and value-added tax computations
- In-depth analysis of customs, maquiladora and foreign investment legislation.
- Official English-language versions for all of Mexico's tax treaties or expert translations of treaties not drafted in English.

PRINT

1 Loose-leaf Volume
Quarterly Updates

MEXICAN TAX, CUSTOMS AND FOREIGN INVESTMENT LAWS

This one-volume loose-leaf reporter is comprised of authoritative English translations of Mexico's tax laws, as well as laws concerning customs and foreign investment. When combined with the *Mexican Tax Guide*, subscribers can research both law text and detailed explanations to ensure accurate answers to Mexican tax issues. And, you're always up-to-date because translations of new legislation are sent to subscribers immediately to ensure that you are working with the latest law text.

The publication, developed by CCH editors working with Bryan, Gonzalez Vargas y Gonzalez Baz, a leading Mexican law firm, includes professional translations of the following:

- Income, asset and value-added tax laws and regulations
- Federal Fiscal Code and regulations
- Customs law and regulations
- Foreign investment law
- Maquiladora decrees
- Miscellaneous Resolution (i.e., annual general rules)

Unlike other translations that come without reference tools, CCH *Mexican Tax, Customs and Foreign Investment Laws* provides an extensive topical index and is fully cross-referenced among the law, regulations and annual general rules.

PRINT

1 Loose-leaf Volume
4 - 6 Updates Per Year

MEXICAN LAW & BUSINESS REPORT NEWSLETTER

This newsletter can't be beat for coverage of what's important to U.S. businesses that trade with or have operations in Mexico. This extensive news and information source provides the "big picture" of the Mexican legal and business environment:

- Coverage on trade, taxation, finance, intellectual property, labor, real estate, environment, business and industry and economic indicators.
- Mexican news developments provided by INFOSEL, a leading Mexican information service.
- Feature articles and practical insights from leading practitioners.
- Translations of key Mexican laws and regulations.
- The latest Mexican official technical standards (NOMS).
- Status of NAFTA dispute panels.

...and more!

NEWSLETTER

Monthly Newsletter

CCH® perform plus™

The most current and comprehensive library of tax forms available on just one CD-ROM! Infinitely faster and more convenient than traditional print products, this innovative electronic resource enables you to locate, view, fill out, and laser print any of more than 5,000 federal and state tax forms and their complete instructions in seconds.

Limit or expand your purchase to federal forms, state tax forms, or a combination of both—you have the flexibility to choose what best meets your needs.

The complete ***CCH® perform plus™*** library includes forms, schedules and instructions for virtually every type of return and offers the following helpful features:

- A convenient search function, a forms list and form category help you quickly find the form you need.
- Complete, official instructions are accessible while viewing the form on the screen, providing helpful guidance on less familiar or more complex forms.
- Federal forms feature automatic calculations which streamline data entry and minimize errors.
- Updated every two weeks during tax season to ensure that you have the most current tax forms and instructions.
- A CD-ROM archival library of forms and their instructions gives you convenient access to the late filing procedures and appropriate forms.

With complete fill-in-the blanks capability, context-sensitive instructions, and print and save functions just a keystroke away, you'll have a comprehensive and efficient system that facilitates your compliance work—all on one easy-to-use CD.

Periodic Updates—
Biweekly During Tax Season

FEDERAL TAX FORMS

Federal Tax Forms is a handy compilation of income, estate, gift, excise and employment tax forms, supplementary schedules and official Internal Revenue Service instructions. All of these forms are gathered together in three convenient loose-leaf binders—eliminating the need for maintaining an independent file of tax forms. Timely loose-leaf reports keep you up-to-date with the latest revisions and annual versions of tax forms.

This convenient, desktop resource offers the following helpful features:

- New and amended forms are sent to you upon release, giving you quick access to the latest forms.
- Forms are printed full size and ready to reproduce.
- Topical and numerical indexes make finding the appropriate form a breeze.
- Includes a handy tax calendar to remind users of filing dates.
- Report letters offer brief summaries of all new developments.

Includes a separate division containing the full text of Internal Revenue Service rules and procedures on the private reproduction and printing of forms, the filing of returns on magnetic tape, computer preparation of income tax returns and related matters.

PRINT

Periodic Updates

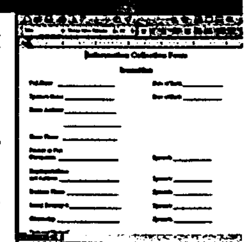
Did you know that government could end up liquidating a thriving business if the unthinkable happens? Most wills won't protect your business.

LivingTrust*Builder* will help you work more efficiently with your attorney to create a living trust that protects your personal and business assets, just in case.

Did you ever think that your partner's heirs could ruin everything you've worked for?

Even if you or your partner is only temporarily incapacitated.

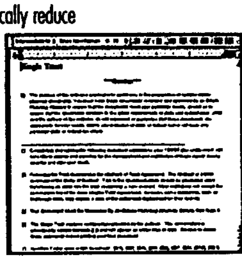
That's why JIAN developed LivingTrust*Builder*™. It's the only solution on the market designed for small and growing business owners.



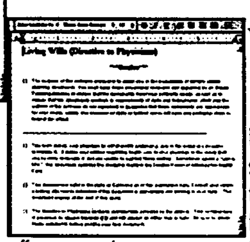
All of the documents in LivingTrust *Builder* are designed to simplify the process when you meet with your attorney. So you maintain control, while keeping costs to a minimum.

Lawyers and customers alike tell us that LivingTrust*Builder* gives business owners greater understanding and more control over their legacy, while saving time. Which slashes legal costs. And gives you more say.

LivingTrust*Builder* helps you create the framework for your living trust so you can dramatically reduce your legal fees.



Of course, we'd like to take credit for protecting people's businesses. But we know better. We just provide the templates and ask the questions.



You fill in the blanks.

In addition to the standard living trust documents, LivingTrust*Builder* offers a comprehensive assortment of agreements and documents to protect your heirs and your business.

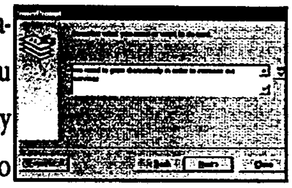
To Order, Call 1-800-346-5426 or Visit www.jian.com

Solutions for Growing Businesses

We all the *information*, structure, *and* organization *you* need.

You fill in the blanks.

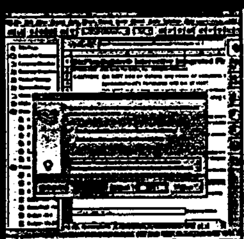
Ten years ago, JIAN started offering our first spreadsheet and word-processing templates. Pre-formatted documents brimming with information that you could easily customize to suit your company.



With JIAN's interactive solutions, you simply fill in your company information once, and the software places the date throughout.

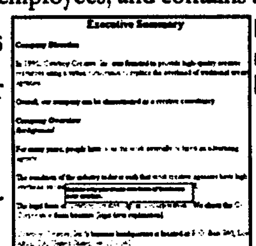
It was all about information.

Today, it's still all about information. But now we've got some extra features that make it easier to use. Today our software coaches you while asking questions. And then it places your answers throughout the document, so you don't always have to search and replace on your own.



JIAN software will step you through the entire planning process. You fill in the blanks.

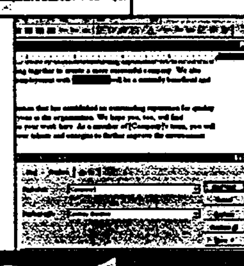
But most of all, the documents we help you produce are first class. Not cookie-cutter. Just consistent, with all the information in the right places. So your business plan is easy to understand and easy to finance. Your employee manual inspires your employees, and contains all the right language to protect your company. Your marketing plan is thorough and easy to follow and implement. Your employee records are impeccably organized.



Helpful hints tell you not only what to do, but why.

You will add too much of you into each document to make your company look much like any other company using JIAN software.

With one exception. We will help you look and be more successful.



All of our documents are also available as templates the you can use with your own, familiar word processor.

Today's Business Solutions

TRUSTS AND ESTATES
November 1997

A Small Firm's Perspective On Document Assembly Software

UTILIZING DOCUMENT ASSEMBLY SOFTWARE will be imperative for every estate planning attorney who wants to maintain a thriving practice in the 21st Century. This article surveys all of the popular document assembly software programs for Will and trust drafting that are on the market today. The authors explore the strengths and weaknesses of the best programs as well as offer analysis as to what programs would work better for different office structures.

By **Shelley D. Ebenal, Susan L. Evans, Cindy L. Violette** *and* **Richard W. Hompesch II**
Hompesch & Associates, P.C.
Fairbanks, AK

All estate planning attorneys have to solve the problem of how to deliver comprehensive estate planning documents to their clients quickly and at a reasonable cost. Our firm includes three attorneys, a certified legal assistant, an accountant/office manager and a secretary, who live in a town that supports a population of nearly 80,000 people. We rely on document assembly software as an essential part of our estate planning practice and believe it is critical to our success. Although our location is unique (in the interior of Alaska, 165 miles south of the Arctic Circle, in a borough as big as Connecticut), the practical problems we face in our practice are not.

We are surprised by how few good document assembly programs are on the market today. We are more surprised by the number of attorneys that do not use at least one of these programs on a daily basis. Without question, all sole practitioners and all estate planning firms or departments with less than five attorneys should consider making document assembly software the workhorse of their Will and trust business. Larger firms may have good reasons for their reluctance to install a document assembly software program (or programs), but these reasons will seem less compelling in the near future than they may seem now.[1]

Our purpose in writing this article is three-fold. First, we wanted to assist attorneys and office managers who are looking for their firm's first document assembly software program and who want to know what is out there. Second, we wanted to alert firms who already are using document assembly software to the new programs. Third, we wanted to challenge the conclusions of all attorneys, whether from large firms or small, who do not appreciate the economic importance of these programs and their inevitable future impact on our profession.

A Brief Personal History

All but the newest members of the profession have seen how technology has changed our practices. Many of us graduated law school without learning how to type. When some of us started practicing, our secretaries used manual typewriters and lots of carbon paper. One of the authors remembers that it took him nine hours to cut and paste his first Will for a client with a $1 million estate. Later mag cards with their limited memory were the rage, only to be trumped a few years later by personal computers. After our secretaries had been using personal computers for some time, a few of us tried them out for ourselves and some of us even kept them on our desks to impress our clients. Eventually we found out how important personal computers were for file management, keeping our calendar and tickling important dates.

In our office, we began using document assembly software by accident. We were subscribing to the old Drafting Wills and Trust Agreements form book for a year or two when they sent a flyer announcing their new DOS -based software program. On a lark, we mailed in our money and apparently were the first firm in Alaska to get the program. After we installed the program we were stunned. It simplified all of the complicated commands that we had created in WordPerfect to merge the forms. Later at a training seminar in South Carolina, the author of the program, Robert L. Wilkins, taught us how to prepare "the five minute Will." We were hooked. The Wills and trusts flowed out of our printers and to our clients.

In 1994, we attended the annual TRUSTS & ESTATES conference in San Francisco and saw a demonstration of Jonathan G. Blattmachr's and Dan Hastings' new program, Wealth Transfer Planning. We stood in a group of other attorneys, who probably had drafted hundreds more CRUTs and CRATs and Wills with reverse QTIP elections than our firm ever had. They scrutinized the program and commented on how the program did not do "it" the way they did. We quietly bought the program and for less than $1,000 hired two expert estate planning attorneys as our "senior partner." At the time it sounded just too good to be true.[2]

In a few years our practice was transformed in ways we had never imagined. Now after receiving the financial and family information about a client, our legal assistant enters the pertinent data into the program, selects the options directed by the attorney, and sends the attorney an e-mail that the documents are ready. The attorney reviews the data and the selected options and finalizes the document. Then the legal assistant formats and prints the drafts. Drafting customized documents for most married couples does not take more than an hour. Our goal is to mail drafts of all documents to our clients no later than two weeks after the initial appointment. It usually takes us twice as long to review documents with our clients, than it took us to draft them in the first place.

Exploring Advantages And Disadvantages

The advantages of a good document assembly program are quality, consistency and speed. These advantages favor the new attorney with little experience who faces a drafting problem that he has never seen before and who does not have a senior partner close at hand to direct him to the file where he can find the appropriate provision for that special client. Most good programs include a checklist that will prevent even an experienced attorney from overlooking important considerations that are easy to forget, such as whether both spouses are U.S. citizens. Document assembly programs have made it easier for attorneys to produce specialized documents that previously would have taken hours of research and drafting. Although no computer generated document should be taken verbatim, a good document assembly program will give an inexperienced attorney a good first draft. These programs have made smaller firms more competitive and have assisted attorneys everywhere to deliver quality documents previously only available from a few experts.

One disadvantage of adopting a document assembly program is the unbillable time it takes to learn a new program; but the toughest part is that, to some extent, you must surrender your ego. We all have our favorite forms. However, we have to ask why we need three or four different perpetuities saving clauses or survivorship clauses in our form bank. On the other hand, no one wants to be accused of sending out "cookie-cutter" Wills. The undeniable economic fact is that when uniformity saves time and money, our egos must yield.

Our Survey Of Estate Planning Document Assembly Software

We began our survey of estate planning document assembly software almost two months before we started writing this article.[3] We searched the Internet and the articles listed in the Current Law Index of legal periodicals for estate planning from 1991-1996 for document assembly software.[4] We found more than 20 different programs and then began the tedious task of contacting the vendors and requesting either a demo or a copy of the program on a trial basis. We deleted any programs that claimed to be, or appeared to be, state specific.[5] In some cases we could not contact the vendors, despite numerous attempts.[6] Our request for the demo or copy of one program was refused[7] and another program simply did not arrive before our deadline for submitting this article.[8] We apologize in advance to any vendors with good programs that we may have overlooked.

We reviewed each demo or program on the basis of available features, cost, user friendliness, network capability, hardware requirements, modification capability and word processing. We preferred "interactive" document assembly software. Interactive programs ask the user a series of questions and then based upon the responses, asks other relevant questions. For example, an interactive program will ask if the client is married. If the answer is yes, then the program will ask you for the spouse's name and other relevant information, such as whether the spouse is a U.S. citizen. If any answer is no, then the program will move on to another series of relevant questions. After entering the client data and selecting the options for the particular plan, the software will assemble the estate planning documents by using the appropriate provisions. If the plan is for a married client, an interactive program will not offer provisions that only should be used for a single client.

The Honor Roll

The three programs that we liked the best are Cowles Legal System (Cowles), Drafting Wills and Trust Agreements (DWTA) and Wealth Transfer Planning (WTP).[9] Each of these programs is interactive, allows the user to enter the client data once regardless of the number of documents that will be assembled, and allows the user to permanently modify the text and insert his own provisions. All three programs have network versions, good tech support, convert final documents to Word or WordPerfect, and include other resources in the program to assist the drafter.

Cowles Legal System. Cowles' drafting software comes in three modules: Will-Do-It, Trust Plus, and Trust Plus Life Insurance. You can prepare Wills, pour-over Wills, revocable trusts and irrevocable trusts on this software, plus a wide variety of supporting documents including durable powers of attorney, powers of attorney for health care, health care directives (living Wills), community property agreements, asset transfer letters, assignments, state specific real estate deeds, itemized invoices, customized document envelopes and covers, and letters to corporate trustees, personal representatives, and to clients including a follow-up questionnaire to clients and a thank you letter. In addition to software, Cowles offers videos, booklets, binders, envelopes, worksheets and fee agreements. The purpose of Cowles' videos and booklets is to educate clients, thereby making the estate planning process more time and cost efficient. Although we only reviewed the Windows95 version, Cowles will run on DOS, Windows 3.1 or higher, and Windows95.

Cowles is very user friendly and is easy to navigate. Cowles provides explanations and warnings with its provisions. These explanations and warnings are not as comprehensive as WTP's, but are easy to understand and are helpful when making an informed decision as to whether the option you are choosing is appropriate for your client. The software includes easy-to-read user manuals, online substantive legal "help," phrase preview "help" and online technical "help."

Cowles offers a complete practice system with membership in a program called the Forum. The purpose of this membership is to facilitate contact and communication between estate planning attorneys and offers additional technical support and information, including a quarterly newsletter. There are two levels of the membership that entitles you to varied levels of free technical support and discounts on seminars. Cowles offers various seminars to update their customers on estate planning issues and changes in the system.

Although Cowles offers more options than DWTA, the software is expensive. Will-Do-It $490 (standard) or $690 (network); Trust Plus $1,990 (standard) or $2,390 (network); and Trust Plus for Life Insurance $590 (standard) or $790 (network). You can buy Cowles' entire comprehensive system which includes: Trust Plus; Trust Plus Life Insurance:

The Honor Roll

Of the programs that the authors reviewed, the following programs were selected as the top three:

(Note: This list is not in ranking order.)

- **Cowles Legal System;**
- **Drafting Wills and Trust Agreements and**
- **Wealth Transfer Planning**

Each of these programs is interactive, allows the user to enter the client data once regardless of the number of documents that will be assembled, and allows the user to permanently modify the text and insert his own provisions. All three programs have network versions, good tech support, convert final documents to Word or WordPerfect, and include other resources in the program to assist the drafter.

Will-Do-It; Estate Planning Development System; The Estate Planning Substance, Procedure and Prosperity; six additional estate organizers; and six months free membership to the executive Forum for $3,490 (standard) and $4,290 (network).[10]

Drafting Wills and Trusts Agreements. DWTA is probably the best known document assembly program on the market. Its reputation is well-deserved. On DWTA a user can prepare simple Wills, pour-over Wills, long form Wills, revocable trusts, trust amendments, codicils, joint property trusts, community property trusts, durable powers of attorney, checklists, sample flow charts, easy-to-read synopses of all documents and letters to clients. DWTA offers resources within the program to view the actual text that will be assembled into your client's documents and to modify the text. Although explanations are not available for all options, they usually are available for the more complex choices. DWTA is available for Windows, but is no longer available for DOS. The program includes manuals along with technical support.

Although DWTA does not offer irrevocable trusts and does not offer as comprehensive a system as Cowles does, its price of $695 for a program for one user or a network is a steal. This program has been the workhorse in our office for the last five years.[11]

Wealth Transfer Planning. When the Windows version of this program is released this winter, it will be the hands-down winner for the experienced estate planner. It will be the most comprehensive estate planning document assembly program on the market. WTP goes beyond all of the programs we reviewed and offers the most comprehensive list of advanced estate planning documents, including grantor retained annuity trusts, charitable remainder trusts and family limited partnerships. The program also can prepare a memorandum with analysis to help you determine whether a particular estate planning strategy is appropriate for your client. We understand that in the future, WTP will add Alaska trusts and limited liability companies to its menu. The Windows version of the beta release appears to have applications that are almost limitless.

In addition to explanations for each option and warnings on options that can have unintended or adverse results, WTP supports its estate planning documents with a unique resource. In conjunction with the Research Institute of America (RIA), a WTP user who has RIA Estate Planning System on CD-ROM can access the Internal Revenue Code (IRC), IRC regulations and other RIA information directly from WTP. This allows you to instantaneously review the IRC or research an issue while drafting a client's estate planning document. This combination will create an effective research tool.

WTP is designed for the advanced estate planning attorney with clients with significant wealth. Many questions may be irrelevant for small estate plans and some of the documents generated from WTP will be difficult for the novice estate planning attorney to understand. This is a function of the inherent complexity of the documents offered on the program. To assist the less experienced user, WTP has a nice feature that enables you to choose whether you are a beginner or an advanced user of the program. It also includes numerous windows with explanations to give the user a general understanding of the documents he is drafting.

For the most part, WTP is user friendly. However, because the program offers so many variations compared to some of the other programs, you may find WTP to be a little more difficult to navigate, especially the first time. WTP provides manuals and technical support and training seminars on how to use the program.

Our only real criticism is that the Windows version of WTP is not scheduled to be released until December 1997. The price of $995 is so competitive that this program will be a "must" for every attorney who does advanced planning for clients with significant wealth.[12]

Honorable Mention

DL Drafting Libraries. DL Drafting Libraries (DL) is a DOS - based program that is not as user friendly as other programs, but its price and the fact that it offers all the basic estate planning documents and some advanced documents, makes it a contender for the user on a limited budget or with older computer hardware. DL offers two libraries for estate planning, a Wills library and an inter vivos trust library. Unlike Cowles and DWTA, DL includes advanced estate planning tools such as charitable remainder trusts and qualified domestic trusts. Although DL is by no means as sophisticated as WTP, it does include some of the same advanced estate planning provisions and documents. Of the programs we reviewed, DL was the only one that specifically addressed blended families. This is a desirable feature because more and more of our clients have blended families and many of these clients want to treat their step-children as their own children.

Although DL allows you to permanently modify the provisions within the program and add your own provisions, we understand that it is very difficult because the coding is complex and difficult to edit. However, the documents can be edited in your word processors. You can order the program with state specific forms. Because it is a DOS -based program and is not mouse-driven, we found DL to be difficult to navigate. Options are selected by pressing numbers and letters.

You can purchase the Will library for $200 and the inter vivos library for $200. DL will run on any PC including systems with Windows or Windows95. There is no reason why an estate planning attorney with an old of 386 or 486 computer should not consider purchasing this program.[13]

Honorable Mention

DL Drafting Libraries

DL Drafting Libraries (DL) is a DOS -based program that is not as user friendly as other programs, but its price and the fact that it offers all the basic estate planning documents and some advanced documents, makes it a contender for the user on a limited budget or with older computer hardware.

Creating Your Own Document Assembly Drafting Software

One reason some attorneys do not use estate planning document assembly software is because they do not like the language in the provisions of the programs. In our view, there are two reasons why this is invalid. First, the better programs allow the user to permanently modify the text of each provision. Second, you can purchase your own document assembly engine and insert all of your own provisions and, in effect, create your own interactive document assembly program. For attorneys who are not satisfied with the better document assembly programs and want to spend the time it takes to develop their own program, there are a number of good engines to drive their system. We found at least three that should be mentioned.[14]

Fast Draft. Fast Draft works with any PC supporting DOS, Windows 3.1 or higher, and Windows95. Fast Draft works with either Microsoft Word or WordPerfect. Fast Draft allows you to save your text and forms to a database, and from the information in the database, create documents quickly and easily. Fast Draft allows you to enter client information one time and use this information in a variety of documents. Fast Draft appears to be a very sophisticated interactive program that will fulfill your document assembly needs. This program costs $595 for a single user using Windows and $495 for a single user using DOS. You also can purchase the program for networks at an additional cost.[15]

Form Bank. Form Bank is a sophisticated document assembly software program for legal professionals that is very user friendly. Form Bank works in conjunction with Microsoft Access, a database program that allows you to catalog your provisions into tables. Once the provisions are cataloged, then you use Form Bank to develop questions that correspond with the provisions in the table. This program costs $395 per user, but for more than 10 users a sliding scale is used.[16]

Hot Docs. Hot Docs is a very popular program that can be purchased at most computer software retail outlets for $100 or less. It allows you to create a matrix of questions with a variety of available provisions depending upon the response to the question. Although Fast Draft and Form Bank are more sophisticated programs and are easier to use, it is hard to beat Hot Docs considering its price.

Other Document Assembly Programs

There are a few other document assembly programs that you may want to consider. These programs are probably better described as merge document assembly programs, instead of interactive document assembly programs.

Will Builder. This document assembly program allows you to use the forms in the program or create your own forms. Like the other programs, you enter the client information one time and then can assemble several different types of documents. We did not find this program to be user friendly and it was very difficult to navigate. You can purchase this program for $175 (single user) or $275 (network version).[17]

In Trust. This is a document assembly funding software for Windows. Like Will Builder, In Trust asks for basic client information and then merges that information into the form you choose, whether it is a form already created in the program or one you added to the program. Although In Trust has incorporated generic forms for Wills and trusts, its best feature is for asset transfers. After entering the client data once, you can generate all of the documents necessary to transfer your client's assets to his trust. You can print reports which set out what assets have been transferred, what assets still are left to be transferred and to what trust they have been transferred.[18]

Attorney Organizations with Document Assembly Software

Hundreds of attorneys are joining commercial organizations to help them develop and maintain an estate planning practice. The National Network of Estate Planning Attorneys and the American Academy of Estate Planners offer document assembly software with their memberships. Although the cost to become a member of either of these organizations is substantially more than the cost of any other software, membership includes additional benefits. These benefits may be particularly attractive to attorneys who want to enter this area of practice, but who have limited experience.

The membership fee to join the National Network of Estate Planning Attorneys is $10,000, with a refund option. Each member receives the Network's Net Plan software, free attendance at two training seminars and two practicums, marketing videos, a nine-volume trust compendium, a slide presentation, an assigned development adviser to help develop the member's practice, a subscription to the Network newsletter with legal updates and access to an electronic bulletin board. Each member pays a fee to the Network for each estate plan prepared on its software.[19] The fee for a married couple with mirror-image documents who do not have a taxable estate is $90. The fee for mirror-image documents for a married couple with A-B trust provisions and other tax provisions is $120.[20]

The fee to join the American Academy of Estate Planners is $9,500. To continue your membership and license you must pay $1,595 per month beginning 30 days after you receive the Executive Starter Kit. Partners and staff members may participate at no additional charge. The Executive Starter Kit includes the Academy's proprietary Estate Planning Practice-Building System and the marketing tools, software programs,[21] seminar presentation system, and participation in the Academy's Executive Training Program.[22]

Software For Laypersons

Some of your clients may be tempted to prepare their own Wills or trusts and there is software out there to help them.[23] We reviewed two of these types of programs: WillMaker 6 and Living Trust Maker 2 for Windows from Nolo Press. Nolo Press claims "WillMaker has made more Wills than any lawyer or law firm in history." We were curious about these programs and wanted to report what we found.

Each program was easy to use and included a 200-plus page manual and an extensive tutorial. Other than the basic client information, names of personal representatives, trustees and guardians, each program limits the user to standardized forms that cannot be modified. Neither program offers any estate tax planning provisions, but the manuals and estate tax tutorial recommend that users with assets valued over $600,000 who wanted to minimize their exposure to estate taxes should contact an attorney.

The manuals for each program are written for the layperson and are designed to allow the average person to create his own Will or trust. However, if all the points in the lengthy legal manuals and tutorials are not read and understood, errors will occur. The person who uses either of these programs to create his or her own Will or trust may not understand the ramifications of what he has created. For example, if the layperson creating his own estate planning documents fails to remember what he has read in the manual or tutorial, he may believe that by naming an individual other than his spouse as his devisee or beneficiary that he has effectively disinherited his spouse, which of course, cannot be done in most states without a written agreement with that spouse.

Trust Maker was specifically designed for people with a small estate who want to avoid probate. We were astonished that Trust Maker does not allow the user to prepare a pour-over Will and, in fact, the manual for the program states that "[p]our-over wills are not usually a good idea." In addition, Trust Maker does not include any documents to help the user transfer assets to his trust or to change beneficiaries of retirement accounts or life insurance. The manual provides some examples for transferring certain assets to a trust. As you may imagine, the manual does not address every type of asset, or why or why not, a certain asset should be transferred to a trust. For example, the manual explains that if you want to name your trust as a beneficiary of your life insurance policy or individual retirement account, you do not need to transfer the ownership of the account or policy to the trust. However, the manual did not address the income tax or other consequences of naming your trust as a beneficiary of a retirement account rather than your spouse or children.

These programs are inappropriate for all but the most basic estate plans. These programs may sound like a great deal to someone out there who needs an estate plan, but does not want to spend the money to retain an estate planning attorney. The problem is that it is impossible to cram all of the information one needs to prepare an effective estate plan into a simple software program, manual or tutorial. We are concerned that people who use these programs without later getting the documents and their assets reviewed by a competent attorney may generate more legal fees than the authors of the programs claim the programs save.

Conclusion

Document assembly software is here to stay. In the future, the programs will only become more sophisticated and comprehensive. The combination of the escalating technological revolution and increased competition will take its toll on all of us, whether we like it or not. The trend is clear: Document assembly software will be a requirement for *every* estate planning attorney in the 21st Century. ◆

The authors wish to thank Diana Kelch for her assistance and patience in contacting the software vendors mentioned in this article.

End Notes

1. These reasons may include (1) the fact that the firm already has a complete library of forms, (2) the costs of the computer hardware to support a network version of a program, and (3) the difficulty of getting a large number of attorneys to agree to use a particular system.
2. Later Howard M. Zaritsky and Dennis I. Belcher joined Jonathan Blattmachr and Dan Hastings to revise and improve the program. After attending a training session in Baltimore in June 1995 we were asked to test two of the Beta release versions of the new Windows program. That program should be released in December.
3. We were challenged by Paul Bernstein's statement in "Cowles' Top-Notch Estate Planning Software System" Illinois Legal Times (June 1996): "Even if the names and addresses of vendors were available, it would be impossible for one person or even a small team of people to adequately, fairly and thoroughly review and evaluate each such software package."
4. The most comprehensive list of estate planning document assembly software programs that we found was on a Web site entitled "Small Office / Home Office Consumer: Software for the Estate Planning Law Office" and can be found at http:\\www.ca-probate.com/legal_sw.htm.
5. The continuing education section of

your state bar association may have information about specific software programs for drafting Wills and trusts for your state. Our list of these programs is not inclusive:

CAPS Practice System Series - California Wills and Trusts Software (John Hartog). We understand that this software may be purchased through Matthew Bender.

California Continuing Education of the Bar ("CEB"). Many of CEB's books for estate planning provide forms on disks and also are available on CD-ROM. You can contact CEB at 800-232-3444 for more information.

Automated Legal Systems, Inc.: Pro Doc. We understand that Pro Doc is specifically designed for drafting estate planning documents in Texas. You can contact Automated Legal Systems, Inc. at 800-659-1973.

Texas Probate Library with State Bar of Texas Forms from Lawyer's Cooperative Publishing (LCP). We understand that they provide some type of software program for drafting Wills and trusts.

6. We did not review the following programs:

(1) EP Expert and Win Draft. We contacted Eidelman Associates regarding EP Expert and Win Draft and were told that we could review a demo of the software from their Web site. We tried to download the software, however, we were only able to download more information concerning the programs. When we called them back to request that they mail us a copy of their demo, we were told that someone would call us back. We are still waiting for a response. From the information we obtained over the Internet, it appears that Win Draft is a document assembly engine similar to Hot Docs that works with Windows and Microsoft Word. A WordPerfect version will be released in the near future. EP Expert is an estate planning system for Win Draft. The program allows an attorney to customize the provisions and questions to meet their specific needs. It appears that EP Expert provides options for preparing such documents as revocable trusts, Wills, irrevocable trusts and health care powers of attorney. For more information contact Eidelman Associates at 800-775-2786 or visit their Web site at http:\\www.lawtech.com/windraft/ep-expert.

(2) Legal Ease Auto Systems. "Wills and Trusts 2000" by Microcomputer Concepts, Inc. This DOS software is designed to work with WordPerfect. Although we were able to download Legal Ease's software demo from their Web site, we could not get the demo to run. When we attempted to contact Legal Ease at 800-232-1321 there was no answer. We sent Legal Ease an e-mail (legalease@netline.net), but did not receive a response. This program regularly costs $795. According to their Web site they have an Internet Special for $395. For more information contact Microcomputer Concepts, Inc. at 6424 Central Avenue, St. Petersburg, FL 33707; fax number 813-384-0882; or visit their Web site at http:\\www.netline.net\legalease.

(3) Provisions Plus Estate Document Generation System from Legal Works, Inc. All we found for this product is a 800 number that is no longer in service.

(4) Northern Trust. One of us attended a seminar where she gained a limited exposure to Northern Trust's program. It allows you to enter client information and then create the estate planning document by choosing pertinent provisions. Although she found the process rather frustrating, attorneys with more experience appeared to like the program very much. For more information visit their Web site at http:\\www.ntrs.com.

7. We contacted the American Academy of Estate Planning Attorneys and requested a demo of their document software program. We were advised that the software could not be reviewed without reviewing the entire membership package and paying a one-time fee of $9,500 for their Executive Starter Kit that comes with a 30 day money back guarantee.

8. The National Network of Estate Planning Attorneys said they would send us their program to review, but we did not receive it before the deadline for submitting this article.

9. Our list is alphabetical. Neither program will be the absolute best for every estate planning attorney. Each of these programs has its own strengths and weaknesses.

10. For more information contact Cowles Legal Systems 3410 Sky Park Blvd. Eau Claire, WI 54701 800-366-1730 or visit their Web site at http:\\www.cowleslegal.com. Cowles has recently released a software program entitled "TrusTerminator" to assist you when terminating a trust. The standard price for TrusTerminator is $3,990.

11. For more information on this program contact Clark Boardman at 800-336-6365.

12. For more information contact RIA at 800-346-7377 or visit their Web site at http:\\www.riatax.com.

13. For more information contact Attorneys' Computer Network, Inc. 415 Marlboro Road, Kenneth Square, PA 19348 610-347-1500 or visit their Web site at http:\\www.draftinglib.com.

14. Another engine to consider is EP Expert. Supra n. 7.

15. For more information contact InterActive Program Software, 11 Piedmont Center, Suite 806, Atlanta Georgia 30305; 800-364-24189 or 404-262-2340 (fax) or visit their Web site at http://www.fastdraft.com.

16. For more information contact Expert-Text, 144 Front Street West, Ste. 460, Toronto, Ontario Canada M5J 2L7; 800-387-2625.

17. For more information contact Easy Soft, Inc. 475 Watchung Avenue, Watchung, NJ 07060; 908-754-SOFT (7638).

18. For more information contact AtLaw Software at 800-828-5154 or visit their Web site at http:\\www.atlaw.com.

19. We did not review the Network's Net Plan software. Infra n. 9.

20. For information contact National Network of Estate Planning Attorneys at 410-17th, Ste. 1260, Denver, Colorado 80202; 303-446-6100 or 303-446-6100 (fax) or visit their Web site at http:\\www.netplanning.com.

21. We did not review the Academy's software. Infra n.8.

22. For more information contact American Academy of Estate Planning Attorneys at 800-846-1555 or visit their Web site at http:\\www.aaepa.com.

23. Or hurt them.

How to Avoid Losing your License

On The Information

Superhighway

Ethical Issues Raised by the Use of the Internet in the Practice of Law

by Kurt Metzmeier and Shaun Esposito

The last three years have seen a revolution in the way that Americans communicate with each other, entertain themselves, and research purchases and services. Millions of Americans have learned how to negotiate the expanding byways of the information superhighway. One of the most popular uses of the network of computers, collectively known as the Internet, is the transfer of written messages. Electronic mail, or email, is increasingly employed in the practice of law by small and large firms alike. A recent survey by the ABA's legal technology research center showed that 64% of responding small law firms reported using the Internet in 1997, up from 38% just one year earlier.[1] Some 54% of the respondents used email to communicate with colleagues, and 41% employed the Internet to communicate with clients.

Almost as popular as email is the use of the world-wide web.[2] The same ABA study found that most large firms have invested in Internet development: A majority of the larger firms had firm web pages; 60% of those who did not have pages planned to create one in the near future.[3] The ubiquitous web address has become as essential to American business as the toll-free number and the yellow page ad. The challenge for attorneys is to incorporate these new communication technologies into their practices without compromising the interests of their clients or falling afoul of the rules of professional ethics.

Using Email in the Practice of Law

The increasing use of email by law firms, as well as lingering doubts over the security of the Internet, has raised questions about whether the responsibility of lawyers to protect the confidentiality of client information is being unwittingly violated by the use of email to communicate with clients.[4] Although the Kentucky bar has not yet visited the issue, the initial ethics opinions from other states have been mixed. Advisory boards in Iowa and South Carolina concluded early on that either encryption or the explicit consent of the client would be required to shield an attorney from ethics liability. The Illinois bar, on the other hand, has taken the position that, because the likelihood of the interception of email is comparable to traditional communications and is heavily prohibited by federal law, no special protections are required. The split between these ethics advisory committees can, to a large degree, be explained by the varying degree of understanding that these bodies have of the technical processes involved in electronic communication over the Internet.

The increased use of email listservs and discussion groups has caused commentators to question whether the participation of attorneys in these forums is a form of advertising, or if it is more analogous to the participation of lawyers in public interest programs broadcast on radio and television.

How Email on the Internet Works

The Internet is, at its most basic level, a loosely interwoven network of computers connected by telephone lines that, by use of a variety of accepted rules, or protocols, can be used to exchange information. It was reportedly designed by the defense establishment to withstand a nuclear war on the idea that an open network of computers, each able to pick up the tasks of another, would be better able to adapt to the loss of component parts than a closed network.[5] The transfer of messages from one computer account owner to another was one of the earliest uses of the Internet.

One relevant characteristic of email over the Internet is that the path of a particular piece of email is unpredictable. Instead of being transferred whole from the sender to the recipient, each email document is broken up by the sender's host computer into small "packets" of data, each roughly the size of a paragraph. Each packet is then sent out onto the Internet and passed from computer to computer in a path determined by which computer is least busy at that millisecond. The packets are then reassembled by the recipient's host computer where the message remains until accessed and deleted by the recipient.[6] The architecture of the Internet makes it extremely difficult to intercept a particular piece of email while the packets are on their journey. In fact, the majority of Internet email security breaches occur not on the Internet itself, but rather when a hacker gains access to the recipient's host computer or when a system administrator abuses his or her legitimate access rights. Tampering with electronic mail is a federal offense under the Electronic Communications Privacy Act and anyone who violates the ECPA risks both criminal and civil sanctions.[7]

Protecting Client Confidentiality

Neither Rule 1.6 of the Rules of Professional Conduct adopted by the Kentucky Supreme Court, nor the official Comments, explicitly provide guidance on the technical means used by lawyers to communicate with clients and share confidential client information with colleagues. The text of Rule 1.6 itself indicates only that "A lawyer shall not reveal information relating to the representation of a client unless the client consents after consultation . . . " By implication, the rule has been found to impose a responsibility on an attorney to prevent the inadvertent publication of client information,[8] but there are currently no formal or informal ABA opinions or Kentucky formal ethics opinions that discuss the issue of email confidentiality. For guidance, the Kentucky lawyer must turn to the admittedly mixed message conveyed by the advisory bodies of other states that have examined the issue.

One of the first state ethics bodies to take up the issue of the ethics of email communication was the South Carolina bar. In a 1995 opinion, the South Carolina Ethics Advisory Committee determined that "the confidentiality requirements of Rule 1.6 are implicated by any confidential communication which occurs across electronic media, absent express waiver by the client."[9] The committee found what it believed was a cogent analogy to email communications in cellular telephony and noted three state ethics advisory opinions barring the use of cellular telephones to communicate confidential client information without that client's consent.[10] Ignoring the possibility that perhaps another wire-based means of communications, like ordinary telephony, was more analogous than the cellular technology, which broadcasts

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Kurt X. Metzmeier is a graduate of the University of Louisville School of Law and a member of the Kentucky Bar since 1995. He is currently the Coordinator of Information Systems Services at the University of Kentucky College of Law, where he is responsible for integrating technology into the teaching of the law and for instructing students in the use of electronic resources in the practice of law. Metzmeier has an upcoming article appearing in the Kentucky Law Journal that analyzes the current and future state of Internet legal resources in Kentucky.

signals over the air, the advisory committee found:

> "Thus, it is the opinion of the committee that unless certainty can be obtained regarding the confidentiality of communications via electronic media, that representation of a client, or communication with a client, via electronic media, may violate Rule 1.6, absent an express waiver by the client."[11]

The South Carolina opinion was followed in May 16, 1996 by a formal opinion of the ethics committee of the Iowa bar association that advised that: "Pure inter-exchange of information or legal information with clients [need not conform to advertising rules], but sensitive material must be encrypted to avoid violation of DR4-101 . . . "[12] Apparently the ruling was later found to be too restrictive and was slightly revised three months later in an August 29, 1996 opinion:

> "[I]f sensitive material is to be transmitted via e-mail, the lawyer must have written acknowledgment by client of the risk of the violation of Rule 4-101 [i.e. client confidentiality] and obtain consent for the communication via Internet or non-secure Intranet or other forms of proprietary networks. Otherwise the communication must be encrypted or protected by a password/firewall or other generally accepted equivalent security system. Opinion 95-30 is rescinded."[13]

The Iowa body did not go into its rationale in requiring either encryption or explicit consent, but it was no doubt influenced by the perception that email communication was somehow less safe than traditional forms of communication such as fax, telephone, courier and ordinary mail. The implicit assumption of the South Carolina and Iowa opinions was that email communication is inherently so unsafe as to require an assurance of "certainty" regarding confidentiality not required for other means of communication. Under this theory, only encryption or explicit waiver could satisfy Rule 1.6.

In stark contrast with the initial response of the South Carolina and Iowa ethics bodies (both of which later revised their opinions), the Illinois State Bar Association, in an intelligent and well-reasoned advisory opinion, found that attorneys may communicate with clients using ordinary, unencrypted email, unless unusual circumstances dictated otherwise.[14] The Illinois committee began its opinion by noting the implied duty of lawyers to prevent the inadvertent publication of confidential client information, and recalled its opinion barring the transmission of client secrets over cordless and mobile telephones because of the susceptibility of that medium to interception. It then briefly discussed the opinions of the Iowa and South Carolina bodies, but decided those opinions were in error. The committee noted that "courts and ethics committees have uniformly held that persons using ordinary phones for confidential communications have a reasonable expectation of privacy. The three common types of electronic mail messages appear no less secure."[15] The committee then examined three common types of email, finding them more analogous to wire-based telephony than over the air cellular and wireless technologies. The committee admitted that dishonest persons could intercept email at a host machine, but that same type of threat could occur using ordinary telephonic communication, and that, in each case, the Electronic Communications Privacy Act[16] made criminal such activities: "The committee does not believe that the possibility for illegal interception by the personnel of an ISP (Internet Service Provider) makes it unreasonable to expect privacy of the message."[17] The Illinois committee thus found:

> "In summary, the Committee concludes that because (1) the expectation of privacy for electronic mail is no less reasonable than the expectation of privacy for ordinary telephone calls, and (2) the unauthorized interception of an electronic message subject to the ECPA is illegal, a lawyer does not violate Rule 1.6 by communicating with a client using electronic mail services, including the Internet, without encryption. Nor is it necessary, as some commentators have suggested, to seek specific client consent to the use of unencrypted email. The committee recognizes that there may be unusual circumstances involving an extraordinarily sensitive matter that might require enhanced security measures like encryption. These situations would, however, be of the nature that ordinary telephones and other normal means of communication would also be deemed inadequate."[18]

Since the Illinois decision, those state ethics bodies examining the issue of client communications via electronic mail have generally avoided requiring encryption or written waivers in all circumstances.[19] Recently, both Iowa and South Carolina have revised their previous opinions to allow greater freedom for unencrypted email.[20] Iowa shifted ground slightly to require a written waiver from the client, but South Carolina turned full circle recognizing a "reasonable expectation of privacy" in email communications that satisfied Rule 1.6.[21] North Dakota, the latest state to take up the issue, refused to require encryption for "routine matters with clients, and/or other lawyers jointly representing clients."[22]

So, Should a Kentucky Lawyer Avoid Email?

Although it is clear that recent decisions by ethics committees in other states indicate a strong trend toward the view that routine email communications are as safe as other ways attorneys maintain contact with clients, the absence of a state advisory opinion leaves a lawyer in Kentucky that chooses to use email with the legitimate fear that he or she will be second-guessed down the road. Some attorneys have decided to avoid the issue by refusing to use email, but the prevalence of email use makes this a short-term solution for most lawyers. Increasingly, potential clients will expect and, in many cases demand, the opportunity to communicate with their lawyer by email. Attorney's Liability Assurance Society (ALAS), a large attorney malpractice insurance firm, has carefully examined the issue and perhaps offers the soundest course. The ALAS insists that it is not necessary for its insured attorneys to encrypt ordinary client communications over the Internet to protect confidences. Nonetheless, it urges its clients to use "great caution" because of the possibility that courts and ethics committees "will be tempted to bypass a careful analysis" and hold that unencrypted email "either violates ethics rules or waives the [attorney-client] privilege."[23] Until the KBA offers any guidance on email communication, the prudent lawyer wishing to use email to communicate with his client should seek the client's written consent and perhaps investigate one of the email packages that includes encryption. Fortunately, several easy-to-use email packages with encryption capabilities are now beginning to enter the market.[24]

Solicitation by Email

Persons using email often subscribe to interactive discussion groups and listservs. Listservs or discussion groups are independently organized electronic forums where participants "post" email messages concerning the discussion topic around which the listserv or group has been organized. The participation by attorneys in public electronic forums may implicate ethics rules concerning advertisement and solicitation, especially when the topic of discussion explicitly involves legal issues. The Kentucky Rules of Professional Conduct regulate the way a Kentucky lawyer can broadcast information about his or her practice to the general public. There are specific rules concerning advertisements, direct and indirect solicitation, professional cards, telephone listings, announcements, signs, and letterheads. There is no discussion of the participation of lawyers on electronic discussion groups or listservs. However, Rule 7.02 which defines an advertisement, also notes exceptions to the advertising rules that are relevant to the activities of lawyers on listservs and online discussion groups. Rule 7.02(1)(f) states that:

> "Any communication by a lawyer to third parties that is published or broadcast by a third party who is not in any way controlled by the lawyer, and for which publication or broadcast the lawyer pays no consideration, shall be exempt from all the provisions of these Rules except Rule 7.10 [Rule 7.10 bars "false, deceptive or misleading communication about the lawyer or the lawyer's service"]."

The rule seems to indicate that ordinary postings by an attorney to a listserv or discussion group would not be subject to advertising and solicitation rules so long as the group was independent of the lawyer and the lawyer not pay to post his message. However, if the posting did not flow from the topic of the group and/or explicitly solicited clients, this narrow exemption would likely not apply. Four KBA formal ethics opinions relating to other media seem to support this theory. In Opinion KBA E-50, the committee said an attorney could appear on a commercially sponsored radio program in a "public service context" to discuss legal problems involved in real estate transactions. In Opinion KBA E-78, an attorney was allowed to write a series of articles for a local newspaper discussing probate and estate law. In 1975, a local bar association was allowed to place a series of articles in newspapers on legal issues by Opinion KBA E-110. Finally, Opinion KBA E-270 allowed a local bar association to sponsor a television show and allowed lawyers to participate. A number of states have also explicitly allowed the participation of attorneys in email discussion groups, so long as their participation does not cross over from discussion to solicitation,[25] but others have found it to be subject to rules regulating advertisements.[26]

A few additional cautionary notes for attorneys using email. When using listservs and other electronic forums, lawyers need to be cautious that their replies are made publicly to the listserv, not privately to individuals. Answering questions "off-list" could inadvertently establish an attorney-client relationship or lead to a charge that the attorney is practicing law in a state where he or she is not licensed. Also, attorneys should take every means to ensure that email is properly addressed. Finally, lawyers must take care that their firm's technical support staff[27] and email service provider are competent and trustworthy.

Advertising on the World-Wide Web

An information explosion in the last few years has changed the Internet from a scholarly back road to a major marketplace for information, ideas and products. The web provides the opportunity for those using it to obtain graphically rich and visually appealing information with the click of a mouse. A major part of the web now deals with the marketing of products and services. Businesses ranging from auto dealers to book sellers have set up stalls on the information superhighway. Given these marketing opportunities, it is not surprising that lawyers have begun to promote themselves and market their services in this new marketplace.[28] The marketing of lawyers' services naturally raises questions of the propriety of lawyer advertising and the ethical questions inherent in such activity. Kentucky's rules on lawyer advertising make no specific reference to the web, but a number of other states have issued rules regarding this issue that may be instructive.

Basic Mechanics of the Web

Information on the web is provided through specific locations on the Internet known as home pages. Attorneys using the web for marketing will have a home page with a unique address. That address, known as an URL (Uniform Resource Locator) follows a standard naming convention that typically begins with http://www. and includes the name of the host computer and ends with a three-letter code that indicates whether the site is educational, governmental or commercial. Information consumers view these home pages through the use of a web browser, such as Netscape Navigator or Microsoft Internet Explorer. An interested person might reach the site by typing a known URL directly into the browser, or by "hyper linking" to it by clicking on a link to that site in another home page. Several web search engines also provide access to specific pages in response to a search query entered by the person seeking information. On a web browser the pages display in a graphical mode providing colorful packaging for the information conveyed. The underlying program language for a web page, Hypertext Markup Language (HTML) looks like gibberish to most web users, but provides a wealth of information about the home page creator's desired audience.

Attorney Web Pages As Advertising

Kentucky provides no specific guidance on whether attorney home pages fall under the general rules of attorney advertising. An examination of the rules dealing with lawyer advertising would seem to include this type of communication within their scope. Concerning applicability of the rules, Kentucky Rule of Professional Conduct 7.01 states that the rule "shall apply to advertisements related to or concerning legal services . . . " Under the definitions provided in Rule 7.02, "advertise or advertisement means to furnish any written, printed or broadcast information or any other communication containing an attorney's name or other identifying information" [with certain exceptions]. These provisions seem to strongly imply that Kentucky's rules cover web-based marketing. Few states' rules provide explicit mention of the web- or computer-based activities, but the ethics committees of a number of state bars have provided guidance through ethics opinions or commentaries.[29]

Reporting Requirements As Applied to Web Advertising

Kentucky Rule of Professional Conduct 7.05 provides the procedural mechanism required of all attorneys wishing to advertise. In particular, section 7.05(1)(b) requires that "simultaneously with the publication of any advertisement under this subsection, the attorney shall mail to the Commission . . . a copy of the advertisement, or if by radio or television, a fair and accurate representation of the advertisement plus a typed transcript of the words spoken. ... A list of all persons or firms or groups to whom the advertising has been sent shall be maintained in the principal office in Kentucky of the advertising lawyer or firm for a period of two (2) years . . . "

Just what is required of a Kentucky attorney using the web is not clear from this rule. Would a notification of the home page's address (its URL) be enough? What about a printed copy of the home page? And, if so, how much of the home page—the opening screen, or every screen? Some law firms provide a wealth of information on various topics, and providing copies of all this material could become burdensome for both the attorney and the Commission. Nearly every home page provides links to other sites maintained by third parties. Would hard copies of these sites also be necessary? Web pages require constant updating and changing. Are Kentucky attorneys under a continuing duty to disclose any changes to the web page by providing additional hard copies of the whole web site or just the changes? Do any changes trigger the reporting requirement or just material ones, and if so, what is a material change?

While Kentucky has remained silent on these points, other states have offered some guidance to attorneys attempting to comply with these type of requirements. Florida's Bar Ethics Department advised that a hard copy must be filed with the department, as well as a statement explaining when and where it will appear.[30] Although Florida provides some guidance with this bit of advice, it still provides little insight into the amount of material that must be filed. And, the advice seems to be ignorant of how the web is used. Any web user anywhere could view the page with the click of a mouse. It would be impossible for an attorney to know who will view the page. Texas has provided more guidance on the amount of material to be filed, limiting it to the first page viewed and any subsequent screens primarily dealing with client solicitation.[31] Iowa has also provided that the first screen and biographical screens must contain required disclosures.[32] Recently, the Utah State Bar Ethics Advisory Opinion Committee advised attorneys to keep copies of all pages of the web site (not just the initial home page) for the required two year period.[33] Recognizing that web pages are frequently updated, the Committee approved the retention of electronic rather than hard copies of the changes to web pages. The North Carolina Bar's Ethics Committee, also recognizing the frequency of web page updates, requires hard copies be retained only of any "material changes in format or content" to the original pages.[34]

Jurisdiction and Choice of Law on the World-Wide Web

By its very nature, the web spans the globe; it is, after all, the world-wide web. Thus, persons anywhere in this country or around the world might access a given home page. This raises troublesome questions for both the advertising attorney and the bar's governing ethical body. Which state's ethical rules apply: the attorney's home state, or any state where someone can access the home page?[35] Must an attorney licensed in more than one state meet requirements in all states in which the attorney is licensed? And for those states where the attorney is not licensed, does contact with potential clients in those states resulting from web pages give rise to unauthorized practice of law problems?[36]

Although no reported cases deal specifically with attorney web advertising, conflicting decisions have been issued by courts concerning jurisdictional issues related to web pages.[37] Many commentators believe that attorneys should list those jurisdictions in which they are admitted to practice, in order to avoid any confusion and to remain consistent with those ethical rules requiring the avoidance of false, deceptive or misleading communications (see Kentucky Rule of Professional Conduct 7.10). Cautious attorneys will at a minimum provide disclaimers about the limits of their practice and provide information about states in which they are licensed to practice. At minimum, attorneys should be certain to comply with the requirements for each state in which they are licensed.[38] Finally, some commentators suggest that the conflicting state rules are so confusing, some national standards need to be developed.[39]

Web Pages As Solicitation

For the most part, states examining the topic consider web home pages with proper disclaimers to be akin to advertising rather than solicitation.[40] Solicitation rules are much stricter than those governing advertising (see Kentucky Rule of Professional Conduct 7.30). By their nature, web pages are viewed only when someone purposely chooses to seek out and view them. This makes a charge of improper solicitation very unlikely. Some commentators, though, have noted that with developing technology, such as interactive web pages, concerns about solicitation might grow.[41] Even now, some have raised concerns about banner advertising (where a firm or company ad will appear, unsolicited, on a web search engine's page following entry of a research query). Additionally, web page creators can put keywords in fields used by Web search engines to determine whether a given site matches the search query entered by the user. Some web page designers "pack" this field with every possible relevant term, many duplicated or triplicated to increase possible hits. If a lawyer uses these tactics this could be held to border on solicitation depending upon the index terms used and how accurately they reflect the contents of the home page.[42]

While existing ethical rules in Kentucky may seem to cover attorneys' activities on the web, the questions raised here, and the activities of the bar governing authorities in several other states, suggest the need for clarification of exactly how these rules apply to web activities. To craft meaningful new rules or commentaries on existing rules, the bar's governing authority must consult those who are knowledgeable about the workings of the web. If rule drafting in the area is left to persons without an understanding of how the web works, more rather than less confusion will likely result.[43]

Conclusion

The information superhighway may be fraught with dangers for attorneys, particularly those who are apt to skirt the rules. Unwary lawyers may risk losing their license for inadvertently betraying client confidences, by soliciting clients on listservs and in chat rooms, or by passing over unclear ethical lines with a flashy web page. Despite these road hazards, attorneys will find that in the very near future a web page will be as essential as a shingle and a yellow page listing, and that clients will insist on using email to communicate with their lawyer, just as they use it to manage their businesses and to stay in touch with their kids. ■

ENDNOTES

1. American Bar Association, Legal Technology Resources Center, *1997 Small Firm Technology Survey* (July, 1997); American Bar Association, Legal Technology Resources Center, *1997 Large Firm Technology Survey* (July, 1997).
2. *Id.*
3. *Id.*
4. *See, generally,* William Freivogel, *Communicating with or About Clients on the Internet; Legal Ethical and Liability Concerns*, 1 ALAS Loss Prevention J. 17 (Jan. 1996).
5. A good description of the origin of the Internet, as well as its current architecture, can be found in Paul Gilstar's New Internet Navigator 19-43 (1995).
6. *Id.* at 19.
7. 18 U.S.C. § 2510 *et seq* (1994).
8. A widely used treatise of legal ethics notes that the "general obligation" under Rule 1.6 "gives rise to a number of duties." Charles W. Wolfram, Modern Legal Ethics §6.7.5 (1986). Among these duties is a duty "to see that the client's interest in full confidentiality of information is adequately protected. Conferences with clients should be arranged to avoid the presence of third parties. ... The lawyer's files should be confidentially maintained, and nonlawyer employees should be instructed, and periodically reminded, to keep all office matters strictly confidential." *Id.* Generally, all client communications, even those that are not "confidences," fall under this general obligation. *See*, KBA E-253 (1981) (committee advised that even the very existence of an attorney-client relationship should be held confidential).
9. S. C. Ethics Advisory Op. 94-27 (1995). This opinion was substantially revised in 1997 to allow unencrypted lawyer-client email communications. S. C. Ethics Advisory Op. 97-08 (1997).
10. Mass. Advisory Op. 94-5 (1994); N.Y.City Advisory Op.1994-11 (1994); N. H. Advisory Op. 1991-92/6 (1991).
11. S. C. Ethics Advisory Op. 94-27 (1995).
12. Iowa Formal Op. 95-30 (1996)
13. Iowa Formal Op. 96-1 (1996). The Iowa bar group further amended its opinion by adding the following language:

    III. Pure exchange of information with clients is an exception to Division I of this opinion, but with sensitive material to be transmitted on email counsel must have written acknowledgment by client of the risk of violation of DR 4-101 which acknowledgment includes consent for communication thereof on the Internet or non-secure Intranet or other forms of proprietary networks to be protected as agreed between counsel and client.

    Iowa Formal Op. 97-1 (1997) Iowa attorney David A. Hirsch, whose appeal of 96-1 prompted the revision, argues that this "revision" only stated explicitly what was implied in its prior decision and, by adding the undefined phrase "sensitive materials" muddled the issue even further. Listserv discussion on legalethics-1@lawlib.wuacc.edu listserv (October 22-25, 1997).
14. Ill. State Bar Assoc. 96-10 (1996).
15. *Id.*
16. 18 U.S.C. §§ 2510-2520 (1998). The ECPA also makes any illegally intercepted communication inadmissible as evidence in any "trial, hearing or other proceeding" held under the authority of "the United States, a State, or a political subdivision thereof." 18 U.S.C. § 2515 (1998).
17. Ill. State Bar Assoc. 96-10 (1996).
18. *Id.*
19. Pa. [Informal] Op. 97-130 (1997); Mass. Bar Assoc., Inquiry Response No. 1997-T30 (1997). Internet legal ethics commentator Peter Krakaur sees a trend away from encryption that will grow as bar ethics bodies become more educated about the Internet. Peter Krakaur, *E-mail Emancipation*, 1.1 Internet Law Practice News 1 (Oct. 20, 1997).
20. Iowa Formal Op. 97-09 (1997); S. C. Ethics Advisory Op. 97-08 (1997).
21. *Id.*
22. State Bar Assoc. of N. D. Ethics Comm. Op. 97-09 (1997).
23. William Freivogel, *Communicating with or About Clients on the Internet: Legal Ethical and Liability Concerns*. 1 ALAS

Loss Prevention J. 17, 19 (Jan. 1996).

24. One easy means of encryption is available to all attorneys worried about the transfer of confidential information: both Corel WordPerfect or Microsoft Word allow the password protection of documents. An attorney can simply password-protect the document, send it as an email attachment, and transmit the password by other means.
25. Ill. State Bar Assoc. Op. No. 96-10 (1996).
26. S. C. Ethics Advisory Op. 94-27 (1995); Mich. State Bar Comm., Informal Op. RI-276 (1996).
27. Prudent lawyers should treat those persons managing their computers and electronic networks as nonlawyer assistants subject to Rule 5.3 and "should give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to the representation of the client, and should be responsible for their work product." Comment to SCR 3.130, Rule 5.3.
28. For an introduction to web marketing by a couple of savvy lawyers who know how to play by the rules, see Gregory H. Siskind & Timothy J. Moses, The Lawyers Guide to Marketing on the Internet (1996), distributed by the American Bar Association's Law Practice Management section.
29. Most opinions that have considered attorney web marketing consider the pages to be no different than other forms of print and electronic advertising. *See* Pa. Informal Op. 96-17 (determining that "a web page qualifies as 'public media'"); N.Y. Cty. Law. Assn. Comm. Prof. Eth. Op. No. 721 (1997)(determining that web page information is not prohibited by the Code of Professional Responsibility and constitutes advertising); Conn. Bar Assn. Informal Op. 97-29 (finding that "the same rules apply to Internet advertising that apply to advertising in other media"); Mich. Prof. Jud. Eth. Op. RI-276 (1996)(distinguishing among types of internet information and finding that where the user "initiates the contact with the posted information" normal rules concerning advertising, rather than those related to solicitation, apply); Cincinnati Bar Assn. Eth. Prof. Resp. Comm. Op. 96-97-01 (finding that ordinary rules of professional conduct apply to internet sites); Florida Bar Assoc., Standing Comm.on Advertising. Internet Guidelines (1997)(available at the FBA web site: http://www.flabar.org/Regulation/AdReg/adguide.html) (advising that web pages fall under general advertising rules); Iowa Formal Op. 96-1 (1997)(determining that web pages fall under usual advertising rules); Utah Eth. Op. 97-10 (1997)(finding attorney web sites to be a form of advertising).
30. Florida Bar Assoc., Standing Comm.on Advertising. Internet Guidelines (1997). Available at the FBA web site: (http://www.flabar.org/Regulation/AdReg/adguide.html).
31. Texas Disciplinary Rules of Professional Conduct, Part 7, Interpretive Comment 17. For an extensive analysis of this Comment, *see* Mitchel L. Winick, et al, *Attorney Advertising on the Internet: From Arizona to Texas—Regulating Speech on the Cyber-Frontier*, 27 Tex. Tech L. Rev. 1487 (1996).
32. Iowa Formal Op. 96-1 (1997).
33. Utah Eth. Op. 97-10 (1997).
34. North Carolina State Bar Assn. Eth. Comm. Op. 239 (1997).
35. One Iowa ethics opinion has gone so far as to suggest that two distinct, unlinked web sites be maintained, one for Iowans, one for all others. Iowa Formal Op., 96-14 (1997). *But see*, Pa. Informal Op. 96-17 (warning that it may not be possible to comply with all advertising rules throughout the country due to their contradictory requirements).
36. For a discussion of one possible solution to the myriad of interstate problems, see Peter Krakuar, *Internet Advertising: States of Disarray?: Are Uniform Rules a More Practical Solution*, N.Y. Law J. (Sept. 15, 1997). *See also* Kathryn N. Fenton, *Legal Ethics and the Internet*, 11-Sum Antitrust 43 (1997)(discussing unauthorized practice of law issues).
37. In a series of cases dealing with the use of state long-arm statutes and the constitutional limits of personal jurisdiction, conflicting rulings have been handed down. *See* Compuserve, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996)(finding personal jurisdiction appropriate in Ohio over Texas defendant whose only contact had been electronic with Ohio plaintiff Compuserve), *see also* Hall v. Laronde, 56 Cal. App. 4th 1342, 66 Cal. Rptr. 2d 399 (1997)(holding personal jurisdiction appropriate where contacts with California were only electronic) and Telco Communications v. An Apple A Day, 977 F. Supp. 404 (E.D. Va. 1997)(finding personal jurisdiction appropriate under Virginia long-arm statute over Missouri defendant that placed material on web site that allegedly defamed Virginia corporation); *but see* Cybersell v. Cybersell, 130 F.3d 414 (9th Cir. 1997)(holding that mere use of trademark on Internet advertisements by Florida defendant did not establish personal jurisdiction in Arizona); Bensusan Restaurant Corp. v. King, 126 F.3d 25 (2d Cir. 1997)(finding no jurisdiction under New York long arm statute over Missouri defendant where only contact with New York was web advertisement concerning defendant's Missouri establishment).
38. For a handy checklist of ethics considerations related to web advertising, *see* John B. Kennedy, *Legal Advertising and Ethics on the World Wide Web*, N.Y.L.J. S1 col. 5 (1/27/97); *see also* J.T. Westermeier and Leonard T. Nuara, *Ethical Issues for Lawyers On the Internet and World Wide Web*, 14 Computer Lawyer 8 (1997).
39. H. Geoffrey Moulton, Jr., *Federalism and Choice of Law in the Regulation of Legal Ethics*, 82 Minn. L. Rev. 73, 171 (1997)(stating, in regard to internet advertising, "we may have reached the point that effective state-based regulation of lawyer advertising and solicitation is a practical impossibility"); *see also* Peter Krakaur, *Internet Advertising: States of Disarray?: Are Uniform Rules a More Practical Solution*, N.Y. Law J. (Sept. 15, 1997).
40. *See* Mass. Bar Assoc. Op.1997-130 (Advising that not only are attorney web pages not solicitation but they are also not advertising under the rules) and Michigan Ethics Op. RI-276 (1996)(contrasting the posting of a web page with the direct solicitation involved with sending email to specifically targeted potential clients).
41. *See* Kennedy, *supra*, n. 38 (noting the continued development of "push" technology makes web pages much more interactive and much less like a "passive" television or radio advertisement).
42. In its interpretive comment concerning the application of ethics rules to internet activity, *supra* n. 31, the Texas disciplinary body included in its list of examples of activities generally **not** considered to be solicitation the following: questionnaires and survey forms, E-mail and E-mail response forms, online registration for seminars and events, and links to other internet sites.
43. Readers interested in monitoring further developments in this area should consult a new Kentucky legal ethics web page, the result of a joint effort of the Kentucky Bar Association and the University of Kentucky College of Law Library www.uky.edu/Law/kyethics. This site contains the text of recent KBA Ethics Opinions as well as other information of interest to Kentucky practitioners.

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WHAT CURRENT TECHNOLOGY CAN DO TO ASSIST THE ESTATE PLANNING ATTORNEY

**** Estate Administration Software ****

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SECTION I (b)

WHAT CURRENT TECHNOLOGY CAN DO TO ASSIST THE ESTATE PLANNING ATTORNEY
— Estate Administration Software —

TABLE OF CONTENTS

Estate Administration Software

I. INTRODUCTION

What is Estate Administration Software and how can it make my life easier?

Generally, the purpose of such software and applications is to provide accurate, complete and timely information to the court, the client and the government.

For many years, PNC Bank's tax and estate administration areas have been enjoying the efficiencies achieved by utilizing estate administration software. We have found that there are three main areas that can significantly benefit from the use of software; 1) asset valuation, 2) fiduciary accounting and 3) death tax return preparation.

OBJECTIVE: **The objective of this outline is to provide a broad overview of the various types of software available to the estate administrator within these defined areas.**

II. ASSET VALUATION

A. Introduction

Trying to manually value securities as of a decedent's date of death can be a trying experience. If the security is even remotely exotic you may have to go through some pretty extreme mathematical contortions. With the use of estate valuation software it is no longer necessary to go sifting through old editions of The Wall Street Journal, S&P's Dividend Record and Capital Changes reports. We use a software product called **EstateVal** which allows us to efficiently value all types of traded securities.

1. Importance of Valuation

The importance of an accurate estate valuation can not be overstated. Date of death values are necessary to step up the basis in estate property and to accurately determine death taxes, including the calculation of the marital and charitable deduction. To this end, EstateVal does an excellent job of valuing all kinds of securities. Moreover, the program includes accrued interest and dividends as of date of death.

B. <u>How It Works</u>

1. EstateVal software comes in many forms. There are packages for both DOS and Windows formats. However, it is necessary that your computer have a modem.

2. To produce valuations, the user must first enter some preliminary data about the decedent; namely date of death. Thereafter, all that is needed for an accurate valuation is the security's CUSIP # and the quantity owned.

3. EstateVal can successfully value all of the following traded securities: Equities, Municipal Bonds, Mutual Funds, Savings Bonds, Corporate and government Bonds, GNMA's, FNMA's, FHLMC's, CMO's, UIT's, and US. Treasuries.

4. While much legal software charges by the amount of time the user is "on-line," EstateVal charges by the security.

5. EstateVal allows you to generate four different kinds of security valuation reports. Date of Death, Alternate Date, and Distribution Date reports pertain to an estate valuation.

   a. Date of Death reports provide the following information: Security Descriptions, Accrual interest/dividend, Total Security Values, Total Portfolio Value; and Mean Pricing.

   b. Date of Death reports provide mean pricing on the valuation date when actual trades are available. If trades are not available on the valuation date, EstateVal searches forward and backward in time, for a reasonable period, for trade dates.

   c. If actual trades are not available within a reasonable period of time, ask and bid prices are retrieved either on the valuation day if available, or most recent and next prices if not.

C. <u>The IRS Uses EstateVal</u>

EstateVal has recently signed a five-year contract with the Internal Revenue Service to provide "on-line" automated valuation services for estate and gift tax returns. Estate Val will be used to verify all audited Form 706 Estate Tax Returns through year 2003. The contract covers all IRS offices.

III. FIDUCIARY ACCOUNTING

A. Introduction

Fiduciary Accounting can be challenging because of the need to differentiate between income and principal postings. Income in respect of a decedent, intangible tax refunds and may other items can make the books of an estate less than a model of clarity. Unfortunately, your clients and possibly the court all want to see the receipts and disbursements of the estate set forth in an accurate and easy to understand format.

B. Software For All Types of Administrators

Throughout the pages of periodicals such as Trusts & Estates there are several advertisements for various types of fiduciary accounting software. Generally, this type of software falls into two categories; mainframe and PC based.

1. The mainframe, multiple-user products are geared towards large institutional trust departments.

   i. Fiduciary accounting software allows each user to closely monitor the income and principal postings in each estate.

   ii. At the end of the month, statements are generated from the system which list all postings and include an asset summary. Various other statements can be produced, allowing some degree of customization.

   iii. Such mainframe accounting systems are most commonly used by financial institutions and have the added benefit of expediting the preparation of fiduciary tax returns and K-1's.

2. The PC based products, more thoroughly discussed in Section V of this outline, are geared more toward accounting firms, law firms and the individual serving as a fiduciary. This type of software is generally installed on only a few computers in the office. One benefit is that software of this nature allows the user to highly specialize their fiduciary accounting system. It is also easier to update PC based software because the update only needs to be installed on a few computers.

C. The Benefits of Fiduciary Accounting Software

1. Organization - Using software provides a common database where all receipts and disbursements can be easily recorded and retrieved. Most software will allow you to produce reports that can group various activities within the estate (i.e. all principal receipts, all income disbursements, all medical bills paid).

2. Efficiency - Recent activity within the estate can be easily retrieved to instantly provide information.

3. Presentation - Reports generated from most fiduciary accounting software are very professional looking and can go straight from printer to envelope.

IV. TAX PREPARATION

A. Introduction

One of the major responsibilities of a personal representative is the preparation and filing of death tax returns and fiduciary income tax returns. Typically, the most time consuming responsibility of the estate administrator is preparing and analyzing these returns. Luckily, it is also an area that benefits from technology. The following lists just a few items which are challenging to calculate manually, but can be done with software at the "touch of a button," and virtually eliminates the potential for mathematical errors assuming, of course, the correct data was input.

1. Fiduciary Return Preparation - Use software to tally interest and dividends, to calculate distributable net income ("DNI"), the corresponding income distribution deduction and to navigate the most confusing Schedule D in income tax history!

2. Death Tax Return - Use software to tally the schedules for the gross estate and corresponding deductions. Use it to figure the new unified credit, the credit for state death taxes and the total tax due. Most death tax software can even apply Applicable Federal Rates and IRS Actuarial Tables to determine remainder interests for the charitable deduction.

B. Different Types of Software

1. General Tax Software - Some packages, such as **CCH's "ProSystems"** can produce the whole range of income and transfer tax returns. This includes returns not only for estates and trusts, but also individuals, corporations partnerships and tax-exempt organizations. However, CCH can tailor your ProSystems package to provide only those applications needed by your office. Apart from basic tax return preparation, there are other reasons ProSystems stands out:

    a. Forms Access - How many times have you needed one form SS-4 to obtain a Tax ID number for an estate? With CCH, you have the ability to access and print miscellaneous forms, such as W-9's, Form 56 and SS-4, as they are needed.

    b. Organizers and ProForma's - Once a taxpayer has been setup in ProSystems, it is possible to produce Tax Organizers and ProForma's to aid in the return preparation.

        i. The organizer generally follows the 706 or 1041 schedules and allows the preparer to gather all the pertinent information in one place. Then it is transformed to the ProForma.

        ii. The ProForma mirrors the "on-screen" menu of a ProSystems taxpayer. By transferring the organizer to the ProForma, the actual data entry can be delegated.

    c. A Word About the Kentucky Inheritance Tax Form - ProSystems, like other companies, does not offer software that will produce a completed Kentucky Inheritance Tax Return. That is, all the beneficiary classifications, applicable tax calculations and discounts must still be done by hand or self designed software programs. CCH does offer a blank on-screen Kentucky Inheritance Tax Form the fields of which must be manually populated.

2. Death Tax Specific Software - At PNC, the professionals who specialize in the preparation of death tax returns are very fond of using **West Group's "Federal Estate Tax Returns"** ("FET"). FET is software that is specific to Form 706 and is, therefore, a littler more streamlined than ProSystems.

    a. How it works - Currently FET is a DOS based program. However, I understand that in the fall of this year, West will be releasing a Windows version that will also contain the recent legislative changes.

b. Pro's and Con's

i. Pro's - Our tax specialists like FET because it allows the user to really micro-manage the return. Unlike ProSystems, which has very rigid data entry criteria, you can enter information in FET anywhere you want on the return as if you were writing on it. In this manner, FET is considered by some to be more "user friendly."

ii. Con's - The obvious drawback to FET is that you are limited only to the preparation of Form 706 returns.

V. TYING IT ALL TOGETHER

A. Introduction

While those who have the latest in software technology often boast about increased efficiency, they may have in fact gained very little at the cost of much hardrive space. This phenomenon occurs when people do not use software effectively. There are two easy ways you can maximize effectiveness with Estate administration software. The first, is through importing and exporting information from one application to another. The next way to increase effectiveness is by purchasing software packages that "Do it all."

B. Import and Export

The best example of this is with asset valuation and death tax return preparation.

1. If a decedent dies with a large portfolio of securities, entering that information into the computer can be a very long process; especially if it must be entered first into EstateVal and then into FET.

2. However, through the application of an export format, the two programs can communicate and share the same information. Information entered into EstateVal can be transported to FET. Thus, the data entry time is cut in half.

C. "Do It All" Software

This type of all-inclusive software, often used by law firms, provides nearly one-stop shopping for the estate administrator.

1. These packages provide fiduciary accounting, federal estate tax return preparation, fiduciary income tax return information, checklists, ticklers and administrative reports all wound into one application.

2. Data has only to be entered once and it is automatically carried to all necessary schedules. This eliminates hours of duplicated work, therefore maximizing your time.

3. Two very popular companies offering all-inclusive software are **"ProBATE Software"** and **"ZANE."**

    a. ProBATE Software - This company touts an all-inclusive, windows based package that is extremely user friendly. The data entry screens are almost identical and the tax screens resemble IRS forms. According to the company, this type of formatting greatly reduces the learning curve and increases efficiency.

    b. ZANE - According to ZANE, their clients report a 50% to 80% time savings by the use of their "fully integrated" software. The company points out that their program is not an accounting program. Rather, it is dedicated to keeping principal and income cash flow and inventory records specific to trust and estate accounting. This design philosophy is supposed to facilitate the ease of use for its dedicated purpose.

        i. Also of interest is that ZANE Software keeps track of time applied to its use both by user and by client account. Therefore, creating billable hour reports is simplified and may be generated on demand, by either client account or by user.

VI. CONCLUSION

Hopefully, with this brief overview the reader will see the benefits technology can bring to the estate administration process, particularly with respect to valuation of securities, automated estate accounting and tax return preparation. While this outline reviews only those programs or applications currently used by the writers, a more comprehensive list of available software is attached.

ATTACHMENT

Estate Valuations & Pricing Systems, Inc.
5855 Topanga Canyon Boulevard, Suite 520
Woodland Hills, CA 91367
1-800-237-3440
www.evpsys.com

HWA International
Trust Accounting Software
1-800-328-8661

CLR FAST-TAX/Omega
2395 Midway Road
Carrollton, Texas 75006
1-800 FAST-TAX, Ext. 8778

AM HORIZON
Trust Management Software For Windows
1-800-786-5168

ProSystems
1577 Parsons Place, Suite 2
Louisville, KY 40205
1-888-CCH-REPS Ext. 1065
www.prosystemfx.com

BNA Software
BNA 709 & 706 Preparer
Tax Management, Inc.
1-800-372-1033

U.S. Trust
The UST 706/709 System
Contact: Nicole S. Splitter, V.P.
(212) 852-3564

ProBATE Software
1990 59th Avenue, Suite E
Greely, CO 80635
www.probate-software.com

ZANE
130 West White Horse Pike
Berlin, New Jersey 08009
1-800-331-2533
email: lou@zanenet.com

TAX AND ESTATE PLANNING CONSIDERATIONS

IN MULTIPLE MARRIAGES

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SECTION J

TAX AND ESTATE PLANNING CONSIDERATIONS IN MULTIPLE MARRIAGES

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TAX AND ESTATE PLANNING CONSIDERATIONS

in

MULTIPLE MARRIAGES

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I. INTRODUCTORY COMMENTS AND GENERAL DISCUSSION OF AFFECTED INDIVIDUALS

II. PROPERTY AGREEMENTS

A. Antenuptial Agreements

1. Purpose

a. Protection at Death. Used to effect a transfer of property at time of marriage or death and to protect the rights of the spouses at time of death. Kentucky has long recognized the validity of these contracts. ***Gaines v. Gaines***, 163 Ky. 260, 173 S.W. 774 (1915).

b. Protection upon Divorce. Provisions relating to property payments or division upon divorce in Kentucky were originally considered void and unenforceable as being violative of public policy. ***Stratton v. Wilson***, 170 Ky. 61, 185 S.W. 522 (1916).

c. Recent Kentucky Cases.

(1) ***Gentry v. Gentry***, 798 S.W.2d 928 (Ky. 1990). In ***Gentry***, the husband and wife entered into an antenuptial agreement whereby they each renounced any and all right, title and interest in any property of the others. There was full disclosure and, at the time of the agreement, H's net worth was approximately $1,500,000 and W's was nominal. The contract provided that one of its purposes was to prevent any claim to the estate of the other upon his or her death.

(a) **Question of Intent.** The Court held that the agreement was intended to be applicable at time of divorce as well as death even though the language at the end of the contract made reference to the death of the parties. Previous language made it clear that it intended to be applied at time of divorce.

(b) **Public Policy Issue.** The Court cited recent decisions in other states where the underlying public policy issue had been reexamined and where it had been held to no longer prohibit antenuptial contracts becoming effective at time of divorce. Based on these changes, the Court reexamined ***Stratton***. The Court noted that in ***Jackson v. Jackson***, 614 S.W.2d 942 (Ky. 1981), it had acknowledged doubts about the continued validity of ***Stratton***. In ***Jackson***, it distinguished ***Stratton*** and upheld the application of an antenuptial contract in a divorce where the agreement provided that the husband would furnish "decent support" for the wife during his life. In ***Gentry***, it was argued that the Kentucky Legislature had intended to codify a public policy approving antenuptial contracts fixing rights at divorce when it adopted the Uniform Dissolution of Marriage Act in 1972 by defining "marital property" to omit any property excluded by valid agreement of the parties. KRS 403.190

(2)(d). The Court disagreed that this constituted a specific intent to approve such agreements but felt the Legislature "was responding to significant changes in the expectations of parties to the marital contract and in the attitude of society toward divorce." Id. at 934. In light of such changes, the Court concluded that ***Stratton*** no longer reflected public policy and to the extent it precluded a premarital contract on such basis, it was overruled. It then held that spouses may define their rights in each other's property and, provided they are otherwise valid contracts, they are entitled to be enforced upon the termination of the marriage by divorce. The Court noted that no provision in the contract purported to waive any claim to both marital property and maintenance although it felt that the trial court had broad discretion to review such agreements for unconscionability and thus adequately protect this interest.

(c) Application to Marital Property. The Court held that by their agreement and the allocation of assets between them, they had effectively excluded any assets acquired subsequent to the marriage from the definition of marital property under KRS 403.190.

(d) Requirements for Valid Contract. The Court listed the following criteria: **(1)** Was the agreement obtained through fraud, duress or mistake, or through misrepresentation or non disclosure of material facts? **(2)** Is the agreement unconscionable? **(3)** Have the facts and circumstances changed since the agreement was executed so as to make its enforcement unfair and unreasonable?

(e) Adequacy of Maintenance. The amount of maintenance must be determined under KRS 403.200(2) and the award thereof is left to the trial court's discretion unless it be abused.

(2) ***Edwardson v. Edwardson,*** 798 S.W.2d 941 (Ky.1990). Decided on the same day as the ***Gentry*** case, the Court arrived at the same conclusion giving effect to antenuptial agreements and upon the same conditions; those being:

(a) the agreement is free from any material omission or misrepresentation;

(b) the agreement must not be unconscionable at the time enforcement is sought; and,

(c) the agreement may apply only to dispositions of property and maintenance and issues of child support, child custody and visitation are beyond the scope of such contracts. One factual difference in ***Edwardson*** was that the wife was seeking to enforce the terms of the agreement whereas in ***Gentry,*** she was arguing against its validity.

2. General Requirements.

a. Must be executed prior to marriage.
b. Should contain a recitation of the consideration.
c. Must be in writing to comply with Statute of Frauds. See KRS 371.010(5).
d. Must be recorded to be effective against a purchaser for a valuable consideration without notice or against a creditor. KRS 382.080.
e. No particular form must be complied with in Kentucky. Check other relevant states to see if they have the Uniform Premarital Agreement Act or expressly require a specific form.
f. Must be a full disclosure of all assets or adequate independent knowledge thereof.

(1) Should use detailed inventory or balance sheets for each spouse.
(2) Issue of undue influence or overreaching if such documents do not exist.
(3) Issue of fraud if there is a gross disparity between the benefits accorded each party.

g. Should specify exactly which rights the parties are waiving as a result of the agreement and what they are receiving in exchange as well as what time.

3. **Advisability of Separate Legal Counsel.** The specific question as to whether an attorney may represent both parties to an antenuptial agreement was given a qualified yes by the KBA's Ethics and Unauthorized Practice Committee in KBA E-290. After discussing the problems of full disclosure, possession of pertinent facts by the attorney which one client is unwilling to disclose, etc., the opinion concluded that ". . . joint representation should be undertaken only if each

party consents to the representation after full disclosure of the potential problems inherent in such representation." It concluded with the admonition that prudent counsel would obtain such consent in writing. A second question as to whether it would be proper for the attorney representing one spouse to talk with the other and answer questions was given a qualified no.

4. **Advisability of Periodic Review**

5. **Specific Applicable Law if Possible**

6. **Revocation.** The destruction of an antenuptial contract with the intent to negate its effectiveness will rescind the agreement. ***Carter v. Carter***, 656 S.W.2d 257 (Ky. App.)

7. **Modification.** Does a modified antenuptial contract become a post-nuptial agreement?

8. **Failure to Destroy a Proposed Agreement.** A California horror story.

B. **Post-Nuptial Agreements**

1. **Purpose**

   a. **Same as with Antenuptial Agreements**

2. **Potential Problems**

   a. **May require greater care in drafting to accomplish the desired result**

III. JOINT AND MUTUAL WILLS

A. Specific Showing of Intent Necessary

1. Statutory Provision. A Contract to make or not to revoke a will, if executed after June 16, 1972, can be established only by:

   a. the terms of the will stating the material provisions of the contract;

   b. an express reference in the will to a contract and extrinsic evidence proving the terms of the contract; or

   c. a writing signed by the decedent evidencing the contract. KRS 394.540(1).

      No presumption of a contract not to revoke a will can be drawn from the execution of a joint will or mutual wills. KRS 394.540(2).

2. Statutory Interpretation. The Kentucky Court of Appeals has held that the statute is so plain, that no reference of a contract can be drawn from joint or mutual wills, that it is not susceptible to any other interpretation. ***Martin v. Cassady***, 628 S.W.2d 888 (Ky. App. 1982).

IV. TAX CONSEQUENCES

A. Income Taxation

1. Timing of Transfers

a. After Marriage

(1) Gain or Loss. Neither gain nor loss will be recognized on a transfer of property from an individual to (or in trust from the benefit of) his or her spouse but only if the transfer to the former spouse is incident to the divorce. IRC 1041 (a).

(a) Nature of the Transfer. According to the House Committee explanation the nonrecognition rule applies regardless of "whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged." Hence, the Federal income tax consequences of such transfer will be uniform even though the property may be subject to different state property laws. Should eliminate thoughts of forum shopping.

(b) Time of Transfer

(1) During Marriage. Applies to transfers of all property during the marriage as well as transfers related to a divorce or ***annulment***. IRC 1041(a)(1).

(2) Incident to Divorce. A transfer is considered incident to the divorce if it occurs within a year after the marriage ceases, or is related to the cessation of the marriage. IRC 1041(c). The relation to the cessation of the marriage rule has no time limits specified in the Code but the Regs. 1.1041(b)(3) provide for a six year rule. Even then, there may be circumstances where the transfer is still considered to "be related to the cessation of the marriage" even though it takes place more than six years after the divorce. An illustration would be the transfer of an asset, such as an interest in a closely held business, where no other buyer could be found within the six years.

(c) **Exception.** The new rule does not apply if the recipient is a non-resident alien. IRC 1041(d).

(2) **Basis of Transferred Property.** Any property so transferred shall be treated as acquired by the transferee spouse by gift with his/her basis being the adjusted basis of the transferor. IRC 1041(b). The usual section (§ 1015) with respect to the determination of the basis of property received by gift is inapplicable to this transfer.

(3) **Drafting to Prevent Inequitable Tax Consequences**

(a) Problems of Rollovers from Prevous Residence under § 1034 after 1997 Tax Act.

(b) Problems of Gains in General.

b. Before Marriage.

(1) **Gain or Loss.** If the transfer occurred prior to marriage, 1041 is inapplicable and the case law represented by ***United States v. Davis***, 370 U.S. 65 (1962) and ***Faird—Es. Sultaneh v. Commissioners***, 160 F.2d 812 (2nd Cir. 1947)

would still be applicable. Hence, the transferor would have gain measured by the difference in the fair market value of the property at the time of the transfer and its adjusted basis. May be able to recognize a loss but this could be accomplished by selling the property to another and have the would-be spouse buy it if he/she wants the property.

(2) Basis of Transferred Property. In the absence of the applicability of 1041, the above cases treat the recipient spouse as having received the property by purchase so his/her basis would be its fair market value at date of transfer. This is done on the assumption that this is the value of the rights given up by the transferee. The logic is totally lacking but that is the holding in the above cases. The error is magnified by the failure to require the transferee to recognize a gain at the time of the receipt.

B. Gift Taxation

1. **Lack of Consideration.** Even though there may be a relinquishment of certain rights for property received under an antenuptial contract, it may be considered as a gift for gift tax purposes because the transfer was for less than an adequate and full consideration in money or money's worth. IRC 2512(b).

a. **Actual Tax Consequences.** The lack of consideration doesn't automatically cause a gift liability because of the annual $10,000 exclusion, IRC 2503(b), and the potential use of the unified credit; IRC 2505.

2. **Use of Marital Deduction.** The above potential gift tax problems can be resolved by making the transfer

subsequent to the marriage and taking advantage of the unlimited gift tax marital deduction. IRC § 2523.

3. **Transfer After Divorce.** A transfer pursuant to an antenuptial agreement after the divorce of **the parties** will trigger the application of § 2512(b).

4. **Certain Property Settlements.** The relinquishment of marital property rights may be considered adequate and full consideration under certain divorce settlements but that is usually of little help in the estate planning arena. IRC 2516. Neither does the required time period normally provide any relief where the antenuptial agreement is triggered by a divorce.

C. **Estate Taxation**

1. **Lack of Consideration.** Except for some transfers relating to property settlements for purposes of divorce, a relinquishment or promised relinquishment of dower or curtsey, or any statutory rights created in lieu thereof shall not be deemed to be a consideration for money or money's worth. IRC 2043(b).

2. **Included in Transferor's Gross Estate.** The property transferred under the antenuptial contract may have to be included in the decedent's gross estate.

3. **Use of Marital Deduction.** If the parties are **still** married at time of the transferor's death, the inclusion of the property in his/her estate may produce no estate tax consequences because of the marital deduction. See IRC 2056 generally.

4. **Use of QTIPs. § 2056(b)(7)**

D. **Consideration of Retirement Equity Act of 1984.**

1. **In General.** Certain retirement plans and death benefits thereunder are automatically paid to the surviving spouse unless they have taken affirmative action to the contrary.

2. **Scope of Coverage.** Applies to all defined benefit and money purchase pension plans but not to profit sharing or stock bonus plans if certain requirements are met. IRC 417.

3. **Effect of Antenuptial Contract** Should comply with requirements of REA with respect to a waiver if parties agree even though there is an antenuptial contract. New contracts should be drafted with REA in mind.

V. OTHER PROBLEM AREAS EVEN WITH AN ANTENUPTIAL CONTRACT

A. Jointly Held Property

1. **Intent of the Parties**

B. Life Insurance Policies

1. **Non-Tax Considerations**

a. Designation of Owner

b. Designation of Beneficiaries and the need for a possible change.

C. Possible Selection of Domicile

D. Will Provisions

1. In particular make sure that the will refers to the existence of the antenuptial agreement.