# Current Estate, Gift, and Income Tax Developments

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# Recent Wealth Transfer Developments[1]





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## 1. Interim Changes and Adjustments

Every year the Treasury Department is required to update certain figures that are indexed for inflation. For year 2013 the indexed figure for

- the annual exclusion increases to $14,000,
- the §6601(j) 2% portion increases to $1,430,000 (a $40,000 increase),
- the §2032A special use value maximum reduction increases to $1,070,000 (a $30,000 increase), and
- the §2523(i)(2) noncitizen spouse annual exclusion increases to $143,000 (a $4,000 increase).

Legislation enacted in December of 2010 indexed the basic exclusion amount for estate and gift tax, and the GST exemption amount — which were $5,120,000 in 2012 – and added portability. Repeal of the sunset provision in the 2001 Act presumably means that these provisions remain as permanent changes to the law. The index figure was not updated by Treasury for 2013 but, on the assumption that indexing will continue, and doing the math using the adjustments noted above, it appears that the $5,120,000 figure from 2012 should rise to $5,250,000 in 2013. Stay tuned regarding an official calculation and confirmation that this assumption is correct.

Looking forward, it appears that the only change advocated by the Obama administration in its 2010 budget proposal that has been effected is that portability does not sunset. The other changes that may be the most likely to be considered if Congress undertakes serious piecemeal tax reform include :

- Amend §2702 to require a minimum 10 year term for any GRAT and require that a remainder interest have a value greater than zero (this would preempt a §2036(a) full-and-adequate-consideration exception and, as a future interest, require the filing of a gift tax return on creation because the annual exclusion cannot apply). With the §7520 rate hovering around an historically low 1.0%, and an effective date for such a change that promises to be prospective only, this is the perfect time to create a GRAT (or a CLAT — the economics being exactly the same), if the assets used to fund the trust are likely to perform at a higher rate than the (February 2013) assumed 1.2% annually.
- Amend §2704 to eliminate certain additional valuation discounts.
- Refine special interest provisions for farmers and small business owners.
- Amend the generation-skipping transfer tax to preclude perpetual tax free dynasty trusts.
- Preclude lapsing *Crummey* withdrawal rights (a §2642(c) "tax vesting" requirement would be easy and sensible but was not one of the three options considered in 2005).
- Restore the §2011 state death tax credit.

## 2. Priority Guidance Plan

Usually the most useful tax guidance from the government is its "business plan," by which the Treasury Department announces projects it intends to pursue during the next year. A good indication of what bothers Treasury is gleaned from inspecting the business plan (and whatever is released in satisfaction of it). In many cycles most items of significance that the Treasury indicated it would provide are issued — but that dramatically did *not* occur between 2008 and 2011. In addition, the 2009-2010 and 2010-2011 plans both were released very late. The 2011-2012 plan was released timely but virtually every item since 2008 had rolled over (some had rolled over from multiple prior years). The 2012-2013 plan reveals that significant progress was made in 2012 and the list was reduced from 17 to only 10 items. But only Item 7 was new for the current plan. Note that making the portability regulations final is *not* on the plan for 2012-2013, and guidance regarding decanting fell off the list.

Those projects that likely are of interest to most estate planners include the following (in the government's own terms, and using their numbering [with my annotations in brackets]):

**GIFTS AND ESTATES AND TRUSTS**

1. Final regulations under section 67 regarding miscellaneous itemized deductions of a trust or estate. Proposed regulations were published on September 7, 2011. [This addresses the *Rudkin/Knight* issue discussed at page 47.]
2. Guidance concerning adjustments to sample charitable remainder trust forms under section 664.
3. Guidance concerning private trust companies under section 671, 2036, 2038, 2041, 2042, 2511, and 2601. [This has rolled over since 2004-2005 and resulted in Notice 2008-63, which is a proposed Rev. Rul. that was published on August 4, 2008 and is reported at page 16.]
4. Regulations under section 1014 regarding uniform basis of charitable remainder trusts. [This likely is a follow up to Notice 2008-99.]
5. Final regulations under section 2032(a) regarding imposition of restrictions on estate assets during the six month valuation period. Proposed regulations were published on November 18, 2011. [Released as a reaction to *Kohler*; the government's primary concern is that taxpayers will try to manipulate value by postmortem creation and funding of FLPs. The proposed regulations are discussed at page 11.]
6. Guidance under section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate. [This is an important follow up to the final §2053 regulations.]
7. Regulations under section 2642 regarding the allocation of GST exemption to a pour-over trust at the end of an ETIP.
8. Final regulations under section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008. [See page 37 regarding the proposed regulations.]
9. Regulations under section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. [This has rolled over since the 2003-2004 plan.].
10. Guidance under section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. [Treasury officials have indicated publicly that this is their highest priority on the list for 2013.]

## 3. Portability

***Proposed and Temporary Portability Regulations.*** Treasury issued proposed and temporary regulations (meaning that they currently apply, with a June 15, 2015 expiration date) that clarify the concept of the §2010(c)(2)(B) and 2010(c)(4) deceased spousal unused exclusion (DSUE) amount and the §2010(c)(5)(A) portability election. Released on June 15, 2012, which was the last possible day for them to be applied retroactively, many positions taken are taxpayer-favorable, making retroactivity a good deed. Generous in unexpected ways, these regulations address the following important concepts (among many others):

1. Because nontaxable estates are not otherwise required to file an estate tax return, Temp. Treas. Reg. §20.2010-2T(a)(2) continues the position previously stated in Notice 2011-82, 2011-1 C.B. 516, that merely filing an estate tax Form 706 for a nontaxable estate constitutes the requisite §2010(c)(5)(A) portability election. And, because nontaxable estates are not otherwise required to file a return, Temp. Treas. Reg. §20.2010-2T(a)(1) declares that the return filing due date (including extensions) for taxable estates applies for these purposes. Finally, Temp. Treas. Reg. §20.2010-2T(a)(4) makes the election by an appointed executor revocable until the return filing due date passes. Thus, the normal 15 month (nine months plus an automatic six month extension, if sought) filing deadline applies, during which an executor can have a change of mind about whether to make the election. The last timely filed return is the one that counts.

2. Notwithstanding that an election normally is not irrevocable until after the filing deadline, Temp. Treas. Reg. §§20.2010-3T(c)(1) and 25.2505-2T(d)(1) provide that the election relates back to the date of the decedent's death. This means that the surviving spouse can use that DSUE amount before the decedent's return is filed, and before the DSUE amount is known with any certainty. Indeed, the amount is subject to audit at any time until the statute of limitation runs out on the surviving spouse's own estate tax return. If transfers of the surviving spouse's wealth will be taxable in any event, then not knowing the ultimate amount of the DSUE should not dissuade transfers that otherwise make sense, and the relation back nature of the election allows the surviving spouse to make use of the portable exclusion long before any administrative or judicial wrangling is completed.

3. A curious question – unanswered by these regulations – is whether the spouses may establish a presumption of survivorship as between themselves that, if honored for state law purposes, would allow the deemed survivor to use the DSUE amount of the spouse who is deemed to die first. This might be attractive planning to permit a wealthy spouse to use a portable exclusion amount from a less wealthy spouse, in a simultaneous death context. The alternative is for the wealthy spouse to presume the less wealthy spouse to survive for marital deduction purposes, make a transfer to that spouse (for example, using a QTIP trust) that ultimately will benefit the same objects of the wealthy spouse's bounty. Either approach could be followed to effectively shelter the less wealthy spouse's unused exclusion amount, and either spouse ought to be able to presume the other to be the survivor for purposes of either the marital deduction or to make a portability election. Arguably the "relation back" regulation accomplishes that objective, but a statement to that effect would be a nice addition when the regulations become final.

4. An election is made by filing a "complete and properly-prepared" Form 706 estate tax return. There is no Form 706EZ – and statements from Treasury officials strongly suggest that there is not likely to be one – notwithstanding passionate calls for simplicity in making the portability election for nontaxable estates. This likely emanates from the fact that §2010(c)(5)(A) requires the filing of an estate tax return, and the government needs certain information to confirm that the marital deduction is properly allowed for property passing to the surviving spouse, and that there is adequate information to compute the DSUE amount.

Nevertheless, these regulations establish a special valuation rule for some property that will qualify for the marital or charitable deduction. Applicable only if no return otherwise is required, and if four stated disqualifications are avoided, then this deductible property need not be formally appraised. Instead, Temp. Treas. Reg. §20.2010-2T(a)(7)(ii)(A) establishes a good faith and due diligence standard by which the estate may estimate the value of property as falling within a specified range (options that are provided on the draft Form 706 for 2012 decedents).

The preamble to these regulations noted that the same standard is applied to determine whether an estate exceeds the filing threshold itself, so the application is new but the concept is not.

This relief from normal valuation procedures is unavailable if any of the following four disqualifications apply:

(a) If the value of the property involved "relates to, affects, or is needed to determine the value passing from the decedent to another recipient." This means that the amount of the marital and charitable bequests cannot be determined by a formula that divides the estate, such as between marital and nonmarital trusts.

(b) If "[l]ess than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property." This means that an intestate estate cannot qualify unless the surviving spouse and charity receive 100% of the decedent's probate estate – which can occur, for example, in states (such as UPC jurisdictions) in which a spousal support allowance comes off the top of an intestate estate and may consume the entire estate. Note, however, that Temp. Treas. Reg. §20.2010-2T(a)(7)(ii)(C) *Example 2* illustrates a probate estate that qualifies for the appraisal exception, notwithstanding life insurance that passes to children outside of probate. In the *Example* the insurance does not escape normal rules to establish its value, but the probate estate does.

(c) If only a partial QTIP election is made, or there is a partial disclaimer, resulting in less than 100% of the entitlement qualifying for the marital or charitable deductions.

(d) If values are needed to determine the estate's qualification for relief under §§2032 (alternate valuation), 2032A (special use valuation), 6166 (deferred payment of estate tax), "or other provision of the Code."

As a practical matter, the non-appraisal regime is likely to be less valuable to estates than it is symbolic that Treasury, acting subject to the §2010(c)(5)(A) mandate that a return must be filed, is seeking to be sensitive to the cost and inconvenience involved in making the portability election. But it does make it possible to leave an "I love you" will that gives everything to the surviving spouse and thus simplify the administrative return filing burden.

5. An impasse may arise if a surviving spouse wants the decedent's estate to make the portability election but the executor is not the spouse and chooses not to do so. This tension is not relieved, because any "appointed" executor's decision governs. But Temp. Treas. Reg. §20.2010-2T(a)(6)(ii) does specify that, if there is no §2203 appointed executor acting, then any person in possession of estate property ("a non-appointed executor") may file a return and make an election, with the first to file having supremacy. Only appointment of a §2203 executor that then timely files a Form 706 can subsequently overcome or reverse this filing. This puts a premium on any race to file and it gives a surviving spouse who is in possession of estate assets one avenue to accomplish postmortem portability planning.

6. The preamble to these regulations specifies that, under Temp. Treas. Reg. §20.2010-2T(c)(1), the DSUE amount determined for the year of the decedent's death is controlling – meaning that there is no DSUE amount "recapture" or "clawback" if the exclusion amount subsequently declines, prior to the surviving spouse's death. That is the correct rule, because a decedent otherwise could have used a nonmarital trust to take advantage of the full exclusion amount in the year of the decedent's death, and avoided inclusion in the surviving spouse's estate. A change in the exclusion amount after such an election is made should not undo the planning option selected, based on the law in effect in the year of the decedent's death.

7. The preamble also stated that §2010(c)(4)(B)(i) contained a mistake, because it referenced the decedent's "basic exclusion amount" instead of the "applicable exclusion amount." This error was noted by the General Explanation to the 2010 legislation (the Bluebook), with a notation that a technical amendment might be needed to repair the statute. ATRA 2012 §101(c)(2) made that technical correction but, even before Congress acted, Temp. Treas. Reg. §§20.2010-1T(d)(4) and 20.2010-2T(c)(1)(ii)(A) conformed to what the preamble said is the only rule that makes sense. The net result is an "ordering" rule in Temp. Treas. Reg. §25.2505-2T(b) that provides that a surviving spouse uses any portable DSUE amount before using the spouse's own basic exclusion amount. This is particularly significant for inter vivos transfers made by the spouse after remarrying but before that new spouse dies. It means that the surviving spouse can preserve and use a prior deceased spouse's DSUE amount without risk of losing it if the new spouse also predeceases the surviving spouse (which would cause the new spouse to become the last deceased spouse of the surviving spouse). See Temp. Treas. Reg. §25.2505-2T(a)(3) for confirmation that use after remarrying but before the new spouse's death is copacetic.

8. In a related vein, Temp. Treas. Reg. §20.2010-3T(a)(3) also specifies that divorcing a new spouse before that new spouse dies will preserve the surviving spouse's ability to use the DSUE amount from the last prior deceased spouse. Either way, these rules mean that a surviving spouse who did remarry and is likely to survive that new spouse can avoid loss of a portable DSUE amount by acting before the new spouse dies, either via divorce or by making a gift that consumes the portable DSUE amount.

9. Temp. Treas. Reg. §20.2010-3T(b)(1) also confirms that a surviving spouse can make use of multiple DSUE amounts by surviving a series of spouses whose estates all make the portability election, *if* that surviving spouse is willing and able to make gifts of the portable exclusion amount of the last deceased spouse before the next (current) spouse dies. This portends serial "skid-row" monogamy for wealthy individuals who are willing to make inter vivos gifts while their new, penniless spouses are on death's door.

10. Temp. Treas. Reg. §20.2010-2T(c)(2) states a sensible rule that is not likely to apply often, dealing with calculation of the DSUE amount. The §2010(c)(4)(B) calculation subtracts "the amount with respect to which the tentative tax is determined under section 2001(b)(1)" from the decedent's applicable exclusion amount. This means that the DSUE amount is that portion of a decedent's applicable exclusion amount that was not consumed by inter vivos taxable gifts, or by the decedent's taxable estate at death. The regulation fixes a glitch that relates to inter vivos taxable gifts that exceeded the exclusion amount that existed in the year of the gift, as to which the decedent paid gift tax. The regulation provides that, because those taxable gifts did not use the exclusion amount during life, they do not reduce the amount that can be transported at death. This is *only* relevant if (a) the exclusion amount increases subsequent to the year of those gifts, and therefore was not totally consumed by the inter vivos gifts, and (b) the estate at death also does not fully consume this increased exclusion amount (meaning that it remains unused). In such a case the calculation of the DSUE amount that can be transported to the surviving spouse calls for a reduction by only the amount of the exclusion actually used to reduce gift tax inter vivos and estate tax at death. This is a proper adjustment in calculating the exclusion amount, but it won't often apply – because few taxpayers make inter vivos gifts that exceed the exclusion amount at the time of the gift. And it relies on the exclusion amount increasing in the future.

11. Note that this last item applies in precisely the same situation in which a taxpayer can lose credit for gift tax paid inter vivos, by virtue of the calculation of estate tax in §2001(b)(2). Temp. Treas. Reg. §25.2501-1T(b) makes more clear an aspect of the estate tax calculation that results in a "reverse clawback" phenomenon that also can apply only if a taxpayer paid gift tax

inter vivos on gifts that at the time exceeded the exclusion amount but, because the exclusion amount increases prior to death, would not have been taxable had the taxpayer waited until death to make those transfers.

These new regulations are the first ever guidance dealing with the unified credit (which has been in the law since 1976) and, even with the added explanation, the regime under the Code is difficult to decipher. The gist of the rule involved is that a taxpayer at death is deemed to have paid gift tax inter vivos based on the unified credit calculated *as if* the law in effect at death had applied in the year of the gift. This requires use of the rates that apply for the year of death as well as the applicable exclusion amount for the year of death, because the unified credit is a function of both of those elements – the applicable exclusion amount and the rate schedule in §2001(c). The estate tax calculation – which reflects gift tax incurred inter vivos – relies on both of these factors, in each case applied using the law in effect in the year of death, *not* those that actually applied when the gifts were made.

So, for example, a gift in 2012 of $5.12 million did not result in payment of gift tax (if none of the unified credit previously was used), but that does not mean that the credit for gift tax payable will be zero in that taxpayer's estate tax calculation. Instead, if the decedent dies in a year when the exclusion amount is less (not as serious a concern as it was in 2012), the clawback concern expressed by many was that reduction of the exclusion would retroactively result in a deferred tax liability, payable at death, on any differential in the amount in the year of the gift and the lower amount in the year of death. The reason why this does not present a problem is because the amount of gift tax applied as a credit at death is based on the tax that *would have been* paid inter vivos, based on the credit and rates that apply at death. Meaning that the taxpayer would have made a taxable transfer and would have paid gift tax on that amount, which becomes a credit against estate tax at death. Even though no such tax actually was paid. This explains why clawback is a nonstarter (although some still believe that clarification of the law is needed to guarantee that this is the correct result).

The flip side of this entails a gift tax that actually was paid inter vivos on gifted property that would have been sheltered by a larger exclusion amount available in the year of death. That gift tax paid is "wiped out" as a credit in the calculation at death. The new regulations provide that this gift tax paid does not mess up portability of the larger exclusion, which was not actually used, but the net effect is still negative for any donor who made large lifetime gifts that required payment of gift tax that is lost as a credit at death. To avoid that result is as simple as the taxpayer making added lifetime gifts of the amount of any increase in the exclusion amount. Which is to say, such a donor must always consume the larger unified credit that is made available by increases in the exclusion amount. And remember that this is a seldom-encountered problem, limited to taxpayers who made huge lifetime gifts *and* actually *paid gift tax*, followed by the exclusion amount being larger at death (which *will* occur if the exclusion amount has indexed to a higher number when the taxpayer dies). None of that is particularly likely for the vast majority of clients.

12. The portability election is more complex if a decedent employs a qualified domestic trust (QDOT) for marital deduction purposes because the surviving spouse is not a United States citizen. This is because §2056A(b) taxes a QDOT as if it was still the decedent-settlor's property. It is fundamentally unlike a normal marital deduction trust that incurs tax payable by the surviving spouse's estate when the spouse dies. The surviving spouse *also* may incur tax on a QDOT but that does not eliminate the tax imposed on the donor's estate. It simply gives the spouse a nonlapsing credit similar to that in §2013 for tax paid by the deceased settlor. The end result is that a QDOT incurs tax in the settlor's estate, with the calculation deferred in most cases

until the surviving spouse dies. And that tax ultimately will consume what otherwise might appear to be a DSUE amount. Which is to say that the DSUE amount cannot be known until the QDOT has terminated and all tax attributable to that trust and imposed on the settlor has been calculated. As a result, Temp. Treas. Reg. §§20.2010-2T(c)(4), 20.2010-2T(c)(5) *Example 2*, 20.2010-3T(c)(2), and 25.2505-2T(d)(2)(ii) *Example* all address the QDOT situation. In the final analysis these provisions confirm that a QDOT is merely a means by which the decedent's estate tax is deferred, rather than being shifted to the surviving spouse. This may be preferable, however, because the deceased spouse may have a larger exclusion amount than the survivor (who may not be a resident or a citizen at death, and thus whose tax liability may be imposed under §2101, with the much smaller §2102 credit amount).

Note also that Temp. Treas. Reg. §§20.2010-2T(a)(5) and 20.2010-3T(e) confirm that a noncitizen nonresident decedent's estate could not make a portability election in the first instance, even though it could use the §2056A QDOT. So care is required to distinguish between noncitizens and nonresidents and to carefully consider whether estate tax will be imposed under §2001 in either spouse's estate.

13. The Technical Directive that promulgated these regulations invites comment on the guidance given, and on one piece of guidance that was withheld. That one is the proper priority of the credits in §§2010, 2013, 2014, and 2015 in calculating the DSUE amount. Specifically, should any credits reduce the estate tax liability before the unified credit, meaning the DSUE amount would be greater, or is the unified credit in §2010 used first and those other credits are applied in some other sequence? Both §§2013 and 2014 reflect the tax policy that it is improper to subject the same property to two different taxes in certain circumstances – under §2013 if two taxpayers incurred estate tax on the same property and died within 12 years of each other [psst: 12 is not a typo – read the provision again to see why], and under §2014 if one taxpayer owns property that is subject to tax both in the United States and abroad. Each credit relieves the burden of double taxation, which means that they ought to be applied before the §2010 unified credit. Were the sequence otherwise the §2010 unified credit would be used to offset a tax that the tax policy concludes should not be imposed at all. Thus, application of §2010 first would defeat the underlying objective that there should be no double taxation. The DSUE amount ought to be calculated *after* application of those credits, meaning that there will be more exclusion amount available to the surviving spouse. Because §2015 is tied to the credit under §2014, the sensible result is for the same sequencing rule to apply. And note that, if a taxpayer eschews portability, a larger nonmarital trust would result under current law if any of these credits is available. Portability should not alter that application of these rules. Indeed, it raises suspicions about why Treasury thought the question needed added thought – because this result should be obvious.

A second question, not raised by the Technical Directive, may be too obvious or easy for consideration. It is whether a taxpayer may engineer the marital deduction and portability to intentionally incur and pay a small amount of estate tax in the decedent's estate, and a smaller amount if the §2032 alternate valuation election is made. To satisfy the §2032(c)(2) requirement that the aggregate of estate and generation-skipping transfer tax incurred in a decedent's estate must be reduced by making the alternate valuation election. The policy question is whether a taxpayer may pay tax and bank the exclusion amount for portability to the surviving spouse? For gift tax purposes the government's position in Rev. Rul. 79-398, 1979-2 C.B. 338, is that a taxpayer may not bank the unified credit by paying gift tax that the credit otherwise would offset. The primary reason for that rule is to prevent taxpayers from intentionally reducing their gross estates at death by payment of gift tax during life – this rule precludes taking maximum advantage of the tax exclusive calculation of the gift tax by intentional payment of gift tax (itself not a taxable transfer) on transfers that otherwise would be sheltered by the unified credit. If the estate would be taxable at death, the benefit is payment of a gift tax that would be a credit against the estate tax at death – essentially a prepayment – with a corresponding reduction of the gross estate at death. The advantage in the §2032 alternate valuation context from intentional payment of a smidgeon of estate tax is different, but the government may still deem that manipulation to be improper. Treasury may not wish to speak to this issue – the planning involved is not new – and taxpayers may not want to force the government to announce a position. On the other hand, it would be nice to know whether this postmortem planning is (not) viable.

## 4. Sections 2031 and 2032: Estate Tax Valuation

***Discount for Fractional Interest in Art.*** **Estate of Elkins v. Commissioner**, 140 T.C. No. 5 (2013), may be only the second case of it's ilk, seeking a valuation discount for an undivided fractional interest in art. The first case, Stone v. United States, 2007-1 U.S. Tax Cas. (CCH) ¶60,540 (N.D. Cal.); 2007-2 U.S. Tax Cas. (CCH) ¶60,545 (N.D. Cal.), granted the taxpayer only a 5% discount. In *Elkins* the court was twice as generous but essentially rejected the taxpayers' suggestion – made similarly in both *Stone* and *Elkins* – that fractional ownership justified a 44% discount. Indeed, the *Stone* court granted the very modest 5% discount because the government conceded that amount "in a spirit of compromise." Had the government adhered to its original position in *Stone* that no discount was appropriate, the tenor of the decision suggests that the court might have given an even smaller discount. No discount was the government's unbending position in *Elkins*, which the court did not accept, but it primarily reflects the inability of the estates' experts in both cases to present any data regarding sales of undivided fractional interests in art.

This inability reflects what estate planners for art collectors confirm as reality, that art collectors do not sell undivided fractional interests. The *Elkins* estate's own expert also testified that "auction houses simply do not market fractional interest in fine art." On occasion museums jointly purchase an important work, and some speculators may join forces and each acquire fractional interests in anticipation of significant increases in value. But the *Stone* court concluded that undivided fractional interest owners may buy art in concert but they do not sell their undivided fractional interests in the open market. Instead they sell the entire work and divide the proceeds. Which explains why there is no evidence of discounts for fractional ownership interests. And that largely explains why both *Stone* and *Elkins* were unwilling to give valuation discounts in the range advocated by the taxpayers.

Based on the allegation that any fractional interest owner could force a state court action to partition the work, *Stone* allowed a small reduction in value because "the costs of a court-ordered partition must be considered" and "some discount is appropriate to allow for the uncertainties involved in waiting to sell the collection until after a hypothetical partition action is resolved." *Elkins* gave the taxpayer a dinky discount because there would be sales fees if a liquidation occurred, allowed an even smaller discount for legal fees, and yet again a smaller discount for the same "uncertainties involved" in waiting for a partition action to resolve before selling an undivided interest. Although the *Elkins* estate obtained a 10% discount – double the 5% allowed in *Stone* – neither decision is a taxpayer "victory," given the much larger discount that each estate sought.

Seven other matters were of interest in *Elkins*.

- The first was the court's determination that restrictions on sale or partition found in both a cotenant's agreement and a lease to the decedent of the other owners' interests were subject to §2703(a), and the taxpayer's concession that it did not meet the §2703(b) exception. Thus, those restrictions were ignored for valuation purposes.

- The government relied on two revenue rulings that granted income tax charitable deductions for donations of fractional interests, without reduction of the deduction for fractional interest discounts. The *Elkins* rejected these as support for the government's denial of a fractional interest discount for estate tax valuation purposes, basically concluding that income tax and wealth transfer tax are not in pari materia. In reality, these rulings may not have been an act of generosity by the government in the income tax arena. Instead, they may just reflect the reality, confirmed in *Elkins* and *Stone* alike, that there is no market for fractional interests in fine art and therefore no evidence supports a discount.

- Third, the court turned around the testimony of one of the decedent's children that she and her siblings ardently wished to retain all of the decedent's art. The children intended that testimony to support their argument that deep discounts were appropriate, because the children would never agree to sales of their fractional interests in the open market. Which they suggested would significantly reduce the amount a willing buyer would pay to purchase the decedent's interest – because the buyer could not reasonably anticipate being able to liquidate that investment or increase the buyer's ownership percentage by purchasing the children's interests. The court instead relied on the children's ardor as an indication that they would pay an undiscounted price to purchase a third party's interest, and therefore no discount was appropriate. The court's use arguably is improper, because it takes the "hypothetical" out of the willing-buyer, willing-seller equation and informs that analysis with notions of what a particular buyer would pay in a market sale. The court did, however, cite authority for the notion that an actual shareholder of a tiny stock interest could command significant valuation premia rather than suffer a deep discount because the sliver represented "swing vote" control that other shareholders would bid up to purchase.

- Fourth, the decedent owned some 50% interests and some 73% interests and the court apparently did not think they justified different discount amounts. (Note that the manner in which these interests were created entailed planning that predated adoption of Chapter 14 of the Code, a failed GRIT, a partial disclaimer of community property, and maybe even a design flaw in the planning, all of which meaning that taxpayers today likely would not emulate the particular planning involved in *Elkins*.)

- Fifth, the court also ignored testimony by the estate's expert that the art owned by the decedent's family fell into three very different categories, ranging from "highly desirable, rare, and important" to "good examples but not masterpieces by the artist," to pieces that "have a real international value [but] neither the works themselves nor their creators are in the masterpiece category." The testimony was intended to suggest that a speculator or museum might be willing to purchase a fractional interest in the most highly desirable category because this might be the only way to become an owner, but the third category was nearly worthless because no buyer would "take the risk" of buying a fractional interest in such a work. The court apparently thought that no fractional interest discount was appropriate for any of the three categories because there was no empirical evidence of sales of fractional interests in any of the three categories.

- Sixth, the court's 10% discount was selected and applied with no analysis or explanation – there is absolutely no indication why the court selected that figure over any other number that it might pull out of its ear. Which makes it totally unreliable (and may make the decision subject to reversal on appeal).

- Finally, the family entered into a rental agreement that allowed the decedent to retain exclusive possession of the various works until he died. The parties failed to determine the rental value or pay any rent until after he died, which could have been grounds for inclusion in his estate of the portions that he originally owned but transferred by various means before death. Determining the fair rental value of a fractional interest in art is much like the court determining the appropriate discount – there being virtually no data on which to base a fair market value determination.

An experienced insider in the art world reports that a major auction house may begin to offer the service of providing fair market rental value appraisals, in an effort to fill this void. Lacking a fair market rental, implied retention of transferred interests may trigger §2036(a)(1) inclusion, which highlights another aspect of the planning involved in *Elkins* that other advisors might consider. According to planners who are experienced in representing serious art collectors, owners of important works do not wish to relinquish possession, even for a portion of a year. Fractional owners are entitled to their "share" of the use and possession of art, which generates serious issues regarding security and insurance, prudent conservation and maintenance, transportation and storage risks, and use of important works as collateral for loans that often are relied upon by collectors to increase their collections when other desirable works become available. All of these factors may escape consideration by a tax-driven plan that relies on techniques designed to minimize wealth transfer tax values using devices such as those involved in *Elkins*, but that may lack an appreciation for other important considerations. Which may mean that the lack of any real discount in either *Stone* or *Elkins* is a good thing for other art owners, because others may not be encouraged to engage in such planning in the future.

***Not Unexpected (?) Valuation and Deduction Defeat.*** Occasionally a case is decided in which the facts interfere with good planning, and the result is not informative for other planners. Such appears to be the case in **Estate of Koons v. Commissioner**, *** T.C.M. (CCH) *** [T.C. Memo 2013-94], in which the estate completely lost both its valuation and §2053 deduction arguments. Resulting in a deficiency of more than $43 million in estate tax and almost $16 million in generation-skipping transfer tax. Which may inform an appeal (probably to the 11th Circuit, given that the decedent was a Florida domiciliary, as are the executors). Among the critical facts were that the decedent died roughly two months after a variety of asset transfers and, much more importantly, execution of agreements by which interests held by the decedent's children would be redeemed, causing the decedent's voting control to increase from just under 47% to just over 70%. Although the actual redemption did not occur until a month after the decedent's death, the court found that the agreements were binding when the decedent died, the children wanted to sell and the entity wanted to buy, and that no discount for lack of control therefore was appropriate. Had the decedent lived another month there would have been no such discount and, as the facts revealed, a willing seller at the date of death would not have accepted a discount either.

The §2053 deduction was only a slightly more nuanced issue, involving an argument that the government has raised with inconsistent results in various cases. It boiled down to the fact that the loan was for not quite $11 million, repayable over a 78 month period, beginning more than

18 years postmortem, at 9.5% interest, yielding a claimed deduction for interest of over $71 million. All of which the court found to fail the "necessity" requirement under Treas. Reg. §20.2053-3(a)(1) because the decedent's estate had over 70% voting control over the entity making the loan, which itself had over $200 million of "highly liquid assets." Simply put, the court held that the entity could have made a distribution instead of a loan (indeed, it made an almost $23 million distribution in the year after death to pay the decedent's income tax liability for the year of death).

***Alternate Valuation Proposed Regulations.*** **[Note: this item has not changed since its inclusion in 2011; it is here as a "place holder," awaiting final regulations.]** Proposed regulations were released in April 2008. Treasury retracted those original proposals in November 2011 and released a new set of proposed regulations, which are reflected in this summary.

The original impetus for these changes was Kohler v. Commissioner, 92 T.C.M. (CCH) 48 (2006), nonacq., 2008-01 AOD, 2008-1 C.B. 483, which involved three siblings and both gift and estate tax valuations. The primary wealth transfer tax issue was the §2032 requirement that an asset valued on the alternate valuation date must be the same as the asset that was included in the decedent's gross estate at death. Postmortem changes that alter the nature of the includible asset cannot be reflected in the alternate valuation.

The deceased Kohler sibling and two survivors were among family members who held about 96% of the stock in their privately held company (known primarily for its plumbing products). The decedent died in March and the company completed a tax-free reorganization in May, such that on the alternate valuation date in September the asset to be valued was arguably either the stock owned pre-reorganization or the post-reorganization replacement stock.

That made a difference, apparently, because the reorganization forced outsiders to sell their stock and it imposed transfer restrictions and granted purchase options that were designed to keep the reorganization stock within the family's control. Unexplained by the opinion, however, was why the government was exercised about the issue, given a stipulation that the stock-for-stock exchange was a tax-free §368(a) reorganization (apparently a §368(a)(1)(E) recapitalization) and, as a condition to qualify, the stock value before and after the reorganization had to be the same. Indeed, Judge Kroupa expressed surprise in her footnote 7 that the government pursued the §2032 argument. Presumably the rationale was that the value on the date of the reorganization was the same but the value of the new stock declined thereafter (and before the alternate valuation date), due to the restrictions.

At the time, Treas. Reg. §20.2032-1(c)(1) provided that a §368(a) tax-free reorganization is "a mere change of form" and not a disposition that accelerates the alternate valuation date. In large part based on this slightly different issue (acceleration), the court held that valuation of the post-reorganization stock owned on the alternate valuation date was appropriate, because it meant that only the form of the stock had changed (it essentially was the same), and because (of necessity) the values of the old and new stock were unchanged on the date of the reorganization. The court cited no precedent on point and a computer search revealed only TAM 7103129640A (involving the related "disposition/acceleration" issue rather than the question of the proper asset to be valued).

Rather than appeal the decision, the government nonacquiesced to *Kohler* and then issued proposed changes to the §2032 regulations themselves. These sought to preclude what the government apparently anticipated as abuses that evoke planning that is fundamentally different from the *Kohler* reorganization, but arguably validated by that decision. Through changes now found in **Prop. Treas. Reg. §20.2032-1(f)(1)**, the government refined its original approach to articulate a principle that changes will affect the federal estate tax value of includible assets only if they are attributable to (1) "economic or market conditions" or (2) uncompensated theft or casualty losses (that are not deducted under §2054).

The first proposed regulation described postmortem events (including voluntary acts or manipulations) that would be ignored in valuing a decedent's gross estate. The revised proposal now essentially abandons that approach to instead describe events that will accelerate the valuation date under §2032(a)(1). This then triggers valuation at the moment before the acceleration event, which precludes valuations that reflect the postmortem event. By addressing the acceleration issue directly the new proposal also is more in line with prior authority. The construct therefore differs, but examples of events that generate this result are only expanded, and are essentially unchanged from the prior proposed regulations. Which is to say that the new proposal addresses the issue from a different direction but appears to yield the same results.

In addition to the "obvious" acceleration events (such as a sale, reinvestment, or estate distribution), the proposed regulation describes other transactions that may accelerate the alternate valuation date, including

(1) creation, recapitalization, reorganization, or merger of an entity,

(2) redemptions or other changes in the ownership structure of an entity that alter the value of the decedent's interest in that entity, and

(3) postmortem distribution of a fractional interest in an asset or in an entity that otherwise would justify a fractional or minority interest discount.

Also identified in **Prop. Treas. Reg. §§20.2032-1(c)(1)(i)(I)(3) and (4)** are entity-level transactions (such as disbursements, distributions, or reinvestments of an entity's assets) that alter the value of the decedent's ownership interest in the entity. See, e.g., **Prop. Treas. Reg. §20.2032-1(c)(5) *Example 4***, in which the decedent owned an interest in a corporation that contributed all of its assets to a partnership, which was a transaction that accelerated valuation of the decedent's ownership interest in the corporation to the moment immediately prior to the corporation's investment in that partnership. Alternatively, however, **Prop. Treas. Reg. §20.2032-1(f)(1)** provides that "[g]enerally, management decisions made in the ordinary course of operating a business . . . are . . . occurrences related to economic or market conditions" and therefore do not trigger the acceleration rule unless "these decisions change the ownership or control structure of the business . . . ."

**Prop. Treas. Reg. §20.2032-1(c)(1)(ii)** provides an exception to the acceleration rule for "same-value" transactions — such as an exchange of stock for stock of another class or in another entity — that do not change the value of the decedent's interest by more than 5% of the fair market value of the interest held at the date of the decedent's death. Helpful in evaluating this same-value principle is a rule that aggregates the value of all forms of replacement or distributed property with whatever may remain of an original holding to determine whether values have changed. To illustrate, **Prop. Treas. Reg. §20.2032-1(c)(5) *Example 6*** posits a partnership distribution to all partners during the alternate valuation period, which did *not* trigger the acceleration rule because the decedent's share of the distribution plus the value of the decedent's partnership interest after the distribution equaled the value of the partnership interest prior to the distribution. The transaction thus was sheltered in the same-value safe harbor because the aggregate value of the two interests did not differ by more than 5% from the transaction date value of the date-of-death includible interest.

On the other hand, **Prop. Treas. Reg. §20.2032-1(c)(5)** ***Examples 7*** and ***8*** illustrate distributions of fractional interests in real property or minority interests in an LLC that constitute dispositions that accelerate the alternate valuation date. As such they preclude any valuation effect of the transaction on the distributed interest. For example, imagine an estate that owns Blackacre in fee simple or 100% of the stock in a closely held business. During the alternate valuation period the estate transfers fractional or temporal interests in the realty, or minority interests in the entity, with each distributed portion valued on the date of its distribution, leaving a lesser interest in the estate to be valued on the alternate valuation date. As expected, valuation of the portions distributed is accelerated, and no fractional or minority interest discounts may be taken for those distributed portions. In addition, by virtue of an aggregation principle in **Prop. Treas. Reg. §20.2032-1(c)(1)(iv)**, the interests that remain in the estate *also* are denied minority interest or fractional interest discounts, notwithstanding the postmortem distributions.

**Prop. Treas. Reg. §20.2032-1(f)(3)** clarifies that alternate valuation may reflect postmortem market conditions and certain postmortem events — meaning that the value of the interest owned at death could be lower for alternate valuation purposes if there was a general market value decline, or a loss due to theft (***Example 3*** illustrates a loss due to embezzlement, discovered during the alternate valuation period and allowed to be reflected in the alternate valuation), fire, or other natural calamity that otherwise would spawn a §2054 theft or casualty loss deduction.

The government's most immediate *Kohler* related concern is illustrated by **Prop. Treas. Reg. §20.2031-1(c)(5)** ***Example 1*****,** in which the decedent's personal representative and other members of the decedent's family create a new entity postmortem, to which they transfer property — including the estate's interest in marketable assets — taking back ownership interests in the new entity. Without stating whether those new interests are restricted in a manner that would produce a discount for lack of marketability or lack of control, the *Example* merely states that the estate's transfer into the entity will accelerate the valuation date of the marketable assets held at death, and that the interests to be valued are those assets that were owned at death, rather than the interests received back from the entity. Also illustrated is that an estate either could act alone in creating an entity, could act in concert with others, or could transfer assets into a pre-existing entity. Each postmortem transaction is regarded as a disposition that will accelerate the alternate valuation date and result in valuation of the assets distributed, at their distribution date values, rather than any product or reinvestment thereof.

Other modest clarifying changes made in the proposed regulations deal with

(1) the effect of a postmortem grant of a conservation easement, retitling an account in the name of the new account owner, and dividing a trust or account into subaccounts for multiple beneficiaries (none of these will trigger acceleration),

(2) the proper value under §2036(a)(1) of a GRAT that continues to make annuity payments to the decedent's estate for the balance of the retained annuity term, and

(3) a priority-of-distribution rule that treats "excluded property" — such as postmortem earnings (e.g., interest or rent) on estate assets — as the first assets distributed in certain cases (which is taxpayer favorable because those distributions will not trigger the acceleration rule).

As originally proposed these changes, when made final, would have been retroactively effective to decedents dying after April 24, 2008 (the date the first proposed regulations were issued). The new proposed regulations are more traditional and will apply after they are published as final.

***Special Use Valuation Regulation Ruled Invalid.*** Special use valuation under §2032A is available only with respect to realty passing to a qualified heir and only if the decedent or members of the decedent's family owned, and used in a qualified manner, property that constituted a significant portion of the decedent's total wealth. The §2032A(b)(1)(B) standard is that qualified use real property must equal at least 25% of the value of the decedent's gross estate, and §2032A(b)(1)(A) requires that qualified use real *and personal* property must equal at least 50% of the value of the decedent's gross estate.

Multiple qualifying assets may be aggregated to satisfy these threshold requirements. But, according to Treas. Reg. §20.2032A-8(a)(2), the special use election must be made with respect to parcels equal to at least 25% of the adjusted value of the gross estate to satisfy the §2032A(b)(1)(B) test.

**Finfrock v. United States**, 860 F. Supp. 2d 651 (C.D. Ill. 2012), citing and following Miller v. United States, 680 F. Supp. 1269 (C.D. Ill. 1988), rejects that interpretation. Both cases regard Treas. Reg. §20.2032A-8(a)(2) as contrary to their interpretation of the statute that, having met the threshold requirements, the estate may elect any part of the qualifying property and generate the requisite valuation reduction for only that property. This was the estate's preference in *Finfrock* because only one of four parcels was going to be used in a qualified use and an election of any of the other three would have resulted in a recapture tax. So the estate chose to specially value only the one, which the court agreed was permissible, even though that one parcel was less than 25% of the total value of the gross estate.

***Use of Subsequent Facts to Determine Value.*** **Trout Ranch LLC v. Commissioner**, 2012-2 U.S. Tax Cas. (CCH) ¶50,524 (unpub. 10th Cir. 2012), aff'g 100 T.C.M. (CCH) 581 (2010), is a conservation easement valuation case. Its "memorandum" status below and unpublished status on appeal both suggest that it is of limited interest. The court's first footnote says that it is "not binding precedent" but also states that citation is not prohibited. "Unpublished decisions may . . . be cited for their persuasive value," which this opinion has in abundance, because the appellate court addressed a valuation principle of more than casual significance.

The specific legal debate was simple. The taxpayer purchased 453 acres of land, subdivided about 15% of it for development, and deeded a conservation easement over the balance. The experts disagreed over the value of the easement for charitable deduction purposes. The government ultimately argued that the property was no less valuable after its grant than before and, therefore, that the deduction should be zero under the "before-and-after" valuation approach in Treas. Reg. §1.170A-14(h)(3)(i). The Tax Court "refused to accept any of the expert appraisals in their entirety. Rather, it achieved [its own result] by borrowing bits of data from each report to construct its own" valuation. The court ultimately concluded that the deduction should be $560,000. Those machinations are not very important.

On appeal the taxpayer argued that the Tax Court erred by relying on valuation data involving sales that took place after the easement was donated, asserting "that data from after the date of valuation is categorically inadmissible in determining fair market value." The case involved an inter vivos transfer and an income tax deduction, but the valuation issue of universal application for tax law purposes is whether facts and circumstances unknown at the time of a transfer are probative in determining value on the particular valuation date.

Usually taxpayers seek to introduce postmortem facts in an estate tax context because they show that the value established on the date of death was higher than it should be, as shown by subsequent developments. This is important because usually the taxpayer is in control of the valuation process, and postmortem developments that reveal that the date of death value was higher than the taxpayer reported are seldom revealed to the government. Which means that, unless the government is alerted in some other way to challenge the taxpayer's value, postmortem facts are presented only if they establish a lower value than that established on the date of death. Thus, this issue tends to be a one-way street, in favor of the taxpayer, and explains why the government usually opposes the use of postmortem facts.

As explained by *Trout Ranch*, value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." As argued by the taxpayer in *Trout Ranch*, "reasonable knowledge of relevant facts" cannot include sales or other developments that occurred after the relevant valuation date. To this the court said that the taxpayer

> reads the "reasonable buyer" language too literally. The reasonable buyer is a conceptual device meant to illustrate the objective nature of the inquiry, not a limitation on the evidence that can inform it. . . . Data unavailable to a reasonable buyer may still tell us something about the price such a hypothetical buyer would have been willing to pay at the time of the contribution.

Then, citing First National Bank of Kenosha v. United States, 763 F.2d 891 (7th Cir. 1985) (an agreement to sell, entered into 21 months after death but never consummated, still was regarded as probative evidence of estate tax value), the court said that the issue is whether the postmortem evidence makes a particular valuation "more or less probable." In that respect,

> data from events after the donation can be just as informative (and just as distorting) as data from events before the donation. The challenge for the trier of fact is determining whether the data makes the asserted fair market value more or less likely.
>
> . . . The . . . question . . . in real estate appraisal . . . is the estimated value of the land at the time of the taxable event. When we speak of subsequent events in this context, we speak of data that could *inform* fair market value, *not data that could replace it*.

Thus, subsequent events that alter the property itself would not be relevant, nor would new information supplant the value determined using facts known at the valuation date. But facts that reveal information previously unknown about includible property would be relevant to better inform the willing-seller/willing-buyer analysis, determined as of the valuation date. The court acknowledged risks that attend to any consideration of post-valuation date data, but said that the real issue is the weight or relevance to be assigned to such evidence.

As a practical matter, if neither the market in general nor the particular asset has changed in the interim, the government *will* rely on an actual, arm's length sale before an estate tax return is due as the best evidence of estate tax value. Not because the legal principle differs, but because it is practically expedient to consider an actual sale price if the sale was not suspect. In weighing all available evidence of value, the government typically regards an actual bona fide sale as worthy of the highest weight – as the best evidence of the value on the date of death – even though the sale was after the actual valuation date. In *Trout Ranch*, using data from actual sales of comparable property after the valuation date constituted evidence that the court properly considered to better inform the valuation of the taxpayer's property on the earlier valuation date.

## 5. Sections 2036 and 2038: Retained Interests or Powers

***Private Trust Company "Tentative" Guidance.*** [**Note: this item has not changed since its inclusion in 2008; it is here as a "place holder," awaiting the government's promised Revenue Ruling on this subject.**] In an unusual "first draft," the government has issued guidance to taxpayers who wish to create a private or family controlled trust company. **Notice 2008-63**, 2008-2 C.B. 261, is labeled as a "proposed" revenue ruling, available for comment, much like regulations are issued in proposed form. Although not without a few flaws, the general drift of the draft is quite favorable to taxpayers and makes it relatively easy to avoid untoward income or wealth transfer tax consequences by following a number of easy prescriptions. For example:

- a "discretionary distribution committee" (DDC) that controls all discretionary distributions of income or principal will insulate family members from liability if "no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his or her spouse is a grantor, or . . . a beneficiary . . . [or] with respect to any . . . beneficiary to whom the DDC member or his or her spouse owes a legal obligation of support";
- "no Family member may enter into any reciprocal agreement, express or implied, regarding discretionary distributions from any trust for which [the private trust company] is serving as trustee" (although "reciprocal agreement" is not defined, it is fair to assume that this constitutes a broad prescription against any "I'll-scratch-your-back-if-you-scratch-mine" style of arrangement);
- only officers and managers of the trust company may participate in personnel decisions (but family members may be officers and managers of the trust company without hazard);
- an independent "Amendment Committee," "a majority of whose members must always be individuals who are neither Family members nor persons related or subordinate . . . to any shareholder" of the private trust company, has the sole authority to make changes to the documents that govern the trust company.

With these prescriptions, the result is that the private trust company itself will not

- cause estate tax inclusion exposure under §§2036, 2038, or 2041 to family members;
- prevent completed gift treatment for transfers to a trust administered by the private trust company;
- alter generation-skipping transfer tax exemptions and inclusion ratios; and
- affect otherwise applicable grantor trust income tax treatment.

The Subchapter J consequences are the most convoluted:

- §675 exposure turns (as is usual) on how fiduciary powers actually are exercised;
- §677(b) exposure turns on whether distributions are made for the support or maintenance of someone the grantor is obliged to support or maintain (misstated in the draft by reference to actual use to discharge a support obligation — which is not the metric used by the Code but is the short-handed reference made by most casual students of Subchapter J); and
- adverse party treatment will not be provided by the trust company or the DDC.

Interestingly enough, use of "ascertainable" or "reasonably definite external" standards is neither required nor useful (unless it means that a power therefore does not entail discretion, which is neither right nor stated), acting as an employee or director of the private trust company is benign, and "voting control of [the private trust company] has been made irrelevant as it applies to the power to make distributions from the Family trusts. . . . Thus, the ownership of voting stock should not be deemed to be 'significant' under section 672(c)" and, instead, is relevant only to the extent it gives control over discretionary distributions. Thus, related or subordinate party treatment is avoided unless more than half the members of the DDC may be nonadverse parties who are related or subordinate to the grantor. In essence, membership on the DDC is the functional equivalent of service as fiduciary, so in virtually every respect looking at the DDC members is more important than looking at control of the private trust company proper.

Note that, while awaiting further word on private trust companies, the SEC adopted a final rule (the **Family Office Rule**) under the Investment Advisers Act of 1940 that exempts certain family offices from the definition of an investment adviser. Although private trust companies and family offices differ, advisors who represent families with such operations should consult the SEC rule and, when the government releases the private trust company guidance, pay careful attention to the degree of coordination or deviance between the two pronouncements.

***Failed FLP with a Side of Crummey Success.*** **Estate of Turner v. Commissioner**, 102 T.C.M. (CCH) 214 (2011), was a split-the-baby opinion that yielded a taxpayer victory regarding Crummey powers of withdrawal and approved the government's denial of valuation discounts for assets contributed to a family limited partnership. In addition to being a Tax Court Memorandum opinion (which is not citable precedent), it is not a very useful opinion because it is a rote application of generic tests previously formulated by the Tax Court, and it provides little explanation of the basic issues involved or their proper application.

The net result was the court's conclusion that assets transferred to the FLP were includible in the taxpayer's gross estate under §2036 without considering discounts attributable to the FLP. And that lifetime gifts of FLP interests should be disregarded for purposes of calculating the taxpayer's adjusted taxable gifts in calculating the estate tax. "To do otherwise would result in the double inclusion of a significant part of the property transferred" to the FLP. This final conclusion appears to be taxpayer favorable, but it is error, as next illustrated. All of which is useful to know, as a prelude to discussing the next phase of the litigation.

Assume a lifetime transfer of $10x of value to an FLP, in exchange for $6x of FLP interests (reflecting a 40% valuation discount attributable to the terms and restrictions in the FLP agreement). Immediately after creation of the FLP the taxpayer transfers $1x of those FLP interests by gift, retaining $5x. After which all the assets in the FLP double in value, as do the FLP interests.

| Proper Analysis | | IRS/Court Approach |
|---|---|---|
| 10x | §2033 inclusion | 0 |
| 20x | §2036 inclusion | 20x |
| (6x) | §2043 offset | 0 |
| 1x | Adjusted taxable gifts | 0 |
| 25x | Net amount taxable | 20x |

Because the taxpayer actually owns the FLP interests at death, §2033 should include the full value of the interests that the taxpayer received and did not previously give away, which in the left column represents $6x received, reduced by the gift of $1x, and then a doubling in value to $10x by death. By virtue of §2036, *also* includible is the estate tax value of the assets transferred to the FLP, and then the Code ameliorates the double taxation issue correctly perceived by the court through the §2043(a) offset, which provides:

> If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

There is a disparity in this application, as illustrated in the §2036 inclusion of the \$20x fair market value at death of the assets transferred, with a §2043 offset of only \$6x, which is the value of the consideration received at the time of the original creation of the FLP. The offset applies because consideration was received in a transfer that was not a bona fide sale for adequate and full consideration. But as illustrated in the left column, the taxpayer suffers due to appreciation, because the rule is to apply the offset at fair market value of the consideration as measured at the date of the transfer. The government's approach in the right column, embraced by the court without mention of §2043, simply ignores all aspects of the original contribution to the FLP, the gift, and the FLP interests held at death, as if the taxpayer had done nothing during life.

A subsequent decision by the same judge in *Turner* was promulgated seven months after the original, this time as a regularly reported decision, adding one more issue to complicate the FLP analysis. **Estate of Turner v. Commissioner**, 138 T.C. 306 (2012), rejected the taxpayer's request for reconsideration of various issues decided in the original Memorandum opinion and then tackled an issue that originally was left for the Rule 155 calculation of tax following the first decision. Because the taxpayer and the government could not agree on this issue, it came back to the court and reflects a concern that has arisen in several FLP cases that also involved the estate tax marital deduction.

The marital deduction issue comes in two pieces, and Judge Marvel carefully sidestepped the one that has caused taxpayers the most heartburn. That issue entails a "whipsaw" argument by the government that (1) the value includible in the gross estate under §2036(a) is the date of death value of the assets transferred into the FLP, with no valuation discounts, but (2) the value for marital deduction purposes is the discounted value of the FLP interests owned by the decedent at death and that are allocated to the surviving spouse in actual satisfaction of the marital bequest. Denying a valuation discount for inclusion but respecting it for marital deduction funding causes the estate to have phantom value that results in tax liability, notwithstanding an optimum formula marital bequest that is designed to reduce estate tax to zero. The government did *not* assert that issue, so the court was able to sidestep it here.

The other issue, that the court correctly decided in favor of the government, is so clear that the estate's approach is a mystery. The simple fact in *Turner* is that the taxpayer received FLP interests and then made gifts of some of them. That explains why the calculation above shows the \$1x gift of FLP interests, which the court purged from the estate tax calculation when §2036 inclusion of the underlying FLP assets was applied with no discounts. But when estate distribution is called for neither the underlying assets within the FLP nor those gifted FLP interests were actually owned by the estate, and neither was available for satisfaction of the marital bequest.

The amount of marital deduction needed to zero-out the estate tax liability is inflated by inclusion of the FLP assets without discount valuation, but the full amount of that increased marital bequest cannot be satisfied with assets that actually are owned by the decedent at death, that can meet the "passing" test, and that will be includible in the estate of the surviving spouse at the second death. So this second opinion correctly limited the marital deduction to the value of estate assets that actually could be transferred in satisfaction of the marital bequest. Which meant that the estate had phantom value on which it owed estate tax.

Not discussed in the opinion is the fact that the estate presumably must invade the marital bequest to finance the tax generated on the phantom value, which probably will reduce the marital bequest and thus the deduction even further, generating more tax yet again, that also needs to be paid, causing a further invasion of the marital bequest, ad nauseum. Those facts are not given in the opinion – that circular whirlpool calculation is not discussed because it is for Rule 155 calculation after this second decision. But that issue likely is the lurking consequence of the court's resolution of this issue. And it might arise in many other FLP discount cases involving a marital deduction bequest to a surviving spouse.

Here is an illustration of how this resolves, based on the first calculation above:

| Proper Analysis | | IRS/Court Approach |
|---|---|---|
| 10x | §2033 inclusion | 0 |
| 20x | §2036 inclusion | 20x |
| (6x) | §2043 offset | 0 |
| 1x | Adjusted taxable gifts | 0 |
| 25x | Net amount taxable | 20x |
| (1.5x) | AEA (death in 2004) | (1.5x) |
| 23.5x | Formula marital needed | 18.5x |
| 18x | Estate assets available | 18x |
| 5.5x | Phantom amount taxable | 0.5x |

This calculation assumes the whipsaw argument is *not* applied – so the assets deemed to be available to satisfy the marital bequest are not limited to those actually owned (FLP interests worth $10x) but instead are those deemed to be included under §2036 ($20x), less the value that was transferred inter vivos ($1x at the time, which doubled in value under the facts assumed). Given that the court did not resolve the whipsaw issue in the government's favor, presumably we must assume that estate assets available to satisfy the marital bequest are the $20x included under §2036, reduced by those given away during life. In which case, in each column there will be phantom value if the gift is respected. In truth, because the estate actually owns only $10x at the time of funding the marital bequest, the whipsaw argument would yield phantom value of $13.5x in the left column and $8.5x in the right hand column. Neither result is very palatable. And notice how the §2036(a) result is dramatically worse than the other alternatives noted when these marital deduction issues are factored into the equation.

***Active Business FLP Avoids §2036(a) Challenge.*** Sometimes the government litigates FLP cases for reasons that beg explanation. And the court's opinion does not make it clear whether the government's case had merit. A good example of this is Judge Foley's opinion in **Estate of Kelly v. Commissioner**, 103 T.C.M. (CCH) 1393 (2012), which indicates a $2.2 million tax deficiency but not the valuation discounts involved. The opinion does clearly show that Judge Foley was substantially impressed with the bona fides of the family's reasons for creating the entities involved, and he rejected the government's inclusion attempt.

The facts revealed in the opinion fully justify use of the limited liability entities that were created. The primary assets included 27 different parcels of real estate located in the North Georgia mountains (Rabun County has the largest share of the Chattahoochee National Forest, several of the highest peaks in Georgia, straddles the Eastern Continental Divide, and is crossed by the Appalachian Trail). Each parcel posed inherent risks of liability (they included two active rock quarries, rental homes, a public-access property with a large waterfall and picnic facilities, and a post office). By way of example, there had been an accident involving a dump truck, significant injuries, and litigation that sought to impose liability on the decedent.

The partnerships were formed when the decedent was in a nursing home (suffering from Alzheimer's dementia) by three of her children who had been active in managing the family businesses throughout their entire lives (a fourth, who had Down syndrome, died three years before the decedent) and were acting as the decedent's co-guardians. By a series of settlement agreements the children had determined to share the decedent's estate equally, notwithstanding provisions in the decedent's will that would have caused inequities among them (due to valuation fluctuations since that will was executed). The partnerships facilitated their objective in a more facile manner than using disclaimers postmortem would have done.

Because the decedent was incompetent, the partnerships (one for each child, and a fourth that held the quarries) were created by court order, and the only potentially abusive fact was that the partnerships also held the decedent's stock and bond portfolio, presumably to make it easier for the children to manage the decedent's affairs (previously they had been required to obtain court approval "with respect to all matters relating to the routine maintenance and upkeep of decedent's property, including stock transactions, real property improvements, and the purchase and sale of assets"). This also served to effect their agreement to divide her estate equally.

Over $1.1 million worth of liquid property was held outside of the partnerships, in the decedent's name. More detail is not provided by the opinion, which instead provides more detail about how the children worked 60-80 hours per week in managing and maintaining the properties, met regularly and kept minutes of their meetings as managers of the corporate general partner, inspected properties, approved budgets, and essentially managed the family businesses – all for an annual salary of $21,600 per child.

One difficult fact was that stock in the corporate general partner was owned by the decedent and the petition for the court order authorizing all of these entities specified that

> the general partner is entitled to a special allocation of the net income of the limited partnerships . . . . Because the ward will own all the outstanding stock in the corporation that will serve as the general partner, the special allocation of net income for the reasonable management charge will insure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime in the standard of living to which the ward has become accustomed.

This caused the government to argue that the decedent's transfers (by her children, acting as her guardian) into the partnerships constituted a transfer with a retained right to future income, which would cause §2036(a)(1) inclusion of the partnership assets in the decedent's gross estate as if the partnerships had not been created. As it turned out, however, the children contacted various bank trust departments and business leaders in the community to determine what a reasonable management fee would be and actually charged only that smaller amount (which was used to pay taxes, insurance premiums, maintenance and other expenses of the general partner, and the children's salaries).

As in other FLP cases, the court also determined that the decedent's creation of the partnerships and her transfers of assets to them was not subject to §2036(a) inclusion because of the adequate-and-full-consideration exception, which turns on whether there was a bona fide sale, which depends on a finding of legitimate and significant nontax reasons for creation of the partnerships. All of which the court easily found:

(1) in the settlement agreements (even though their design to equalize distribution of the decedent's estate was the *children's* reason for creating the partnership – the decedent being incompetent to formulate any such intent (the equal distribution agreement was needed to *overcome* the decedent's intent, as expressed in her will, which produced the inequity that the children sought to overcome);

(2) in the use of entities to facilitate the active management of the realty assets; and

(3) in this case (unlike so many others) because there was a legitimate need to protect the decedent from liability that could flow from ownership and management of her active business assets.

The court also specifically found that the decedent's primary motive was *not* minimization of tax liability, which is not a critical issue (but it cannot hurt to find that it was not a primary motivation). In addition, it was essential (but easy) to find that the decedent received partnership interests equal in value to the assets she contributed to the partnerships because her contributions were properly credited to her capital accounts. Accordingly, the consideration exception to §2036(a) exposure was applied.

Having found that this exception was applicable, the balance of the court's opinion is dicta – unnecessary to the final resolution of the case. Nevertheless, Judge Foley dismissed the notion that the decedent retained the right to income from assets transferred into the partnerships, saying that the decedent "respected the partnerships . . . as separate and distinct legal entities, observed partnership formalities, and retained sufficient assets for personal needs." The opinion also said that the decedent did not use management fees to pay personal expenses, given that there were sufficient funds in her guardianship account for that purpose. All of which is a funny approach to the question, because §2036 only requires retention of the right to income, with no consideration of whether or how that income is spent.

To the more important notion that the management fee was "an express retention of income by decedent in the partnership interests," the court simply held that the contention was without authority – there was no precedent for it – and that any legally enforceable direction to provide for her support and maintenance would "violate the fiduciary duties imposed upon the general partner." Indeed, the court rejected the contention in part because it was based on a mere statement in the petition for the court order, "merely an expression of financial benefits decedent could receive," and was not "a legally binding directive to provide her support and maintenance." Finding that the management fees paid were reasonable and that "the partnership agreements restricted decedent from requiring that the partnerships pay anything more than a reasonable fee to the general partner," the court denied the government's argument.

Thus, the decedent's ownership of 100% of the stock in the corporate general partner caused inclusion of the value of that entity in her estate, but payment of management fees to that corporation was not a §2036 retention of income from the partnerships that would trigger inclusion of the partnership assets in her gross estate. Albeit dicta, this aspect of the case may be the most important lasting significance of the decision, given that many decedents retain control of FLP operations by naming themselves as the general partner, with a right to receive payment for serving in that capacity.

***Single Asset FLP Found Immune to §2036(a) Challenge.*** In an opinion that reaches the right result but plays a bit fast-and-loose with several legal principles, Tax Court Judge Goeke denied the government's effort to ignore an FLP that owned nothing but undeveloped woodland properties. The opinion in **Estate of Stone v. Commissioner**, 103 T.C.M. (CCH) 1237 (2012), is as interesting for what it does not say as it is for the conclusions it reaches on certain issues.

Thus, for example, there is no indication of the values involved, nor of the discounts claimed or allowed. The decedent and her husband created the partnership eight years before her death and transferred their entire 98% limited partnership interests by gifts to family members over the following four year period. Thus, it appears that the estate tax deficiency was with respect to just the decedent's share of the remaining 2% general partnership interest. Further, the opinion does not indicate whether the decedent made any marital deduction transfers to her surviving husband.

It also does not appear that the government was challenging the value of the lifetime gifts of limited partner interests. Indeed, the opinion notes that the taxpayer did not discount the parcels when transferring them to the partnership, nor for subsequent gift tax purposes. Because the size of the interests transferred annually appears to have been engineered to fall within the gift tax annual exclusion, there also appears to be no gift tax issue for estate tax calculation. Nor was any challenge brought on the present interest requirement for annual exclusion purposes. Given the 2010 decision in Fisher v. United States, 2010-1 U.S. Tax Cas. (CCH) ¶60,588 (S.D. Ind. 2010) (involving vacation property fronting Lake Michigan that generated no income), this might have been a successful argument had the gift tax been involved, because the woodlands produced no income during the taxpayer's life.

Notwithstanding all of these issues, the decision is difficult to challenge. Unfortunately, the facts also make it of limited precedential value. For example, the FLP was formed because one child built a house on property contiguous to the decedent's parcels and negotiated with the local water district to build a dam (and water treatment plant), which created a lake that fronted on the decedent's property. With this new lakefront attribute, the partnership allegedly was created to better allow the taxpayer's family to develop the parcels for sale as home sites. The partnership also precluded partition by family members (which otherwise might have resulted if the taxpayer had transferred undivided fractional interests in the various parcels). Two children were divorced not long after creation of the partnership, so this reason may have been a realistic consideration (unlike the nonsense allegation in Estate of Liljestrand v. Commissioner, 102 T.C.M. (CCH) 440 (2011), involving a Hawaii resident who allegedly was worried about partition under Hawaii law, of realty that was located on the mainland and therefore was not subject to Hawaii law).

A third reason that the court acknowledged as *not* a legitimate nontax purpose was to facilitate gifting shares in the property. It is notable nevertheless that, if the taxpayer had made transfers involving undivided fractional interests in the timber properties, the discounts involved likely would have been in the range of 20 to 25 percent. Meaning that, depending on the values reported, the FLP may not have generated a significant difference. Which leaves the question why the government sought to litigate this case.

As is true of most taxpayer FLP victories, it would be difficult for other taxpayers to replicate the facts and turn this taxpayer victory into favorable precedent for other situations. The decision is compelling because it is not unusual in the geographic area involved for families to invest in timber land and for them to create partnerships to pool resources and share ownership in such properties. Indeed, fifty years ago my uncles and grandfather created just such a partnership to own numerous undeveloped timber tracts just one county distant in the same middle Tennessee region. Those family members all were involved in the family business, and the partnership was a facile method of holding title and dividing ownership among them. All done long before anyone thought about using FLPs for discount valuation.

The court did articulate various factors that it will consider in such cases, including

(1) the taxpayer standing on both sides of the transaction — the court said that this was not determinative if "the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other" and there are legitimate and significant nontax reasons for the transaction;

(2) the taxpayer's financial dependence on distributions from the partnership — in this case that was not a problem because the partnership made no distributions (because it generated no income);

(3) the partners' commingling of partnership funds with their own — in this case the issue was in reverse, because the taxpayer paid the $700 annual property tax (because the parcels generated no income);

(4) the taxpayer's actual failure to transfer the property to the partnership — not an issue here;

(5) discounting the value of the partnership interest relative to the value of the property contributed — also not an issue here, because the taxpayer had the property appraised before the transfer into the partnership and did not claim any valuation discounts; and

(6) the taxpayer's old age or poor health when the partnership was formed — here the taxpayer was 73 but lived another eight years (and her husband survived her and was still alive at the time of the trial).

The aspect of the opinion that is a bit difficult to embrace is the court saying that the exception to §2036(a) for a bona fide sale for adequate and full consideration will not apply if the "intrafamily transaction merely attempts to change the form in which the decedent holds property" and that a "recycling" of value will not be respected. But in this case there "was not merely an attempt to change the form in which decedent held the woodland parcels" because the taxpayer had a legitimate nontax purpose for the transaction. That legitimate nontax reason test speaks to the bona fide sale aspect of the exception, and not to the adequate and full consideration prong that is implicated by the recycling of value issue.

All of which leaves the impression — as do many of these cases — that the courts take their measure of the facts and circumstances of a particular case and reach a conclusion about whether the transaction was abusive, and then the court cobbles together reasons to support its decision. Which is not to suggest that the court decided this case wrongly — the result seems reasonable because the FLP does not appear to have been manipulative — but it leaves some doubt about how the various tests will be applied, one case to the next.

## 6. Section 2041: General Powers of Appointment

***Nongeneral Power of Appointment.*** The powerholders in **PLRs 201231007** and **201229005** are siblings (let's call each P for powerholder), each of whom held a testamentary power to appoint trust principal and income to a class consisting of descendants of their parents.

Yet each PLR concluded that their respective powers were not taxable general powers. Because they were testamentary powers, each PLR concluded that they could not appoint to themselves while living, nor to their creditors inter vivos. Furthermore, the PLRs concluded that the class of permissible appointees "is properly viewed as not including [P's] estate or the creditors of [P's] estate after [P's] death."

The only relevant fact in each PLR was that each powerholder was the life beneficiary of a separate trust share created by P's parents that, upon P's death, was distributable "to one or more of the group consisting of the 'Settlors' issue' . . . as [P] shall appoint by a written instrument delivered to the trustee during [P's] lifetime." The power thus was exercisable at death (albeit the instrument of exercise had to be delivered inter vivos). The only question was whether the power was taxable as a §2041(a)(2) general power because it was exercisable in favor of any one or more of P, P's estate, or creditors of either. The government concluded that it was not, even though P was a child of the trust settlors.

This result is not unprecedented. For example, in PLR 201038004, the taxpayer (T) was trustee and beneficiary of a trust over which T had a testamentary power to appoint to "any or all of the issue of the Settlor." T's parent created the trust, so T was an "issue of the Settlor," which was the class in whose favor T's testamentary power was exercisable. By all appearances T thus had a testamentary power to appoint the entire trust at death to T, which would make the entire trust includible in T's gross estate. The interesting *but unaddressed* aspect of this ruling was that inclusion would be avoided if the power or state law would allow exercise only in favor of *living* issue of the Settlor, which would not include T. No such limitation was mentioned in the PLR, but other cases make it clear that this state law limitation is the key to understanding the issue in each of these cases.

The state law is accurately noted by Borron, *Simes & Smith The Law of Future Interests* §917 (3d ed. 2011), which states an implied condition of survivorship – that "a donor who did not permit the [powerholder] to make an effective appointment until the [powerholder's] death intended . . . an appointment only to persons who survived [the powerholder]." Thus, traditionally a powerholder could not appoint to a deceased permissible appointee. This general rule would apply unless the power specifically authorized appointment to a decedent's estate, meaning that a testamentary power to appoint among a class including the powerholder could not be exercised in favor of the powerholder's own estate unless that exercise expressly was permitted. Silence would mean that exercise to the powerholder's estate was not authorized, meaning that exercise to the powerholder would be precluded if the power was exercisable only at the powerholder's death.

Historically this rule was regarded as preferable because exercise in favor of the estate of a permissible appointee could cause the appointive assets to pass to individuals (beneficiaries of that estate) who might not themselves be permissible appointees. Some states have extended their antilapse statute to the exercise of a power of appointment, which alters this rule. See the latest version of UPC §§2-603(a)(5) and (b), and 2-707(a)(7) and (b). The theory underlying this change to the common law – the response to the impermissible appointee concern – is that exercise to a living permissible appointee, followed by a gift to someone who is not a permissible appointee, is no different than exercise in favor of a predeceased permissible appointee, followed by the property passing through that appointee's estate to the appointee's beneficiaries.

As thus seen, the application of state law appears to be the critical issue. And that reality explains why seasoned estate planners typically include a parenthetical in their nongeneral powers of appointment that expressly excludes a powerholder, the powerholder's estate, and creditors of either from the class of permissible appointees. Because they know that current state law that follows the traditional rule could be amended before the powerholder's death, in which case the new law might be deemed to apply and the nongeneral power might become taxable.

At a minimum, difficult issues involving the retroactive application of a change in the law would be avoided by the insertion of a simple parenthetical limiting the class of permissible appointees. On the flip side, however, those few drafters who intentionally create general powers of appointment typically provide by an equally express parenthetical that the powerholder may exercise in favor of their own estate (or creditors thereof), to make clear that this traditional prohibition will not spoil the intended result of estate tax inclusion.

Finally, note that the issue involved in these situations can arise in unexpected circumstances. For example, PLR 200832015 involved a pre-1942 power of appointment. Recall that, under §2041(a)(1), these powers cause estate tax inclusion in the powerholder's estate only to the extent they are *both* general *and* exercised. The PLR responded to an inquiry whether exercise of the subject power would generate estate tax liability, and the reply was that the power (which clearly *was* exercised) was not general. The power was testamentary — exercisable by the powerholder only by will – in favor only of the powerholder's own spouse and "members of the [Grantor's] family," which was defined by the document to mean "children of Grantor and their descendants." Because the powerholder was a grandchild, the power appeared to be general (and it was exercised), but the PLR dismissed that conclusion, again stating:

> Because [C's] power is a testamentary power, [C] may not appoint . . . to [C] or to [C's] creditors during [C's] life. Further, because [C's] power of appointment is expressly limited to a permissible class of appointees, [C] may not appoint . . . to [C's] estate or the creditors of [C's] estate.

That is virtually the same language as found in PLRs 201231007 and 201229005. Because the powerholder intended to exercise the power in this case, the only way to avoid §2041(a)(1) inclusion was if the power was not general. That generous conclusion was unprecedented and seemingly unreliable, both because it was pronounced in a private letter ruling and because it was not a well established or understood conclusion. Subsequent developments now suggest that it foretold the current government position, and it is an important interpretation to remember.

Because either the government's conclusion or state law could change, the cautious approach is to draft powers that are explicit in their denial or grant of the power to appoint to a deceased permissible appointee's estate. Only in this manner will the drafter be confident of the tax result intended with respect to any power of appointment that is granted.

## 7. Section 2056: Estate Tax Marital Deduction

***Marital Deduction Allowed for Same Sex Surviving Spouse.*** In a string of cases, now culminating in a federal circuit court decision involving the estate tax marital deduction, the federal Defense of Marriage Act (DOMA) discrimination against same sex marriages is declared unconstitutional. The Supreme Court granted certiorari and heard arguments at the end of March and likely will decide the issue, although questions of jurisdiction and standing may yet cause it to duck the underlying issue. In addition to the fact that there is no conflict among any of the decisions, a Court appointed amicus brief also determined that the defendant in the federal case (the BLAG – Bipartisan Legal Advocacy Group – funded by House Republicans) lacked standing to advocate for the constitutionality of the statute, and that the

Court lacks jurisdiction because the petition for review was that of the *winning* party below. Which may portend retraction of the grant of certiorari as improvident.

As of today, for estate planners the significant decision is **Windsor v. United States**, 833 F. Supp. 2d 394 (S.D. N.Y. 2012), aff'd, 699 F.3d 169 (2d Cir. 2012), petition for cert. granted, 2012 WL 4009654, which allowed the estate tax marital deduction because decedent's Canadian same-sex marriage was recognized as valid by New York law (not true then, but today the couple could actually be married in New York). In the process the court held DOMA's discrimination against same sex marriages to be unconstitutional.

That conclusion is hardly a surprise, coming as it did after the companion cases of **Gill v. Office of Personnel Management**, 699 F. Supp. 2d 374 (D. Mass. 2010), and **Massachusetts v. United States Department of Health and Human Services**, 698 F. Supp. 2d 234 (D. Mass. 2010), consolidated and aff'd, 682 F.3d 1 (1st Cir. 2012). They hold that DOMA §3 ("In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation . . . 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife") violates the equal protection principles of the Due Process Clause of the Fifth Amendment, the reservation of "exclusive state authority" to the states under the Tenth Amendment, and the prohibition against forcing states to discriminate against their own citizens in the Spending Clause. "This court is convinced that 'there exists no fairly conceivable set of facts that could ground a rational relationship' between DOMA and a legitimate government objective. DOMA, therefore, violates core constitutional principles of equal protection." Further, "the subject of domestic relations is the exclusive province of the states. And the powers to establish eligibility requirements for marriage, as well as to issue determinations of marital status, lie at the very core of such domestic relations law."

**Perry v. Brown**, 671 F.3d 1052 (9th Cir. 2012), aff'g sub nom. Perry v. Schwarzenegger**,** 704 F. Supp. 2d 921 (N.D. Cal. 2010), petition for cert. granted sub nom., 2012 WL 4009654, held California's DOMA unconstitutional to deny due process and equal protection in violation of the Fourteenth Amendment. It will have only limited significance in the ongoing battle, however, because the court narrowly circumscribed its holding, saying that California at one time allowed same-sex couples to marry and that it was unconstitutional for Proposition 8 "to take away" the meaningful status of marriage from one disfavored group of citizens. "We . . . need not decide whether a state may decline to provide the right to marry to same-sex couples." As a result, even though the case has reached the United States Supreme Court, it likely will not be the watershed case that advocates anticipate.

Most recent among the nontax cases are **Pedersen v. Office of Personal Management**, 881 F. Supp. 2d 294 (D. Ct. 2012) (summary judgment granted to the plaintiffs, based on a determination that denial of the "benefits of the plethora of federal laws which rely on" the definition of marriage violates the equal protection guarantee of the Fifth Amendment), and **Dragovich v. United States**, 848 F. Supp. 2d 1091 (N.D. Cal. 2012), and 764 F. Supp. 2d 1178 (N.D. Cal. 2011), which twice denied the government's motion to dismiss for failure to state a claim in a case challenging California's refusal to permit same-sex spouses to participate in the state's long term care (LTC) program. In *Dragovich* the state feared that permitting same-sex couples to participate would imperil the plan's favorable federal income tax treatment. The court held that denial of equal access to the LTC program was "a barrier that makes it more difficult for members of one group to obtain a benefit than it is for members of another group," that flowed from an "animus toward, and moral rejection of, homosexuality and same-sex relationships [that] are apparent in the Congressional record," and that "bears no rational relationship to a legitimate governmental interest.” “The ‘bare desire to harm a politically unpopular group’ is not a legitimate state interest.”

Of particular interest to the tax consequences of this social drama is the notion that registering as domestic partners (and thereby subjecting all future earnings to the community property laws) is not a voluntary and complete transfer for less than full and adequate consideration that therefore is subject to gift tax (as opposed to being a gift that might be deductible under the unlimited gift tax marital deduction). And, now due to *Windsor*, also notable is the notion that state-recognized marriages of same-sex couples will be allowed the same marital deduction (or other federal tax entitlements) as other spouses whose marriages are respected under state law. The tax status of same sex partners or spouses will continue to evolve, and questions will continue to beguile estate planning and tax specialists as both state and federal laws mature. By way of example, it seems likely that some same sex couples will claim common law marriage status even if there was no formal marriage before one of them dies and qualify for an estate tax marital deduction, or the survivor may be allowed to bring a palimony claim like that in Estate of Shapiro v. United States, 634 F.3d 1055 (9th Cir. 2011), and seek an estate tax deduction for a claim against the decedent’s estate.

In May 2010, prior to these decisions, **PLR 201021048** established that each “registered domestic partner” who is treated as entitled to “full community property treatment” under California law (1) must report half the combined earned income of both partners, (2) is entitled to half of the credits for income tax withholding at the source of both, and (3) makes no transfer subject to gift tax by virtue of being a registered domestic partner. **Chief Counsel Advisory 201021050** similarly provides that California registered domestic partners should be treated the same as any other community property owners. **Chief Counsel Advisory 201021049** correspondingly provides that the government may consider the assets of each registered domestic partner when determining the reasonable collection potential of either taxpayer’s offer in compromise. And released in September of 2011, **Publication 555** contains added guidance regarding the community property treatment of registered domestic partners, including guidance relating to their children and various deductions.

***Contingent Bequest Ignored for Marital Deduction Purposes.*** **Baer Revocable Trust v. United States**, 2010-1 U.S. Tax Cas. ¶60,590 (D. Neb. 2010), was a refund action that disagreed with the government’s reduction of the estate’s marital deduction on account of a contingent bequest to individuals other than the surviving spouse. Saying that “the possibility that the transfer to the contingent beneficiaries would ever come to fruition is so remote that it is negligible,” the court allowed the taxpayer’s refund.

**AOD 2012-01**, 2012-17 I.R.B. 1, correctly observes that there is no de minimis standard or exception under §2056 and that the court’s rationale for allowing the unreduced deduction therefore is incorrect. Nevertheless, the government acquiesced in the result, meaning that there will be no appeal. According to the AOD, the court’s determination that the subject of the contingent bequest “had negligible value rendered the legal error irrelevant to the extent it did not materially affect the amount of the refund” sought by the taxpayer.

The proper treatment in such a case is to reduce the marital deduction under §2056(b)(4)(B) by the date of death value of the contingent bequest to the nonspouse beneficiaries. Postmortem events revealed that the nearly $11 million value originally reported for the subject of the contingent bequest actually was so close to zero that it didn’t matter. The government could have challenged the use of postmortem facts to determine this revised date-of-death value but it did not pursue that aspect of the case. All of which confirms that there is plenty wrong with *Baer*, and the AOD reveals that no litigant should rely on it, nor should any taxpayer mimic the planning involved.

***Odd QTIP Decision Favors Taxpayer.*** In **Estate of Kite v. Commissioner**, 105 T.C.M. (CCH) 1277 (2013), the surviving spouse (S) was more wealthy than her predeceased husband (D). Very shortly before D died S created an inter vivos QTIP marital trust for D's benefit. D apparently had more wealth than his exclusion amount, so it does not appear that this was meant to shelter D's unused exclusion amount (D died in 1995, long before portability was enacted). Instead, S may have engaged in this planning to generate a new basis under §1014 for very low basis stock that S transferred into the QTIP trust. This inter vivos QTIP trust reserved a secondary life estate for S, and inclusion in D's estate was offset with a QTIP election made by D's estate, which qualified the trust for the marital deduction in D's estate. As a result, S's stock passed into this trust and then was held for S's benefit, all tax free due to the two marital deductions.

D died one week after this QTIP trust was created, meaning that §1014(e) should have denied any basis increase for the appreciated stock that S transferred into the trust that was §2044 includible in D's gross estate. Nevertheless, the court's footnote 9 reveals that new basis was generated, despite Congress' intent to preclude such end-of-life planning. See H. Rep. No. 201, 97th Cong., 1st Sess. 188-189 (1981), providing that property passing to D within one year of D's death will not receive a new basis if inclusion increases D's gross estate, which correspondingly increases the amount of D's formula marital deduction bequest back to S. So, new basis on this highly appreciated stock was the first taxpayer victory in *Kite*. (Note, however, that this may have been a hollow victory in *Kite*, given the subsequent events described below, because the end owner of this property was the decedent's children and they bought it for a deferred annuity on which they made no payments, which meant that their basis would be zero from the purchase.)

D's estate created two more marital trusts for the benefit of S. One was a reverse-QTIP trust that sheltered D's GST exemption. The other was a §2056(b)(5) general-power-of-appointment marital deduction trust. These three trusts participated in the transactions that were central to the case. Which (vastly simplified for these purposes) entailed termination of all three marital trusts, distribution of their assets to S, who placed them into S's revocable inter vivos trust, which then sold them to S's children, in exchange for a ten-year deferred annuity payable to S, who died before the deferral period ended. Thus, no payments were ever made in exchange for this wealth, meaning that the private deferred annuity arrangement significantly reduced S's gross estate. The government sought to preclude this reduction in two different ways.

First, the government asserted that the annuity transaction was a taxable gift by S, based on several alternative arguments that the annuities were not full and adequate consideration for the transfers made to the children. Those annuities were structured using the §7520 tables, which applied because the estate established (via a physician's statement that the government did not challenge) that S was not terminally ill at the time of the annuity transaction. Although the annuities proved to benefit the children, the court rejected the government's suggestion that they were not full and adequate consideration for the asset transfers. The court also "disagree[d] with [the government's] position that the annuity transaction lacked economic substance." And it rejected the government's suggestion that the annuity transaction was "illusory," saying that the annuity agreements were enforceable and that the parties intended to comply with their terms.

The court even suggested that S intended to profit from the transaction (which seems unlikely). The result was that the transaction did not constitute a taxable gift because "the annuity transaction was a bona fide sale for adequate and full consideration." This was a second, significant taxpayer victory in *Kite*.

The government also asserted that the annuity transaction triggered gift tax under §2519 because it involved a disposition of S's income interest in the two QTIP trusts. Recall that §2056(b)(7) allows the estate tax marital deduction for a trust that grants S only a life estate. In return, §2519 gift tax or §2044 estate tax inclusion occurs when any part of the income interest is assigned or terminates. The court understood, however, that a mere "conversion of QTIP into other property in which the surviving spouse has a qualifying income interest for life" is not subject to §2519, citing Treas. Reg. §25.2519-1(f). Furthermore, reinvestments, as a substitution of property of equal value for QTIP trust assets, also do not trigger §2519, because there is no diminution in the amount that will be includible in S's gross estate at death. Having found that the annuities were adequate and full consideration for the assets that S transferred to the children, the government's second theory also should have failed.

Instead, the court held that "liquidation of the QTIP trusts and subsequent sale of [S's] interests . . . disregarded the QTIP rules. . . . [T]he termination of the QTIP trusts was part of a prearranged and simultaneous transfer of the QTIP trust assets [and] would circumvent the QTIP regime and avoid any transfer tax imposed by section 2519." Further, the court also turned logic on its head by stating that, because S received adequate and full consideration for S's QTIP trust interests, S therefore "made a disposition of her qualifying income interest" and triggered application of §2519 gift taxation. This would appear to be a significant taxpayer defeat in *Kite*, but it is not, and it is wrong.

The court's §2519 conclusion is baffling, because the government similarly argued that the annuity transaction effectively constituted a §2514 taxable release of S's general power to appoint the §2056(b)(5) marital trust. The court rejected *that* argument because that trust's assets went into S's revocable inter vivos trust and thus did not constitute a transfer to another person. So, termination of S's interest in the QTIP trusts triggered §2519, but termination of S's interest in the general power trust did not trigger §2514. Because §§2514 and 2519 are the corresponding provisions that tax inter vivos termination of general power and QTIP marital deduction trusts, this inconsistency is inexplicable.

The end result was the court holding that "the portions of the annuity value originally traceable to the ownership interest of [the two QTIP trusts] . . . less the value of [S's] qualifying income interest [in those two trusts] . . . are subject to Federal gift tax" under §2519. That statement *also* is inverted, because §2519 taxes the full value of a QTIP trust, less the value of the income interest in that trust. The court's statement therefore confused the annuity amount with the value of the QTIP trust itself. That may make sense, because the estate's attorneys confirm that the annuity amount was equal to the full value of the trusts, and not just the value of S's income interests in them. And that is a critical fact.

The net result in *Kite* should be no §2519 taxation at all, because §2519 only taxes the excess *uncompensated* value of the QTIPs over the value of S's income interest. Oddly, the court never determined the values that will apply, which means that this element remains for a Rule 155 determination. Because the private deferred annuities were equal to the full value of the QTIP trust assets, what appears to be a taxpayer defeat likely will result in the estate owing no gift tax. (Note, however, that this aspect of the QTIP holding – found in the last two paragraphs of the court's opinion – is a muddle; it simply is not clear what the opinion was saying.) By all accounts, therefore, the §2519 result is the third significant taxpayer victory in *Kite*.

Attorney Larry Katzenstein, author of the Tiger Tables valuation software, confirms that calculation of the deferred annuity did equal the full fair market value of the trust assets sold. But he also stresses that the *Kite* annuity transaction may cause capital gain to be realized in the transferred assets, which would not be deferred under current law. In *Kite* the new basis resulting from the initial transfer of appreciated stock into the inter vivos QTIP, and the different law applicable at that time, may have been critical components for the taxpayer's success. And failure to litigate the §1014(e) issue may be the government's most significant error.

One final matter deserves mention. The children were made trustee of the marital trusts immediately before their termination. They also were the remainder beneficiaries. Termination of these trusts and distribution of the assets to S meant that their remainders were destroyed (and, presumably, the GST exemption allocated to the reverse-QTIP also was lost). Yet the court's footnote 37 states that the government "does not raise the issue of whether the . . . children's termination of the QTIP trusts, and the subsequent liquidation of QTIP trust assets, was a gift from the remainder beneficiaries . . . to the lifetime income beneficiary." This actually makes sense, because the marital deduction and the payback inclusion of the full value of the marital trusts in S's gross estate at death means that S is deemed to already own the full fee simple value of these trusts for tax purposes. This should mean that the children could make no gifts to S because, for tax purposes, S already owned the entire value of the marital deduction trusts.

It is true, however, that there was no assurance that the children would receive any value from S, and the annuity transaction posed the possibility that S might live longer than the mortality tables predict. In that case the children could have been significantly disadvantaged by this transaction. Whether those facts suggest that the children made a gift apparently did not warrant government attention, and the court similarly dismissed it. And that result is a fourth taxpayer victory in *Kite*.

Finally, it may be difficult in other cases to terminate a trust, as was done in *Kite*, due to the nearly universal existence of spendthrift trust provisions. And favorable but (according to the court) unique facts also may prevent replication of *Kite* in another circumstance. Advisors who are intrigued by *Kite* will want to study the decision and analyze the various steps involved (most of which are summarized without elaboration here), before seeking to mimic the planning involved.

## 8. Gift Tax

***Trust Dinged for Gift Tax Purposes.*** "Delaware Incomplete Nongrantor" (DING) trusts are created by taxpayers who want to shift state income taxation to a tax-favorable onshore jurisdiction (it need not be Delaware). One objective for settlors of these trusts is that creation not be a taxable gift — the settlor may not wish to accelerate federal wealth transfer tax as a price for lowering state income tax. Further, the trust must *not* be a grantor trust for either federal or state income tax purposes. Otherwise trust income would be taxed to the grantor, presumably in the state of the grantor's domicile, at higher state income tax rates. In **ILM 201208026** (reported in some services as a CCA — either way it is a National Office opinion in support of litigation) the government articulates two theories on which unexpected gift taxation may attend to the taxpayer's creation of the trust.

One theory relates to a provision in the trust itself that is advanced by a growing number of trust drafters. Here it was both an anti-contest (in this case, a forfeiture in terrorem clause) and a mandatory arbitration clause — both designed to either preclude litigation entirely, or to divert legal actions by beneficiaries into an alternative dispute resolution forum. As articulated by the ILM: "Because the threat of severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights [Crummey clauses] are illusory. Consequently, no annual exclusion under §2503(b) is allowable for any of the withdrawal rights."

These provisions may constitute a drafting faux pas for another reason — because the consistent judicial assessment is that mandatory arbitration provisions in trust and estate matters are invalid. See *In re* Chantarasmi, 938 N.Y.S.2d 762 (Surr. Ct. Westchester County 2012) (suggesting that an arbitration provision in a proposed trust would not be enforceable); Rachal v. Reitz, 347 S.W.3d 305 (Tex. Ct. App. 2011), citing Schoneberger v. Oelze, 96 P.3d 1078 (Az. Ct. App. 2004) (superseded by Ariz. Rev. Stat. Ann. §14-10205 – the validity of which has not yet been tested ), Diaz v. Bukey, 125 Cal. Rptr. 3d 610 (Cal. Ct. App. 2011), and *In re* Calomiris, 894 A.2d 408 (D.C. 2006) (involving a will rather than a trust). The good news is that, if those courts are correct in holding that these provisions are not valid, then the government's conclusion that they prevent qualification for the annual exclusion also is invalid. The bad news is that a taxpayer would need to argue against the very provision that the taxpayer included in the trust.

More significant (because it is harder to cure) is the Memorandum's conclusion that creation of the trust entailed a taxable gift in the first instance. (Note that inclusion of a Crummey clause — to garner the gift tax annual exclusion for any gift made — is a belt-and-suspenders approach, because the taxpayer's primary position was that creation of the trust did not entail a gift at all — hence the "incomplete" term in the title of these trusts.) In this case the provision relied upon by the taxpayer to make transfers into the trust incomplete for gift tax purposes was a retained *testamentary* power of appointment.

Many tax advisors believe that such powers make any transfer into a trust incomplete, and thus not yet ripe for gift taxation. (Correspondingly, the trust will be includible in the settlor's gross estate for federal estate tax purposes.) The ILM opines that rights in the trust that exist between creation and death of the settlor are not subject to change by exercise of the settlor's retained testamentary power and, therefore, that the value of the term interest (based on the trust terms and measured by the settlor's life expectancy) *is* a completed gift. That is, the *testamentary* power precludes the transfer from being a competed gift only of the remainder interest in the trust. Oh, and by the way, the ILM states that the testamentary power is a "retained interest" that is ignored for gift taxation due to §2702, meaning that the value of the gift is the full fair market value of the property transferred into the trust.

The fundamental opinion about whether any part of the gift is complete may be incorrect. Treas. Reg. §25.2511-2 contains several statements that surround the issue presented but that leave a gap in the government's position on the competed gift issue. The ILM is seeking to fill that gap. Here are several of those provisions (with emphasis added in each):

> Treas. Reg. §25.2511-2(b): As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be

> partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, *if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment*, but instead provided that the remainder should go to X or his heirs, *the entire transfer would be a completed gift.*

Notice the gap in this paragraph -2(b) — retained personal enjoyment (even in the discretion of the trustee) *and* a testamentary power make the *entire* transfer incomplete, but lack of the testamentary power makes the *entire* transfer a completed gift. Nothing speaks to a transfer with retained testamentary power but *without* retained personal enjoyment. Many planners have assumed that the power alone makes the entire transfer incomplete — and the ILM challenges that conclusion.

> Treas. Reg. §25.2511-2(c): A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. *A gift is* also *incomplete* if and *to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves* unless the power is a *fiduciary* power limited by a fixed or ascertainable standard.

> Treas. Reg. §25.2511-2(d): A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment.

> Treas. Reg. §25.2511-2(f): The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event which completes the gift and causes the tax to apply. For example, if A transfers property in trust for the benefit of B and C but reserves the power as trustee to change the proportionate interests of B and C, and if A thereafter has another person appointed trustee in place of himself, such later relinquishment of the power by A to the new trustee completes the gift of the transferred property . . . . *The receipt of income or of other enjoyment of the transferred property* by the transferee or *by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment* . . . .

Two conclusions seem reliable. First, to the extent creation of the trust is not a completed gift, then any trust distribution to anyone other than the settlor is a gift at the time of that distribution. As to which the gift tax annual exclusion ought to be available, without the need for a Crummey clause to satisfy the present interest requirement. Second, retention of *sufficient* control can prevent complete gift treatment on creation. The issue is how extensive that retained control must be.

An easy solution is found in -2(c) above. The settlor simply needs to retain a *nonfiduciary* power to alter the beneficiaries or their interests during the interval between trust creation and the settlor's death. (Note that it must be more than a -2(d) power to alter the time or manner of the trust beneficiaries' enjoyment.) Doing so raises the specter of estate tax inclusion under §§2036(a)(2) and 2038(a)(1), but the retained testamentary power would have that effect anyway. So the issue is not estate taxation (which should be expected in all of these cases) but, rather, income tax treatment of the retained power to alter the interim enjoyment. Because, recall that the other objective of this trust is to prevent income taxation to the settlor at home state rates, meaning that grantor trust treatment must be avoided.

In this case §674(a) is the linchpin. It provides that retained control over third party enjoyment of trust income or principal is adequate to cause defective grantor trust treatment. That result can be avoided, however, by fitting within the exceptions in §§674(b)(5)(A) for distributions of corpus and §674(d) for distributions of income. The latter provision is not helpful because the power cannot be held by the settlor (or the settlor's spouse) and it must be a fiduciary power. But §674(b)(5)(A) allows the settlor to hold a nonfiduciary power to distribute corpus and the exception applies if the settlor's retained power is limited by a "reasonably definite standard."

Case law establishes that terms that satisfy the more familiar §2041(b)(1)(A) ascertainable (HEMS) standard will suffice under §674(b)(5)(A). So, traditional standards that restrict a settlor's retained control to alter beneficial enjoyment of corpus during the balance of the settlor's life ought to (1) preclude completed gifts of the term interest in the DING trust for gift tax purposes, (2) without grantor trust exposure. This essential feature is now confirmed by **PLRs 201310002** through **-006**. As an added degree of caution, for gift tax purposes it may be wise to make the standard a "may distribute" rather than a "shall" or "must distribute" provision, to clarify that the settlor has discretion and is not a mere automaton, obliged to make distributions to the extent the standard is met.

***Annual Exclusion Allowed for Gift of FLP Interests.*** The §2503(b) gift tax annual exclusion is available only for gifts of assets that satisfy the "present interest" requirement, meaning that the donee must have an "unrestricted right to immediate use, possession, or enjoyment of" the asset or its income. See Treas. Reg. §25.2503-3(b). According to Fondren v. Commissioner, 324 U.S. 18, 20-21 (1945), "to qualify as a present interest, such a gift must confer on the donee . . . a substantial present economic benefit." Cases deny the annual exclusion if, for example, transferred property does not produce income and cannot be converted into either personal use or income producing property. There must be an ascertainable income flow or other present enjoyment. See, e.g., Phillips v. Commissioner, 12 T.C. 216 (1949) (gift of the right to income from non-income-producing property, such as a life insurance policy held in trust, is a gift of a future interest); McManus v. Commissioner, 40 T.C.M. (CCH) 866, 868 (1980) (transfer in trust of an unproductive woodland; the trust was terminable when all the property was sold but until then the beneficiaries had only future interests: "At the time of making the gifts, any sale and subsequent distribution of the proceeds to the donees was a mere future possibility").

A transfer of the present enjoyment of the income from an asset will not qualify if there is no guarantee that any present income will be generated. The government has been relatively successful in denying the annual exclusion for gifts of interests in discount entities in which there was no guarantee of distributions to owners of the entity, and restrictions on the transferred interests made it functionally impossible to convert those interests into other income producing property.

Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003), is a fine illustration of this present enjoyment requisite. The court held that transferred interests in an LLC did not afford a substantial current economic benefit. And, because the asset involved (a timber plantation) was not likely to produce any income for quite some time, it was critically important that the operating agreement foreclosed any transfer of the gifted units to third parties and therefore barred alienation as a means of reaching any present economic value. Having created an entity with restrictions designed to generate significant wealth transfer tax valuation discounts, the taxpayers precluded the more immediate benefit of gift tax annual exclusion treatment for units in the entity.

The government's success in *Hackl* has spawned denial of the annual exclusion in other cases in which the key was the confluence of no present return *and* the donees' inability to convert to more productive assets. See, e.g., Fisher v. United States, 2010-2 U.S. Tax Cas. (CCH) ¶60,588 (S.D. Ind. 2010) (involving an LLC that primarily held undeveloped land on the shore of Lake Michigan), and Price v. Commissioner, T.C. Memo. 2010-2 (2010) (involving interests in an FLP that owned closely held business stock and commercial real estate). The latest iteration of the government's effort to deny the annual exclusion is **Estate of Wimmer v. Commissioner**, 103 T.C.M. (CCH) 1839 (2012). The taxpayer correctly asserted that the present interest requirement was met, but the facts are quite unusual and likely distinguish *Wimmer* from most other discount entity situations. First, because the assets funding the entity (an FLP) were entirely income-producing, marketable securities. That allowed the court to determine that there was an ascertainable and reliable income flow into the FLP. This alone distinguishes *Wimmer* from most discount entity cases.

A second unusual fact was that one partner in the FLP was a trust that owned no other property, which meant that it had no resource with which to pay the income tax it owed on flow-through income from the partnership. This meant that the FLP was required to make regular distributions to the trust, with which the trust could pay its income tax. And that one distribution triggered a provision in the partnership agreement that required corresponding pro rata distributions to all other partners in the FLP. As a result, the assets inside the FLP were producing a predictable flow of income and at least a portion of that steady income flow would be distributed to the partners. That confluence of income-producing assets and income flowing to the partners justified the court's holding that the present interest requirement was satisfied.

The *Wimmer* court articulated three present interest requirements that apply if a transferred asset is nontransferable, meaning that the right to income is the peg on which the annual exclusion hangs. The estate must prove that (1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained. The taxpayer likely would have been denied the annual exclusion lacking either of the income flow into the FLP or the steady distribution out. Because few discount entities will present both facts found to be critical in *Wimmer*, the authority itself is of only modest significance. Indeed, given the nearly unique facts in *Wimmer*, the real mystery is why the government sought to challenge the annual exclusion, rather than the valuation discounts claimed by the taxpayer. The equally fascinating question about litigation strategy is why the government did not assert the present interest issue in the *Stone* case reported at page 22, which involved timber property that was not producing income, but instead the government challenged the valuation discounts in that case. By all appearances *Wimmer* and *Stone* were reversed – each should have asserted the other case's issue.

***Defined Formula Gifts Are Not Invalid.*** Several notable cases decided over the past half decade have involved the government's effort to invalidate transfers made by formula. The courts have routinely decided that these transfers, done properly, are *not* subject to the government's contention that they violate public policy. See Petter v. Commissioner, 98 T.C.M. (CCH) 534 (2009), aff'd, 653 F.3d 1012 (9th Cir. 2011), Christiansen v. Commissioner, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009); McCord v. Commissioner, 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006), and Hendrix v. Commissioner, 101 T.C.M. (CCH) 1642 (2011).

Even more recent in this string of decisions is **Wandry v. Commissioner**, 103 T.C.M. (CCH) 1472 (2012), nonacq., 2012-46 I.R.B. 543, after a 10th Cir. notice of appeal was filed and then withdrawn), which involved inter vivos gifts defined by the gift tax annual exclusion and the gift tax applicable exclusion amount. The critical portion of each gift was the following language:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units . . . so that the fair market value of such Units for federal gift tax purposes shall be as follows:
>
> . . .
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift . . . . I intend to have a good-faith determination of such value made . . . and . . . if . . . the IRS challenges such valuation and a final determination of a different value is made . . . the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination . . . .

According to the court, the "only gifts . . . that [the taxpayers] ever intended to give were of dollar amounts equal to the Federal gift tax exclusions. At all times [the taxpayers] understood and believed that the gifts were of a dollar value, not a specified number of membership units." And, as such, the court determined that nothing about the formula provision would "undo the gift. [The taxpayers] transferred a fixed set of interests to the donees and do not seek to change those interests." Meaning that the formula provision was not an invalid effort to take back any part of the gifts that were made.

That determination is important because the government's core argument is that a formula or adjustment clause "creates a condition subsequent to completed gifts and is void for Federal tax purposes as contrary to public policy," based on Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1943). It is the post-facto unraveling of a transfer that is deemed to be invalid and here the court determined that an after the fact valuation of the entity and, based on that, the number of units that make up the dollar value of the intended gift is not a "condition subsequent" that would reverse or "undo" the gift that the taxpayer intended to make.

Citing and following Estate of Christiansen v. Commissioner, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009), and Estate of Petter v. Commissioner, 93 T.C.M. 534 (2009), aff'd, 653 F.3d 1019 (9th Cir. 2011), the court determined that formula gifts that limit the value of a completed transfer are valid. According to the court, there is a critical distinction between a "savings clause" that seeks to avoid tax by trying "to take property back" and a "formula clause" that merely transfers a "fixed set of rights with uncertain value." And here, as in those prior cases, the court held that the formula provision did not rely on a condition subsequent (valuation) to undo the transfer. Reference also was made to McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g on other grounds 120 T.C. 358 (2003), but, oddly, the court did not cite or refer to Hendrix v. Commissioner, 101 T.C.M. 1642 (2011).

Several elements of the case are important. First is that the taxpayer's gift tax return contained a schedule that described the dollar amount gifts in terms of certain percentages of the entity's value, based on an appraisal that was obtained 18 months after the date of the gift (purporting to establish the value on the date of the gift). When it was determined that the appraised value was too low, the government attempted to convert those percentage gifts into a larger value for gift tax purposes and, correspondingly, to assess a gift tax – because that higher value exceeded the taxpayer's annual exclusion and applicable exclusion amounts. Had the taxpayers not converted the formula dollar-amount gifts into a percentage of the entity itself, quaere whether the government would have sought to ding the taxpayer for some other reason. Either way, the government seeks leverage by which to assert that the gifts by formula are not legitimate.

Second, and vastly more important to most watchers of this development, a critical distinction between *Wandry* and both *Christiansen* and *Petter* is that the former cases had a charitable component, and *Wandry* did not. In the earlier cases if the value reported by the taxpayer was lower than finally determined the excess value would pass to charity. The intent of those provisions was to discourage a valuation challenge by the government (because a government victory on the valuation determination would only serve to cause more value to pass to charity, generating a charitable deduction and no added revenue for the government). Language in *Petter* caused some observers to wonder whether the charitable element made the difference in result. According to Judge Holmes in *Wandry* it does not: "In Estate of Petter we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern." And, further, "In Estate of Petter . . . we held that there is no well established public policy against formula clauses."

Another factor is worth considering, although none of the parties (nor the courts) have mentioned it. In cases like *Christiansen*, *Petter,* and *Hendrix* the taxpayer retains nothing of the transferred interest. What does not pass to private beneficiaries goes tax free to charity. In *Wandry*, to the extent the taxpayer's valuation is wrong the amount not transferred under the umbrella of the gift tax exclusions is still held by the taxpayer, to be taxed at a later date (eventually, at death). Taxpayers somehow regard the charitable alternative as safer – because there is more authority sanctioning it. But the *Wandry* approach is less susceptible to abuse. In the sense that a valuation challenge that puts a higher value on the transfer will cause the excess to be exposed to tax on a subsequent taxable event.

In that respect, quaere why the government is upset about the formula gift in a case like *Wandry* – nothing escapes taxation in *Wandry* if the government's valuation is correct. And *Wandry* should be seen as *less* prone to abuse of the government than are the charity cases, in which everything the taxpayer meant to transfer is removed from the taxpayer's gross estate. *Wandry* is similar to formula marital deduction gifts – whatever does not go into the credit shelter trust is going to be included in the surviving spouse's gross estate at the second death, meaning that formula transfers do not abuse the government in those cases either. As such, these formula transfers should not raise governmental concerns – they work in the marital deduction arena, and they ought to work in the gift tax exclusion arena too, as the formula did work in *Wandry*. Even without the purported purification of public policy favoring charity.

Note that *Wandry* is only a Memorandum opinion, meaning that it cannot be relied upon as precedent – Memo cases are like unpublished District Court opinions. Nevertheless, because *Wandry* will not be appealed or reversed on this issue, it further cements the conclusion that a properly drafted formula gift is not improper.

## 9. Generation-Skipping Transfer Tax

***Exemption Allocation Regulations.*** **[Note: nothing new regarding this item has occurred since promulgation of proposed regulations in 2008; it is here as a "place holder," awaiting release of the government's final regulations.]** Newly proposed generation-skipping transfer tax exemption allocation regulations will make Notice 2001-50, 2001-2 C.B. 189, obsolete and override the relief provisions of Treas. Reg. §301.9100-3. **Prop. Treas. Reg. §26.2642-7** applies to taxpayers seeking (1) to make an affirmative allocation, (2) to elect out of the automatic (default) allocation, or (3) to elect to treat a trust as a §2632(c) GST trust — in each case after the deadline for a timely allocation/election. The mechanism to obtain relief remains by private letter ruling, with a filing fee. That cost may be palatable, however, if exemption allocation is permitted at the value that would have applied had the action been timely, rather than the (typically, inflated) value when the late allocation actually occurs.

To qualify for relief the "taxpayer" (shorthand here for either the transferor or the transferor's personal representative — which reflects that failure often is discovered after the transferor's incapacity or death) must establish *reasonable*, *good faith* action that *does not prejudice* the government. Prop. Treas. Reg. §26.2642-7(d)(2)(i) through (v) contain a nonexclusive list of elements speaking to the reasonable and good faith elements; -7(d)(3) speaks to prejudice to the government; -7(e) identifies several circumstances in which relief absolutely will not be granted. A full study of these provisions is advisable but, in summary fashion, here are highlights gleaned from them:

- Taxpayer intent to timely allocate/elect may be found in transfer documents, tax returns, and correspondence. For example, a trust instrument may refer to a "GST Exempt Grandchild Trust" — a pretty good illustration of original intent to allocate exemption. As would be a GST tax return that shows zero tax for a direct skip transfer. Conversely, payment of tax on a nondirect skip taxable transfer would indicate that the taxpayer thought that election out of automatic allocation had been accomplished. Common correspondence is among a taxpayer, an attorney, and an accountant, all referring to an allocation/election that everyone anticipated would be made on a gift tax return that would be filed by one of them but that fell into a crack.
- Events beyond the taxpayer's control that caused the allocation/election to fail. For example, perhaps the taxpayer, or a professional who was involved in the transaction, became ill, incompetent, or died before anticipated action was taken and there was no follow up to protect against a missed timely allocation/election.
- Lack of taxpayer awareness of the need to allocate/elect, despite reasonable diligence, given the complexity of the allocation/election and the taxpayer's experience. For example, a sophisticated taxpayer who has engaged in similar transfers and who regularly deals with wealth transfer tax advisors has less credibility in alleging lack of awareness than a taxpayer with no history of prior transfers.
- Consistency in allocating/electing, which normally bespeaks an intent to do the same thing (unless a change in circumstances or beneficiaries makes a change in intent appear likely).

Imagine a series of annual transfers to a GST trust with the requisite allocation/election to all but one, and whether it would matter if that one was the first, the last, or somewhere in the middle of the series, and what this indicates, considered alone or in conjunction with other factors.

- Reasonable reliance on the advice of a qualified tax professional, which requires a showing that the professional was competent and was made aware of all relevant facts. An affidavit must list every advisor (agent, representative, or tax professional) who consulted in the transfer or return preparation, along with a description of the scope of their engagement and responsibilities, and an attestation by those advisors to the taxpayer's representations (or an explanation of an advisor's refusal to attest) — basically making advisors fall on their swords if they were the source of a failure to properly allocate/elect.
- Whether hindsight informs a late allocation/election. For example, the taxpayer is strategically choosing among multiple transfers to which allocation/election might apply, retroactively considering investment performance since the time a proper allocation/election was required. Or if an economic factor changed, arose, or was discovered after the time for a proper allocation/election.
- Indications that delay strategically deprived the government of time to evaluate aspects of the transaction (such as valuation, or the transferor's identity). Exceedingly helpful is Prop. Treas. Reg. §26.2642-7(d)(3)(ii), stating: "the combination of the expiration of any . . . period of limitations with the fact that the asset or interest was valued for transfer tax purposes with the use of a valuation discount will not by itself prohibit a grant of relief." This should quash previous governmental misbehavior in evaluating relief requests.
- Whether a taxable transfer occurred between the time when an allocation/election was due and the requested relief, and whether relief would require difficult adjustments of GST tax consequences in the interim.
- Relief will not permit a taxpayer to subsequently decrease an allocation or revoke an election; an affirmative allocation/election is irrevocable once made. See, e.g., **PLR 200816007** in which the taxpayer sought to reverse an allocation to one trust to reallocate the exemption to another.
- Relief also will not allow alteration of an allocation/election decision that follows accurate advice of an adequately informed and competent advisor.
- Increased exemption cannot be allocated retroactively to transfers occurring before the increase.

Relief does not extend any statute of limitation that bars a refund/credit. But the government may request an extension of a gift or GST (but not estate) tax statute of limitation that relates to the transfers involved in the request for relief.

Two final matters: Treas. Reg. §301.9100-2(b) continues to permit the automatic six-month extension, and Rev. Proc. 2004-46, 2004-2 C.B. 142, continues to provide "a simplified alternate method for obtaining an extension to make an allocation of . . . exemption under §2642(b)(1)" if its somewhat rigid requirements are met: (1) the transfer occurred before 2001 (after 2000 the automatic allocation rule in §2632(c) likely applies), (2) no taxable transfers have been made yet from the trust involved, (3) the gift involved did not exceed the gift tax annual exclusion amount (in combination with all other gifts to the same donee in that year), (4) no exemption was allocated to the transfer, and (5) the taxpayer has exemption remaining available to allocate.

A detailed process avoids the need to file a ruling request or pay the normal fee. The most important requirement is that the application must be made "on or before the date prescribed for filing the federal estate tax return for the transferor's estate (determined with regard to any extensions actually obtained), regardless of whether an estate tax return is required to be filed." This is a function of §2632(a)(1), requiring affirmative allocations before that time, and Treas. Reg. §26.2632-1(d)(2), which automatically allocates any remaining exemption at that same time. As illustrated by PLR 200710001, after that time these irrevocable exemption allocations will have exhausted any exemption remaining at death.

## 10. Chapter 14: Antifreeze Provisions

***Application of §2704 to Lapsing Voting Control at Death.*** The decedent was owner of the NFL's Atlanta Falcons franchise. Originally a C Corp., it converted in 1986 to S Corp. status, which required that its preferred and common stock structure be converted into two classes of common stock — Class A with super voting control, and Class B. The decedent owned only Class A stock when the owners entered into a stock purchase agreement with two outsiders in 1991. That agreement automatically converted the Class A common stock into Class B common stock on the decedent's death. The consequent loss of the Class A super voting control was stipulated by the parties to cause a $7.5 million loss of value at the decedent's death. **Estate of Smith v. United States**, 103 Fed. Cl. 533 (Ct. Fed. Cl. 2012), held that this loss of value was subject to §2704(a)(1) inclusion in the decedent's gross estate.

The opinion is much longer than necessary, perhaps because the Claims Court seldom decides tax cases. The controversy itself also lasted far longer than normal (the decedent died in 1997). In the end the court reached three conclusions that defeated the estate's case.

First the court concluded that the estate's greater than 50% voting control was sufficient to satisfy the §2701(b)(2)(A) control requirement (which is incorporated by §2704(c)(1) by reference). In so ruling the court rejected the taxpayer's argument ("as compelling as it might be") that control *also* requires that the decedent's family be entitled to restore the voting rights that lapsed at death (which they could not do because the 1991 agreement required the outside buyers' consent). In the process, the court also rejected the estate's effort to equate lapsing liquidation rights with lapsing voting rights, which precluded the estate's effort to apply different rules in the regulations that apply only to liquidation rights.

Second, the court rejected the estate's argument that the voting rights lapsed due to the 1986 conversion, rather than the 1991 stock purchase agreement. The estate's argument would have precluded application of §2704 under its 1990 effective date provision. The court also rejected the estate's alternative argument that the voting rights lapsed when the 1991 agreement was executed — which would have triggered gift tax and would have precluded application of §2704 at the decedent's death. In each case the court reasoned that the decedent retained his voting rights until death and that the 1991 agreement merely caused the decedent to lose those voting rights at death. That also differed from the 1986 agreement, which would have allowed the decedent to transfer the voting stock with all its voting rights to family members at death.

Finally, the court rejected the estate's argument that the 1991 agreement caused the decedent's stock to lose value immediately, because a willing buyer would have anticipated the conversion into Class B stock, with its loss of super voting control. According to the court the rule in §2704 requires valuation of shares with lapsing voting rights "as if the voting rights were nonlapsing," which trumps any willing buyer analysis. In addition, not relied upon by the court was the fact that the estate's argument appears inconsistent with its stipulation to the stock value immediately before and immediately after death. In the process the court also rejected the estate's assertion that the 1991 agreement produced restrictions on sale that the §2703(b) safe harbor provision would respect because that agreement was bona fide, at arm's length, and not a device to transfer value to the decedent's family for less than adequate and full consideration. In addition to misstating the three requisites for §2703(b) to apply, the court also disregarded the estate's argument because §2703 applies to restrictions on the right to sell property and §2704 deals specifically with lapsing voting rights, which were the subject of this case.

Notwithstanding the nearly total dearth of §2704 guidance, *Smith* provides little value for readers seeking insights into its treatment of lapsing rights and restrictions.

## 11. Subchapter J and Other Income Tax Developments

***Deduction Denied for Fire Department's License to Taxpayer's Dwelling.*** **Patel v. Commissioner**, 138 T.C. *** [No. 23] (2012), is not an important case for either income tax or estate planning purposes. Yet it is a Tax Court reviewed case that split the court 9-to-8 on an issue that takes readers back to law school property class.

The taxpayer bought residential real estate – a house and the land combined – for $625,000 and planned to raze the structure to build a new house. After obtaining all the necessary permits, the taxpayer instead gave the local fire department the right to use the dwelling for training – the fire department (joined by six others) burned the structure – and the taxpayer paid only to have the remaining debris removed. The issue was whether this transfer qualified for the §170 income tax deduction.

Forget about the various arguments of the taxpayer and government. The interesting element of the *Patel* opinions is the difference between how the majority and dissenting judges viewed the transaction. By the one-vote margin the majority view was that:

- taxpayers who contribute to charity less than their entire interest in property are not entitled to a charitable deduction unless the donated interest fits within one of the §170(f)(3)(B) exceptions, one of which is a fractional or percentage portion of all the taxpayer's rights, title, and interest,
- under the common law everything that is affixed to land is a part of the property, including fixtures (such as a dwelling) that are not severed from the land,
- the taxpayer could have severed the structure from the land, in which case the building alone could have qualified for the charitable deduction, but that did not occur in this case because (among other things) the taxpayer received what was left of the structure after the fire (and was responsible for public safety from dangers such as open basements and falling walls or chimneys),
- therefore, the taxpayer gave the fire department a mere license to use the property, which is not a deductible §170(f)(3)(B) exception. It also therefore is not a §2522(c)(2) gift-tax-deductible transfer, meaning that it could subject the taxpayer to gift tax on its transfer. That issue was not involved or decided by the court.

The majority also summarily rejected the suggestion that the taxpayer gave a remainder interest in a personal residence or farm, or a conservation easement.

The dissent disagreed with the mere license construction because a licensee agrees to return property in the same condition, only normal wear and tear excepted. So the dissent concluded that the fire department's destruction of the structure itself constituted a severance of it from the land, which converted the gift into one of personal property, all substantial interests in which were given to the fire department (the taxpayer didn't expect to receive any part of the structure back, and what the taxpayer did receive in return was not a substantial interest and therefore could be ignored under Treas. Reg. §1.170A-7(b)(1)(i)).

The majority's response to the "normal use" suggestion regarding a license was that this taxpayer did not want the property back in its original condition – that normal presumption of intent was irrelevant because the donor wanted to make improvements that required destruction of the existing building.

The unanswered question – that the court dodged by denying an income tax charitable deduction entirely – relates to value. What is a structure worth that the taxpayer wants to demolish? The deduction claimed in *Patel* was based on an appraisal that valued the structure at just under $340,000 (almost 55% of what the taxpayer paid for the improved property). That almost certainly is wrong, for at least three reasons.

First, consider the value of the dwelling itself. In some neighborhoods land is valued more for its location and is purchased as a blow-down rather than as an existing dwelling. That presumably was the case in *Patel*, in which the structure had a negative value (the cost to demolish it and haul it away). The land alone was worth the full price paid.

At the other end of the housing spectrum, in some depressed neighborhoods property can be bought in foreclosure or for delinquent taxes and the dwelling can be demolished and hauled away, all for less that it would cost to buy a vacant lot and then pay the impact fees to connect water and sewer and cut the curb for a driveway. These properties are valued as blow-downs because the dwelling is uninhabitable.

In either case, if the donor gives only the structure to charity (the fire department), its value presumably is no more than zero – because it is worth less standing than if it is destroyed. Indeed, the taxpayer benefits from the donation because the cost to demolish and cart away the debris is greater than just hauling off what remains after the fire. At a minimum, the charitable contribution deduction should not be anything near the lived-in value of the structure. This is a good thing for the taxpayer, who makes a taxable gift for which no deduction is available.

Second, consider that taxpayers have long advanced the argument that the gift tax value of any property transferred should be determined in the hands of the donee, for example as encumbered with value-reducing restrictions, such as those imposed on FLP and LLC interests. In a case like *Patel*, the value for deduction purposes might be determined in the hands of the fire department, which only values the property for training purposes. That value also is nowhere near 55% of the purchase price of the land and structure combined. And quaere whether it qualifies for the gift tax annual exclusion?

Third, the *Patel* dissent noted that, whatever is the value of the structure, the taxpayer's deduction must be reduced by any benefit received by the taxpayer – any quid pro quo for the donation – which the dissent identified by saying that the taxpayers "must show that the value of the house, taking into account the conditions on its donation, exceeded the value of the benefit they received from the fire department in the form of demolition services."

All tolled, even if the dissent had prevailed, any of these three valuation arguments suggests that the charitable deduction, if allowed at all, should be a very modest amount, relative to the amount paid to purchase the improved property. Indeed, the deduction might be so small as to make the game (the deduction) not worth the candle (the cost of an appraisal). And if no deduction is allowable it also means the taxable gift is de minimis too.

***Relation Back Principle Applies for Charitable Deduction Purposes.*** **PLR 201225004** reaches a proper result – regarding a proposition for which there appears to be scant authority – making the issue involved and the result itself somewhat unexpected. The PLR involved a trust claiming the §642(c) deduction for income distributed to charity, and the issue was satisfaction of the §642(c)(1) requirement that the income be distributed "pursuant to the terms of the governing instrument." In this case the distribution was directed by a beneficiary's exercise of a nongeneral inter vivos power of appointment, which was deemed to satisfy the "pursuant to" requirement even though the governing instrument did not specify a charitable bequest – it only authorized exercise of the power in favor of charity.

The PLR correctly held that the distribution pursuant to exercise of the power of appointment met the "pursuant to the terms of the governing instrument" mandate, but it did not explain why that is the correct result. And a search for other authority to support the result reveals that there is a dearth of case law or rulings on point. Indeed, GCM 34277 (1970), may be the most recent comprehensive authority on the issue. It correctly concludes that the holder of a power of appointment acts as an agent for the donor of the power, "so that upon its exercise the property is regarded as passing to the appointee from the donor of the power under the instrument by which it is created rather than from the [powerholder]." As a result, applying the so-called relation-back principle, "the exercised power of appointment is deemed to speak as part of the [donor's estate plan]," which satisfies the "pursuant to the terms of the governing instrument" requirement in §642(c)(1). Regarding the state law relation-back principle itself see Restatement (Second) of Property – Donative Transfers at 4 (1986).

Perhaps the circumstance doesn't arise often, or maybe the answer is so clear that taxpayers seldom seek guidance and the government seldom litigates the question. Analogous authority *does* exist that entails payments to charity pursuant to the settlement of a will contest or other controversy. Curiously, the law on that issue also was slow to develop, although the current position is that these resolutions also relate back and satisfy the governing instrument requirement. See, e.g., GCM 38227 (1979) for a collection of authorities on point and a summary of the conflict that existed prior to reaching the result that applies today.

***Charitable Lead Trust Income Ordering Rules.*** Originally proposed in 2008 but reflecting PLRs issued as much as a decade earlier, now final (effective 16 April 2012) **Treas. Reg. §§1.642(c)-3(b)(2)** and **1.643(a)-5(b)** establish the simple proposition that lead interest distributions to charity, from qualified charitable lead trusts, are deemed to carry out a pro rata portion of each flavor of income of an estate or trust, unless provided otherwise by local law or a governing instrument provision that alters that result and that is (1) specific and (2) has "economic effect independent of income tax consequences." New §1.642(c)-3(b)(2) *Example 2* illustrates a trust instrument that specifies "that 100 percent of the trust's ordinary income must be distributed currently" to a charity, which would be respected as having economic effect independent of income tax consequences "because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year." But *Example 1* in the same section states that a fixed annuity or unitrust obligation "is not dependent upon the type of income from which it is to be paid" and, therefore, does not vary in amount based on the kinds of income earned. Thus, the independent economic effect standard would *not* be met, even if the class of income used to satisfy the annual distribution amount might vary, such as under a worst-in, first-out distribution mandate (that is, first from ordinary income, then from short-term capital gain, followed by long-term capital gain – which would match the §664(b) allocation priority rules for a charitable remainder trust).

***Forgiveness of Insurance Policy Loans.*** The discharge-of-indebtedness income concept recognizes that there is no income when a taxpayer borrows money, because the obligation to repay offsets or precludes any "undeniable accession to wealth, clearly realized, over which the taxpayer has complete dominion or control" that otherwise might exist by receiving loan proceeds. Instead, (subject to numerous exceptions) income is realized when the taxpayer's obligation to repay is forgiven. At first blush this might appear to be the applicable concept if a taxpayer borrows against a life insurance contract and does not repay the loan (which typically is a permissible option under the policy).

But it is not. Instead, the income tax treatment of the forgiveness of a policy loan differs because the insurer will not lend in excess of the cash surrender value of the policy, and failure to repay is accompanied by the insurer taking the cash value in satisfaction of the outstanding liability. If the loan is outstanding at death the insurer repays the loan out of the policy proceeds, which is not an income taxable event because §101(a)(1) excludes the proceeds from income, regardless of whether they are payable to a beneficiary or, in this case, to the insurance company in repayment of the outstanding balance on the policy loan. But repayment of the loan on surrender of the policy inter vivos is subject to §72(e)(5)(A) and (e)(5)(C), which provide that amounts received under a life insurance policy on surrender inter vivos are includible in income to the extent they exceed the taxpayer's investment in the contract.

Rev. Rul. 2009-13, 2009-1 C.B. 1029, provides that the surrender of a policy for its cash value (or amounts received upon the lapse of a policy) results in ordinary income, not capital gain. Pursuant to Rev. Rul. 64-51, 1964-1 C.B. 322, the government's rationale for denial of capital gain treatment is that capital transaction treatment cannot apply because there is no sale or exchange involved in a surrender or lapse. The amount of income is the amount received (including the amount of outstanding loans that are repaid out of policy cash values) in excess of the owner's basis in the policy. See Barr v. Commissioner, 98 T.C.M. (CCH) 406 (2009) (involving a viatication settlement, not a surrender for cash value, but this principle is the same).

For these purposes basis is determined under §72(e)(6) as premiums paid, less dividends previously declared (which is appropriate because dividends are a return of excess premiums). Unlike the treatment in a viatication, in a surrender the government's position in Rev. Rul. 2009-13 is that basis is *not* reduced by the cost of pure insurance protection already received under the policy. However, premiums allocable to such enhancements as a waiver of premiums benefit, accidental death multiples, additional purchase options, or an inflation rider do not add to the basis in the underlying policy. For numerous reasons, not limited to ascertaining what premium dollars are allocable to what portions of the coverage, the only way to be certain of the basis in a policy is to inquire of the insurer.

Two excellent illustrations of this unknowable-basis reality are **Moore v. Commissioner**, T.C. Summ. Op. 2012-83, and **Feder v. Commissioner**, 103 T.C.M. (CCH) 1068 (2012), in which the taxpayers thought they had cancelled policies but, when the taxpayers ceased paying premiums, the insurers instead borrowed against the cash value for more than two decades and only cancelled the policy when these unsolicited policy loans equaled the cash surrender value. In *Moore* the 1099-R reported income to the taxpayer of almost $18,000, even though the insured only paid $472 of premiums before walking away from the policy. In each case income was based on the loan amount (which included accumulated unpaid interest) in excess of basis – which was total premiums paid in cash and with loans, reduced by dividends that the insurer paid on the cash value of the policies. These numbers are so unexpected, and advisors should recognize that their clients easily could have similar lurking liabilities in policies they thought they cancelled decades earlier. In *Moore* the taxpayer dodged the income only because the court held that the government did not show how the policy continued in effect so long after it should have terminated. The taxpayer in *Feder* was not so lucky, even though she claimed to know nothing about what happened inside her policy, all of which occurred beneath the radar.

**Brown v. Commissioner**, 101 T.C.M. (CCH) 1374 (2011), aff'd, 693 F.3d 765 (7th Cir. 2012), involved these principles and resulted in the imposition of a §6662 accuracy-related penalty, in part because the taxpayers both were "licensed attorneys, and one has a master of laws degree (LL.M.) in taxation." The court basically treated these rules as simple enough, particularly given that the insurer sent the taxpayers a Form 1099-R showing the taxable income figure, none of which was reported by the taxpayers. **McGowen v. Commissioner**, 98 T.C.M. (CCH) 566 (2009), aff'd, 2011-2 U.S. Tax Cas. (CCH) ¶50,608 (unpub'd 10th Cir.), rejected the taxpayers' assertion that the bankruptcy exception to the discharge of indebtedness income rule was applicable. And **Ledger v. Commissioner**, 102 T.C.M. (CCH) 119 (2011), held that the taxpayer had income from a lifetime payment upon maturity of the contract, which occurred when the insured reached age 65 — the amount payable, reduced by basis in the contract, was income in its entirety, even though the taxpayer only received a fraction of that amount after the insurer repaid the taxpayer's outstanding policy loans from the proceeds.

A potent source of confusion in these cases is that the policy loans went into payment of added premiums, which did not alter the tax consequences of the loan and ultimate surrender of the policy, but may have caused the taxpayers to view the situation as if nothing actually had been received. Except the pure insurance coverage under the policy. These cases are significant in highlighting that insurance policy loans may have serious implications for income tax purposes. They are not tax neutral upon an inter vivos termination of an encumbered policy. And any affirmative transfer of a policy subject to a policy loan is treated as a part-sale, part-gift, with the policy loan regarded as an amount realized, which may cause the §101(a)(2) transfer-for-value rule to apply and defeat the income tax exclusion that normally would apply at a taxpayer's death. See Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964); PLR 8951056.

***Defective Grantor Trust Avoids Transfer-for-Value Disaster***. The §101(a)(2) transfer-for-value rule is one of the third rails of estate planning. It provides that the exclusion from income for insurance policy proceeds is lost if a policy of life insurance is transferred for valuable consideration. Effectively, tax-free income is made taxable, often through inadvertence.

Several exceptions prevent loss of the exclusion. Under §101(a)(2)(A) the exclusion from income is preserved if basis in the hands of a transferee is determined in whole or in part by reference to the transferor's basis – in most cases meaning that there is a carryover of basis from the transferor to the transferee. For example, a part-sale, part-gift transfer will avoid loss of the exclusion if the transferee's basis is a carryover from the transferor, which is the case if cost (the sale element) is less than the transferor's basis. This provision most often applies when a policy is transferred subject to a policy loan. Because policy debt seldom exceeds the value of the policy, the transfer is a part-sale, part-gift – with the gift element being the excess of fair market value over the amount of the debt. The transferee – who takes the policy subject to the debt – is deemed to pay an amount equal to the debt to acquire the policy, which is the transfer for value. But if the debt is lower than the transferor's basis, then §101(a)(2)(A) preserves the exclusion from income, because basis in a part-sale, part-gift transfer is the greater of cost or carryover.

A second useful exception to transfer-for-value loss of the exclusion is §101(a)(2)(B), which preserves the exclusion if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder.

It is transfers that are deemed to be made to the insured that often avoid a disastrous loss of the exclusion. Indeed, it is transfers to grantor trusts, of which the insured is deemed to be the owner, that typically are saved. See Rev. Rul. 2007-13, 2007-1 C.B. 684. And that reveals one of the most important benefits of "defective grantor trust" planning.

**PLR 201235006** involved this grantor trust avoidance of the income tax disaster that can flow from a transfer for value. It involved Trust A, which made a transfer of an insurance policy to Trust B. Trust A was not a grantor trust. If it had been, and if the grantor of both trusts had been the same, then the transfer would be ignored in its entirety – each trust being treated as owned by the same person – the notion being that you cannot make a transfer to yourself. Instead, only Trust B was a grantor trust, of which the insured under the policy was the grantor. That translated into Trust A making a transfer to the insured personally, which qualifies for the §101(a)(2)(B) exception to the transfer-for-value rule.

The provision that made Trust B a grantor trust was a §675(4)(C) power to reacquire trust assets. The government normally refuses to determine that §675(4)(C) applies in any particular case because there is a factual issue whether the grantor is acting in "a nonfiduciary capacity." True to form, here the PLR collared its conclusion with a caveat "if it is determined that Trust B is a grantor trust." Notwithstanding that reservation, and much more important, was the Ruling's conclusion that, if it was a grantor trust at all, then it was a grantor trust "in its entirety." This also is an important determination, under the so-called "portion" rules, which could alter the result sought if the grantor was deemed to own only the income portion of a trust.

Also very important about this PLR was that Trust B contained Crummey rights of withdrawal, which normally make third-party powerholders pseudo-grantors under §678, as to that portion of the trust that they could withdraw, even after a withdrawal power has lapsed. In this case, without any indication that the government really considered the issue, the PLR stated that §675(4)(C) treatment would apply to the whole trust "notwithstanding the withdrawal rights held by the beneficiaries that otherwise would make them owners" under §678. The authority cited for that conclusion was §678(b), which on its face does not appear to apply because it provides that pseudo-grantor status will not apply "with respect to a power over income . . . if the grantor of the trust . . . is otherwise treated as the owner" of the trust. Crummey withdrawal rights do not typically apply with respect to trust income – usually they relate to trust corpus – so at least on its face it is not a reliable reading of §678(b) to provide that pseudo-grantor trust status is trumped in this or other similar Crummey power cases.

One final conclusion was a confirmation that, under Rev. Rul. 2011-28, 2011-2 C.B. 830, the grantor's power to exchange assets under §675(4)(C) would not trigger §2042 inclusion of Trust B in the grantor's gross estate at death. Based on eight stated requisites that must be shown, that conclusion was both correct and it is reliable.

***BDIT Under Scrutiny.*** The government recently added to its "no rule" list a new item (actually six separate items, all dealing with the same situation as it applies under various Code provisions) that confronts the so-called "beneficiary defective inheritor's trust" (BDIT). In this plan an ostensible grantor creates a trust with a modest contribution (such as $5,000) and gives the beneficiary a §678 power of withdrawal that will apply to the entire contribution. Upon lapse (presumably gift and estate tax free under §§2514(e) and 2041(a)(2) and (b)(2) – the so-called five-or-five exception) that withdrawal right allegedly makes the *entire* trust a defective grantor trust for income tax purposes, as to that powerholding beneficiary. The powerholder then sells an asset to the trust in exchange for a note, and argues that the sale is not a gain or loss realization event because the trust was ignored with respect to the beneficiary, due to it being a §678 pseudo grantor trust. Meanwhile, the beneficiary has on-going entitlements in the trust, ostensibly without estate tax exposure because the beneficiary did not create the trust and did not make a gratuitous transfer of property to the trust with a retained interest or power.

The exact language of **Rev. Proc. 2013-3 §4.01(43)**, 2013-1 I.R.B. 113, is

> (43) Section 678.—Person Other than Grantor Treated as Substantial Owner.— Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under §671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

It is clear from the no rule position that the government has the BDIT concept under a microscope, although it does not appear to be ready to announce why it thinks that it does not work.

***§67(e) Exception to the 2% Floor.*** [**Note: this item has not changed since the second set of proposed regulations were issued in 2011; it is here as a "place holder," awaiting final regulations.**] **Knight v. Commissioner**, 552 U.S. 181 (2008), unanimously held that fees paid by a trustee to an investment advisor are subject to the 2% loss of deduction rule in §67(a). Notwithstanding the exception in §67(e)(1), which provides that miscellaneous itemized deductions are not subject to the 2% loss of deduction rule to the extent that they represent expenses that are "paid or incurred in connection with the administration of the . . . trust and . . . would not have been incurred if the property were not held in such trust . . . ." *Knight* is significant because many fiduciaries charge nearly as much for their investment services alone as they charge as their "Bundled Fiduciary Fee" to serve as a full-fledged fiduciary (a practice that may change in the wake of *Knight*). It also resolves a conflict among the circuits and may foretell how other deductible expenses will be treated. Now the government is attempting to resolve how it intends to interpret §67(e).

**Notice 2011-37**, 2011-1 C.B. 785, promised that "[t]he IRS and the Treasury Department expect to issue final regulations . . . consistent with the Supreme Court's holding in *Knight*" and not long thereafter the government withdrew the original proposed regulations promulgated before the Supreme Court decided *Knight*, and issued a new set of proposed regulations, reported below. These regulations will apply only prospectively and will not require unbundling of "costs incurred in-house by the fiduciary" that are subject to the 2% floor for any tax year that began before the date final regulations are published. They will, however, require unbundling once they become final, unless the government heeds the recommendation of industry groups like the American Bankers Association, which by letter on December 6, 2011, ardently stated that:

> There is no mention in any of the case law (*Mellon*, *Scott*, or *Knight*) of any ambiguity with regard to fiduciary fees. In fact, . . . in each of these cases, the various courts all agreed that fiduciary fees are fully deductible, which implicitly rejects [the] existence of any statutory ambiguity. Therefore, the unbundling proposal attempts to fill a gap regarding an ambiguity that, in fact, does not exist.

And that, the Bankers argue, makes the regulation invalid under Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

*Knight* thus closed only the first chapter of the §67(e) story, which began with the taxpayer's victory in O'Neill Irrevocable Trust v. Commissioner, 98 T.C. 227, 230 (1992), rev'd, 994 F.2d 302 (6th Cir. 1993), nonacq., and then was followed by government victories in Mellon Bank v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶50,642 (Ct. Fed. Cl. 2000), aff'd, 265 F.3d 1275 (Fed. Cir. 2001), Scott v. United States, 186 F. Supp. 2d 664 (E.D. Va. 2002), aff'd, 328 F.2d 132 (4th Cir. 2003), and Rudkin Testamentary Trust v. Commissioner, 467 F.3d 149 (2d Cir. 2006), aff'g 124 T.C. 304 (2005) (a unanimous reviewed opinion), aff'd sub nom. in *Knight*. Each case dealt with fees paid by trustees to independent investment advisors. And each fashioned its own statement of the statutory rule, no doubt to make sense of the double negative in §67(e) ("would *not* have been incurred if the property were *not* held in trust").

With the Supreme Court's interpretation, redefinition of the Code may no longer be appropriate. Quoting the Court:

> [T]he statute . . . asks whether . . . individuals would have incurred such costs in the absence of a trust.
>
> [T]rust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers.
>
> The question whether a trust-related expense is fully deductible turns on a prediction about what would happen . . . if the property were held by an individual . . . [and] excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for . . . [an] individual to incur.

This formulation is close to that fashioned by two prior appellate court opinions. *Mellon Bank* held that §67(e)(1) "treats as fully deductible only those trust-related administrative expenses that are . . . not customarily incurred outside of trusts." *Scott* stated that "trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers." Collectively, however, these tests rely on a distinction that may be easier to articulate than to apply. So, while further redefinition of the Code itself probably is foreclosed by *Knight*, more guidance is needed, to actually apply the Court's restated rule. That challenge is discussed below.

Before turning to that topic, however, it may be useful to note that the only item specifically addressed under existing caselaw is investment advisor fees. As stated by the Bankers, no case yet has treated undifferentiated, in-house, "bundled fiduciary fees" as subject to the 2% rule. In addition, *Knight* left dangling the possibility that

> some trust-related investment advisory fees may be fully deductible if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts . . . such that . . . the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.

The new proposed regulation addresses both investment advisor surcharges and fiduciary fees in general, and parrots this language from *Knight* with no elaboration, leaving significant uncertainty regarding the Court's meaning.

We now know that a fiduciary's election to hire an investment advisor is regarded as no different than an individual investor's election, which therefore causes any fee paid to that advisor to be subject to the 2% rule, without protection by the §67(e)(1) exception. According to the lower court in *Mellon Bank*, "[t]he same reasoning applies to the fees paid . . . for accounting, tax preparation, and management services. Certain types of such services would be employed whether or not the property were held in trust." Based on the rationale in *Knight*, those expenses therefore are subject to the 2% haircut — to the extent they would be incurred regardless of the existence of the fiduciary relation. And to the suggestion made by the American Bankers Association in an amicus brief in *Mellon Bank* that this interpretation will require a costly individuated inquiry into the facts and circumstances of each and every fiduciary administration, the Claims Court replied that only Congress can provide relief from the difficult burden of the exception in §67(e)(1).

Shortly after the Supreme Court granted certiorari in *Knight* the government issued **Prop. Treas. Reg. §1.67-4**, which articulated a test extracted essentially from the lower court's opinion in *Rudkin Trust*. That test was rejected by the Supreme Court (notwithstanding that the underlying decision itself was affirmed). The position taken in the first proposed regulation was that only items that are "unique" to fiduciary administration are immune from §67 — adopting the term used in *O'Neill* (which was the sole taxpayer victory) — but defining the term consistent with *Rudkin* as referring to items that "an individual **c**ould not have incurred . . . in connection with property not held in an estate or trust." The statute says "**w**ould" not have incurred, and the Supreme Court criticized the *Rudkin* court for that deviation (written by Judge — now Justice — Sotomayor). Although it took four years to occur, that proposed regulation has been replaced with a new proposal that essentially mirrors the *Knight* opinion, without adding new meaning.

The proposed regulation reflects a fundamental fairness issue that was identified on appeal in *Mellon Bank*, in which the court stated that "Mellon Bank chose to hire outside consultants to satisfy their fiduciary duty as trustees. The plain meaning of §67(e)(1) prevents the deduction of fees thus incurred unless they satisfy the general requirements of §67(a)." Taken one step further in the proposed regulation, even if a fiduciary incurred fees out of its own pocket and then charged a single unbundled fee large enough to cover all its costs, the very act of hiring outside consultants would preclude qualification for the exception to §67(a). And because it hardly makes sense to require every fiduciary to provide all the services it needs from within — that would not be the most prudent course, nor would it be the most reasonable in cost — the proposed regulation seeks to create a level playing field by requiring an administrative determination of how much of a fiduciary's fee should be allocated to various fiduciary functions — known as "unbundling" the fee.

Thus, the proposed regulation requires what no court has yet mandated, that a fiduciary's commission that includes "both costs that are subject to the 2-percent floor and costs (in more than a de minimis amount) that are not" must be separately stated, using "any reasonable method" to allocate the fee. Potentially the only helpful aspect of the proposed regulation is nonexclusive listings of items that fall on one side or the other of the line.

The first proposed regulation listed items that would be fully deductible as fees for services related to

> fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters.

And falling outside the safe harbor list were fees for services related to

> custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

No similar lists are included in the new proposed regulation, but these prior proposed regulations presumably give a clue regarding the reasonable allocation standard, which did not change. Items that the newly proposed regulation *does* mention as subject to the 2% floor include (1) costs incurred in defense of a claim against the decedent or the estate or trust that are unrelated to the existence, validity, or administration of the estate or trust, (2) carrying costs incurred by an owner of property, such as condo fees, property taxes, insurance premiums, and maintenance expenses, (3) costs of preparing gift tax returns (but not estate, generation-skipping, or fiduciary income tax returns), and (4) investment fees.

Analyzed under the Supreme Court's test (items that individuals commonly incur) at least some items in these illustrations may be on the wrong list. For example, individuals commonly incur costs to file income tax returns, albeit the particular return filed will differ (a Form 1040 for an individual versus a Form 1041 for a fiduciary entity). So the parenthetical exception granted for certain income tax returns is a generous application. Similarly, Temp. Treas. Reg. §1.67-1T regards all §212 expenses for the production or collection of income or for the determination of any tax as subject to the 2% rule when applied to individuals. And the Bankers' comments to the new proposed regulation states that the reference to ownership costs associated with property being subject to the 2% floor is a misapplication of §67(e) to the extent it mentions property taxes, because real estate taxes are not miscellaneous itemized deductions (because they qualify as a §62(a)(4) trade or business expense) and therefore cannot be subject to §67 at all.

Regarding the *Knight* test incorporated in Prop. Treas. Reg. §1.67-4(b)(4) —

> an incremental cost is a special, additional charge added solely because the investment advice is rendered to a trust or estate instead of to an individual, that is attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen), in each case such that a reasonable comparison with individual investors would be improper

— the proposed regulations admit that this is so amorphous that the notice issuing the proposed regulation actually asks for comments that will help the government interpret this exception. Note also that Temp. Treas. Reg. §1.67-1T(a)(1)(ii) states that investment advisory fees are subject to the 2% floor. It effectively was extended to fiduciaries in the form of Prop. Treas. Reg. §1.67-4, and potentially other items not addressed specifically in a §67(e) regulation will be applied consistent with the temporary regulation.

Regarding the most important factor under the proposed regulations — unbundling — the only guidance given to guide a fiduciary is that "[a]ny reasonable method may be used to allocate a bundled fee . . . ."

In addition, the beguiling question for fiduciaries remains whether the government is paying attention to fiduciary income tax returns. Is Form 1041 being audited and, if not, how were the trusts in these cases targeted for litigation? The answer in *Mellon Bank* was that the fiduciary filed a return that respected the 2% rule and then, on the strength of *O'Neill*, filed a claim for refund, which put the case on the government's radar. The *Scott* opinion indicated that the government simply audited the trust's return. There is no indication in *Rudkin*/*Knight* or *O'Neill*.

Is this the one item that the government will examine on any Form 1041 return, such that a fiduciary that attempts to deduct 100% of its fees and expenses will invite an audit?

*Knight* involved a picayune $4,448 income tax deficiency. Were it just for the 2% floor a fiduciary might wisely apply a cost/benefit analysis and write off that much of the entity's deductions rather than incur the cost involved in an unbundling determination (or risk audit). Before the government's proposed regulation was issued it was not uncommon for fiduciaries to take a blanket position that all fees paid by a fiduciary are free from the 2% rule. Now the pendulum may swing in the opposite direction and fiduciaries may choose to assume that none of their fees are free from the 2% rule. In many cases, however, a potentially much larger alternative minimum tax consequence will lurk in the background. That liability may preclude fiduciaries from comparing the cost of losing itemized deductions equal to 2% of the trust or estate's adjusted gross income to the cost involved in unbundling its fees. Care will be required to be certain that such ancillary tax consequences have been evaluated closely and that there are no extraordinary or hidden costs of such a decision.

***"Longevity" Annuity Regulations Proposed.*** The opportunity that is offered by proposed regulations for the payout of retirement benefits will not be very important to the higher-net-worth clients of many wealth advisors, because the regulation caps the benefit it offers at the lesser of 25% of the account balance or $100,000. But the proposal may be of great interest for many middle-rich Americans.

The release (REG-115809-11, released on February 2, 2012) describing the proposed regulations states that the government is motivated by reports of retirees who fear that they may outlive their wealth by living too long, and therefore want to invest a portion of their retirement benefits in "longevity" annuities – which do not *begin* to pay out until the retiree reaches an advanced age – such as 80 or 85. Given only two pay out options in many plans – payment either as a cash lump sum, or an annuity – the release suggests that the typical retiree chooses the former lump sum distribution, unaware that they could take a portion of their benefits in a lump sum and invest the balance in a deferred annuity. And then fiscal calamity occurs because they exhaust the cash.

The proposed rules "streamline the calculation of partial annuities" and make it easier for plan sponsors to "offer combination options . . . such as . . . to take a portion of an individual's plan benefit as a stream of regular monthly income payable for life, while perhaps taking the remainder in a single lump-sum cash payment," with the stream of payments beginning "at an advanced age, such as age 85, and continue as long as the individual lives."

Applicable to §401 qualified plans, §408 IRAs (but not Roth IRAs), and §§403(b) and 457 plans as well, the proposed regulations create QLACs – qualified longevity annuity contracts – that must meet requirements. Designed in part to prevent use of this option to shelter benefits from the required minimum distribution rules, the requirements seek to preclude accumulating larger amounts that will pass at death as an inheritance. As an exception to the required minimum distribution rules, the QLAC rules seek to prevent taxpayers from using this option to insulate tax exempt funds for ultimate distribution to their intended beneficiaries after death.

So, for example, the deferred – "longevity" – annuity must commence no later than when the taxpayer reaches age 85, it must be annuitized over the taxpayer's remaining life expectancy, it cannot contain variable or equity-indexed investment-return features, nor may it be commuted, surrendered for cash, viaticated, or otherwise converted at a later date. Like the required minimum distribution rules themselves, the only major exception to these limits is special rules applicable to a taxpayer's surviving spouse. An annuity benefit that is payable postmortem to a designated beneficiary also is permissible – which reflects the reality that a taxpayer may elect the longevity annuity to protect against living too long, but then the annuitant dies earlier than feared or expected.

An individual whose plan balance exceeds the relatively low maximums might consider the cash pay out option, with investment of a portion in a deferred commercial annuity. Loss of income tax deferral under this alternative may make it less attractive than the opportunity presented by the proposed regulations, but it still may be desirable. For example, at some point some taxpayers may find that deferring added income in a qualified plan and incurring income tax in the future at ordinary income rates is less attractive than paying current income tax and investing the balance, such that qualified dividends and capital appreciation on the net amount will be taxed at capital gain rates in the future. And in some cases it may appear that an immediate income tax payment at today's rates is likely to save substantial sums relative to the rates that are expected later in that individual's life. All of these calculations entail nearly impossible imponderables to model, given the number of unresolvable factors (such as future tax rates, market performance, and life expectancy) that will affect the calculation.

Also released on February 2 are **Rev. Ruls. 2012-3**, 2012-1 C.B. 383, and **2012-4**, 2012-1 C.B. 386, similarly dealing with the purchase of longevity annuities in a §401(k) profit sharing plan and as part of a rollover from a defined contribution plan to a defined benefit plan maintained by the same employer.

## 12. Procedure

***Proposed Changes to Circular 230.*** The government's ethics rules that govern taxpayer representation appear in 31 C.F.R., commonly known as Circular 230. Positions that may be taken on a tax return are regulated by §10.34, which was amended several years ago. In September 2012 the government issued proposed changes to §10.35, which relates to written tax advice for aggressive transactions, such as tax shelters. It also is the source of the disclaimer that appears at the end of every email received from a tax practitioner, routinely advising something like "any tax advice contained herein cannot be used to avoid penalties or to promote or market any transaction."

The first major proposed change is to eliminate the need for such disclaimers. In a refreshing admission the preamble to the proposal states that "use of disclaimers on nearly every practitioner communication" breeds confusion and "causes clients to ignore the disclaimers altogether," which has made their use "irrelevant."

Regarding the covered opinion regulation itself, the preamble concedes that it has increased "the likelihood that practitioners will provide oral advice to their clients when written advice is more appropriate." So, in essence, §10.35 is eliminated entirely and all written tax advice rules are moved to §10.37, which provides that a practitioner must:

(i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

(ii) Reasonably consider all relevant facts that the practitioner knows or should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable; and

(v) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

The "audit lottery" factor in (v) is interesting because the proposal eliminates a prior prohibition that a practitioner may not consider the possibility that an issue raised on audit "will be resolved through settlement." The preamble states that "the current rule may unduly restrict the ability of a practitioner to provide comprehensive written advice because the existence or nonexistence of legitimate hazards that may make settlement more or less likely may be a material issue for which the practitioner has an obligation to inform the client."

Also altered would be rules relating to reliance on the tax advice of others (imposing a "reasonableness" standard) and adopting a "heightened standard of review" if tax advice will be used "in promoting, marketing, or recommending" a transaction or arrangement "a significant purpose of which is the avoidance or evasion" of tax. Finally, a proposed change to §10.52 would limit sanctions to practitioners who "willfully" or "recklessly or through gross incompetence" violate various of these rules – all of which are of slight to concern to most estate planners.

***Penalty for Late Filing.*** The substantive issue in **Estate of Liftin v. United States**, 101 Fed. Cl. 604 (Ct. Fed. Cl. 2011) (denial of summary judgment), *** Fed. Cl. *** [2013 WL 1316533] (Ct. Fed. Cl. 2013) (deciding the case), is not important to many estate planners, because it involved §2056(d), dealing with a decedent's surviving spouse who was not a United States citizen. Rather than creating a QDOT to qualify for the marital deduction under §2056A, the spouse chose to become a naturalized citizen, which entailed delay beyond the return filing deadline (even with a six month extension). The compliance issue was whether the §6651(a) late filing penalty properly was imposed on the decedent's estate, which made a timely tax payment by estimate but did not file the decedent's estate tax return until nine months after the spouse became a U.S. citizen. Indeed, the damaging element was that the estate waited three months after it settled a claim by the surviving spouse against the estate, relying on erroneous advice to delay filing until it had "sufficient information to file an 'accurate' return."

The important aspect of *Liftin* is that the estate's delay was based on the advice of counsel who was expert and well informed – in all but one respect. The question was whether the estate's reliance on that advice constituted reasonable cause and was not the result of willful neglect. The court concluded that relying on the advice to wait to file until the spouse was naturalized was reasonable, but that it was not reasonable to rely on the erroneous advice about waiting for accurate information, saying that the estate should have filed with the best available information and not delayed until it had complete information. That error cost the estate a penalty of almost $170,000.

Interesting about the court's first opinion was it quoting United States v. Boyle, 469 U.S. 241, 251 (1985), as holding that:

> The Estate did not have an obligation to "challenge [the expert], to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code" because doing so "would nullify the very purpose of seeking the advice of a presumed expert in the first place." . . . [T]he Estate may well be able to make a plausible case that it acted as a

> "prudent taxpayer" by "seek[ing] and rely[ing] on the advice of a tax expert" in an effort to qualify for the marital deduction and file within the appropriate deadline. . . . Similarly, the Estate may be able to prove facts demonstrating that its failure to file timely was due to reasonable cause.

*Liftin* is one of only a handful of cases since *Boyle* that have wrestled with these questions. On the issue of reasonable cause it held that reliance on "advice [that] concerned a substantive question of tax law" was reasonable but that only the marital deduction aspect of the attorney's advice involved a substantive question of law. The advice about submitting an accurate return "was not an interpretation of substantive tax law" and therefore it could not constitute reasonable cause for the delay in filing.

Similarly significant is **Estate of Young v. United States**, *** F. Supp. 2d *** [2012 WL 6585327] (D. Mass. 2012), in which the estate obtained an extension of time to file and an extension of time to pay, made estimated tax payments before the extended time to pay deadline, but incurred roughly $260,000 of penalty for late *filing* because the accountants on whom the taxpayer relied misunderstood the late filing penalty rules. Usually the penalty is a function of misunderstanding that an extension of the time to file is not also an extension of the time to pay, but here the estate obtained both and paid before the extended due date. As such, the accountants involved advised that there would be no penalty for late filing, because the estate had paid more than its eventual tax liability. This was an easy mistake to make – and their advice would have been correct if the payment of its estimate had been made before the original payment due date. But part of that payment was made before the payment due date, and the bulk was paid after the due date but before the *extended* due date. Which was not adequate to prevent the penalty for late filing.

As acknowledged by the court, "[t]he late-filing penalty that the Estate faces here may seem unfair. After all, if the Estate had paid its estimated tax liability before the original payment deadline – as opposed to before the extended payment deadline – there would be no late-filing penalty." The estate was advised to delay filing until reappraisals were obtained for difficult to value realty – death occurred just before the 2008 meltdown in the economy and the bottom fell out of the real estate market (the opinion does not state whether the alternate valuation election was made). Essentially making the same mistake as in *Liftin*, the accountants in *Young* advised the estate that it would be better to file late – in this case with accurate appraisals – than to timely file with inaccurate values and then submit an amended return. According to the court the taxpayer should have timely filed "with the best available information" rather than "to wait for complete information before filing a return."

To top it all off, because the estate "was aware of the applicable deadline, and it consciously and intentionally failed to file a return until after that deadline," the estate was guilty of willful neglect, which is the same conclusion reached in *Liftin*. "A taxpayer cannot disregard a known duty to file a timely return just because it believes no penalty will result . . . . A taxpayer cannot decide that his desire to lighten his audit is more important than his duty to comply with a known filing deadline." So, the estate lacked reasonable cause and its neglect was willful, resulting in the quarter-million dollar penalty. Even though it paid all its tax before the extended payment deadline. Knowing the rules, this would have been an easy mistake to avoid.

More easily decided than either *Liftin* or *Young*, **Knappe v. United States**, *** F.3d *** [2013 WL 1339106] (9th Cir. 2013), involved a nearly $200,000 penalty for late filing, totally attributable to an accountant who performed corporate tax services for the executor's company. The executor did not have time to obtain real estate appraisals before the return filing deadline so the accountant obtained an extension of both the time to file and the time to pay, which were not for the same length of time. Notwithstanding a clear indication on the extension form itself and in the instructions for that return, the accountant mistakenly believed that both extensions were for one year, advised the executor of that, and the executor failed to verify whether this was correct. And then, even though the executor could have filed the return by the proper extended due date, it was filed late.

In denying relief from the penalty based on the reasonable cause exception, the court acknowledged that cases have split on the question that was not reached in *Boyle*:

> Courts have differed over whether a taxpayer demonstrates "reasonable cause" when, in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available.

The question boils down to whether the timing requirement is a "substantive" question (on which reliance on expert advice is reasonable cause) or a "nonsubstantive" question (on which reliance is not reasonable cause). The court simply concluded that "determining the filing date of a tax return is a nonsubstantive matter . . . . It requires no special training or effort to ascertain a deadline and make sure that it is met" (quoting from *Boyle*). Saying that the instructions to Form 4768 are "unambiguous" and that it is "clear from the face of Form 4768, from the corresponding instructions, and from the governing statute that the maximum available extension of the filing deadline was six months" meant that the executor could not show reasonable cause.

In closing the court acknowledged that "the result today imposes a heavy burden on executors," which is undoubtedly true in *Knappe* because the executor was named because he was "a longtime fried and successful businessman" who had no prior experience, and the accountant worked for the executor's company and likely had no malpractice insurance. Meaning that only gratitude from the estate beneficiaries will likely preclude either Knappe or the accountant from digging deep to personally pay the penalty that the estate should not suffer. Serving as a fiduciary is no privilege or honor.

Yet again more easily decided that *Liftin*, *Young*, or *Knappe*, a $450,000 penalty for late filing of a gift tax return was imposed in **Stine v. United States**, 106 Fed. Cl. 586 (Ct. Fed. Cl. 2012), in which the taxpayer alleged that, in the aggregate, a series of otherwise modest physical maladies were reasonable cause for late filing. The court disagreed because "no single health event . . . approaches the level of serious illness contemplated by" §6651(a). Indeed, most of the alleged health issues were treated on an outpatient basis – a single night being the only hospital stay involved, and that was for knee surgery – as opposed to something that would prevent a taxpayer from filing a tax return on time. Worse – perhaps for the malpractice liability insurer of her income tax return preparer – is that her income tax return was timely filed. Why not the gift tax return, also? As the court noted, she was well enough to engage in a series of relatively complicated financial transactions *and* to make multi-million dollar gifts to children (on which she owed roughly $1.8 million in gift tax).

***Tax Lien Asserted Against GRIT.*** The source of the unpaid gift tax liability involved in **United States v. MacIntyre**, 2012-1 U.S. Tax Cas. (CCH) ¶60,642 (S.D. Tex. 2012), is not important. Nor is it of more than prurient interest that the trust was created by and held for the first wife of J. Howard Marshall II – whose last wife was Vickie Lynn Marshall, a/k/a Anna Nicole Smith. The bottom line was that stock was held in one of the last grantor retained income trusts created before Chapter 14 of the Code was adopted, there was an unpaid gift tax liability with respect to that stock, the trust had terminated before the §6901(a)(1)(A)(iii) gift tax transferee liability issue arose, and the question was whether the trust, or its income or remainder beneficiary (both now deceased) should pay that gift tax liability. The court held that the income beneficiary should pay, which probably is the wrong result – at least in part.

The fact that the trust was an income tax grantor trust was not discussed, although the result reached – that the settlor as income beneficiary should pay – was the same result that the grantor trust rules would dictate. Thus, it would be easy (but wrong) to misconstrue the result as being a function of grantor trust status. Instead, the fact that the trust would be "ignored" for income tax purposes was irrelevant, because the liability was for gift tax, and the court's challenge was to define the "donee" of the gift for purposes of transferee liability, which the court stated was a question of first impression. That also is potentially misleading, because existing authority is clear that, in such a case, the transferee liability should befall the trust. But within the trust, as between income and remainder beneficiaries, the surprising reality is that this particular issue does *not* appear to have been addressed previously.

In this context, the court's rationale for imposing the unpaid gift tax liability on the trust grantor as its income beneficiary was:

> [T]he Supreme Court has set forth a test for determining whether beneficiaries of a trust are donees eligible for a gift tax exclusion pursuant to [§2503(b) – the gift tax annual exclusion]. In *Helvering v. Hutchings*, the Supreme Court established that "[a] gift to a trust is, in fact, a gift to the beneficiaries." . . . In two companion cases decided the same day the Court determined that exclusions applied only to present rather than future interests and defined a present interest as a right to the present enjoyment of the gift. . . . The court sees no reason why the definition of a donee for a gift tax exclusion should differ from the definition of a donee for purposes of gift tax liability.

Which is to say, the present interest requirement for gift tax annual exclusion purposes is "good enough" for gift tax transferee liability purposes. In a word, that's goofy.

The court elaborated, saying that this rule "makes a great deal of sense" because the unpaid gift tax liability "should be paid from a known present source of money" and that, "if something happened and the remainder beneficiary received little or no money from the remnants of the trust at the time of its disbursement, then collecting the taxes from the remainder beneficiary would create a hardship on a person who never enjoyed any benefits of the gift itself." That also is wrong.

If the gift tax had been timely paid from corpus – which is the result the court realized should apply ("the gift taxes should have been paid from the corpus of the trust at the time it became clear that the donor would not pay them") – the result would have been to amortize that cost, because a reduced corpus would have produced less income that the income beneficiary would have received. The corpus remaining at termination of the trust also would have been less, essentially reflecting the more appropriate amortization of the transferee liability against the value of both the remainder and the income interests. So, at bottom, the court's rationale and its conclusion both are improper.

It also is surprising that the court did not mention the state law Principal and Income Act, which also likely would have dictated that this transfer tax be paid from corpus, not income. See, e.g., Uniform Principal and Income Act §502(a)(6) ("A trustee shall make the following disbursements from principal: . . . estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust"). Also ignored by the court was any mention whether allocation of any part of the gift tax liability to the remainder beneficiary would have left some portion of the tax unpaid, the remainder beneficiary being the settlor's son, E. Pierce Marshall, who died in 2006 and whose trail of litigation might have made collection significantly more difficult. See Stern v. Marshall, *** U.S. *** [131 S. Ct. 2594] (2010), and the history documented therein.

Subsequent to the court's initial decision in *MacIntyre* the court was again presented with a question of some controversy, in this case on which there is a conflict of opinions. The question was whether the donee's transferee liability was capped by §6324(b) (to the amount of the gift received) for *both* the gift tax and interest incurred but not paid by the donor, *plus* any interest of the donee for late payment of the transferee liability. Following the better reasoned decision in Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994), and rejecting the contrary holding in Poinier v. Commissioner, 858 F.2d 917 (3d Cir. 1988), the court held that the donee's liability for the donor's gift tax and the donor's interest is capped, but that there is no limit on the added amount of interest imposed on the donee for late payment. This is the right result because, were the rule otherwise, a donee whose liability for the donor's tax is already capped would have no incentive to timely pay the government to reduce the interest assessed on the donee's late payment.

## 13. Notable State Law Developments

The following materials are provided on the theory that Congress has made the applicable exclusion amount permanent at a level that excludes something over 99% of all decedents from the federal wealth transfer taxes. As such, our attention as estate planners will focus on many issues that affect the "middle rich," for whom competent estate planning services are necessary but wealth transfer tax motivated planning is not. This may be a new orientation for some estate planners, after many years of tax-centric planning. Numerous interesting and new state law nontax issues deserve attention, and developments that have a wider significance than the particular state's law are useful learning tools. Both notions inform these selections.

***RID Agreement Controversy.*** In a surprisingly close (4-to-3) decision, **Hastings v. PNC Bank**, 54 A.3d 714 (Md. 2012), held that a release, indemnity, and discharge (RID) agreement requested by a corporate trustee upon trust termination and distribution was not improper. Several remainder beneficiaries complained that the trustee "improperly demanded that each beneficiary execute a broad release agreement prior to distribution," and a snarky, angry dissent agreed because (1) the agreement "was more favorable to [the trustee] than the protection it would have received upon the court's approval of a final accounting" and (2) the trustee failed to provide the beneficiaries "with full information explaining their rights or the consequences of their signing of the Agreement."

The agreement provided that each beneficiary:

> Releases, indemnifies and holds PNC, in its corporate capacity and as Trustee, harmless from and against any and all losses, claims, demands, surcharges, causes of action, costs and expenses (including legal fees), which may arise from its administration of the Trust, including, but not limited to, the overall investment strategy of the Trustee, all decisions made and actions taken or not taken with regard to the administration of the Trust, and PNC's distribution of the assets to the Beneficiaries as set forth on the attached schedule.

This was broader than a court approval of accounts, because it applied to PNC "in its corporate capacity" as well as its fiduciary capacity, and because it covered "all costs" rather than just all costs "reasonably and properly incurred." The majority agreed that these were "material and represent a fairly sizeable increase in the amount of protection" but that they were differences "of degree rather than kind" and "represent, at bottom, [the trustee's] arm's length request to exchange increased protection and indemnity for a quicker and less costly distribution of trust funds." It also noted that "no matter the terms of the clause itself, the Release Agreement could not protect [the trustee] from liability arising from fraud, material mistake or irregularity" (and it likely would not protect against matters not reasonably disclosed by its accountings).

Distribution agreements commonly are offered in lieu of the trustee incurring the cost of seeking court approval of its accounts, as protection against liability after the trustee distributes the funds under its control. According to the majority, the agreement was merely an acknowledgement that the beneficiaries had consulted with their attorney (or had chosen not to do so), had reviewed the trustee's accountings, and approved of the trustee's administration. Because trustee liability could arise post-termination, the agreement transfers all exposure to the beneficiaries – after all, they receive all of the trust funds – meaning that the trustee otherwise would not be protected if it thereafter was found liable (for example, to a third party claim against trust funds that no longer are under its control).

Quaere whether a trustee must provide legal advice to trust beneficiaries before they execute such an agreement – as suggested by the dissent – or may rely on its saying to the beneficiaries that they have the right to seek legal advice before signing and that their execution indicates either that they did or that they knowingly and voluntarily agreed not to. Or why trustees should not suggest that the beneficiaries either sign the RID agreement or incur the added cost and delay of the trustee seeking judicial approval and protection before releasing trust funds.

***Debts, Expenses, and Taxes Provisions.*** Three items of general interest are raised by **In re Stisser Grantor Trust**, 818 N.W.2d 495 (Minn. 2012). The court rejected an improper effort by the decedent's surviving spouse to benefit from a trust held for the spouse's step-children to discharge debts secured (in all but one case) by nonprobate property passing to the surviving spouse. As personal representative of the decedent's estate, the spouse called upon the trust to pay these debts because the trust directed the trustees, "if requested by the legal representative of my estate" to pay "my legal debts." The court held that (1) the general direction in a will "to pay my legal debts" does not authorize payment of secured obligations, (2) the common law of wills could inform the court's interpretation of a trust that served as a will substitute, and (3) "the boilerplate language of a standard debt-payment clause is now generally viewed as being superfluous" because "statutes have empowered executors to pay a testator's debts, even without a general directive. Nevertheless, the general debt directive remains omnipresent in modern wills and trust agreements."

Because state and federal laws *do* dictate payment of a decedent's debts, expenses, and taxes, the only real significance of such a provision is to allocate or apportion the liability – by stating which interests are reduced by payment of these obligations. And, as the court observed, improper payment provisions may do more harm than good if, for example in this case, it can be alleged to accelerate debts that otherwise are not currently due. Or, in a tax clause, if the provision waives rights of reimbursement that should be preserved.

That there is disagreement about these notions is illustrated, however, by **Estate of Fussell v. Fortney**, 730 S.E.2d 405 (W. Va. 2012), in which the court held that a will direction that "all my just debts be paid" obligated the estate to exonerate a single mortgage that encumbered two separate parcels of realty. That *is* the traditional common law rule, which has been reversed by legislation in many jurisdictions – UPC §2-607 specifically providing that "[a] specific devise passes subject to any mortgage interest existing at the date of death, without right of exoneration, regardless of a general directive in the will to pay debts" – but West Virginia is not one of those. And the facts of the case were relatively unusual, in the sense that the single debt encumbered two different parcels, which were specifically devised to two different daughters, *and* the rest of the estate was sizeable relative to the mortgage debt and passed to a third daughter. The court determined that the decedent would have dictated how to apportion the one debt between the two devisee-daughters if exoneration was not the intent. It also was influenced by the fact that the third daughter took the lion's share of this sizeable estate, even after exonerating the realty. "Should a case arise in the future in which exonerating real property would leave little or nothing for other beneficiaries to whom the testator intended to give a substantial portion of [the] estate, a court could consider that factor along with the other relevant facts of the particular case." The most remarkable aspect of the case was the court's statement that this was the first exoneration case to reach it since 1939.

***Tax Apportionment and the Elective Share.*** Difficult coordination and balancing of priorities accompanies any situation involving the elective share of a surviving spouse, charitable bequests, and tax apportionment if estate tax is not totally avoided by virtue of marital and charitable deductions. Such was the case raised by ***In re*** **Poffenbarger**, *** N.Y.S.2d *** [2013 WL 1007244] (Surr. Ct. 2013), in which the decedent provided preresiduary bequests to friends, residue to charity, and left nonprobate property to a surviving spouse who claimed a statutory forced heir share of the probate estate. The estate tax marital deduction was not available to the estate, because the surviving spouse was not a citizen of the United States, meaning that estate tax was incurred.

The decedent's will contained the typically inappropriate "pay all taxes from the residue of my estate" provision and waived all rights of reimbursement or contribution. Meaning that the charitable residue was reduced by estate tax caused by the spouse's elective share and the nonprobate property that passed to the spouse. Presumably that reduction correspondingly reduced the charitable deduction, which also correspondingly increased estate tax in the estate, which again would be paid from the charitable residue, leading to a circular whirlpool calculation and vastly more tax than would be the case if several aspects of state law and the document were otherwise.

As such, two major flaws in state law are illustrated by *Poffenbarger*. The first is that New York fails to reduce the elective share by nonprobate property payable to the surviving spouse. As is true in the vast majority of states with similarly wooden statutes, a surviving spouse may take all nonprobate property payable to the spouse, plus a share of the probate estate, even if this results in the spouse receiving vastly more than the requisite percentage (one-third in New York) of the decedent's aggregate wealth.

The other flaw is that New York calculates the elective share before payment of estate tax, meaning that all tax incurred in the estate befalls the nonmarital beneficiaries. In most cases this is harmless, because the elective share qualifies for the estate tax marital deduction and generates no tax. This generally produces an "equitable apportionment" result, meaning that the shares that generate the tax pay that tax. Here, however, the elective share was not deductible because the spouse was not a citizen, meaning that equitable apportionment should have required the spouse to pay the tax attributable to what the spouse's received.

An additional issue, also raised in *Poffenbarger*, is known as equitable election, by which the spouse is regarded as having rejected all provisions in the decedent's will that favor the spouse. Equitable election should apply because a claim for the elective share is a rejection of the decedent's will. In effect, the spouse should not be permitted to take inconsistent positions – accepting the will's tax apportionment provision while rejecting the rest of the will to claim an elective share. In this case the court also failed to apply equitable election, allowing the spouse to benefit from the tax provision calling for payment from the charitable residue of the estate. Meaning that virtually every mistake or inappropriate result that could arise in such a situation was generated in this perfect-storm case.

***Do You Want Interest or Appreciation with that Elective Share?*** Two issues of interest to surviving spouses were resolved by **In re Estate of Beren**, *** P.3d *** [2012 WL 5871034] (Colo. Ct. App. 2012), involving the calculation and satisfaction of a statutory elective share. The easy issue was whether to calculate that share before or after reduction of the decedent's estate by any estate tax liability (because the marital deduction for the spouse's entitlement was insufficient to eliminate all estate tax). Under the Uniform Estate Tax Apportionment Act (either freestanding or part of the Uniform Probate Code) the "equitable apportionment" result calls for calculation of the spouse's entitlement before tax (a gross estate division), the rule being that the benefit of deductions belongs to that portion of the estate that generates that tax benefit. Because an elective share qualifies in its entirety for the marital deduction, the entitlement should be calculated before reduction by taxes because that essentially allocates the benefit of the deduction to the elective share. A net estate (after tax) calculation is dictated in some jurisdictions, but the majority of states embrace equitable apportionment. See Pennell, Cline, & Turnipseed, SPOUSE'S ELECTIVE SHARE, 841 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2012), and Pennell, TRANSFER TAX PAYMENT AND APPORTIONMENT, 834 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2011).

More difficult in *Beren* was whether delayed satisfaction of the elective share entitles the surviving spouse to interest to compensate for the delay, or is the spouse's entitlement a fractional share of the estate that fluctuates with any appreciation or depreciation that occurs during the delay. UPC §2-202(a) regards the share of a surviving spouse as "an amount" determined by a formula and §2-209(e) (by virtue of a cross reference to §3-904) regards that as a general pecuniary amount that is entitled to interest for any delay in distribution, beginning one year after the date of death.

Colorado law differs – it has not adopted the 2008 amendment to the UPC that entitles the spouse to interest on a delayed distribution – nor is the elective share regarded as a fraction of the estate that would participate in either appreciation or depreciation during estate administration. As a result, in this significantly delayed estate distribution (due to six years of litigation over computation of the elective share itself), the spouse was denied any portion of a very significant appreciation in value, and the lower court's award of an "equitable adjustment" of $24.5 million (based on a 17.5% investment rate of return) was reversed in this appeal. Obviously – given the amounts involved – this issue can be a matter of some significance under any state's elective share law.

***Probable Intent in Funding Bequests.*** It is not realistic to think that the typical testator might (or even could) appreciate the funding issues that are involved in dividing an estate into two portions – one generating a deduction (typically the marital deduction) and each passing to different remainder beneficiaries. As a result, drafters normally determine which funding alternative is most likely to produce the best result overall, and include that approach without much (or any?) discussion with the client. This means that any court's application of the doctrine of "probable intent" to reform a document to convert a pecuniary bequest into a fractional share is curious, in the sense that the typical testator has no intent regarding funding whatsoever. Nevertheless, ***In re* Estate of Fisher**, 2013 WL 560700 (N.J. Super. Ct. 2013), concluded that the decedent's will would have provided for a different funding alternative if the testator had appreciated the potential for facts to develop as they did. In reality the court was simply doing equity, as it saw the facts. And applying probable intent to the overall purposes of the plan and not the particular provisions that sought to accomplish those goals.

The will provided for a classic optimum marital and credit shelter division of the estate, with the remainder interest in the marital portion passing to charities and the credit shelter benefitting favored nieces and nephews. The testator's spouse did not survive, but the plan still called for the division, which might cause a tax-conscious observer to opine that the plan revealed a clear desire to pay zero estate tax in the estates of both the testator and the surviving spouse – because only the amount that could pass free of all taxes was left to beneficiaries of the nonmarital portion. Defined using the term "pecuniary amount," the plan used a traditional residuary credit shelter approach, meaning that the formula marital/charitable portion came off the top and the nondeductible portion was whatever remained. The problem was that the decedent died shortly before the market melt-down in 2008 and, by the time the estate was ready to make distribution, so much value had been lost that the formula preresiduary amount exceeded the full value of the available assets. Thus, the residue had abated entirely. Which meant that the charities would take the entire estate and the favored nieces and nephews would receive nothing.

The court's response was that this could not have been the testator's intent, and that reformation therefore was appropriate. According to the court, the relevant inquiry was the testator's probable intent, which was that the beneficiaries of each portion of the estate should receive something, and the testator did not foresee the significant decline in asset values that served to disinherit the residuary credit shelter trust beneficiaries. Thus, applying the doctrine of probable intent, the court reformed the document to convert the pecuniary bequest into a fractional division. The effect of which was to pro rate the asset value decline, allowing each of the charities and the nieces and nephews to receive something, albeit less than they would have received if values had not declined during the period of estate administration. The most important of the court's holdings was this:

> Although . . . there is no ambiguity in the Will in the sense of language that can reasonably be interpreted in two ways, . . . a will can be considered "ambiguous where an unforeseen contingency occurred which might have resulted in unexpected intestacies." Such an unforeseen contingency implicates the doctrine of probable intent. [Citations omitted.]
>
> . . . [A]t the time the Will was drafted and signed, a diminution in the value of the assets sufficient to exclude any distribution to the [nieces and nephews] was unforeseen.
>
> [The testator] clearly intended to favor the charities over the relatives in the amount of their respective shares. However, . . . [the testator] expected both parts of the trust to be

> funded and . . . he did not anticipate that a significant drop in his assets' value would frustrate that expectation . . . .

To planners and drafters who seriously consider the funding issue, it is an affront to conclude that the notion that the consequences of the decision regarding which funding approach to embrace were unanticipated. It simply is not realistic to regard the careful decision entailed in selecting between a fractional and a pecuniary division as unaware of the consequences involved in *Fisher*. Indeed, if the values had fluctuated higher rather than lower during administration, it is very doubtful that a court would use the doctrine to reform the document to send a portion of the appreciation to the preresiduary portion. In this regard, consider the *Beren* decision, reported beginning at page 59.

Fortunately, the deductions involved – either charitable or marital – are not imperiled by the selection between a pecuniary or a fractional bequest. Either approach can generate the estate tax result that the testator intends. It is not so clear, however, whether a postmortem alteration that denies the deductible portion of its rightful distribution (based on the approach drafted) will result in a reduction of the deduction otherwise allowed. And certainly the portion that should have been protected from the asset decline in values has lost rights due to the court's determination, which at a minimum could entail gift tax issues if, for example, a surviving spouse did not object to a reformation that would send more value to beneficiaries other than the spouse.

Had the charitable remainder in the marital trust not been involved the easy answer to the possibility that developed in *Fisher* would be to combine both portions after the death of the surviving spouse and then distribute them in a predetermined percentage to each of the intended remainder beneficiaries. A charitable remainder that was not determinable at the testator's death would not generate a charitable deduction in the testator's estate, however, meaning that this alternative would not suffice in a case like *Fisher*. But it would in most cases in which the marital and nonmarital trusts pass to different beneficiaries after the death of the surviving spouse. And, in *Fisher*, the alternative could have been to qualify the entire preresiduary portion for the marital deduction in the testator's estate, and generate a charitable deduction in the estate of the surviving spouse for whatever portion passed to charity after the survivor's death. That presumably would work even if the marital and nonmarital portions were combined and then divided based on a percentage of the total amount remaining.

***Equitable Election Applied to a Trust.*** As its name predicts, "equitable election" is a doctrine that applies in appropriate equitable circumstances. Thus, it was no surprise that **In re Estate of Boyar**, 964 N.E.2d 1248 (Ill. Ct. App. 2012), applied it to a living trust that received the residue of a decedent's estate, saying:

> Although no Illinois case has yet directly extended the doctrine of election to trusts, it is well established in Illinois that when 'construing trusts . . . the court will apply the same rules of construction that are applicable in construing wills.' [And] . . . jurisdictions that have addressed the application of the doctrine of election to trusts have rejected the notion that the doctrine is exclusively confined to wills . . . .

Thus, a beneficiary who removed trust property – personalty that was located in the decedent's home – was barred from challenging the trust. Having been informed that he took trust property, which he refused to return, he was deemed to have voluntarily accepted a benefit from the trust and thus was deemed to have ratified and confirmed the trust. As such he could not thereafter challenge the trust.

Further, a subsequent offer to return the personal items was inadequate to reverse the equitable election. According to the court:

> . . . some jurisdictions have adopted [an] exception to the doctrine of election, under which a beneficiary will be permitted to challenge the validity of the will if he timely tenders or repays the benefits received under the will and the estate is not prejudiced by his temporary acceptance of those benefits. [Citations omitted.] Our courts have held that "the better view is that, in order to permit a contest of the will, the return of or an offer to repay a legacy should be made prior to instituting the contest proceeding." . . . [O]ur courts have repeatedly held that where the beneficiaries challenging the will did not return or, in the very least, offer to return the property at the time the will contest was filed or within a reasonable time thereafter, they could not avail themselves of the . . . exception to the doctrine of election. . . . By accepting and then retaining the property, in spite [of] repeated requests for its return, [the beneficiary] made a binding election, thereby ratifying the trust document, and he cannot now evade that election by tendering the property.

*Boyar* is a predictable and proper extension of the doctrine of equitable election to trusts, which is consistent with a general trend to treat wills and will substitutes as entitled to consistent treatment, including application of traditional principles, one to the other. State laws do not consistently dictate that various statutes or doctrines will apply to trusts the same as to wills. *Boyar* reflects a judicial proclivity to regard them consistently in matters such as questions of status (e.g. adopteds being treated as natural born, adult adoption not being respected in certain circumstances, or the treatment of a former spouse as predeceased). Notable exceptions include the persistent inflexibility in some jurisdictions relating to will execution formalities, and the refusal of some to augment a decedent's estate with nonprobate property for purposes of calculating a surviving spouse's elective share.

***When In Terrorem Clauses Are Enforceable.*** By simple observation (rather than by empirics) it seems that there are more cases recently deciding the validity of in terrorem (anti- or no-contest) clauses than historically has been the case. These cases arise with respect to both wills and trusts. Drafters whose clients are worried about the increasingly litigious nature of beneficiaries, or individuals who are totally excluded from an estate plan, worry about challenges to everything from the basic validity of the document to actions seeking trust accountings or asserting fiduciary breach that can hamper administration of estates and trusts, perhaps to evoke settlement payoffs or otherwise simply to assuage anger or spite. So various drafting approaches are being evaluated in cases that involve actions brought by beneficiaries or disinherited heirs, testing the validity or reach of various forms of provisions that seek to minimize this form of disruption. And the results of the cases are more uniform and less satisfying than some observers might imagine.

When are these forms of provisions valid? The concern on one side is that undue influence may inform inclusion of a no-contest provision, the same as it did document provisions that improperly favored one beneficiary over other natural objects of the transferor's bounty. After all, if you know what you are doing when overbearing a transferor, you will generate a document that makes it more difficult for anyone to challenge your handiwork. The concern on the other side is that litigation by ungrateful or deservedly disinherited heirs should not tie up an estate or trust and generate unnecessary delay and costs. Any case likely lies somewhere between these poles.

One very well respected commentator suggests that these are important provisions in cases in which the dispositive provisions predict a contest, and that wise drafters include in terrorem clauses as insurance. To the concern about overreaching in both the document provisions and in the no-contest provision, this planner's response is that an ethical attorney would not agree to draft a document for a client who was not competent and who was acting under any form of duress or undue influence. This observer suggests that use by an ethical drafter should not raise concerns. But the courts don't know whether a particular client's advisor was so ethical, and legislation such as Uniform Probate Code §§2-517 and 3-905 are targeted at garden-variety or vanilla estate planning situations that may fall at one or the other end of the spectrum. It is hard to fashion a one-size-fits-all rule regarding the validity of such provisions. Here are the nearly identical UPC rules:

> **§2-517. Penalty Clause for Contest.** A provision in a will purporting to penalize an interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings.
>
> **§3-905. Penalty Clause for Contest.** A provision in a will purporting to penalize any interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings.

Notice the presumption of invalidity. Some seemingly similar statutes reverse the rule to presume validity but provide an exception if probable cause exists, which may shift the burden of proof or persuasion regarding enforceability. In **Hamel v. Hamel**, *** P.3d *** [2013 WL 1365335] (Kan. 2013), the court applied Kansas law that presumed no contest clauses to be valid unless probable cause exists, applied the same rule to an in terrorem clause in a trust, and then found probable cause, based in part on the fact that the beneficiary's challenge was accepted as correct and in part on the fact that "the beneficiary relied upon the advice of disinterested counsel sought in good faith after a full disclosure of the facts," quoting from Restatement (Second) of Property: Donative Transfers §9.1 comment *j*.

The challenging aspect of all of these rules – regardless of the direction of the presumption – is the "probable cause" standard. Various cases address the validity question in different ways, but boiled down the rule that usually applies is that no-contest provisions are *not* enforceable if a challenge was brought "in good faith, based on reasonable grounds" and was not "frivolous or vexatious" – again depending on what those terms mean. The comment to §3–905 refers to Restatement (Third) of Property (Wills and Other Donative Transfers) §8.5 comment *c* for a definition of probable cause as "evidence that would lead a reasonable person . . . to conclude that there was a substantial likelihood that the challenge would be successful."

**In re Estate of Stewart**, 286 P.3d 1089 (Ariz. Ct. App. 2012), is representative of cases that wrestle with these standards. There was a will and a trust, both excluding a child of the decedent, both containing in terrorem clauses. The provisions were broader than often is found, reading substantially the same in each document – the following is quoted by the court from the will:

> 8.01 **In Terrorem Clause.** To the maximum extent applicable state law permits, if any person should take any one or more of the actions described in this paragraph, either directly or indirectly, then thereafter for all purposes the provisions of this will shall be construed and my estate shall be disposed of as though such person had predeceased me, effective as of the date such action is taken. This paragraph shall take effect if any person identified in the preceding sentence:

> (a) Contests my will or any codicil thereto, any exercise of a power of appointment by me, either during life or at death, or any transfer of property from any person to a trust identified in the immediately following subparagraph;
>
> (b) Contests my revocable trust or any other trust created by me either during life or at death . . . ;
>
> (c) Contests any discretionary action taken by the personal representative or by the trustee or the adviser of my revocable trust with respect to the allocation or distribution of trust property at my death under my revocable trust, the sale or disposition of any Family Business (as defined in my revocable trust), or the allocation of estate charges against any trust property or beneficiary;
>
> (d) Seeks to obtain an adjudication in any court with respect to my testamentary capacity, capacity to enter into binding contracts, or mental capacity in general at any time; or
>
> (e) Cooperates or aids in any action described in the preceding provisions of this paragraph with any other person, regardless of whether that other person is himself or herself subject to this article.
>
> 8.02 **Interpretation.** For purposes of this article, a person shall be deemed to contest an instrument, action, or transaction if that person takes any action seeking to invalidate, nullify, set aside, render unenforceable, or otherwise avoid the effect of such instrument, action or transaction. This article shall take effect regardless of whether any such contest is made in good faith or is ultimately successful. The personal representative is authorized to defend any contest by any person at the expense of my estate.

Because the child was disinherited, these provisions were worthless to dissuade a contest action – the child had nothing to lose for bringing any action noted in paragraph 8.02. This is an important lesson about in terrorem clauses – they don't instill the requisite restraint or fear in someone who has no entitlement to lose.

What *did* matter, however, was discovery in such an action, "because the *in terrorem* clauses may compel [other] beneficiaries to refrain from cooperating with [the contestant], thereby impairing [the] ability to prosecute [an] action" and "impede the judicial process" by making it difficult or impossible for a contestant to gather. If in terrorem clauses were interpreted to disqualify beneficiaries who, for example, were deposed or subpoenaed to testify, then the clause would violate public policy. But the appellate court in *Stewart* concluded that "[a] better interpretation of the clauses, and one that does not violate public policy, is that beneficiaries forfeit their interests when they urge or *voluntarily* aid a party to contest testamentary documents" and not when they submit to judicial process.

The final result in *Stewart* was reversal of the trial court's holding that the in terrorem clauses in both the will and trust were invalid. This was true for the trust because the Arizona version of UPC §2-517 does not purport to apply to a trust. It was true for both documents because the court found that the clauses did not impede the judicial process because they did not apply to beneficiaries who were compelled to testify as opposed to voluntarily participating or instigating for someone else to challenge the document.

Other cases raise similar concerns if, for example, a beneficiary seeks an accounting or otherwise to enforce beneficial interests, redress a fiduciary breach, or to remove and replace a fiduciary. Like binding arbitration provisions that similarly are regarded with suspicion if they preclude the enforceability of fiduciary duties, provisions must not make it impossible to redress a breach of duty because an unenforceable duty is no duty at all, which would invalidate the fiduciary entity itself. Further, shifting enforcement to a third party (such as a trust committee or trust protector) simply shifts the inquiry to whether the beneficiaries may enforce the third party's duty to enforce the fiduciary's duties. Which likely does not ease the issues addressed by these sorts of cases.

***Harmless Error Rule Broadly Construed.*** UPC §2-503 is the harmless error rule – sometimes referred to as a "dispensing power" – giving courts authority to regard a document as a will that was properly executed, even though one or more formal compliance requirements were not met. A not unusual example would be a will signed by the testator or witnesses on the self-proving affidavit but not in the testimonium, or husband-and-wife wills signed by the wrong spouse – he signing hers and vice-versa. As a relief provision for errors that do not entail the forms of havoc that will execution formalities are meant to minimize, the UPC stands for the proposition that testamentary intent should not be defeated by slavish adherence to the execution formalities. But **In re Estate of Ehrlich**, 47 A.3d 12 (N.J. Super. Ct. 2012), takes this relief rule to an unnecessary extreme, given that the court was dealing with a lost will and could have decided the case on a much less dangerous ground.

The decedent was a trusts and estates attorney with over 50 years of practice experience. A copy of an unsigned will was found in a drawer in the decedent's home. It had a marginal note written by the decedent that the original was mailed to the executor named by that will, who predeceased the decedent. If ever an executed copy existed, the original document was never produced. So the estate had what likely was the unsigned copy, presumably the best evidence of the original that was lost. Rather than proceed on a lost will theory, however, the court instead admitted the unexecuted document as the decedent's will, saying that the New Jersey counterpart to §2-503 "dispenses with the requirement that the proposed document be executed or otherwise signed in some fashion by the testator." Rather, "under New Jersey's codification of the 'harmless error' doctrine, a writing need not be signed by the testator to be admitted to probate." All based on the court's notion that the dispensing power "is remedial in nature" and, therefore, that "it should be liberally construed."

***Financial Abuse Slayer-Style Statute.*** Often family members take advantage of elderly relatives by misusing a financial power of attorney – some folks are not content to wait for their inheritance, making financial abuse a serious and growing concern about the security of elderly individuals. ***In re* Haviland**, *** P.3d *** [2013 WL 992042] (Wash. 2013), applied a new statute that treats a beneficiary of a decedent's estate as having predeceased the decedent – the same as would be a slayer – if found guilty of financial abuse of the decedent during life.

> Rev. Code Wash. 11.84.020: "No slayer or abuser shall in any way acquire any property or receive any benefit as the result of the death of the decedent."
>
> Rev. Code Wash. 11.84.010(1): An abuser is "any person who participates, either as a principal or an accessory before the fact, in the willful and unlawful financial exploitation of a vulnerable adult."
>
> Rev. Code Wash. 11.84.160(1): Financial abuse is "willful action or willful inaction causing injury to the property of the vulnerable adult."
>
> Rev. Code Wash. 74.34.020(6): Financial exploitation is "[t]he use of deception, intimidation, or undue influence by a person or entity in a position of trust and confidence

with a vulnerable adult to obtain or use the property, income, resources, or trust funds of the vulnerable adult for the benefit of a person or entity other than the vulnerable adult."

In *Haviland* the decedent met the financial abuser when the decedent was 85 and a patient in a hospital where she worked. She was 50 years his junior but they began dating and he began providing significant financial benefits for her – including transfers of $450,000 prior to their marriage. He changed his will to provide for her, to the nearly total exclusion of his four children by his predeceased spouse. He suffered what the court called "advanced dementia" and, by the time he died, she had totally depleted his estate, leaving him over $45,000 in debt. Which led to application of the new Washington state financial abuse slayer-style statute.

The litigated issue in *Haviland* was alleged retroactive application of that legislation, which was enacted after the decedent's death but before distribution of the estate. The fact that it was not the law when the financial abuse occurred or when the decedent died was held not to be determinative. Given the equitable intent of the statute, that result is not surprising.

*Haviland* highlights a different issue, recently addressed by courts in several jurisdictions, generally involving the right of a remainder beneficiary to receive accountings from a trustee who served during the lifetime of a revocable inter vivos trust's settlor. ***In re*** **Trimble Trust**, 826 N.W.2d 474 (Iowa 2013), is representative. The decedent was settlor of a self-trusteed declaration of trust. She stepped down as trustee only eight months before her death (at age 104). Taking her place was one daughter, who was asked by another daughter to account for the eight month "gap period" that existed after the trustee succession and death of the settlor. The daughter who was trustee refused, and the court concurred that she had no duty to account to anyone other than the settlor while the settlor was still living. Such is the general rule under Uniform Trust Code §103, which was the model statute adopted in Iowa.

The court recognized that a trust settlor may become incompetent prior to death, and that accounting to the settlor alone would not protect the settlor or the subsequent beneficiaries from financial misdeeds by the successor trustee. But it concluded that the solution to that problem lies in allowing the personal representative of the settlor's estate to seek the accounting that the court denied to the remainder beneficiary. The problem in this case – as might exist in many situations – was that the personal representative was the same daughter who was successor trustee. The solution to that, according to the *Trimble* court, is a beneficiary's right to request appointment of a temporary administrator of the settlor's estate, to request and receive the successor trustee's accounting for the gap period. That right may not exist if the aggrieved trust beneficiary is not also a beneficiary of the estate – meaning that standing in the probate court may not exist. And the *Trimble* court did not explain how a beneficiary who does have standing would know to request appointment of a temporary administrator without first having an account that might reveal the kind of financial misuse that would justify a court's appointment of such an administrator.

The issues here are difficult, because courts legitimately view inter vivos trusts as will substitutes, and they acknowledge that a settlor should have the same right to privacy regarding premortem transactions as would a testator – whose beneficiaries typically do not have the right to examine the testator's premortem financial activities. According to the *Trimble* court, "settlors of a revocable trust should be entitled to the same privacy for predeath transactions as they would if they used a will." Which ignores the financial abuse remedy in *Haviland* that requires some form of postmortem transparency regarding premortem transactions.

The conflicts inherent in this controversy are apparent in the results in several recent cases. Compare Boyd v. Boyd, 57 So. 3d 169 (La. Ct. App. 2011), In re Gunther Revocable Living

Trust, 350 S.W.3d 44 (Mo. Ct. App. 2011), and Pennell [no relation to Prof. Pennell] v. Alverson, 2012 WL 4088679 (Ariz. Ct. App. 2012) (all denying remainder beneficiaries the right to challenge the trustee for acts while the settlor was alive), with In re Estate of Giraldin, 290 P.3d 199 (Cal. 2012) (allowing remainder beneficiaries to sue the trustee for breach of duty to the settlor while the trust was revocable "to the extent that violation harmed the beneficiaries' interests").

***Trust Ignored for Asset Protection Purposes.*** **United States v. Evseroff**, 2007-1 U.S. Tax Cas. (CCH) ¶50,222 (E.D. N.Y. 2006), rev'd and rem'd by 2008-1 U.S. Tax Cas. (CCH) ¶50,240 (2d Cir. 2008), on remand, 2012-1 U.S. Tax Cas. (CCH) ¶50,328 (E.D. N.Y. 2012), originally appeared to confirm that a properly planned asset protection trust may preclude even the federal government from reaching trust assets (in *Evseroff*, in satisfaction of tax liabilities). The settlor retained sufficient nontrust assets to maintain the settlor's solvency, which originally appeared to establish that creation of the trust was not a fraudulent transfer and therefore could not be defeated. On remand, however, the court found that trust assets could be reached, on three different grounds – that the trust was the taxpayer's alter ego, that it was his nominee, and that his transfer into the trust was a fraudulent conveyance – even though judgment on the tax liability was not entered until approximately five months after the conveyance, and the taxpayer technically was not insolvent at that time.

It is notable (but ultimately not determinative) that the tax debt in *Evseroff* predated creation of the trust and the taxpayer's transfer of assets into the trust. But that tax liability was not reduced to judgment until thereafter, which is relevant in terms of whether the United States was a present or only a future creditor. As against both, present and future creditors, §4(a)(2) of the Uniform Fraudulent Transfers Act, 7A Pt. II U.L.A. 58 (2006), specifies that conveyances made without fair consideration are *deemed* to be fraudulent without regard to actual intent *if* the transferor is or is about to be engaged in activities for which the transferor's remaining property is "unreasonably small" in relation to that activity, or if existing debts or debts that are likely to be incurred after the transfer will exceed the transferor's ability to pay. The facts of *Evseroff* arguably raised the possibility of this form of fraudulent transfer liability, but this was not the source of the court's determination.

Under §4(a)(1) of the Act a transfer is *actually* fraudulent if the transferor had actual intent to hinder, delay, or defraud any present or future creditor. The *Evseroff* court made note of the fact that an actual intent to "hinder or delay" is adequate, even without an actual intent to defraud. And some asset protection planners assert that it doesn't matter whether creditors are precluded from reaching trust assets, so long as they are slowed down enough that they will go after other players in a financial deal that has gone bad, or other actors in a malpractice situation, or just give up in an offshore asset protection trust scenario. That admission alone might suffice to cause exposure, as found by *Evseroff*.

Actual intent for these purposes may be shown by any number of factors or circumstances surrounding the transfer, such as that

- the transfer was concealed,
- the transferor was being sued or being threatened with suit,
- the transfer was of "substantially all" of the transferor's assets,
- the transfer was for inadequate consideration,
- the transfer occurred close to when a substantial debt was incurred,

- the transferor retained possession, use, or benefit of the transferred property, or
- the transferor was insolvent following a conveyance (meaning that the sum of the transferor's debts exceeds the sum of the transferor's readily accessible assets or that the transferor cannot pay debts as they become due).

The conclusion in *Evseroff* was that this form of actual fraud existed, based on findings that the taxpayer was concerned about liabilities to both the government and his estranged wife, that the transfers were not for consideration, that he remained in possession of a dwelling that was transferred into the trust and continued to make payments that an owner would make (rather than paying rent as a tenant), and that his "readily accessible assets were insufficient to satisfy his tax debt." In addition, his general intent was evident from financial conduct that included "suspicious movements of funds" that "support[ed] a finding that he intended to hinder or delay collection of his assets, particularly his tax debt." For an even more dramatic case in which a transfer into trust was deemed to be fraudulent under various of these badges of fraud, see **United States v. Spencer**, *** F. Supp. 2d *** [2012-2 U.S. Tax Cas. (CCH) ¶50,610] (N.D. Okla. 2012), in which the trustee (the settlor's accountant) was facing transferee liability, both as trustee and individually (which puts aiding-and-abetting exposure in a new light).

Bankruptcy Code (11 U.S.C.) §548 is very similar to the Uniform Fraudulent Transfers Act in that it grants the trustee in bankruptcy power to set aside any transfer made within one year of filing a petition for bankruptcy if the transfer was made with actual intent to hinder, delay, or defraud any present or future creditor or it was made for less than fair market value consideration and the transferor was insolvent following the conveyance, the transferor was or was about to be engaged in activities for which the transferor's remaining property was "an unreasonably small capital," or the transferor intended to incur debts beyond the transferor's ability to pay as they matured. See, e.g., In re Schwarzkopf, 626 F.3d 1032 (9th Cir. 2010) (transfer while settlors were insolvent with respect to a prior creditor was deemed fraudulent and thus was invalidated in a subsequent bankruptcy proceeding, unrelated to the original creditor issue). The addition of §548(e) in 2005 gives the bankruptcy trustee ten years to avoid transfers to a "self-settled trust or similar device" if the debtor is a beneficiary and made the transfer with the same actual intent. **In re Mortensen**, 2011 WL 5025252 and 5025249 (Bkrptcy D. Ak. 2011), reached this conclusion with respect to creation of an Alaska asset protection trust by an Alaska domiciliary settlor.

A trust settlor may acquire a degree of protection against *future* potential creditor claims if a valid asset protection trust exists. The future creditor distinction is an important refinement, because these fraudulent conveyance laws distinguish between present and subsequent creditors. The former are those to whom liability already exists (or at least those to whom the transferor knew a future liability might run), as to whom fraudulent transfers may be set aside. Future creditors are those "nameless, faceless" persons about whom the transferor had no awareness and no current dealings that might ripen into future liability (such as the next unknown client of a professional person or a tort claimant alleging liability from a yet unanticipated future harm), as to whom fraudulent conveyance limitations do not apply. As to these future creditors, there are several other legal theories that may permit a creditor to defeat transfers into trust. These were relevant in *Evseroff*.

For example, consider the following "alter ego" discussion from Dexia Credit Local v. Rogan, 2008 WL 4543013 (N.D. Ill. 2008) (citations omitted), which allowed creditors to attach trusts created for a debtor's children. In reading it consider that a frequent distinction between the alter ego and nominee theories is that the alter ego theory looks to control over the entity that owns property (the trust) while the nominee theory looks to control over the property itself:

> . . . A trust may be considered to be the alter ego of a judgment debtor if the debtor used the trust's assets for his own benefit and exercised authority over the trust's assets. The factors considered include whether there was a close personal relationship between the transferor and the trust; the transferor received consideration for the transfer; the trust was created to shield the transferor's assets from creditors and the transfer was made in anticipation of incurring debts or in anticipation of collection activity; the transferor continued to enjoy the benefits of the property following transfer; the transferor contributed all or just part of the trust's assets; and there was commingling of management and record keeping of the assets of the transferor and the trust.
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> . . .
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> . . . A judgment creditor may levy upon property held in the name of someone other than the judgment debtor if the debtor engaged in a legal fiction by placing title to the property in the hands of someone else while, in actuality, retaining all or some of the benefits of ownership. In determining whether a person . . . is a nominee for a debtor, courts consider factors such as whether the person paid consideration for the property, whether the property was given to the person in anticipation of a suit or liability, whether the judgment debtor exercises control of the property after its transfer, whether there is a family or other close relationship between the debtor and the transferee, whether the debtor has the benefits of the property after the transfer, and whether the debtor maintains the property after the transfer.

In *Evseroff*, arguably the United States was only a future creditor, because the tax debt was not reduced to judgment until after the taxpayer's transfers into the trust. One reason for a court to rely on the alter ego or nominee theories is to avoid any limitations under applicable law that do not apply fraudulent transfer concepts to future creditors. In *Evseroff*, therefore, one of the theories on which the court relied to find the trust was liable for the tax claim was that the trust was the settlor's "nominee." This concept allowed the United States to access trust assets as if they were still owned by the settlor.

In discussing the nominee concept, the *Evseroff* court applied criteria that are very similar to the *Dexia* alter ego and nominee concepts (indeed, the degree of overlap can create confusion between these two concepts). *Evseroff* concluded that, "rather than intent, the nominee theory focuses on control" and that the "critical consideration is whether the taxpayer exercised active or substantial control" over either the trust itself or the assets within the trust. In *Evseroff* this was easy to find based on the identity of the trustees, their lack of active participation in trust management, and the taxpayer's retained use and control over trust assets (such as a dwelling that the taxpayer continued to treat as a personal asset). Also relevant was that the asset transfer was "in anticipation of a lawsuit or other liability," which was the case in *Evseroff*.

The *Evseroff* court *also* found that the trust was the settlor's alter ego and this *too* allowed access to the trust assets, the court saying that:

> although the New York Court of Appeals has never held that the alter ego theory may be applied to reach assets held in a trust, . . . there is no policy reason why veil piercing would apply only to corporations but not to trusts. The policy behind corporate veil piercing is to prevent a debtor from using the corporate legal form to unjustly avoid liability. That policy applies equally to trusts.

This corporate-veil-piercing alter ego theory was supported in *Evseroff* because numerous facts revealed that neither the settlor nor the trustees respected the separate existence of the trust, such as "to give rise to an inference that the Trust was not a bona fide entity . . . [and] that there was little substance to the Trust and that it was merely an extension of Evseroff." According to the court, "[t]he essence of the alter ego theory is that the existence of the Trust as a separate entity is a fiction." This aspect of the case ought to be easy to avoid in any legitimate trust, administered by a conscientious trustee whose independence from the trustee is beyond question.

Invalidation of a trust under any of these theories is critical to the creditor, but helpful only if assets then are subject to the court or to the creditor's reach – which makes the onshore version of asset protection planning more dangerous to the settlor. Indeed, as revealed in **Rush University Medical Center v. Sessions**, *** N.E.2d *** [2012 IL 112906] (Ill. 2012), location of the trust assets is critical, not where the trust itself is settled or administered. In that case a trust administered by the settlor's brother designated Cook Islands law as governing, but the trust owned realty located in Illinois that was sufficient to satisfy the creditor's entire claim (a charitable pledge that the settlor failed to honor before dying).

Notable about the case is that the Illinois Attorney General joined the creditor – the opinion does not clarify why (because a charity was involved, because the defendants were challenging the operation of the Illinois fraudulent transfer law, or what?) – and that the court held that traditional self-settled spendthrift rules allowed the creditor to reach the trust assets.

Also important was the court's determination that death did not alter the creditor's right to reach the full amount of the trust income and principal that could have been distributed to the settlor during life. "The common law rule is clearly not limited only to claims brought against a trust by creditors who were 'judgment creditors' of the settlor during his lifetime." Creditors may reach trust assets postmortem if "the placement of the funds into the trust is void as against existing and future creditors . . . as if placement into the trust never occurred." The court noted that, if this result was otherwise a debtor could borrow large sums, keep the debt current during life but die with the underlying liability unpaid and thereby cheat the lender (if the decedent's assets were all in an inter vivos trust). Nary a mention was made of Cook Island law, and the only theory upon which the court resolved that the creditor was allowed to prevail was the traditional common law of self-settled spendthrift trusts. All of which may indicate a lack of effective representation in the creation, administration, and the litigation stages of this trust plan and controversy.

Because of the ability of creditors to set aside transfers that are in actual or constructive fraud of their rights, the asset protection trust form of planning has been regarded as effective only against the potential future claimant who is not yet even a cloud on the horizon. "Asset protection planning is a vaccine and not a cure . . . . [It is] best implemented when the client is least inclined to do so; that is, when the client's legal seas are calm." Engle, Using Foreign Situs Trusts for Asset Protection Planning, 20 Est. Plan. 212, 217 (1993). Although the facts in *Evseroff* make the "potential future creditor" label suspect, the intriguing aspect of the case is the ease with which the court on remand found that other legal theories threw open the door to creditor satisfaction.

One recommendation made in the asset protection trust arena is to provide in the trust that all claims of present and *existing* (albeit future) claimants be paid from the trust (sometimes known as a "Jones clause"), making it clear that the protection sought by the trust is only with respect to those subsequent potential unknown claims as to which the present transfer is not an actual or constructive fraud. Indeed, experienced practitioners in this arena report that advisors and reputable trust companies will not assist a client who is looking to dodge existing creditors, spousal or child support obligations, tax liabilities, or to engage in any form of criminal activity.

But as *Evseroff* reveals, even that form of planning may not suffice to defeat the alter ego or nominee theories, which are novel today but may find currency in the future as more cases involving the asset protection trust concept reach the courts.

***Lawyer Who Sold Product Disbarred.*** The result in **Florida Bar v. Doherty**, 94 So.3d 443 (Fla. 2012), cannot surprise anyone – hopefully not even the attorney who was disbarred. It involved facts that may not be common. Yet there are several ethics lessons that even most seasoned estate planners may benefit from considering.

In a nutshell, the attorney involved was "marginal" – he had been suspended by at least one other state (about which he lied when subsequently obtaining malpractice insurance), and he was in financial trouble. Other damning factors may have compelled the ultimate resolution – he "acted with a selfish motive" (he directed business to a company to which he owed a large sum of money), refused to acknowledge his wrongdoing, and was not a rookie who could claim inexperience or ignorance. He also had absented himself to Arizona *and* had the proverbial fool for a client – he represented himself before the Florida Supreme Court.

His ethical lapse was simply that he provided both legal and financial services to clients – and he sold product (in this case, he sought to sell annuities to a dying client). In addition, because he owed the company a substantial sum, he steered business to that company because it reduced his debt (the opinion provides inadequate information to know whether the product was not the best option for the client; it seemed reasonably clear that no annuity was appropriate for the particular client involved). And, most importantly, he never disclosed that he had a conflict of interest, *nor* did he seek to obtain an informed and voluntary consent from the client.

On top of this, the attorney also was named as both personal representative of the client's estate and trustee of the client's trust. Writing yourself into a document in either role is not necessarily ethically improper, but it is incumbent to establish that the selection was the client's free and well-informed choice, based on reasonable knowledge of all the other options that were available. In this case that seemed like a "minor" lapse, and the court did not dwell on it.

Model Rule 1.8(a) provides that a lawyer must not enter into a business transaction with a client unless (1) the transaction is fair and reasonable, (2) the client was advised in writing about the desirability of obtaining independent legal counsel, and (3) the client gave an informed consent, in writing. The court summarily rejected the attorney's argument that the sale of annuities is not a business transaction, citing the Comment to Rule 1.8(a) that "lawyers engaged in the sale of goods or services" are subject to the rule "even when the transaction is not closely related to the subject matter of the representation." Here the sale of annuities would seem to be very closely related to estate planning and the court specifically held that Rule 1.8(a) applies to the sale of investment services to clients.

Note that "fair and reasonable" though a transaction may be, Rule 1.8(a) requires more. For example, it is not enough to argue that a client would pay the same sales commission to any agent. Indeed, the Law of Agency would say that any commission received on a sale to an agent's principal (that is, on a lawyer's sale to a client) must be paid over to the client. See Restatement (Third) of Agency §8.02. Because the Model Rules are a subset of the Law of Agency, these notions may be topics about which some estate planners need to be aware. At a minimum, the conduct in *Doherty* constitutes "conduct [that] created a clear conflict of interest in that there was a substantial risk that his representation of the client would be limited by his own interests."

An informed and voluntary consent, in writing, is the protection needed. If the transaction is on the up-and-up that shouldn't be difficult to obtain.

***The New Biology.*** An issue that has become increasingly common relates to the "new biology," by which a child can be conceived by means of artificial insemination using the egg or sperm of donors, who do not constitute parents simply by virtue of their biological contribution. Instead, other more important factors are involved.[1] Thus, the Uniform Parentage Act and, before it, the Uniform Status of Children of Assisted Conception Act both provide generally[2] that any child conceived following artificial insemination of a woman is the child of that woman regardless of the lack of a biological relation. Similarly, if the birth mother is married, her husband is presumed to be the father, regardless of a lack of biological connection, unless he can prove that he did not consent to the artificial insemination.[3]

This may prove to be true even if the insemination and subsequent birth both occur after the husband's death.[4] When heirship is established under these new-biology dictates, a child produced by artificial insemination is treated as a naturally conceived child of the husband and wife for all purposes. Indeed, the child may be regarded as a *marital* child, because the parents *were* married, albeit one parent is deceased when the child is born (although this depends on state law and may not be true if state law provides that marriage ends upon the death of either spouse).

Easy early cases that confronted the policies involved here were In re Estate of Kolacy[5] and Woodward v. Commissioner of Social Security.[6] Both cases began in federal court and were certified to state court for a determination of heirship under state law. Both involved young, intestate, leukemia victims who banked sperm before beginning chemotherapy that proved to be unsuccessful. The issue was the child's entitlement to federal survivor benefits under the Social Security Act, which the courts resolved based on heirship as determined under state law.[7] Both

1. See Uniform Parentage Act §702, and Uniform Status of Children of Assisted Conception Act §4(b).

2. Absent a gestational agreement otherwise. See Uniform Parentage Act Article 8.

3. See Uniform Parentage Act §705. See also Restatement (Third) of Property (Wills and Other Donative Transfers) §14.8, and §2.5 comment *l* (1999), stating that

> the traditional view is that a child who is conceived and born after the decedent's death cannot be an heir. This proposition, however, is open to reexamination with respect to a child produced from genetic material of the decedent by assisted reproductive technology. Most statutory codifications . . . are not inconsistent with such a reexamination because they do not preclude inheritance by a child conceived after the decedent's death.
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> This Restatement takes the position that, to inherit from the decedent, a child produced from genetic material of the decedent by assisted reproductive technology must be born within a reasonable time after the decedent's death in circumstances indicating that the decedent would have approved of the child's right to inherit. If the . . . procedure occurs after the husband's death, and if the child is born within a reasonable time after the husband's death, the child should be treated as the husband's child for purposes of inheritance *from* the husband. Once conceived, such a child is the husband's and wife's child for all purposes of inheritance by, from, or through an intestate decedent who dies thereafter (emphasis in original).

4. See Uniform Parentage Act §707.

5. 753 A.2d 1257 (N.J. Super. 2000).

6. 760 N.E.2d 257 (Mass. 2002).

7. The federal statutory construct in 42 U.S.C. §§402 and 416 involves the following provisions, the last of which providing the state intestacy connection:

> §402(d)(1)(C): an applicant is entitled to survivor benefits if the applicant is "a child (as defined in section 416(e)) [who] was dependent upon the [decedent] at the time of the [decedent's] death."

cases involved posthumously conceived children—twin girls in each case—the product of their mother S being inseminated using the banked sperm after the donor D's death. Each court concluded that D was the legal, genetic, and biological father of children born to his surviving widow 18 and 24 months (respectively) after his death.

The *Kolacy* court found that D's premortem deposit of sperm for artificial insemination of S after D's not unexpected death was consistent with the policy underlying an inapposite state law providing that a child born as a result of the artificial insemination of a woman "with the consent of her husband . . . with semen donated by a man *not* her husband is treated in law as if [the husband] were the natural father of a child thereby conceived" (emphasis added, to underscore that the statute did not address the case of semen donated by the inseminated mother's husband, which the legislature apparently did not anticipate). In *Woodward* the court did not make a factual finding whether the requisite consent existed to (1) permit posthumous reproduction and (2) support any resulting child. But the court did determine that, if unspecified timing requirements also are met, the resulting child will be a legal heir notwithstanding the traditional common law rule that heirs are ascertained at D's death.

Originally contrary to both cases was Gillett-Netting v. Commissioner of Social Security,[8] which is distinguishable only because the man was older and the twins were one boy and one girl, but otherwise involved essentially the same facts and issue as both *Kolacy* and *Woodward*. The lower court held that heirs under state law must "survive" D and therefore had to be in existence at D's death, and rejected notions of D's intent because the intestate statute applies in the absence of a will, which is how decedents are expected to indicate their intent. On appeal the court relied on Arizona state law to the effect that all legitimate (marital) children are dependents and that the children involved in the case were the undisputed biological children of the decedent, citing *Woodward*.[9]

The original holding in *Gillett-Netting* is basically the same as the final decision in Khabbaz v. Commissioner, Social Security Adm'n,[10] a fourth pea out of essentially the same pod. The court focused on language in the applicable state law that referred to "surviving issue" and concluded that "survive" implies remaining alive after another person's death. This child was not yet alive when D died and therefore could not meet the intended classification as a "surviving" heir. In the process the court dodged a social policy argument that D's DNA product should be included in the benefited class, saying that these policy issues are best left to the legislature to resolve.[11]

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§416(e)(1): one of several enumerated categories of persons who are a "child," this states that "child" means "the child or legally adopted child of an individual."

§416(h)(2)(A): "In determining whether an applicant is the child of [a decedent] for purposes of this subchapter, the Commissioner of Social Security shall apply such law as would be applied in determining the devolution of [the decedent's] intestate personal property . . . by the courts of the State in which [the decedent] was domiciled at the time of . . . death."

8. 231 F. Supp. 2d 961 (D. Ariz. 2002), rev'd, 371 F.2d 593 (9th Cir. 2004).

9. Later cases reveal that this holding ignored 42 U.S.C. §416(h)(2)(A) and essentially relied on only §§402(d)(1)(C), requiring dependency, and 416(e)(1), defining a child, which the court held was not disputed, in terms of the biology.

10. 930 A.2d 1180 (N.H. 2007).

11. Curiously, the *Kolacy* court specifically disregarded the state Attorney General's request that it not rule, recognizing that the state court's ruling might not bind a federal determination of heirship and that its ruling in this particular case would not "unfairly intrude on the rights of other persons or . . . cause serious problems in terms of the orderly administration of estates." The court regarded its ruling as helpful until such time as the legislature undertook

Following a very similar path under slightly different facts, Finley v. Commissioner, Social Security Adm'n[12] passed on the opportunity to make law and deferred to the legislature to address this issue. One difference in *Finley* was that a frozen embryo was implanted after the putative father's death, and the court rejected an argument that the child was "conceived" premortem when the embryo was created, the court noting that this "determination . . . would implicate many public policy concerns" that were beyond the court's purview. Reflecting a similar concern, the drafters of the UPC altered §2-120(k) to refer to a child "in gestation" at a particular time, rather than in conception, to circumvent this issue.[13]

Also rejecting claims to survivor benefits, Stephen v. Commissioner of Social Security[14] found the critical factual difference to be that D's sperm was harvested on the day after his unexpected death due to cardiac arrest. The court held that, under the applicable state (Florida) law, "a child conceived from the . . . sperm of a person . . . who died before the transfer of their . . . sperm . . . to a woman's body shall not be eligible for a claim against the decedent's estate unless the child has been provided for by the decedent's will,"[15] which clearly could not have occurred here because the sperm was not obtained, much less transferred, prior to D's death.[16]

Similar to *Finley*, D's sperm also was harvested postmortem in Vernoff v. Astrue,[17] which allowed the court to reject the claim to survivor benefits – in *Vernoff* because a posthumously conceived child could not be dependent on a decedent who died prior to the child's conception. Subsequently, Beeler v. Astrue[18] rejected the child's claim because state law in effect at the decedent's death required conception of the child during the decedent's lifetime, and Schafer v. Astrue[19] rejected the child's claim because state law in effect at the decedent's death required that the child be born within ten months after the decedent's death and in *Schafer* the child was born almost seven years after the decedent died.

Both *Beeler* and *Schafer* are poignant because they were decided subsequent to, and they rejected, the approach dictated by the court of appeals in **Capato v. Commissioner of Social Security**.[20] As such, those three cases created a conflict between the circuits, which the U.S.

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"to deal consciously and in a well informed way with at least some of the issues presented by reproductive technology" in the kind of situation posed.

12. 372 Ark. 103 (2008).

13. See Bass, What If You Die, And Then Have Children, 145 Trusts and Estates 20 (April 2006); Bailey, An Analytical Framework for Resolving the Issues Raised by the Interaction Between Reproductive Technology and the Law of Inheritance, 47 DePaul L. Rev. 743, 783, 797 (1998) (suggesting that, in states that presume paternity based on conception during the marriage, if a woman's egg is fertilized before the husband dies, a posthumous child will be his heir regardless of the interval between his death and the child's birth, and stating that inheritance based on conception prior to death was the law in 19 states at that time); and Shapo, Matters of Life and Death: Inheritance Consequences of Reproductive Technologies, 25 Hofstra L. Rev. 1091 (1997).

14. 386 F. Supp. 2d 1257, 1260 (M.D. Fla. 2005).

15. See Fla. Stat. §742.17(4).

16. Readers who wish to inquire how this postmortem medical procedure works may consult Andrews, The Sperminator, NY Times Magazine, Mar 28, 1999, 62-65. See also Goldfarb, Posthumous Conception and Inheritance Rights, 36 N.Y. State Bar Ass'n Trusts and Estates L. Section Newsletter 43 (Summer 2003); Scott, A Look at the Rights and Entitlements of Posthumously Conceived Children: No Surefire Way to Tame the Reproductive Wild West, 52 Emory L.J. 963 (2003).

17. 568 F.3d 1102 (9th Cir. 2009).

18. 651 F.3d 954 (8th Cir. 2011).

19. 641 F.3d 49 (4th Cir. 2011).

20. 631 F.3d 626 (3d Cir. 2011), rev'd sub nom., Astrue v. Capato, 132 S. Ct. 2021 (2012).

Supreme Court resolved by reversing *Capato*. By that convoluted pathway, *Capato* thus became the lodestar in this context.

Unlike the test articulated by the Social Security Administration, which relies on the law that would determine devolution of D's intestate personal property in the state of D's domicile,[21] the appellate court in *Capato* applied a simplistic analysis in which "dependency" would play the critical role *if* the parties agreed that the applicant was the DNA offspring — an "undisputed biological child" — of the decedent.[22] That conclusion would have resulted in a remand to address the question whether the claimants could have been the decedent's dependents at his death, given that they were born after he died, but the Supreme Court's grant of certiorari and reversal of the appellate court's ruling instead made the dependency question irrelevant.

The unanimous Supreme Court opinion in *Capato* validates the government's state law intestacy approach as being consistent with Congress' intent that survivor benefits only assist children who lost their source of support due to the unanticipated death of a parent. According to the Court, if state intestacy law permits a child to inherit, "it may reasonably be thought that the child will more likely be dependent during the parent's life" – which is a funny construct in the case of a posthumously conceived child, who could not possibly have been the decedent's dependent during life. In a sense, the government's approach, blessed by *Capato*, avoids the dependency issue entirely.

In doing so, however, *Capato* does little to alter the fact that the government's approach yields different results under different state laws, because intestacy statutes differ. In *Capato*, the Court relied on Florida law,[23] under which a posthumously conceived child can only inherit as provided in a decedent's will – not by intestacy. But the Court acknowledged that intestacy determined by statute in other states would provide an inheritance to posthumously conceived children who are born or conceived within statutorily specified time limits.[24] As such, the Court's conclusion simply blesses the SSA approach of looking to state intestacy law as a valid and controlling regulatory approach, but it fails to establish a uniform national rule.

Albeit that these cases have produced inconsistent results, the issue in each was relatively easy. The more challenging situation is one that the courts have just begun to address. If D leaves DNA in the freezer and that DNA is used postmortem with the requisite permission to produce a child, it seems relatively clear that D intended that child to be a beneficiary of D's estate. As illustrated by **Burns v. Astrue**,[25] however, even that may not always be so clear. More difficult yet, however is the intent of relatives of the DNA provider. Assume, for example, that the provider's ancestor created a trust for the provider's benefit for life, remainder to the provider's descendants. Does the settlor intend to give anyone (the provider's surviving spouse or anyone else) a blank check to

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21. See Program Operations Manual System (POMS) GN 00306.001(C)(1)(c), "to meet the definition of 'child' under the Act, an after-conceived child must be able to inherit under State law." This provision is available at secure.ssa.gov/poms.nsf/lnx/0200306001.

22. See 42 U.S.C. §§416(e)(1) and 402(d)(1)(C).

23. Fla. Stat. Ann. §742.17(4), which applied because Florida was the state of the decedent's domicile at death.

24. The Court listed intestacy provisions in California, Colorado, Iowa, Louisiana, North Dakota, and the UPC.

25. 289 P.3d 551 (Utah 2012) (a certified question from a federal case seeking to reverse denial of Social Security benefits), in which the court determined that "without more, a Semen Storage Agreement that leaves frozen preserved sperm to the donor's wife upon his death does not constitute sufficient consent in a record to be the parent of the child conceived by artifical means following the donor's death." As a result, notwithstanding a lower Utah court's determination of paternity, the decedent donor, predeceased husband of the mother who sought the Social Security benefits, was not treated as a parent of the child for purposes of the Utah version of Uniform Parentage Act §707.

create more remainder beneficiaries? That question was answered in the affirmative by In re Martin B.[26]

The question whether a provider intends for a posthumously conceived child to be treated as their own is easier than the question whether an ancestor intends for someone else to be able to use the DNA to create more beneficiaries of the ancestor's trust. Indeed, if clients were asked the question, "would you want your daughter-in-law to be able to make herself pregnant with your son's frozen sperm, to create more beneficiaries of your trust," would their answers predictably be the same as if they were asked "do you want your son-in-law to be able to withdraw your daughter's frozen egg (or their frozen embryo) and find a surrogate mother to make more beneficiaries of your trust"? There is likely no way to predict a typical client's reaction to either question, nor to predict whether any client's response would distinguish between a daughter-in-law using the son's sperm and bearing the child herself as opposed to a son-in-law finding a surrogate mother to carry the daughter's child.

The court in *Martin B* may have reflected the direction the law appeared to be developing at that time, treating the offspring as a child of the DNA provider and therefore as a descendant of any other ancestor, for all purposes. But the issue in *Martin B* is similar to the stranger-to-the-adoption rule, as to which the law remains unsettled. Remember the common law rule that an individual who adopted a child was regarded as the child's parent for all purposes relating to the adopting parent's estate, but the child was not treated as a descendant of the adopting parent's ancestors. That rule then was changed by statute and adopteds were treated as natural born for all purposes. But more recently there has been a push back with respect to adult adoption and the stranger-to-the-adoption rule. The notion being that maybe an ancestor's intent is not the same if adoption is used to make an adult a beneficiary of an ancestor's estate plan, meaning that individuals adopted as adults should not be treated as natural born. It may be that a similar iteration will occur in the posthumous conception context as well, by creating a stranger-to-the-freezer rule.

As all this shakes out, it may be wise for estate planners to draft for these issues, to articulate their clients' intent in each regard. Particularly because state law is in flux, because one-size-fits-all legislation may not reflect a client's intent, and because conflict of laws issues may inform a court's reliance on the law of a different state.

26. 841 N.Y.S.2d 207 (Surr. Ct. 2007).