**Section News**

**RPTE Sponsors Annual Meeting Programs**
The Section will co-sponsor several valuable programs at the ABA Annual Meeting in New York, on Friday, August 8 through Sunday, August 10. If you are attending the Annual Meeting, be sure to check out these RPTE sponsored programs. *If you have not yet decided to attend the Annual Meeting, here are seven more reasons to do so.*

The **2007 Industry Trends Survey** names Probate & Property the second most subscribed to publication by estate planning attorneys throughout the country.

Join us in NYC for the **Skills Training for Estate Planners CLE Program**. This very popular program sells out quickly. Early registration is advised!

**Technology**

**She's a Spreadsheet Wizard: Winning Ways with Spreadsheets**

Originally presented at ABA TECHSHOW 2008, sponsored by the ABA Section of Law Practice Management. **Laura Calloway and Dan Pinnington**

**CLE Spotlight**

**REAL PROPERTY CLE**
The Newest AIA Family of Documents: Will Integrated Project Delivery Make Conflict Obsolete? 
**Date:** Thursday, July 11, 2008  
**Time:** 12:00 p.m. to 1:30 p.m.

**TRUST AND ESTATE CLE**
17th Annual Advanced ALI-ABA Course of Study/Live Video Webcast, Estate Planning for the Business Owner. 
**Date:** Wednesday-Friday July 9-11, 2008. **Location:** Boston, MA
The Latest Draft from NCCUSL

ASTLEFORD V. COMMISSIONER
Steve Akers

NON-FIDUCIARY SUBSTITUTION POWER AS GRANTOR TRUST TRIGGER AND HELPFUL GUIDANCE IN REVENUE RULING 2008-22
Steve Akers

HOLMAN V. COMMISSIONER
Steve Akers

PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES
Mario A. Mata

GUARDIANS AT THE GATE: UPDATE ON THE GATEKEEPER INITIATIVE
Duncan Osborne

THE YEAR IN REVIEW: AN ESTATE PLANNING PERSPECTIVE ON RECENT TAX DEVELOPMENTS
Howard Zaritsky

Real Property News

TRANSFER FEES - HOW TO MAKE MONEY IN REAL ESTATE (AND RENDER YOUR PURCHASER’S TITLE UNMARKETABLE) WITHOUT REALLY TRYING
Janice Carpi

STATES MOVE TO LIMIT ENFORCEABILITY OF TRANSFER FEES
Lavinia James Vaghn and Kathleen E. Kraft

Entrepreneurial creativity is limitless, as are the legislative means for curtailing it. Follow these links to learn more about how covenants obligating subsequent grantees to pay "transfer fees" could be clouding a title near you.

THE TREATMENT OF MORTGAGE LOAN REPURCHASE AGREEMENTS IN CHAPTER

Committee administers the “RPTE Committee Website Award” for the best substantive committee websites. Click here for the winners!

REAL PROPERTY

Emerging Issues and Specialty Leases Committee
The Emerging Issues and Specialty Leases Committee could use your legal expertise on three projects! Click here for project information.

TRUST AND ESTATE

Business Planning Group
The Business Planning Group has assembled a task force to submit comments to Alternative Valuation Proposed Regulations Section 20.2032-1(f)(1). If you would like to become a member of the task force, please contact William S. Forsberg at (612) 335-1413, william.forsberg@leonard.com or Hugh Drake at (217) 544-8491,Hdrake@bhslaw.com. The comments are due July 24, 2008.

Young Lawyers

The RPTE Young Lawyers Network and the Tax Practice Management, Tax Young Lawyers Forum and Diversity Committees will co-sponsor a panel at the Joint Fall CLE Meeting in San Francisco this September on Making Your Name: Self-Promotion, Achieving Success, and Delivering Your Message.

Bestselling author, Tucker Max, and David Roy Eaton, master lifestyle coach and author, offer a point-counterpoint talk on their distinct approaches to success. The panelists will discuss their different approaches to networking techniques, building business
11 BANKRUPTCY
Katherine A. Burroughs and Jonathan F. Tross
The 2005 Bankruptcy Code Amendments expanded protections for rights under "repurchase agreements". In a case of first impression, the Delaware Bankruptcy Court recently found these new protections apply to an agreement for the sale and repurchase of mortgage loans.

UPDATE: OHIO FORECLOSURE CASES: LENDERS BEWARE
Stephen Buchenroth and Gretchen Jeffries
The fallout from the subprime lending crisis continues. Stephen Buchenroth and Gretchen Jeffries update their prior article and cover the latest on foreclosures in Ohio.

Would you like to write an article for the eReport?
If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

New Book from RPTE
From Handshake to Closing: The Role of the Commercial Real Estate Lawyer
Sidney G. Saltz
From Handshake to Closing is an invaluable and practical mentoring guide intended to bridge the gap between the way law firms train young lawyers today, often thrusting upon them complicated matters and asking them to learn through trial and error rather than through observation. It teaches real estate lawyers to avoid pitfalls that can kill the deal, and serves as a valuable refresher for more experienced attorneys. Suggestions on how to handle various stages of a deal, the history of the practice, and ample examples are provided. Learn More....

FOR OFFLINE READING:
The **RPTE eREPORT** is the bi-monthly electronic publication of the Real Property, Trust and Estate Law Section. It includes practical information for lawyers working in the real property and estate planning fields, together with news on Section activities and upcoming events. **RPTE eREPORT** also provides resources for young lawyers and law students to succeed in the practice of law. For further information on **RPTE eREPORT** or to submit an article for publication, please contact: Susan Talley (Editor) at stalley@stonepigman.com; Cheryl Kelly (Real Property Editor) at CKELLY@thompsoncoburn.com; Robert Steele (Trust and Estate Editor) at steele@whafh.com; or Michael Goler (Managing Editor Emeritus) at Goler@MillerGolerFaeges.com. We welcome your suggestions and submissions.

The materials contained herein represent the opinions of the authors and editors and should not be construed to be those of either the American Bar Association or The Section of Real Property, Trust and Estate Law unless adopted pursuant to the bylaws of the Association. Nothing contained herein is to be considered as the rendering of legal advice for specific cases and readers are responsible for obtaining such advice from their own legal counsel. These materials and any forms and agreements herein are intended for educational and informational purposes only. The authors and other contributors to **RPTE eREPORT** are solely responsible for the content of their submissions, including the accuracy of citations to legal resource materials.
SECTION OF REAL PROPERTY, TRUST & ESTATE LAW
2008 ANNUAL MEETING PROGRAMS

REAL PROPERTY

What Every Real Estate Attorney Needs to Know about Environmental Law

Date and time: Friday, August 8, at 9:45-10:45 a.m.
Speakers: TBD
Other sponsor: Young Lawyers Division
Location: Marriott Marquis, Music Box/Winter Garden/Palace, Majestic Complex, 6th Floor

Business Improvement Districts and Urban Revitalization

Date and time: Friday, August 8, 2008, at 2:00 - 5:00 p.m.
Location: Sheraton New York, Conference Room H, Executive Conference Room
Speakers:

Michael Buckley, the Director of the Columbia University Real Estate Development Program, will be our moderator. See: http://www.arch.columbia.edu/realestate/view.shtml.

Dan Biederman, President of the 34th St. Partnership and co-founder of the 34th Street Partnership, the Grand Central Partnership, and Bryant Park Corporation, will speak from the perspective of the private sector. See: http://www.34thstreet.org/.

David Greenbaum, President Vornado Realty Trust. See:

One of the following speakers from New York City’s Department of Business Services, which oversees BIDs:

Andy Schwartz, First Deputy Commissioner of the Department of Small Business Services. See:

Anthony Dell’Olio, General Counsel for the Department of Small Business Services. See:

Rochelle E. Lento, affordable housing expert with the Dykema law firm, will present a case study from a BID experience in Michigan, including the development of affordable housing. See:
Topsy Turvy Markets? When Lenders and Credit Providers are in Financial Trouble

**Date and time:** Saturday, August 9, at 2:30 - 4:30 p.m.

**RPTE Speaker:** Timothy M. Lupinacci, Baker Donelson Bearman, Caldwell & Berkowitz, PC

**Other sponsor:** Business Law Section

**Location:** Grand Hyatt, Empire State Ballroom E, Ballroom Level

How Climate Change and Its Regulation Will Affect Law Practice

**Date and time:** Sunday, August 10, 10:30 a.m. - Noon

**Speakers:** TBD

**Other sponsors:** Section of Environment, Energy and Resources and others

**Location:** TBA

Environmental Hot Topics

**Date and time:** Sunday, August 10, 2:00 - 4:00 p.m.

**RPTE Speaker:** Monique M. Mooney, from the Environmental Committee of the Land Use and Environmental Group of RPTE (speaking on vapor intrusion issues)

**Other sponsor:** Section of Environment, Energy and Resources

**Location:** Grand Hyatt, Empire State Ballroom B, Ballroom Level

TRUSTS AND ESTATES

Investment Strategies for Lawyers

**Date and time:** Friday, August 8, at 2:00 - 2:30 p.m.

**Speakers:**

- **Dawn J. Bennett**, Bennett Group Financial Services, LLC, Washington, DC: The Portfolio Approach to Investments by Lawyers
- **Michael Weissman**, Deloitte & Touche Investment Advisors, LLC, New York City: Tax Planning as Part of a Lawyer’s Investment Strategy
- **Edward J. Finley, II**, JPMorgan Private Bank, New York City: Alternative Investment Vehicles Lawyers Should Consider
- **Walter T. Burke**, Burke & Casserly PC, Albany, NY: A Lawyer’s Advice to Lawyers in Choosing Who to Rely on for Investment Advice

**Panelists:**

- **Susan M. Harmon**, Susan M. Harmon & Associates, Bala Cynwyd, PA
- **Maralee MacDonald**, Shareholder, Boutin Gibson DiGiusto, Hodell Inc., Sacramento, CA
- **Joel Haims**, Partner, Morrison & Forester, New York City
Family-Controlled LLCs and Partnerships: How Can the Business Lawyer Avoid Estate and Gift Tax Traps?

**Date and time:** Friday, August 8, at 2:30 - 4:30 p.m.

**Speakers:** Steve Gorin and Sharon Klein

**Location:** Grand Hyatt, *Imperial*, Conference Level

**Other sponsors:** Business Law Section Taxation Committee and Committee on LLCs, Partnerships and Unincorporated Entities
Skills Training for Estate Planners CLE Program

July 21-25, 2008
New York Law School – New York, NY

For over ten years, this skills training has been the ideal CLE program for lawyers with less than five years of estate planning practice, and for lawyers who are interested in changing their careers.

This intensive five day program will provide expert instruction on:

- Basic Fundamentals
- Substantive Skills Development
- Technical Skills Development
- Ethical Considerations

For complete program information, please visit our website: [http://www.abanet.org/rppt/meetings_cle/2008/SkillsTraining/home.html](http://www.abanet.org/rppt/meetings_cle/2008/SkillsTraining/home.html).

To register, please complete the registration form and pre-registration survey here. Both forms should be sent to Mary Ann Peter (fax 312.988.5262 or email mpeter@staff.abanet.org). Please contact Mary Ann with any questions at 312.988.6155.
Each year the RPTE Technology Committee administers the “RPTE Committee Website Award” for the best substantive committee websites. Two winners are selected—one from the 45 Real Property Division committees, and one from the 26 Trust and Estate Division committees. Winners are selected based on the amount, type and timeliness of the website content displayed.

This year’s “RPTE Committee Website Award” winners are the same as last year’s! Congratulations to the following two committees:

Uniform Acts Committee for Trust and Estate Law (Non-Tax Estate Planning Considerations Group)

Mortgage Lending (Real Estate Financing Group)

Check out their websites through the links above!
**Group & Committee News**

**The Emerging Issues and Specialty Leases Committee** is working on 3 projects and could use your help! The first project is a **Glossary of Leasing Terms** that will include audit standards, CPA standards and other specialty information.

A **Use Clause Glossary** is the second project. This resource will help lawyers who work on retail leases—especially street deals—where use clauses for a food store, a clothing store or an art gallery, for example, will be easily accessible.

The third project is **compiling specialty leases** such as leases for a garage/parking lot, a health club/spa, an ATM facility, any type of retail at airports and others.

Please contact Richard Frome at rmf@rmfromelaw.com or 212-751-1700 if you have information to share. Any help is greatly appreciated!
The Business Planning Group has assembled a task force to submit comments to the Alternative Valuation Proposed Regulations under § 20.2032-1(f)(1). The comments are due July 24, 2008. If anyone is interested in participating on the task force, please contact the task force co-chairs: William S. Forsberg at (612) 335-1413 william.forsberg@leonard.com, and Hugh Drake at (217) 544-8491 Hdrake@bhslaw.com. The task force plans to have weekly phone conferences each Friday at 10:30AM (Central Time) until the comments are submitted.
2008 Joint Fall CLE Meeting

September 11-13, 2008 | Hyatt Regency San Francisco | San Francisco, CA

The ABA Section of Taxation and the Trust and Estate Law Division of the ABA Section of Real Property, Trust and Estate Law will host this year’s Joint Fall CLE Meeting.

Join us and take advantage of the opportunity to meet with the country’s leading tax and estate planning lawyers and government officials to discuss the latest federal tax policies, initiatives, regulations, legislative forecasts and planning ideas.

In addition, you will have the opportunity to earn valuable CLE and ethics credits and network with Tax Section and Trust and Estate Division members and government guests. The Hyatt Regency San Francisco will serve as the host hotel.
The RPTE Section, along with the GPSolo Division’s Real Estate Committee, hosted a meet and greet for DC area law students at Holland & Knight, LLP on April 18, 2008. Kyrus L. Freeman moderated the panel, which offered words of wisdom to about 30 law students in attendance. Youshea A. Berry offered insight into using bar resources to build a practice. Carmen Irizarry-Diaz talked about the importance of mentors and gave examples of how to succeed in a firm. Marianne Kayan shared tips for finding the right job based on one’s individual needs. Garland H. Stillwell stressed the importance of identifying the right practice area and how the right fit allows for a natural work and life balance.

A special thanks to Holland & Knight, LLP for hosting the event and to the moderator and panelists for participating. The event was organized by RPTE Fellows, Marianne Kayan, Karin Prangle, Rana Salti and Arnettia Wright. Another meet and greet for DC area law students is being planned for the fall.

Moderator:
Kyrus L. Freeman, Esquire of Holland & Knight, LLP

Panelists:
Youshea A. Berry, Esquire of the Law Office of Youshea A. Berry, PLLC
Carmen Irizarry-Diaz, Esquire of Greenberg Traurig
Marianne Kayan, Esquire of Paley Rothman
RPTE New Book

*From Handshake to Closing:*
*The Role of the Commercial Real Estate Lawyer*
Sidney G. Saltz

*From Handshake to Closing* is an invaluable and practical mentoring guide intended to bridge the gap between the way law firms train young lawyers today, often thrusting upon them complicated matters and asking them to learn through trial and error rather than through observation. It teaches real estate lawyers to avoid pitfalls that can kill the deal, and serves as a valuable refresher for more experienced attorneys. Suggestions on how to handle various stages of a deal, the history of the practice, and ample examples are provided.

Written by Sidney G. Saltz, a practicing general real estate lawyer with 40 years of experience, this practical guide shows how to convert that handshake in the beginning of the deal into a heartfelt handshake at the closing -- which is, in the end, what the role of the commercial real estate lawyer is all about.

Topics covered include:

- The real estate broker
- Pre-documentation documents
- Documenting the transaction
- Reviewing and analyzing documents
  - Negotiating
  - Final steps
- Other issues, including title, survey, and due diligence
  - Preparing for the closing
  - Handling the closing
PROPOSED PREPARER PENALTY REGULATIONS:
A BRIEF AND BASIC INTRODUCTION

By Robert S. Balter

On Tuesday, June 17, 2008, the IRS proposed regulations regarding preparer penalties.1 Because of the significant recent Congressional action in this area, the proposed regulations represent “a comprehensive review and overhaul of all the tax return preparer penalties and related regulatory provisions.”2 The proposed regulations are generally effective for returns and claims for refund filed after the date that final regulations are published in the Federal Register, but no sooner than December 31, 2008.3

A summary of the operation of these penalties4 is provided in Proposed regulation Section 1.6694-1(a)(1) as follows:

“The section 6694(a) penalty is imposed in an amount equal to the greater of $1,000, or 50 percent of the income derived (or to be derived) by the tax return preparer for an understatement of liability with respect to tax that is due to an undisclosed position for which the tax return preparer did not have a reasonable belief that the position would more likely than not be sustained on its merits (or due to a disclosed position for which there is no reasonable basis). The section 6694(b) penalty is imposed in an amount equal to the greater of $5,000, or 50 percent of the income derived (or to be derived) by the tax return preparer for an understatement of liability with respect to tax that is due to a willful attempt to understate tax liability or that is due to reckless or intentional disregard of rules or regulations.”5

The proposed regulations address various details of compliance including requirements to furnish a copy of the return to taxpayers6 as applied to electronic filings (generally, a “replica” of the official return “that provides all of the information” will do).7

© Copyright 2008. Robert S. Balter is Director of Tax and Estate Planning Services at Guggenheim Partners, LLC – The Private Family Office, LLC in King of Prussia, Pennsylvania and is a co-reporter of eReport. Guggenheim Partners, LLC is a global diversified financial services firm with wealth management, capital markets, investment management and proprietary investing businesses. Mr. Balter holds an LL.M. in Taxation from Temple University’s Beasely School of Law and graduated from the University of Pennsylvania. Previously, Mr. Balter was with IRS Chief Counsel’s Office in Washington, D.C. Mr. Balter has written for professional journals, including the BNA Estates, Gifts & Trusts Journal, and has lectured on estate planning topics.
The Demise of “One Preparer Per Firm” Rule. A major development is the abandonment of the “one preparer per firm” rule. As one might paraphrase Caesar, all return preparers are divided into two types: signing return preparers, who are the individuals who either have signed the return or are required to sign the return, and all other tax return preparers who are “nonsigning tax return preparers.” Under current law, as out forth in the Preamble:

“… if a signing tax return preparer is associated with a firm, that individual, and no other individual in the firm, is treated as a tax return preparer with respect to the return or claim for purposes of section 6694. Under the current regulations, if two or more individuals associated with a firm are tax return preparers with respect to a return or claim for refund, and none of them is the signing tax return preparer, only one of the individuals is a nonsigning tax return preparer with respect to that return or claim for purposes of section 6694. In such a case, ordinarily, the individual who is a tax return preparer for purposes of section 6694 is the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or claim. The ‘one preparer per firm’ rule and the corollary rule included in § 1.6694–2(d)(5) of the current regulations precluding a tax return preparer from relying on the advice of an individual associated with the tax return preparer’s same firm for purposes of penalty protection were intended to eliminate the administrative difficulty of attempting to apply the section 6694 penalty on an intra-firm basis.”

That rule is abandoned under the proposed regulations in favor of a rule assigning responsibility on a position-by-position basis, described as follows:

“Specifically, the Treasury Department and the IRS believe this evolution requires the adoption of a framework that centers on the return or claim for refund on a position-by-position basis, with the focus of any penalty on the position(s) giving rise to the understatement on the return or claim for refund and any responsible parties with respect to such position(s). Thus the Treasury Department and the IRS believe that the “one preparer per firm” rule is no longer appropriate and have proposed to adopt a framework defining a preparer-per-position within a firm.”

The proposed regulations then go on to set forth the general rule of these regulations: “Under both the current and the proposed regulations, an individual is a tax return preparer subject to section 6694 if the individual is primarily responsible for the position on the return or claim for refund giving rise to the understatement.”
The application of the proposed rules is then further expanded upon: “Under proposed § 6694–1(b)(1), only one person within a firm will be considered primarily responsible for each position giving rise to an understatement and, accordingly, be subject to the penalty. (Emphasis supplied.)”

Thus, “the IRS may advise multiple individuals within the firm that it may be concluded that they are the individual within the firm who is primarily responsible.”

If more than one firm is involved, “there may be more than one tax return preparer who is primarily responsible for the position(s) giving rise to an understatement ....”

It is only fair to say, however, that assigning responsibility begins with the signing tax return preparer.

The rationale for this approach is recited as follows:

“The Treasury Department and the IRS believe that amending the regulations to better target the person or persons responsible for the position(s) giving rise to the understatement will further compliance and result in more equitable administration of the tax return preparer penalty regime.”

A similar rule is established for multiple nonsigning preparers. Acknowledging that under this “position-by-position” approach there may be greater uncertainty as to who the preparer to be penalized is, the preamble to the proposed regulations give some idea of the application of these rules in the following excerpt:

“This rule in proposed § 1.6694–1(b)(3) is intended to address the potential for uncertainty regarding the identification of the primarily responsible tax return preparer prior to the time of the expiration of the period of limitations on making an assessment under section 6694(a). The proposed rule is distinguished from the current ”one preparer per firm” rule in the current regulations because under the proposed rule the IRS may assess the penalty against either the signing tax return preparer or the nonsigning tax return preparer with overall supervisory responsibility for the position(s) giving rise to an understatement depending on the facts and circumstances. Specifically, when the facts indicate that the signing tax return preparer is the primarily responsible tax return preparer under pro-
posed § 1.6694–1(b)(1) and (b)(2), the IRS may assess the section 6694 penalty against that individual when appropriate under the statute and regulations. In situations when the facts indicate that the nonsigning tax return preparer with overall supervisory responsibility is the primarily responsible tax return preparer under proposed § 1.6694–1(b)(1) and (b)(3), the IRS may assess the section 6694 penalty against that individual when appropriate. In situations when it is unclear which individual, as between the signer and other nonsigning tax return preparers at the firm, the IRS may assess the section 6694 penalty against the nonsigning tax return preparer with overall supervisory responsibility with respect to the position giving rise to the understatement when appropriate.”

Treasury and IRS “specifically request comments regarding the approach taken in these proposed regulations and any recommendations to improve this rule.”

§ 1.6694–1(f) of the proposed regulations provides conforming rules in order to ensure that the penalty is not assessed twice with respect to the same matter in determining the amount of the section 6694 penalty.

**Firm Penalty Liability.** When the firm’s review procedures are disregarded “by the firm through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed,” the penalty may be imposed on the firm.

**Reliance on Information Provided by Others.** A major issue has been the extent to which a defense that information was provided by others should be permitted under the preparer penalty rules. This is a matter of major concern since such a defense has been traditionally recognized, e.g., with respect to unverified information provided by taxpayers and the new rules’ emphasis on a position-by-position analysis makes such a defense even more important.

**Reliance on Taxpayer Provided Information.** Regulation Section 1.6694–1(e) allows a tax return preparer generally to rely in good faith without verification upon factual information furnished by the taxpayer, and Proposed Regulation § 1.6694–1(e) continues that rule, but provides that a tax return preparer may not rely on information provided by taxpayers with respect to legal conclusions on Federal tax issues.
Reliance on Information Provided by Those Not the Taxpayer. The proposed regulations expand this defense so that a tax return preparer may rely in good faith and without verification on information furnished by another advisor, another tax return preparer, or another party (even when the advisor or tax return preparer is within the tax return preparer’s same firm). Similarly, “a tax return preparer may rely in good faith and without verification upon a tax return that has been previously prepared by a taxpayer or another tax return preparer and filed with the IRS.”20 It seems that this should include information in a “replica” when the return is filed electronically, but there is no mention of that in the proposed regulations as written.21

Cautionary and limiting rules are also provided in this regard. The first provides that tax return preparers “may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer,” and the second provides that the preparer “must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.”22 This “expansion of the current rules” regarding reliance seems “necessary given the heightened standards imposed on tax return preparers by the 2007 Act and the increased complexity of the tax law, which often requires signing and nonsigning tax return preparers to rely on the work of others in ensuring compliance.”

Determination of the Penalty Amount. Numerous rules are provided with respect to determining the amount of the penalty to be imposed, many of which are quite complicated. This is due primarily to the linking of the penalty amount to the amount of income the preparer derives from the work done.24 Proposed Regulation § 1.6694-1(f) defines “income derived (or to be derived)” with respect to a return or claim for refund as “all compensation the tax return preparer receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.”25 Importantly, the proposed regulations provide that “only compensation for time spent on tax advice that is given with respect to events that have occurred at the time the advice is rendered and that relates to the position(s) giving rise to the understatement will be taken into account for purposes of calculating the section 6694 penalty.”26 Furthermore it is specifically recognized that allocable portion may well be less than the total amount of the compensation associated with the engagement:

“The proposed regulations provide that it may be concluded, based upon information received from the tax return preparer, that an appropriate al-
location of compensation attributable to the position(s) giving rise to the understatement on the return or claim for refund is less than the total amount of compensation associated with the engagement. For example, it may be concluded that the number of hours of the engagement spent on the position(s) giving rise to the understatement may be less than the total hours associated with the engagement. If this is concluded, the amount of the penalty will be calculated based upon the compensation attributable to the position(s) giving rise to the understatement. Otherwise, the total amount of compensation from the engagement will be the amount of income derived for purposes of calculating the penalty under section 6694.”

The rules also break out both the individual and firm penalty liability in this regard. Finally, an anti stacking rule with respect to monetary penalties under Circular 230 is expected so that penalties under 31 U.S.C. § 330 are not imposed with respect to the same conduct.

**The New Standard for Undisclosed Positions: Reasonable Belief of More Likely Than Not.** Under the exact language of the statute, the penalty is to be imposed when “there was not a reasonable belief that the position would more likely than not be sustained on its merits.” It therefore might be thought that imposition of the penalty depends on the subjective state of mind of the preparer at the time when the return or claim for refund is being prepared. And the Proposed Regulations provide that the “reasonable belief that the position would more likely than not be sustained on its merits” standard will be satisfied “if the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits.” In making that determination, the fact that the position may not be challenged is not considered.

The Preamble describes the effect of the Proposed Regulations as follows:

“Whether a tax return preparer meets this standard will be determined based upon all facts and circumstances, including the tax return preparer’s due diligence. In determining the level of diligence in a particular case, the IRS will take into account the tax return preparer’s experience with the area of tax law and familiarity with the taxpayer’s affairs, as well as the complexity of the issues and facts in the case. The proposed regulations also provide that a tax return preparer may meet the ‘reasonable belief that the position would more likely than not be sustained on its
merits’ standard if a position is supported by a well-reasoned construction of the applicable statutory provision despite the absence of other types of authority, or if the tax return preparer relies on information or advice furnished by a taxpayer, advisor, another tax return preparer, or other party (even when the advisor or tax return preparer is within the tax return preparer’s same firm), as provided in proposed § 1.6694–1(e).”

This may seem to approach this matter subjectively, but other provisions make clear that these subjective points of view, to the extent they are subjective, are substantially limited. For example, Proposed Regulation § 1.6694–2(b)(2) provides that a tax return preparer may not rely on unreasonable assumptions, and the reference is clearly a reference to objective, not subjective unreasonableness. Proposed Regulation § 1.6694–2(b)(3) also states that the authorities contained in § 1.6662–(d)(3)(iii) (or any successor provision) are to be considered in determining whether a position satisfies the “more likely than not” standard and Proposed Regulation § 1.6694–2(b)(4) provides examples illustrating positions meeting the “reasonable belief that the position would more likely than not be sustained on its merits” standard.

**Disclosed Positions and the Reasonable Basis Test.** Proposed §§ 1.6694–2(c)(1) and (2) establish that the “reasonable basis” standard that must be met for disclosed positions is “the same standard as defined in current Regulation § 1.6662–3(b)(3) (or any successor provision).” Under that provision, it is almost questionable whether “more likely than not” is a higher or lower standard than the “reasonable basis” test! Consider the following excerpt from Regulation Section 1.662-3(b)(3):

“(3) Reasonable basis. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662–4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in §1.6662–4(d)(2).”

**What is Adequate Disclosure?** When a return preparer has a “reasonable basis” for a tax return position but does not have a “reasonable belief that the position would more likely than not be sustained on its merits,” the penalty require “ade-
quate disclosure” in order to avoid imposition of the penalty. Proposed Regulation Section 1.6694–2(c)(3) expands on the current regulations and on the interim guidance provided in Notice 2008–13.

**For a signing tax return preparer** within the meaning of § 301.7701–15(b)(1), the proposed regulations provide that a position may be “adequately disclosed” in one of five ways, the first of which is disclosure on a properly completed and filed Form 8275, Disclosure Statement, or Form 8275–R, Regulation Disclosure Statement (whichever is applicable) or on the tax return itself in accordance with the applicable annual revenue procedure.36 This method is applicable to all returns and claims for refunds whereas, three of the four remaining methods are only applicable to income tax returns, and the last method is only applicable where the penalties involved do not include the accuracy related penalty.

The first income-tax-returns-only method of adequate disclosure is only available when the tax return position also does not meet the “substantial authority” standard described in § 1.6662–4(d). To satisfy this approach the tax return preparer must provide the taxpayer with a prepared tax return that includes the appropriate disclosure.

The second income-tax-returns-only method is only available when the tax return position *does* meet the “substantial authority” standard. Disclosure of the position is considered adequate if the tax return preparer advises the taxpayer of all of the penalty standards applicable to the taxpayer under section 6662. This author considers this option particularly useless since it only seems realistically applicable to the tax returns the preparer no longer wishes to prepare! Such a disclosure regarding standards for imposition of penalties seems all but certain to lose the client, unless another preparer has previously given the same disclosure with respect to the same position, an event that seems extraordinarily unlikely.

The Proposed Regulation with respect to this method of making “adequate disclosure” provides that “the tax return preparer must also contemporaneously document the advice in the tax return preparer’s files.”37 The exact import of this requirement seems uncertain. For example, if the tax return preparer clearly made written disclosure to the client contemporaneously, but failed to contemporaneously put the document in his or her tax return work papers, would adequate disclosure then not have been provided because the advice, though given in writing contemporaneously, was kept in someone else’s file? For that matter, what if the tax return preparer clearly and contemporaneously advised the client of the required matters but also put the letter in his or her tax return work papers
after a substantial period of time had elapsed so that the pertinent document was not put in the tax return preparer’s work papers “contemporaneously”—would that mean that adequate disclosure had not been made? This aspect of these rules seems overly formalistic and likely to give rise to abuse and controversy. If the disclosure was made contemporaneously in writing, where the writing was kept and when it was filed there seem altogether irrelevant to the merits of having made the required disclosure. A similar bit of non-sense infects the same requirement as applied to the next two methods of making adequate disclosure.38

The third income-tax-returns-only method applies to positions taken with respect to tax shelters under IRC Section 6662(d)(2)(C) or a reportable transaction to which IRC Section 6662A applies. Disclosure of the position is considered adequate if the tax return preparer advises the taxpayer that there needs to be at a minimum “substantial authority” for the position, that the taxpayer must possess a “reasonable belief that the tax treatment was more likely than not” the proper treatment, and that disclosure will not protect the taxpayer from assessment of an accuracy-related penalty.

The last method applies to tax returns or claims for refund subject to penalties other than the accuracy-related penalty for substantial understatements under sections 6662(b)(2) and (d). Disclosure under this method is considered adequate when the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662. This rule is said to be “intended to address the situation when the penalty standard applicable to the taxpayer is based on compliance with requirements other than disclosure on the return (for example, section 6662(e)).”

This author considers this option almost as useless as the second method—and for the same reasons: a tax return preparer can only do this is he or she is willing to lose the client.

In summary, then, for signing preparers, there are the following options:

1. Use Form 8275 (or Form 8275-R if applicable).
2. Provide the taxpayer with a return disclosing the position.
3. Provide written descriptions of the applicable penalties to taxpayers.

In the case of a nonsigning tax return preparer within the meaning of § 301.7701–15(b)(2), the preamble to the Proposed Regulations provides:
“... the position may be disclosed in one of three ways. First, the position may be disclosed on a properly completed and filed Form 8275, “Disclosure Statement,” or Form 8275– R, “Regulation Disclosure Statement,” as appropriate, or on the tax return in accordance with the annual revenue procedure. Second, a nonsigning tax return preparer may meet the disclosure standards if the nonsigning tax return preparer advises the taxpayer of all opportunities to avoid penalties under section 6662 that could apply to the position and advises the taxpayer of the standards for disclosure to the extent applicable. Third, disclosure of a position is adequate if a nonsigning tax return preparer advises another tax return preparer that disclosure under section 6694(a) may be required. The nonsigning tax return preparer must document contemporaneously in the tax return preparer’s files that this advice required by the proposed regulations was provided.”39

The Preamble includes the following warning to nonsigning tax return preparers attempting to comply with either the second or third methods:

“In order to satisfy the disclosure standards when the position is not disclosed on or with the return, each return position for which there is a “reasonable basis” but for which the tax return preparer does not have a “reasonable belief that the position would more likely than not be sustained on the merits” must be addressed by the tax return preparer. Thus, the advice to the taxpayer with respect to each position must be particular to the taxpayer and tailored to the taxpayer’s facts and circumstances. No form of a general boilerplate disclaimer will satisfy these standards. Proposed § 1.6694–2(c)(iv) provides that disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level in accordance with the rules in § 1.6662–4(f)(5). For example, a tax return preparer of a partnership tax return need only advise the partnership in order to satisfy any of the above disclosure rules and does not need to advise each individual partner in the partnership of the applicable penalties.”40

The Reasonable Cause Exception. Proposed Regulation § 1.6694–2(d) provides, in accordance with current law:

“The penalty under section 6694(a) will not be imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the tax return preparer acted in good faith.”41
While this exception could have been used to make clear that some of the more feckless applications of the documentation rules are not intended—as surely they should not be, instead the Proposed Regulations seem to do their level best to make this exception as narrow as possible and perhaps even not applicable to circumstances in which the required disclosures were made and were contemporaneously made and in writing, but were not kept—or were not contemporaneously kept— in the right file folder.

However, generally, these proposals are intended to expand the scope of the reasonable cause exception in specific situations and otherwise the rule “maintains the rules in the current regulations regarding reasonable cause and good faith...”

The “reasonable cause exception” is expanded in two ways. The first is a proposal to revise the rule “to provide that whether a position is supported by a generally accepted administrative or industry practice is an additional factor to consider in determining whether the tax return preparer acted with reasonable cause and good faith.” This preamble to the Proposed Regulations explains that this “provision is intended to address situations in the absence of published guidance when administrative or industry practice has developed that would not reasonably be subject to challenge by the IRS.” What sort of practice would “not reasonably ...be subject to challenge by the IRS” seems uncertain, and no example illustrates the sort of thing Treasury has in mind.

Second, the reasonable cause factor regarding reliance on advice of another tax return preparer is also expanded to allow a tax return preparer to reasonably rely on information or advice furnished by a taxpayer, advisor, another tax return preparer, or other party (even when the advisor or tax return preparer is within the tax return preparer’s same firm), as proposed in proposed § 1.6694–1(e). Other factors taken into account in determining “reasonable cause” include the number of errors, the frequency of the errors, the materiality of the errors, the return preparer’s normal office practice, as well any reliance on others or on generally accepted administrative or industry practice. It should be noted that the return preparer bears the burden of proof on this issue. Nonetheless, the Proposed Regulations warn preparers, perhaps ominously:

“Notwithstanding these rules, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.”
In context, the implication is plain—perhaps even threateningly plain— that general practices, no matter how laudable, will not save a preparer no matter how diligent from a “flagrant error.”

But what is a really “flagrant error”? Say a 1040 return has four major schedules (A, B, D, and E) and the Schedule E has three properties with approximately the same rents on each, no one of which is greater in amount than $13,000. Assume further that the preparer asked the taxpayer for the rents and received the rents for only two of the three properties (the rents for the omitted property were about $9,000). Assume further the preparer filed the return later in the rush of the filing season without realizing that the rents for the one property had been omitted. Is that a “flagrant error?” Perhaps stupid one might concede, but hardly nefarious—so that office practices involving cross-referencing returns to work papers and peer reviews cannot be taken into account, even if in this case they failed? No example illustrates the new “flagrant error” rule. Perhaps examples should be added to illustrate this concept.

**Definition of Tax Return Preparer.** Although this matter was discussed above, we return to it because it is so central to the overall approach in the Proposed Regulations. The proposed regulations add two subsections (Proposed §§ 301.7701–15(b)(1) and (2)) to the Regulations under section 7701, defining “signing tax return preparer” and “nonsigning tax return preparer.” These terms are central to Regulation § 1.6694–1. Proposed Regulation § 301.7701–15(b)(1) provides that a signing tax return preparer is “any tax return preparer who signs or who is required to sign a return or claim for refund as a tax return preparer....” Proposed Regulation § 301.7701–15(b)(2) provides that a nonsigning tax return preparer is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund within the meaning of § 301.7701–15(b)(3) with respect to events that have occurred at the time the advice is rendered.

The proposed regulations provide that any time spent on advice that is given with respect to events that have occurred, and which is less than 5 percent of the aggregate time incurred by the person with respect to the position(s) giving rise to the understatement will not be taken into account in determining whether an individual is a nonsigning tax return preparer. The intent of this “less than 5 percent” exclusion is to encourage tax professionals who principally rendered advice regarding events that had not yet occurred to provide follow-up advice when requested by a taxpayer without the concern that, by providing such advice to a taxpayer, the advisor would become a tax return preparer.
Proposed Regulation § 301.7701–15(b)(3)(i) clarifies that whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined “based upon all facts and circumstances,” and a single tax entry may constitute a substantial portion of the tax required to be shown on a return. The proposed regulations include additional factors to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion, such as the size and complexity of the item relative to the taxpayer’s gross income and the size of the understatement attributable to the item compared to the taxpayer’s reported tax liability.

The Preamble closes, instructing:

“Finally, Proposed Regulation § 301.7701–15(b)(3)(ii) increases the de minimis exception in determining what is and what is not “a substantial portion” of a return or claim for refund for nonsigning tax return preparers. Under the proposed regulations, the de minimis exception applies if the item giving rise to the understatement is (i) less than $10,000, or (ii) less than $400,000 if the item is also less than 20 percent of the taxpayer’s gross income (or, for an individual, the individual’s adjusted gross income). This de minimis rule does not apply for signing tax return preparers within the meaning of § 301.7701–15(b)(1). This change to the regulations updates the current de minimis amounts to reflect the passage of time since those amounts were set in 1977. The Treasury Department and the IRS are considering whether other de minimis rules applicable to nonsigning tax return preparers of non-income tax returns are warranted.

It seems that a de minimis should be considered for signing tax preparers. We are all human, and as long as we are all human, we will all make mistakes, no matter how diligently we proceed. And perhaps this brief introduction to the proposed regulations regarding preparer penalties should close with that simple, but hopefully illuminating observation.

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2. Preamble to Proposed Regulations, 73 Federal Register 34560 (6-17-08) at 34561 (“Preamble”).
3. Id.
4. The proposed regulations make the penalties as described in the Income Tax Regulations applicable to estate (Proposed Regulation §20.6060-1, 73 Fed Reg 54581, et seq.), gift (Proposed Regulation §25.6060-1, 73 Fed Reg 54582, et seq.) and generation skipping tax returns (Proposed
Regulation §26.6060-1, 73 Fed Reg 54583, et seq.), but there are no provisions tailored to those types of returns that are of any substance.

5 Proposed Reg’s §1.6694-1(a)(1), at 73 Federal Register at 34570.

6 Proposed Reg’s §1.6107-1, at 73 Federal Register 34563.

7 Id. No definition of “replica” is given, but the reference seems to be to an unfiled copy of the return that would have been filed had a paper return been filed.

8 G. J. Caesar, De Bello Gallico, Book 1, Ch. 1: “Gallia est omnis divisa in partes tres” which loosely translated means, “All Gaul is divided into three parts.”

9 Proposed Regulation §301.7701-15(b)(1), 73 Federal Register at 34595 defines a “signing tax return preparer” as “any tax return preparer who signs or who is required to sign a return or claim for refund as a tax return preparer pursuant to §1.6695-1(b) of this Chapter.” That provision requires “an individual who is the tax return preparer as described in §301.7701-15 of this chapter with respect to a return of tax or claim for refund of tax” to sign the return. 73 Fed. Reg. at 34577. These circular definitions seem to be cut off by Proposed Regulation §1.6695-1(b)(3) which provides that the “individual tax return preparer who has the primary responsibility as between or among the tax return preparers for the overall substantive accuracy of the preparation of such return or claim for refund shall be considered the signing tax return preparer for purposes of this paragraph (b) and §301.7701-15(b)(1) of this chapter. Any other tax return preparer as described in §301.7701-15(b)(2) of this chapter is not required to sign the return or claim for refund.” A more specific reference, i.e., to §1.6695-1(b)(3) might be more helpful rather than referring to §1.665-1(b) generally. And see discussion at text accompanying notes.

10 Proposed Regulation §301.7701-15(b)(2), 73 Federal Register at 34595.

11 73 Federal Register at 34563.

12 Id.

13 Id.

14 73 Federal Register at 34563-34564: “Proposed § 1.6694–1(b)(2) provides that the individual who signs the return or claim for refund as the tax return preparer will generally be considered the person that is primarily responsible for all of the positions on the return or claim for refund giving rise to an understatement. The ‘one preparer per firm’ rule, however, is revised by these proposed regulations if it is concluded based upon information received from the signing tax return preparer (or other relevant information from a source other than the signing tax return preparer) that another person within the signing tax return preparer’s same firm was primarily responsible for the position(s) giving rise to the understatement. In this situation, the ‘one preparer per firm’ rule in the current regulations could unduly limit the IRS to assessing the penalty against a person who may have overall responsibility in terms of signing the return, but who may lack detailed knowledge of, or responsibility for, a problematic return position, and who reasonably relied on another professional at the same firm with greater knowledge of, and responsibility for, the accuracy of a position giving rise to the understatement.”

15 73 Federal Register at 34564.

16 Id: “Proposed § 1.6694–1(b)(3) establishes a similar rule for situations when there are one or more nonsigning tax return preparers at the same firm. If there are one or more nonsigning tax return preparers at the firm and no signing tax return preparer within the firm, the individual within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement is the tax return preparer who is primarily responsible for the position for purposes of section 6694. Additionally, if after the application of proposed § 1.6694–1(b)(2) it is concluded that the signer is not primarily responsible for the position or the IRS cannot conclude which in-
dividual (as between the signing tax return preparer and other persons within the firm) is primarily responsible for the position, the individual nonsigning tax return preparer within the firm with overall supervisory responsibility for the position(s) is the tax return preparer who is primarily responsible for the position(s) giving rise to the understatement.”

17 Id. (Emphasis supplied).
18 Id.
19 73 Federal Register 34565; and see Proposed Regulations §§ 1.6694-2(a)(2), 1.6694-3(a)(2).
20 73 Federal Register 34564.
21 This author has called that deficiency to the attention of the authors of the proposed regulations.
22 73 Federal Register 34564.
23 Id.
24 See text accompanying note 5, supra.
25 73 Federal Register at 34564 (emphasis supplied). The Preamble summarizes some of the rules proposed to implement this approach: “In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with whom the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement. In the situation where a firm that employs the individual tax return preparer (or the firm with which the individual tax return preparer is associated) is subject to a penalty under section 6694(a) or (b), income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement. If the tax return preparer or the tax return preparer’s firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the position(s) taken on the return or claim for refund that gave rise to the understatement are considered for purposes of computing the income derived (or to be derived). In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with whom the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the relevant firm engagements.”
26 73 Federal Register at 34565.
27 Id.
28 Id. “If the tax return preparer or the tax return preparer’s firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the position(s) taken on the return or claim for refund that gave rise to the understatement are considered for purposes of computing the income derived (or to be derived). In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with whom the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the relevant firm engagements.”
29 Id.
30 IRC § 6694(a)(2)(B) (emphasis supplied).
Section 2 of H.R. 5719, 110 Cong., 1st Sess., would amend the statute to provide that the penalty is only imposed when the tax return position lacks “substantial authority.”

Proposed regulation § 1.6694–2(b)(1), 7e Federal Register at 34573.

Id.

73 Federal Register 34565.

Regulation Section 1.6662-3(b)(3)(emphasis supplied). Note that the Regulation also provides “In addition, the reasonable cause and good faith exception in § 1.6664–4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.”


Proposed Regulation § 1.6694-2(c)(3), 73 Federal Register at 34576.

Id.

73 Federal Register at 34566.

Id.

Proposed Regulation § 1.6694-2(d), 73 Federal Register at 34575.

See text accompanying note 38 and ante.

Preamble, 73 Federal Register at 34566.

Proposed Regulation § 1.6694-2(c)(2), 73 Federal Register at 34574.

Proposed Regulation § 1.6694-2(d)(1), 73 Federal Register at 34575.

Proposed Regulation § 1.6694-2(d)(2), 73 Federal Register at 34576.

Proposed Regulation § 1.6694-2(d)(3), 73 Federal Register at 34576.

Proposed Regulation § 1.6694-2(d)(4), 73 Federal Register at 34576. It seems that this reference should be plural, i.e., the reference is to the totality of the preparers’ “office practices.”

Proposed Regulation § 1.6694-2(d)(5), 73 Federal Register at 34576.

Proposed Regulation § 1.6694-2(d)(6), 73 Federal Register at 34576.

Proposed Regulation § 1.6694-2(e), 73 Federal Register at 34576.

Proposed Regulation § 1.6694-2(d)(4), 73 Federal Register at 34576.

See note 9, supra.

See Preamble at 73 Federal Register

Compare, R. Reagan, White House Transcript of “Remarks of the President to Fallston High School Students and Faculty” (12-4-1985): “[We’d] find out once and for all that we really are all human beings here on this earth together.” (in a rhetorical plea to Mikhail Gorbachev) and Francois Marie Arouet (known by his pen name, Voltaire), “The Philosophical Dictionary” (1764) (“It is a consequence of humanity. We are all formed of frailty and error; let us pardon reciprocally each other’s folly--that is the first law of nature.”).
MEMORANDUM

To: ABA-RPTE Symposium, Spring 2008, Washington, D.C.

From: Thomas P. Gallanis
Professor of Law, University of Minnesota
Reporter, Uniform Real Property Transfer on Death Act

Re: Uniform Real Property Transfer on Death Act

This memorandum introduces the Uniform Real Property Transfer on Death Act, currently in progress.

One of the main innovations in the property law of the twentieth century has been the development of will substitutes for the transfer of property at death. By these mechanisms, an owner may designate beneficiaries to receive the property at the owner's death without waiting for probate and without the beneficiary designation needing to comply with the witnessing requirements of wills. Examples of assets that today routinely pass outside of probate include the proceeds of life insurance policies and pension plans, securities registered in transfer on death (TOD) form, and funds held in pay on death (POD) bank accounts. The National Conference of Commissioners on Uniform State Laws has been a leader in the promulgation of laws authorizing such nonprobate transfers and in harmonizing the substantive rules governing death-time transfers whether in or out of probate.

Today, nonprobate transfers are widely accepted. The trend has largely focused on assets that are personal property, such as the assets described in the preceding paragraph. However, long-standing uniform law speaks more broadly. Section 6-101 of the Uniform Probate Code provides: "A provision for a nonprobate transfer on death in an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature is nontestamentary" (emphasis supplied).

A small but emerging number of jurisdictions have given fuller effect to the principle of UPC §6-101 by enacting statutes expressly authorizing the nonprobate transfer of land. This is
done by permitting owners of interests in real property to execute and record transfer on death (TOD) deeds. By these deeds, the owner identifies the beneficiary or beneficiaries who will succeed to the property at the owner’s death. During the owner’s lifetime, the beneficiaries have no interest in the property, and the owner retains full power to transfer or encumber the property or to revoke the TOD deed.


Our drafting committee welcomes comments and suggestions on all sections of the draft act, and in particular on the forms in Article 3. These are designed for readability. Please send comments to me at <gallanis@umn.edu>.

After each section of the act, a Reporter’s Note discusses the drafting of the section. These notes should be read in conjunction with the proposed statutory text.
REAL PROPERTY
TRANSFER ON DEATH ACT

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

Draft of March 27, 2008
For discussion at the ABA-RPTE symposium in Washington, D.C.

WITH PREFATORY AND REPORTER’S NOTES

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By
NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter’s notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners and the Drafting Committee and its Members and Reporter. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.
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REAL PROPERTY TRANSFER ON DEATH ACT

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REAL PROPERTY TRANSFER ON DEATH ACT

Reporter’s General Prefatory Note

This draft is for discussion at the Spring 2008 meeting of the ABA Section on Real Property, Trust and Estate Law in Washington, D.C. The draft is divided into four articles. Article 1 contains general provisions. Article 2 authorizes transfer on death deeds and addresses the formal and substantive issues concerning such deeds. Article 3 contains suggested statutory forms. These forms are drafts, and suggestions for improvement are encouraged. Article 4 contains miscellaneous provisions.

After each section, a Reporter’s Note discusses the drafting of the section. These notes should be read in conjunction with the proposed statutory text.
REAL PROPERTY TRANSFER ON DEATH ACT

[ARTICLE] 1

GENERAL PROVISIONS

SECTION 101. SHORT TITLE. This [act] may be cited as the Real Property Transfer on Death Act.

SECTION 102. DEFINITIONS. In this [act]:

(1) “Beneficiary” means a person designated as a beneficiary in a transfer on death deed.

(2) “Joint owner” means an individual who owns property concurrently with one or more other individuals with a right of survivorship. The term includes a joint tenant [, an owner of community property with a right of survivorship,][ and a tenant by the entirety]. The term does not include a tenant in common [or an owner of community property without a right of survivorship].

(3) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(4) “Property” means an interest in real property that is transferable on the death of the owner.

(5) “Transfer on death deed” means a deed authorized under this [act].

(6) “Transferor” means an individual who executes and acknowledges a recorded transfer on death deed.
The definition in Paragraph (1) links the term “beneficiary” to the standard NCCUSL definition of “person.” The Comment will explain that the definition includes the trustee of a trust even if the trust is revocable, a rule that accords with the current transfer on death deed statutes that address the issue. For example, Ark. Code §18-12-608(c)(2) provides: “A beneficiary deed may be used to transfer an interest in real property to a trust estate even if the trust is revocable.”

Paragraph (2) provides a definition of owners who hold concurrent interests with a right of survivorship.

Paragraph (3) is a standard NCCUSL definition.

The effect of Paragraph (4) is that the Act applies to all interests in real property that are transferable at the death of the owner.

Paragraph (6) limits the use of a transfer on death deed to a transferor who is an individual. The term “transferor” does not include a corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any legal or commercial entity other than an individual. The Comment will explain that the term also does not include an agent. The power of an agent to create or revoke a transfer on death deed is determined by other law, as indicated in the Comments to Sections 204 and 206.

SECTION 103. APPLICABILITY. This [act] applies to a transfer on death deed executed before, on, or after [the effective date of this [act]] by a transferor dying on or after [the effective date of this [act]].

This section essentially tracks Uniform Probate Code §6-311, which provides that the Act “applies to registrations of securities in beneficiary form made before or after the effective date, by decedents dying on or after the effective date.”

SECTION 104. NONEXCLUSIVITY. This [act] does not affect any method of transferring property otherwise permitted under the law of this state.
This section tracks the essence of the first part of Ark. Code §18-12-608(g)(1): “This section does not prohibit [the committee preferred “affect”] other methods of conveying property that are permitted by law and that have the effect of postponing enjoyment of an interest in real property until the death of the owner.”
SECTION 201. TRANSFER ON DEATH DEED AUTHORIZED. An individual may transfer property to one or more beneficiaries effective at the transferor’s death by a transfer on death deed.

Reporter’s Note

This section authorizes a transfer on death deed and makes it clear that the transfer is not an inter vivos transfer. The transfer occurs at the transferor’s death.

The Comment will explain that the transferor may select any form of ownership, concurrent or successive, absolute or conditional, contingent or vested, valid under state law. Among many other things, this permits the transferor to designate one or more primary beneficiaries and one or more alternate beneficiaries to take in the event the primary beneficiaries fail to survive the transferor. This freedom to specify the form of the beneficiary’s interest comports with the fundamental principle articulated in the Restatement (Third) of Property: Wills and Other Donative Transfers §10.1 that the donor’s intention should be “given effect to the maximum extent allowed by law.” As the Restatement explains in Comment c to §10.1, “American law curtails freedom of disposition only to the extent that the donor attempts to make a disposition or achieve a purpose that is prohibited or restricted by an overriding rule of law.”

SECTION 202. TRANSFER ON DEATH DEED NONTESTAMENTARY. A transfer on death deed is nontestamentary.

Reporter’s Note

This section is based on Uniform Probate Code §6-101(a), which provides: “A provision for a nonprobate transfer on death in an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature is nontestamentary.”

As the Comment to UPC §6-101 explains, because the mode of transfer is declared to be
nontestamentary, the instrument of transfer does not have to be executed in compliance with the formalities for wills, nor does the instrument need to be probated, nor does the decedent’s personal representative have any power or duty with respect to the asset.

SECTION 203. CAPACITY OF TRANSFEROR. The capacity required to make or revoke a transfer on death deed is the same as the capacity required to make a will.

Reporter’s Note

This section is drawn from Uniform Trust Code §601: “The capacity required to create, amend, revoke, or add property to a revocable trust, or to direct the actions of the trustee of a revocable trust, is the same as that required to make a will.” The rule is consistent with the Restatement (Third) of Property: Wills and Other Donative Transfers §8.1(b), which applies the standard of testamentary capacity, and not the higher standard of capacity for inter vivos gifts, to revocable will substitutes: “If the donative transfer is in the form of a will, a revocable will substitute, or a revocable gift, the testator or donor must be capable of knowing and understanding in a general way the nature and extent of his or her property, the natural objects of his or her bounty, and the disposition that he or she is making of that property, and must also be capable of relating these elements to one another and forming an orderly desire regarding the disposition of the property.”

SECTION 204. REQUIREMENTS. A transfer on death deed must:

(1) contain the essential elements of an inter vivos deed, except as otherwise provided in paragraph (2);

(2) state that the transfer is to occur at the transferor’s death;

(3) be acknowledged by the transferor before a notary public or other individual authorized to take acknowledgments; and

(4) be recorded before the transferor’s death in the [county] where the property is located.

Reporter’s Note

Paragraph (1): The Act requires the same essential elements of a deed, other than a
present intention to convey, as are required for inter vivos deeds under state law. In most
jurisdictions, these elements are: identification of the parties, description of the property, and the
transferor’s signature.

Paragraph (2): This requirement emphasizes the fundamental distinction between an inter
vivos deed and a transfer on death deed. An inter vivos deed evidences a present intention to
convey. A transfer on death deed evidences an intention that the transfer occur at the transferor’s
death. Under no circumstances should a defective transfer on death deed be given effect as an
inter vivos deed; to do so would violate the transferor’s intention that the transfer occur at the
transferor’s death.

Paragraph (3): The requirement of acknowledgment fulfills at least four functions. First, it
cautions a transferor that he or she is performing an act with legal consequences. Such caution is
important where, as here, the transferor does not experience the wrench of delivery because the
transfer occurs at death. Second, acknowledgment helps to prevent fraud. Third,
acknowledgment facilitates the recording of the deed. Fourth, acknowledgment is important in
order to implement the rule in Section 206(a)(1) that a later acknowledged deed prevails over an
earlier acknowledged deed.

Paragraph (4): The rule requiring recordation before the transferor’s death is consistent
with the transfer on death deed statutes that address the issue. The Comment will explain that, if
the property described in the deed is in more than one county, the deed is effective only with
respect to the property in the county or counties where the deed is recorded. A NCCUSL drafting
committee is recommending the amendment of Uniform Probate Code §2-502 to validate a
signed and notarized will without the need for attesting witnesses. If the amendment is approved,
an unrecorded transfer on death deed satisfying Paragraphs (1), (2), and (3) could be given effect
as a will.

The Act does not define, but instead relies on other law to determine, the authority of an
agent. An individual’s agent may execute a transfer on death deed on the individual’s behalf to
the extent permitted by other law, such as the Uniform Power of Attorney Act.

**SECTION 205. NOTICE, DELIVERY, ACCEPTANCE, CONSIDERATION NOT**

**REQUIRED.** A transfer on death deed is effective without:

(1) notice or delivery to or acceptance by the beneficiary during the transferor’s lifetime;

or

(2) consideration.
SECTION 206. REVOCATION.

(a) A transfer on death deed is revoked by the recording, before the transferor’s death, in the [county] where the property is located, of:

(1) a subsequently acknowledged transfer on death deed that revokes the deed expressly or by inconsistency; or

(2) a subsequently acknowledged revocation form that revokes the previously acknowledged deed either by description of the property or by reference to the recording information of the deed.

(b) A transferor may revoke a transfer on death deed as to the interest of that transferor, but the revocation does not affect the deed as to the interest of another transferor.

(c) A transfer on death deed made by joint owners is not revoked unless it is revoked by all of the surviving joint owners.

(d) After a transfer on death deed is recorded, it may not be revoked by a physical act performed on the deed.

(e) A transfer on death deed may not be revoked or modified by will.

Reporter’s Note

Subsections (a)(1) and (a)(2) provide that a transfer on death deed deed can be revoked by executing, acknowledging, and recording a subsequent instrument. The Comment will explain that, if the property described in the deed is in more than one county, the revocation is effective only with respect to the property in the county or counties where the revocation is recorded. The Comment will also explain, with examples, the principle of revocation by inconsistency, drawing on the well-established law of revocation by inconsistency of wills.
Subsection (b) is based on §5662(b) of the California draft statute: “A coowner may revoke the transfer on death deed as to the interest of that coowner. The revocation does not affect the transfer on death deed as to the interest of another coowner.”

Subsection (c) is based on the third sentence of Ariz. Stat. §33-405(F): “If the property is owned as joint tenants with right of survivorship or community property with right of survivorship and if the revocation is not executed by all the owners, the revocation is not effective unless executed by the last surviving owner.”

Subsection (d): A Comment will explain that a physical act includes burning, tearing, canceling, obliterating, or destroying the deed or any part of it.

Subsection (e) is consistent with the transfer on death deed statutes that address the issue, and with Uniform Probate Code §6-213(b) on multiple-party bank accounts.

The Act does not define, but instead looks to other law to determine, the authority of an agent. An individual’s agent may revoke a transfer on death deed on the individual’s behalf to the extent permitted by other law, such as the Uniform Power of Attorney Act.

The Comment will mention ademption by extinction as the practical equivalent of revocation.

SECTION 207. EFFECT OF DEED DURING TRANSFEROR’S LIFETIME.

During the transferor’s lifetime, a transfer on death deed does not:

(1) affect the rights of the transferor or other owners in the property;

(2) affect the rights of creditors in the property;

(3) affect the transferor’s or a beneficiary’s eligibility for any form of public assistance;

(4) create a legal or equitable right to the property in favor of the beneficiary; or

(5) make the property subject to process of the beneficiary’s creditors.

Reporter’s Note

The fundamental feature of a transfer on death deed is that it does not operate until the transferor’s death. During the transferor’s lifetime, the deed is both revocable and ambulatory, just as is a will. A transfer on death deed has no more effect during the transferor’s lifetime than a will. Thus, a transfer on death deed, during the transferor’s lifetime, does not sever a joint
tenancy (Paragraph (1)). It does not affect the rights of creditors, whether secured or unsecured (Paragraph (2)). It does not affect the transferor’s or beneficiary’s eligibility for any form of public assistance, including Medicaid (Paragraph (3)). On this point, the committee specifically disapproves of the contrary approach of Colo. Rev. Stat. §15-15-403. A transfer on death deed does not create any legal or equitable right in the beneficiary (Paragraph (4)), nor does it make the property subject to process of the beneficiary’s creditors (Paragraph (5)).

SECTION 208. EFFECT OF DEED AT TRANSFEROR’S DEATH.

(a) Except as otherwise provided in this section [and in [cite state statute on antilapse, if applicable to nonprobate transfers]], on the death of the transferor, the following rules apply to property that is the subject of a transfer on death deed:

(1) The property owned by the transferor at death is transferred to the beneficiaries who survive the transferor in accordance with the deed.

(2) Unless the deed provides otherwise, concurrent beneficiaries receive equal and undivided interests in the property with no right of survivorship among them [unless two of the beneficiaries are husband and wife, in which event they receive their interests in the property as [joint tenants][tenants by the entirety][owners of community property with right of survivorship]].

(3) If no beneficiary survives the transferor, the transfer on death deed is void.

(b) On the death of a transferor who is a joint owner, the property belongs to the surviving joint owner or owners, and the right of survivorship continues between or among the surviving joint owners. A transfer on death deed is effective at the death of the last surviving joint owner if that owner is a transferor on the deed.

(c) A beneficiary receives a transferor’s interest at the transferor’s death subject to all:

(1) conveyances made during the transferor’s lifetime; and
(2) encumbrances, assignments, contracts, mortgages, liens, and other interests affecting the property, whether or not recorded and whether created before or after the recording of the transfer on death deed, to which the property is subject at the transferor’s death.

**Reporter’s Note**

Subsection (a)(2) is modeled on Uniform Probate Code §6-212 governing multiple-party accounts. There will be a Legislative Note explaining that states without tenancy by the entirety or community property with right of survivorship should delete these references in brackets. States preferring no right of survivorship between beneficiaries who are husband and wife should delete the entire bracketed material.

Subsection (b) is consistent with the majority rule, namely that the survivorship right trumps the transfer on death deed.

Subsection (c) is modeled on Colo. Rev. Stat. §15-15-407(2): “A grantee-beneficiary of a beneficiary deed takes title to the owner’s interest in the real property conveyed by the beneficiary deed at the death of the owner subject to all conveyances, encumbrances, assignments, contracts, mortgages, liens, and other interests, affecting title to the property, whether created before or after the recording of the beneficiary deed, or to which the owner was subject during the owner’s lifetime including, but not limited to, any executory contract of sale, option to purchase, lease, license, easement, mortgage, deed of trust, or other lien. The grantee-beneficiary also takes title subject to any interest in the property of which the grantee-beneficiary has either actual or constructive notice.” The committee rejected the requirement of California draft §5652(c) that the limitation must be “of record,” because the beneficiary should merely step into the transferor’s shoes; the beneficiary should not be in a better position (i.e. free of limitations not of record) than the transferor.

The Comment will refer approvingly to In re Estate of Roloff, 143 P.3d 406 (Kan. Ct. App. 2006) (holding that crops should be transferred with the land under a transfer on death deed because this result would be reached on the same facts with any other deed).

The Comment will also address the following fact-pattern. H and W are married and own property as tenants by the entirety. H executes, acknowledges and records a transfer on death deed in favor of X. W later dies, at which point H owns the property in fee simple absolute. Under the law of some states, there may be a question whether the transfer on death deed is valid, given that H executed it when the property was owned, not by H and W, but by the marital entity. The correct answer is yes. The transfer on death deed is effective at H’s death because the property is owned by H at H’s death (recall the first sentence of subsection (a): “…and owned by the transferor at death”).
SECTION 209. DISCLAIMER.

Alternative 1

A beneficiary under a transfer on death deed may disclaim all or part of the beneficiary’s interest as provided by [cite state statute or the Uniform Disclaimer of Property Interests Act].

Alternative 2

Subject to the law of this state limiting the right to disclaim property, a beneficiary under a transfer on death deed may disclaim all or part of the beneficiary’s interest by recording a disclaimer in the [county] where the property that is the subject of the disclaimer is located.

Reporter’s Note

There will be a Legislative Note explaining that Alternative 1 is for a state with a disclaimer statute, such as the Uniform Disclaimer of Property Interests Act, providing a mechanism for disclaiming interests created in a transfer on death deed. The statute need not have contemplated the transfer on death deed specifically, but the statutory scheme applies, or can be readily amended to apply, to such deeds. In most cases, the only necessary amendment would be to replace the usual requirement that the disclaimer be delivered (for here, after the transferor’s death, there is no obvious individual to whom delivery can be made) with a requirement that the disclaimer be recorded in the county where the property that is the subject of the disclaimer is located. Along these lines, the committee recommends the following technical amendments to Sections 12 and 15 of the Uniform Disclaimer of Property Interests Act:

SECTION 12. DELIVERY OR FILING.

(a) In this section, “beneficiary designation” means an instrument, other than an instrument creating a trust, naming the beneficiary of:

(1) an annuity or insurance policy;
(2) an account with a designation for payment on death;
(3) a security registered in beneficiary form;
(4) a pension, profit-sharing, retirement, or other employment-related benefit plan; or
(5) any other nonprobate transfer at death.

(b) Subject to subsections (c) through (l), delivery of a disclaimer may be effected by personal delivery, first-class mail, or any other method likely to result in its receipt.

(c) In the case of an interest created under the law of intestate succession or an interest created by will, other than an interest in a testamentary trust:

(1) a disclaimer must be delivered to the personal representative of the decedent’s estate; or
(2) if no personal representative is then serving, it must be filed with a court having jurisdiction to appoint the personal representative.

(d) In the case of an interest in a testamentary trust:

(1) a disclaimer must be delivered to the trustee then serving, or if no trustee is then serving, to the personal representative of the decedent’s estate; or

(2) if no personal representative is then serving, it must be filed with a court having jurisdiction to enforce the trust.

(e) In the case of an interest in an inter vivos trust:

(1) a disclaimer must be delivered to the trustee then serving;

(2) if no trustee is then serving, it must be filed with a court having jurisdiction to enforce the trust; or

(3) if the disclaimer is made before the time the instrument creating the trust becomes irrevocable, it must be delivered to the settlor of a revocable trust or the transferor of the interest.

(f) In the case of a disclaimer of an interest created by a beneficiary designation made before the time the designation becomes irrevocable, the disclaimer must be delivered to the person making the beneficiary designation.

(g) In the case of a disclaimer of an interest created by a beneficiary designation made after the time the designation becomes irrevocable:

(1) a disclaimer of an interest in personal property must be delivered to the person obligated to distribute the interest;

(2) a disclaimer of an interest in real property must be recorded in the [county] where the real property that is the subject of the disclaimer is located.

(h) In the case of a disclaimer by a surviving holder of jointly held property, the disclaimer must be delivered to the person to whom the disclaimed interest passes.

(i) In the case of a disclaimer by an object or taker in default of exercise of a power of appointment at any time after the power was created:

(1) the disclaimer must be delivered to the holder of the power or to the fiduciary acting under the instrument that created the power; or

(2) if no fiduciary is then serving, it must be filed with a court having authority to appoint the fiduciary.

(j) In the case of a disclaimer by an appointee of a nonfiduciary power of appointment:

(1) the disclaimer must be delivered to the holder, the personal representative of the holder's estate or to the fiduciary under the instrument that created the power; or

(2) if no fiduciary is then serving, it must be filed with a court having authority to appoint the fiduciary.

(k) In the case of a disclaimer by a fiduciary of a power over a trust or estate, the disclaimer must be delivered as provided in subsection (c), (d), or (e), as if the power disclaimed were an interest in property.

(l) In the case of a disclaimer of a power by an agent, the disclaimer must be delivered to the principal or the principal’s representative.

Comment

The rules set forth in Section 12 are designed so that anyone who has the duty to distribute the disclaimed interest will be notified to provide notice of the disclaimer. For example, a disclaimer of an interest in a decedent’s estate must be delivered to the personal representative of the estate. A disclaimer is required to be filed in court only...
when there is no one person or entity to whom delivery can be made in very limited circumstances.

SECTION 15. RECORDING OF DISCLAIMER. If an instrument transferring an interest in or power over property subject to a disclaimer is required or permitted by law to be filed, recorded, or registered, the disclaimer may be so filed, recorded, or registered. Except as otherwise provided in Section 12(g)(2), failure to file, record, or register the disclaimer does not affect its validity as between the disclaimant and persons to whom the property interest or power passes by reason of the disclaimer.

Comment

This section permits the recordation of a disclaimer of an interest in property ownership of or title to which is the subject of a recording system. This section expands on the corresponding provision of previous Uniform Acts which only referred to permissive recording of a disclaimer of an interest in real property. While local practice may vary, disclaimants should realize that in order to establish the chain of title to real property, and to ward off creditors and bona fide purchasers, the disclaimer may have to be recorded. This section does not change the law of the state governing notice. The reference to Section 12(g)(2) concerns the disclaimer of an interest in real property created by a “beneficiary designation” as that term is defined in Section 12(a). Such a disclaimer must be recorded.

Alternative 2 is for a state without a disclaimer statute that can be readily amended to apply to transfer on death deeds.

The Comment will mention the state-law doctrine of “relation back”: an effective disclaimer typically relates back to the time of the initial transfer (here, the transferor’s death).

SECTION 210. NO COVENANTS OR WARRANTIES. A transfer on death deed transfers property without covenant or warranty of title even if there is a contrary provision in the deed.

Reporter’s Note

This provision is based on §5652(d) of the California draft statute: “Notwithstanding a contrary provision in the deed, a revocable transfer on death deed transfers the property without covenant or warranty of title.” This rule is mandatory, not a default as in Colo. Rev. Stat. §15-15-404(2) [“Unless the owner designates otherwise ...”], in order to prevent mishaps from uninformed grantors.

SECTION 211. PROTECTION OF BONA FIDE PURCHASERS OR
ENCUMBRANCERS. A bona fide purchaser or encumbrancer to whom a beneficiary transfers an interest in the property received under a transfer on death deed has the same rights and protections as if the transfer had been made by a grantee of an inter vivos deed.

Reporter’s Note

The committee observed that it is hard to articulate a substantive rule on bona fide purchasers or encumbrancers (BFPs), because some jurisdictions are notice jurisdictions (protecting BFPs regardless of when the BFP files), some are race-notice jurisdictions (protecting only BFPs who file first), and a few are race jurisdictions (protecting anyone who files first). Instead, the committee decided to articulate the rule that a BFP from the beneficiary of a transfer on death deed is in the same position as a BFP in the standard inter vivos transaction.

SECTION 212. PROOF OF DEATH. Proof of the death of a transferor or a beneficiary of a transfer on death deed must be established in the same manner as proof of the death of a joint tenant [under [cite state statute]].

Reporter’s Note

The committee was initially uncertain whether a Uniform Act should spell out a procedure for the proof of death. The Uniform Probate Code, for example, refers in §6-223 and §6-307 to “proof of death” without elaboration.

The committee decided to incorporate the state’s existing procedures for proving the death of a joint tenant, essentially tracking Colo. Rev. Stat. §15-15-413: “Proof of the death of the owner or a grantee beneficiary shall be established in the same manner as for proving the death of a joint tenant.”

SECTION 213. PROCEEDING TO CONTEST TRANSFER ON DEATH DEED.

(a) After the transferor’s death, the transferor’s personal representative or an interested person may contest the validity of a transfer on death deed on the basis of fraud, undue influence, duress, mistake, or other invalidating cause.

(b) A contest proceeding under this section must be brought in the [ ] court in the
[county] where [the administration of the transferor’s estate would be proper][the property that is
the subject of the transfer on death deed is located].

(c) A contest proceeding under this section must be commenced within the earlier of:

(1) [three years] after the transferor’s death; or

(2) [one year] after the beneficiary establishes the transferor’s death.

[(d) Upon initiation of a contest proceeding, the contestant may record a notice of lis
pendens in the [county] where the transfer on death deed is recorded.]

Reporter’s Note

The grounds of contest in subsection (a) are drawn from §5696 of the California draft statute: “Nothing in this chapter limits the application of principles of fraud, undue influence, duress, mistake, or other invalidating cause to a transfer of property by a revocable transfer on death deed.”

Subsection (b) will be accompanied by a Legislative Note explaining that the blank in brackets should be filled in, as appropriate, by each enacting state.

Subsection (c) is drawn from §§5690(c) and 5692(b) of the California draft statute. Section 5690(c) provides: “On commencement of a contest proceeding, the contestant may record a lis pendens in the county in which the revocable transfer on death deed is recorded.” Section 5692(b) provides: “A contest proceeding shall be commenced within the earlier of the following times: (1) Three years after the transferor’s death. (2) One year after the beneficiary establishes the fact of the transferor’s death....”

Subsection (d): A Legislative Note will explain that subsection (d) is in brackets so that it can be deleted by states not using, or not wishing to refer to, the notice of lis pendens.

The Comment will emphasize that the limitations period for commencement of the contest should be the same as for other nonprobate transfer contests (if state law already provides a limitations period for such contests) or (if not) for will contests.

The Comment will also cross-reference the rule governing bona fide purchasers or encumbrancers in Section 211 and the provision on proof of death in Section 212.

SECTION 214. LIABILITY OF A BENEFICIARY FOR CREDITOR CLAIMS
AND STATUTORY ALLOWANCES. A beneficiary of a transfer on death deed is liable for allowed claims against the transferor’s probate estate and statutory allowances to the extent provided in [cite state statute or Section 6-102 of the Uniform Probate Code].

Reporter’s Note

This section defers to other law, such as Uniform Probate Code §6-102, to establish the liability of a beneficiary of a transfer on death deed for creditor claims and statutory allowances. For these purposes, a state should treat a beneficiary of a transfer on death deed the same as a beneficiary of any other nonprobate transfer outside of trust, for example a beneficiary of a “pay on death” bank account. The state’s approach to such beneficiaries should be consistent.
 REPORTER’S PREFATORY NOTE

These forms are drafts, designed to provide a basis for discussion. Suggestions for improving the forms are encouraged.

LEGAL NOTE: An enacting jurisdiction should review its statutory requirements for deeds and for acknowledgments and amend the statutory forms provided in Sections 301 and 302 where necessary for conformity with those requirements.

SECTION 301. FORM OF TRANSFER ON DEATH DEED. A document substantially in the following form satisfies the requirements for a transfer on death deed under this [act]:

[front of form]

TRANSFER ON DEATH DEED

Notice to Owner

You should carefully read all information on the other side of this form. YOU MAY WANT TO CONSULT A LAWYER BEFORE USING THIS FORM.

This form must be recorded before your death, or it will not be effective.

IDENTIFYING INFORMATION

Owner(s) Making This Deed:

________________________________________  ______________________________

(name)  (mailing address)
(name)  (mailing address)

________________________________________  ______________________________________

(name)  (mailing address)

Legal Description of the Property:

________________________________________________________

________________________________________________________

________________________________________________________

Beneficiary or Beneficiaries

I revoke all my previous transfer on death deeds affecting the described property, and designate the following beneficiary(ies) who survive me to receive the property (in equal and undivided shares with no right of survivorship between them, unless I say otherwise in this deed):

Primary Beneficiary(ies) – include mailing addresses if available

________________________________________________________

________________________________________________________

Alternate Beneficiary(ies) – Optional

If no above beneficiary survives me, I designate the following alternate beneficiary(ies) who survive me to receive the property (in equal and undivided shares with no right of survivorship between them, unless I say otherwise in this deed):

Alternate Beneficiary(ies) – include mailing addresses if available
Transfer on Death

I transfer my interest in the described property to the beneficiary(ies) on my death.

Before my death, I have the right to revoke this deed.

Signature(s) of Owner(s) Making This Deed:

______________________________ [(SEAL)] ________________________

(signature) (date)

______________________________ [(SEAL)] ________________________

(signature) (date)

Acknowledgment

[insert acknowledgment here]

COMMON QUESTIONS ABOUT THE USE OF THIS FORM

What does the Transfer on Death (TOD) deed do? When you die, the beneficiaries will become owners of the property described in the TOD deed, subject to any debts or liens or mortgages (or other encumbrances) you have put on the property during your lifetime. Probate is not required. The TOD deed has no effect until you die. You can revoke it at any time. If you transfer the property to someone else during your lifetime, the beneficiary under this deed will not receive it.

How do I make a TOD deed? Complete this form. Have it notarized. Record the form in
each [county] where any part of the property is located. The form must be notarized and recorded before your death or it has no effect.

*How do I find the “legal description” of the property?* This information may be on the deed you received when you became an owner of the property. This information may also be available in the office of the [county recorder] for the [county] where the property is located. If you are not absolutely sure, consult a lawyer.

*How do I “record” the TOD deed?* Take the completed and notarized form to the [county recorder] for the [county] where the property is located. Follow the instructions given by the [county recorder] to make the form part of the official property records. If the property is in more than one [county], you must record the deed in each [county].

*Can I revoke the TOD deed if I change my mind?* Yes. The TOD deed is revocable. No one, including the beneficiaries, can prevent you from revoking the deed.

*How do I revoke the TOD deed?* There are two ways to revoke a recorded TOD deed: (1) Complete and notarize a revocation form, and record it in each [county] where the property is located. (2) Complete and notarize a new TOD deed that disposes of the same property, and record it in each [county] where the property is located. In addition, you can transfer the property to someone else during your lifetime.

*I am being pressured to complete this form. What should I do?* Do not complete this form under pressure. Seek help from a trusted family member, a friend, or a lawyer.

*Do I need to tell the beneficiaries about the TOD deed?* No, but it is recommended. Secrecy can cause later complications and might make it easier for others to commit fraud.

*What if I name more than one beneficiary?* You may name more than one beneficiary.
Unless you say otherwise in the deed, the primary beneficiaries who survive you (or if none survives you, the alternate beneficiaries) will become co-owners in equal shares.

**Reporter’s Note**

These forms are based on the California proposed form, with modifications.

**SECTION 302. FORM OF REVOCATION.**

A document substantially in the following form satisfies the requirements for a form of revocation under this [act].

**REVOCATION OF TRANSFER ON DEATH DEED**

**Notice to Owner**

This revocation must be recorded before you die or it will not be effective. This revocation is effective only as to the interests in the property of owners who sign this revocation.

**Identifying Information**

Owner(s) of Property Making This Revocation

_________________________ _______________________________

(name) (mailing address)

_________________________ _______________________________

(name) (mailing address)

_________________________ ______________________________

(name) (mailing address)

**Legal Description of the Property:**
Revocation

I revoke all my previous transfer on death deeds affecting this property.

Signature(s) of Owner(s) Making This Revocation

____________________________ [(SEAL)] ________________

(signature) (date)

____________________________ [(SEAL)] ________________

(signature) (date)

Acknowledgment

[insert acknowledgment here]

COMMON QUESTIONS ABOUT THE USE OF THIS FORM

How do I use this form to revoke a Transfer on Death (TOD) deed? Complete this form. Have it notarized. Record the form in each [county] where the property is located. The form must be notarized and recorded before your death or it has no effect.

How do I find the “legal description” of the property? This information may be on the TOD deed. It may also be available in the office of the [county recorder] for the [county] where the property is located. If you are not absolutely sure, consult a lawyer.

How do I “record” the form? Take the completed and notarized form to the [county recorder] for the [county] where the property is located. Follow the instructions given by the
[county recorder] to make the form part of the official property records. If the property is located
in more than one [county], you must record the deed in each of those [counties].

_I am being pressured to complete this form. What should I do?_ Do not complete this form
under pressure. Seek help from a trusted family member, a friend, or a lawyer.

**Reporter’s Note**

The form is based on the form in Section 301.
MISCELLANEOUS PROVISIONS

SECTION 401. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among the states that enact it.

Reporter’s Note

This provision is standard in all uniform acts.

SECTION 402. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001, et. seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

Reporter’s Note

The NCCUSL Drafting Rules state: “If an act contains a provision requiring a notice or other record or a signature, whether electronic or written, [this] section should be included” (emphasis supplied).

A Legislative Note will explain that jurisdictions with the Uniform Electronic Transactions Act do not need this section.

SECTION 403. REPEALS. The following acts and parts of acts are hereby repealed:

(1) ..................................
There will be a Legislative Note, either here or at the beginning of the Act, drawing states’ attention to the growing harmonization of the rules governing probate and nonprobate transfers. The Legislative Note will encourage states enacting this Act to consider extending probate rules to transfer on death deeds and other nonprobate transfers, with respect to the following: (1) ademption of specific devises; (2) antilapse; (3) revocation by divorce; (4) revocation by homicide (also known as the “slayer rule”); (5) survivorship; and (6) the surviving spouse’s elective share.

**SECTION 404. EFFECTIVE DATE.** This [act] takes effect .........................
The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter’s notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners and the Drafting Committee and its Members and Reporter. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.
DRAFTING COMMITTEE ON REAL PROPERTY TRANSFER ON DEATH ACT

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# REAL PROPERTY TRANSFER ON DEATH ACT

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REAL PROPERTY TRANSFER ON DEATH ACT

Reporter’s General Prefatory Note

One of the main innovations in the property law of the twentieth century has been the development of will substitutes for the transfer of property at death. By these mechanisms, an owner may designate beneficiaries to receive the property at the owner’s death without waiting for probate and without the beneficiary designation needing to comply with the witnessing requirements of wills. Examples of assets that today routinely pass outside of probate include the proceeds of life insurance policies and pension plans, securities registered in transfer on death (TOD) form, and funds held in pay on death (POD) bank accounts. The National Conference of Commissioners on Uniform State Laws has been a leader in the promulgation of laws authorizing such nonprobate transfers and in harmonizing the substantive rules governing deathtime transfers whether in or out of probate.

Today, nonprobate transfers are widely accepted. The trend has largely focused on assets that are personal property, such as the assets described in the preceding paragraph. However, long-standing uniform law speaks more broadly. Section 6-101 of the Uniform Probate Code (UPC) provides: “A provision for a nonprobate transfer on death in an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature is nontestamentary” (emphasis supplied).

A small but emerging number of jurisdictions have given fuller effect to the principle of UPC §6-101 by enacting statutes expressly authorizing the nonprobate transfer of land. This is done by permitting owners of interests in real property to execute and record transfer on death (TOD) deeds. By these deeds, the owner identifies the beneficiary or beneficiaries who will succeed to the property at the owner’s death. During the owner’s lifetime, the beneficiaries have no interest in the property, and the owner retains full power to transfer or encumber the property or to revoke the TOD deed.


This draft is for the first reading of the act at the 2008 annual meeting of the National Conference of Commissioners on Uniform State Laws in Big Sky, Montana. The draft is divided into four articles. Article 1 contains general provisions. Article 2 authorizes transfer on death deeds and addresses the formal and substantive issues concerning such deeds. Article 3 contains suggested statutory forms. Article 4 contains miscellaneous provisions. Our drafting committee welcomes comments and suggestions on all sections of the draft act, and in particular on the forms in Article 3. These are designed for readability.
After each section, a Reporter’s Note discusses the drafting of the section. These notes should be read in conjunction with the proposed statutory text.
REAL PROPERTY TRANSFER ON DEATH ACT

[ARTICLE] 1

GENERAL PROVISIONS

SECTION 101. SHORT TITLE. This [act] may be cited as the Real Property Transfer on Death Act.

SECTION 102. DEFINITIONS. In this [act]:

(1) “Beneficiary” means a person designated as a beneficiary in a transfer on death deed.

(2) “Joint owner” means an individual who owns property concurrently with one or more other individuals with a right of survivorship. The term includes a joint tenant[,][ and] [an owner of community property with a right of survivorship[,][ and a tenant by the entirety]. The term does not include a tenant in common [or an owner of community property without a right of survivorship].

(3) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(4) “Property” means an interest in real property that is transferable on the death of the owner.

(5) “Transfer on death deed” means a deed authorized under this [act].

(6) “Transferor” means an individual who executes and acknowledges a recorded transfer on death deed.

Reporter’s Note
The definition in Paragraph (1) links the term “beneficiary” to the standard NCCUSL definition of “person.” The Comment will explain that the definition includes the trustee of a trust even if the trust is revocable, a rule that accords with the current transfer on death deed statutes that address the issue. For example, Ark. Code §18-12-608(c)(2) provides: “A beneficiary deed may be used to transfer an interest in real property to a trust estate even if the trust is revocable.”

Paragraph (2) provides a definition of owners who hold concurrent interests with a right of survivorship.

Paragraph (3) is a standard NCCUSL definition.

The effect of Paragraph (4) is that the Act applies to all interests in real property that are transferable at the death of the owner. See Section 201.

Paragraph (6) limits the definition of a “transferor” to an individual. The term “transferor” does not include a corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any legal or commercial entity other than an individual. The Comment will explain that the term also does not include an agent. The power of an agent to create or revoke a transfer on death deed is determined by other law, as indicated in the Comments to Sections 204 and 206.

SECTION 103. APPLICABILITY. This [act] applies to a transfer on death deed executed before, on, or after [the effective date of this [act]] by a transferor dying on or after [the effective date of this [act]].

Reporter’s Note

This section essentially tracks Uniform Probate Code §6-311, which provides that the Act “applies to registrations of securities in beneficiary form made before or after the effective date, by decedents dying on or after the effective date. ”

SECTION 104. NONEXCLUSIVITY. This [act] does not affect any method of transferring property otherwise permitted under the law of this state.

Reporter’s Note

This section tracks the essence of the first part of Ark. Code §18-12-608(g)(1): “This section does not prohibit [the committee preferred “affect”] other methods of conveying property that are permitted by law and that have the effect of postponing enjoyment of an interest in real
property until the death of the owner.”
TRANSFER ON DEATH DEED

SECTION 201. TRANSFER ON DEATH DEED AUTHORIZED. An individual may transfer property to one or more beneficiaries effective at the transferor’s death by a transfer on death deed.

Reporter’s Note

This section authorizes a transfer on death deed and makes it clear that the transfer is not an inter vivos transfer. The transfer occurs at the transferor’s death.

The Comment will explain that the transferor may select any form of ownership, concurrent or successive, absolute or conditional, contingent or vested, valid under state law. Among many other things, this permits the transferor to designate one or more primary beneficiaries and one or more alternate beneficiaries to take in the event the primary beneficiaries fail to survive the transferor. This freedom to specify the form of the beneficiary’s interest comports with the fundamental principle articulated in the Restatement (Third) of Property: Wills and Other Donative Transfers §10.1 that the donor’s intention should be “given effect to the maximum extent allowed by law.” As the Restatement explains in Comment c to §10.1, “American law curtails freedom of disposition only to the extent that the donor attempts to make a disposition or achieve a purpose that is prohibited or restricted by an overriding rule of law.”

SECTION 202. TRANSFER ON DEATH DEED NONTESTAMENTARY. A transfer on death deed is nontestamentary.

Reporter’s Note

This section is based on Uniform Probate Code §6-101(a), which provides: “A provision for a nonprobate transfer on death in an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature is nontestamentary.”

As the Comment to UPC §6-101 explains, because the mode of transfer is declared to be nontestamentary, the instrument of transfer does not have to be executed in compliance with the formalities for wills, nor does the instrument need to be probated, nor does the decedent’s personal representative have any power or duty with respect to the asset.
SECTION 203. CAPACITY OF TRANSFEROR. The capacity required to make or
revoke a transfer on death deed is the same as the capacity required to make a will.

Reporter’s Note

This section is drawn from Uniform Trust Code §601: “The capacity required to create,
amend, revoke, or add property to a revocable trust, or to direct the actions of the trustee of a
revocable trust, is the same as that required to make a will.” The rule is consistent with the
Restatement (Third) of Property: Wills and Other Donative Transfers §8.1(b), which applies the
standard of testamentary capacity, and not the higher standard of capacity for inter vivos gifts, to
revocable will substitutes: “If the donative transfer is in the form of a will, a revocable will
substitute, or a revocable gift, the testator or donor must be capable of knowing and
understanding in a general way the nature and extent of his or her property, the natural objects of
his or her bounty, and the disposition that he or she is making of that property, and must also be
capable of relating these elements to one another and forming an orderly desire regarding the
disposition of the property.”

SECTION 204. REQUIREMENTS. A transfer on death deed must:

(1) contain the essential elements of an inter vivos deed, except as otherwise provided in
paragraph (2);

(2) state that the transfer is to occur at the transferor’s death;

(3) be acknowledged by the transferor before a notary public or other individual
authorized to take acknowledgments; and

(4) be recorded before the transferor’s death in the [county] where the property is located.

Reporter’s Note

Paragraph (1): The Act requires the same essential elements of a deed, other than a
present intention to convey, as are required for inter vivos deeds under state law. In most
jurisdictions, these elements are: identification of the parties, description of the property, and the
transferor’s signature.

Paragraph (2): This requirement emphasizes the fundamental distinction between an inter
vivos deed and a transfer on death deed. An inter vivos deed evidences a present intention to
convey. A transfer on death deed evidences an intention that the transfer occur at the transferor’s
death. Under no circumstances should a defective transfer on death deed be given effect as an
inter vivos deed; to do so would violate the transferor’s intention that the transfer occur at the
transferor’s death.
Paragraph (3): The requirement of acknowledgment fulfills at least four functions. First, it cautions a transferor that he or she is performing an act with legal consequences. Such caution is important where, as here, the transferor does not experience the wrench of delivery because the transfer occurs at death. Second, acknowledgment helps to prevent fraud. Third, acknowledgment facilitates the recording of the deed. Fourth, acknowledgment is important in order to implement the rule in Section 206(a)(1) that a later acknowledged deed prevails over an earlier acknowledged deed.

Paragraph (4): The rule requiring recordation before the transferor’s death is consistent with the transfer on death deed statutes that address the issue. The Comment will explain that, if the property described in the deed is in more than one county, the deed is effective only with respect to the property in the county or counties where the deed is recorded.

The Act does not define, but instead relies on other law to determine, the authority of an agent. An individual’s agent may execute a transfer on death deed on the individual’s behalf to the extent permitted by other law, such as the Uniform Power of Attorney Act.

SECTION 205. NOTICE, DELIVERY, ACCEPTANCE, CONSIDERATION NOT REQUIRED. A transfer on death deed is effective without:

(1) notice or delivery to or acceptance by the beneficiary during the transferor’s lifetime;

or

(2) consideration.

Reporter’s Note

These rules are consistent with the transfer on death deed statutes that address the issues.

SECTION 206. REVOCATION.

(a) Subject to subsection (b), a transfer on death deed is revoked by recording, before the transferor’s death, in the [county] where the property is located:

(1) the transferor’s subsequently acknowledged transfer on death deed that revokes the previously acknowledged deed expressly or by inconsistency; or

(2) the transferor’s subsequently acknowledged revocation form that revokes the previously acknowledged deed either by description of the property or by reference to the
recording information of the deed.

(b) The following rules apply to a transfer on death deed made by more than one transferor:

(1) Revocation by a transferor does not affect the deed as to the interest of another transferor.

(2) A deed made by joint owners is revoked only if it is revoked by all of the surviving joint owners.

(c) After a transfer on death deed is recorded, it may not be revoked by a physical act performed on the deed.

(d) A transfer on death deed may not be revoked or modified by will.

Reporter’s Note

Subsections (a)(1) and (a)(2) provide that a transfer on death deed deed can be revoked by executing, acknowledging, and recording a subsequent instrument. The Comment will explain that, if the property described in the deed is in more than one county, the revocation is effective only with respect to the property in the county or counties where the revocation is recorded. The Comment will also explain, with examples, the principle of revocation by inconsistency, drawing on the well-established law of revocation by inconsistency of wills.

Subsection (b)(1) is based on §5662(b) of the California draft statute: “A coowner may revoke the transfer on death deed as to the interest of that coowner. The revocation does not affect the transfer on death deed as to the interest of another coowner.”

Subsection (b)(2) is based on the third sentence of Ariz. Stat. §33-405(F): “If the property is owned as joint tenants with right of survivorship or community property with right of survivorship and if the revocation is not executed by all the owners, the revocation is not effective unless executed by the last surviving owner.” The rule is consistent with Uniform Probate Code §6-306, which provides in pertinent part: “A registration of a security in beneficiary form may be canceled or changed at any time by the sole owner or all then surviving owners without the consent of the beneficiary.”

Subsection (c): A Comment will explain that a physical act includes burning, tearing, canceling, obliterating, or destroying the deed or any part of it.

Subsection (d) is consistent with the transfer on death deed statutes that address the issue, and with Uniform Probate Code §6-213(b) on multiple-party bank accounts.
The Act does not define, but instead looks to other law to determine, the authority of an agent. An individual’s agent may revoke a transfer on death deed on the individual’s behalf to the extent permitted by other law, such as the Uniform Power of Attorney Act.

The Comment will mention ademption by extinction as the practical equivalent of revocation.

SECTION 207. EFFECT OF DEED DURING TRANSFEROR’S LIFETIME.

During the transferor’s lifetime, a transfer on death deed does not:

(1) affect the rights of the transferor or other owners in the property;

(2) affect the rights of creditors in the property;

(3) affect the transferor’s or beneficiary’s eligibility for any form of public assistance;

(4) create a legal or equitable right to the property in favor of the beneficiary; or

(5) make the property subject to process of the beneficiary’s creditors.

Reporter’s Note

The fundamental feature of a transfer on death deed is that it does not operate until the transferor’s death. During the transferor’s lifetime, the deed is both revocable and ambulatory, just as is a will. A transfer on death deed has no more effect during the transferor’s lifetime than a will. Thus, a transfer on death deed, during the transferor’s lifetime, does not sever a joint tenancy (Paragraph (1)). It does not affect the rights of creditors, whether secured or unsecured (Paragraph (2)). It does not affect the transferor’s or beneficiary’s eligibility for any form of public assistance, including Medicaid (Paragraph (3)). On this point, the committee specifically disapproves of the contrary approach of Colo. Rev. Stat. §15-15-403. A transfer on death deed does not create any legal or equitable right in the beneficiary (Paragraph (4)), nor does it make the property subject to process of the beneficiary’s creditors (Paragraph (5)).

SECTION 208. EFFECT OF DEED AT TRANSFEROR’S DEATH.

(a) Except as otherwise provided in this section [and in [cite state statute on antilapse, if applicable to nonprobate transfers]], on the death of the transferor, the following rules apply to property that is the subject of a transfer on death deed:

(1) The property owned by the transferor at death is transferred to the beneficiaries
that survive the transferor in accordance with the deed.

(2) Unless the deed provides otherwise, concurrent beneficiaries receive equal and undivided interests in the property with no right of survivorship among them [unless two of the beneficiaries are husband and wife, in which event they receive their interests in the property as [joint tenants][tenants by the entirety][owners of community property with right of survivorship]].

(3) If no beneficiary survives the transferor, the transfer on death deed is void.

(b) On the death of a transferor who is a joint owner, the property that is the subject of a transfer on death deed belongs to the surviving joint owner or owners, and the right of survivorship continues between or among the surviving joint owners. A transfer on death deed is effective at the death of the last surviving joint owner if that owner is a transferor on the deed.

(c) A beneficiary receives a transferor’s interest at the transferor’s death subject to all:

(1) conveyances made during the transferor’s lifetime; and

(2) encumbrances, assignments, contracts, mortgages, liens, and other interests, whether recorded and whether created before or after the recording of the transfer on death deed, to which the property is subject at the transferor’s death.

**Reporter’s Note**

Subsection (a)(2) is modeled on Uniform Probate Code §6-212 governing multiple-party accounts. There will be a Legislative Note explaining that states without tenancy by the entirety or community property with right of survivorship should delete these references in brackets. States preferring no right of survivorship between beneficiaries who are husband and wife should delete the entire bracketed material.

Subsection (b) is consistent with the majority rule, namely that the survivorship right trumps the transfer on death deed.

Subsection (c) is modeled on Colo. Rev. Stat. §15-15-407(2): “A grantee-beneficiary of a beneficiary deed takes title to the owner’s interest in the real property conveyed by the beneficiary deed at the death of the owner subject to all conveyances, encumbrances,
assignments, contracts, mortgages, liens, and other interests, affecting title to the property, whether created before or after the recording of the beneficiary deed, or to which the owner was subject during the owner’s lifetime including, but not limited to, any executory contract of sale, option to purchase, lease, license, easement, mortgage, deed of trust, or other lien. The grantee-beneficiary also takes title subject to any interest in the property of which the grantee-beneficiary has either actual or constructive notice.” The committee rejected the requirement of California draft §5652(c) that the limitation must be “of record,” because the beneficiary should merely step into the transferor’s shoes; the beneficiary should not be in a better position (i.e. free of limitations not of record) than the transferor.

The Comment will refer approvingly to In re Estate of Roloff, 143 P.3d 406 (Kan. Ct. App. 2006) (holding that crops should be transferred with the land under a transfer on death deed because this result would be reached on the same facts with any other deed).

The Comment will also address the following fact-pattern. H and W are married and own property as tenants by the entirety. H executes, acknowledges and records a transfer on death deed in favor of X. W later dies, at which point H owns the property in fee simple absolute. Under the law of some states, there may be a question whether the transfer on death deed is valid, given that H executed it when the property was owned, not by H and W, but by the marital entity. The transfer on death deed is effective at H’s death because the property is owned by H at H’s death. See, e.g., Mitchell v. Wilmington Trust Co., 449 A.2d 1055 (Del. Ch. 1982) (mortgage granted by one tenant by the entirety is not void upon execution but remains inchoate during the lives of both spouses, and becomes a valid lien if the spouse who executed the mortgage survives the other spouse or if the spouses get divorced). The act does not require the transferor to have an interest in the property when the transfer on death deed is executed, acknowledged or recorded. As a practical matter, however, it is unwise and may be unfeasible, especially in a recording system using a grantor-grantee index, to attempt to record a deed before acquiring the interest the deed purports to transfer.

SECTION 209. DISCLAIMER.

Alternative 1

A beneficiary may disclaim all or part of the beneficiary’s interest as provided by [cite state statute or the Uniform Disclaimer of Property Interests Act].

Alternative 2

Subject to the law of this state limiting the right to disclaim property, a beneficiary under a transfer on death deed may disclaim all or part of the beneficiary’s interest by recording a disclaimer in the [county] where the property that is the subject of the disclaimer is located.
There will be a Legislative Note explaining that Alternative 1 is for a state with a disclaimer statute, such as the Uniform Disclaimer of Property Interests Act, providing a mechanism for disclaiming interests created in a transfer on death deed. The statute need not have contemplated the transfer on death deed specifically, but the statutory scheme applies, or can be readily amended to apply, to such deeds. In most cases, the only necessary amendment would be to replace the usual requirement that the disclaimer be delivered (for here, after the transferor’s death, there is no obvious individual to whom delivery can be made) with a requirement that the disclaimer be recorded in the county where the property that is the subject of the disclaimer is located. Along these lines, the committee recommends the following technical amendments to Sections 12 and 15 of the Uniform Disclaimer of Property Interests Act:

**SECTION 12. DELIVERY OR FILING.**

(a) In this section, “beneficiary designation” means an instrument, other than an instrument creating a trust, naming the beneficiary of:

- (1) an annuity or insurance policy;
- (2) an account with a designation for payment on death;
- (3) a security registered in beneficiary form;
- (4) a pension, profit-sharing, retirement, or other employment-related benefit plan; or
- (5) any other nonprobate transfer at death.

(b) Subject to subsections (c) through (l), delivery of a disclaimer may be effected by personal delivery, first-class mail, or any other method likely to result in its receipt.

(c) In the case of an interest created under the law of intestate succession or an interest created by will, other than an interest in a testamentary trust:

- (1) a disclaimer must be delivered to the personal representative of the decedent’s estate; or
- (2) if no personal representative is then serving, it must be filed with a court having jurisdiction to appoint the personal representative.

(d) In the case of an interest in a testamentary trust:

- (1) a disclaimer must be delivered to the trustee then serving, or if no trustee is then serving, to the personal representative of the decedent’s estate; or
- (2) if no personal representative is then serving, it must be filed with a court having jurisdiction to enforce the trust.

(e) In the case of an interest in an inter vivos trust:

- (1) a disclaimer must be delivered to the trustee then serving;
- (2) if no trustee is then serving, it must be filed with a court having jurisdiction to enforce the trust; or
- (3) if the disclaimer is made before the time the instrument creating the trust becomes irrevocable, it must be delivered to the settlor of a revocable trust or the transferor of the interest.

(f) In the case of a disclaimer of an interest created by a beneficiary
designation made before the time the designation becomes irrevocable, a the

disclaimer must be delivered to the person making the beneficiary designation.

(g) In the case of a disclaimer of an interest created by a beneficiary
designation made after the time the designation becomes irrevocable:

(1) a disclaimer of an interest in personal property must be
delivered to the person obligated to distribute the interest;

(2) a disclaimer of an interest in real property must be recorded in
the [county] where the real property that is the subject of the disclaimer is located.

(h) In the case of a disclaimer by a surviving holder of jointly held
property, the disclaimer must be delivered to the person to whom the disclaimed
interest passes.

(i) In the case of a disclaimer by an object or taker in default of exercise
of a power of appointment at any time after the power was created:

(1) the disclaimer must be delivered to the holder of the power or to
the fiduciary acting under the instrument that created the power; or

(2) if no fiduciary is then serving, it must be filed with a court having
authority to appoint the fiduciary.

(j) In the case of a disclaimer by an appointee of a nonfiduciary power of
appointment:

(1) the disclaimer must be delivered to the holder, the personal
representative of the holder's estate or to the fiduciary under the instrument that
created the power; or

(2) if no fiduciary is then serving, it must be filed with a court having
authority to appoint the fiduciary.

(k) In the case of a disclaimer by a fiduciary of a power over a trust or
estate, the disclaimer must be delivered as provided in subsection (c), (d), or (e),
as if the power disclaimed were an interest in property.

(l) In the case of a disclaimer by an agent, the disclaimer must
be delivered to the principal or the principal’s representative.

Comment

The rules set forth in Section 12 are designed so that anyone who has the
duty to distribute the disclaimed interest will be notified to provide notice of the
disclaimer. For example, a disclaimer of an interest in a decedent’s estate must be
delivered to the personal representative of the estate. A disclaimer is required to
be filed in court only when there is no one person or entity to whom delivery can
be made in very limited circumstances.

SECTION 15. RECORDING OF DISCLAIMER. If an instrument
transferring an interest in or power over property subject to a disclaimer is
required or permitted by law to be filed, recorded, or registered, the disclaimer
may be so filed, recorded, or registered. Except as otherwise provided in Section
12(g)(2), failure to file, record, or register the disclaimer does not affect its
validity as between the disclaimant and persons to whom the property interest or
power passes by reason of the disclaimer.

Comment

This section permits the recordation of a disclaimer of an interest in
property ownership of or title to which is the subject of a recording system. This
section expands on the corresponding provision of previous Uniform Acts which
only referred to permissive recording of a disclaimer of an interest in real
property. While local practice may vary, disclaimants should realize that in order
to establish the chain of title to real property, and to ward off creditors and bona
de fide purchasers, the disclaimer may have to be recorded. This section does not
change the law of the state governing notice. The reference to Section 12(g)(2)
concerns the disclaimer of an interest in real property created by a “beneficiary
designation” as that term is defined in Section 12(a). Such a disclaimer must be
recorded.

Alternative 2 is for a state without a disclaimer statute that can be readily amended to
apply to transfer on death deeds.

The Comment will mention the state-law doctrine of “relation back”: an effective
disclaimer typically relates back to the time of the initial transfer (here, the transferor’s death).

The Comment will also mention that a beneficiary need not disclaim before the
transferor’s death just as a devisee under the transferor’s will need not disclaim before the
transferor’s death.

SECTION 210. NO COVENANTS OR WARRANTIES. A transfer on death deed
transfers property without covenant or warranty of title even if there is a contrary provision in the
deed.

Reporter’s Note

This provision is based on §5652(d) of the California draft statute: “Notwithstanding a
contrary provision in the deed, a revocable transfer on death deed transfers the property without
covenant or warranty of title.” The rule is mandatory, not a default as in Colo. Rev. Stat. §15-15-
404(2) [“Unless the owner designates otherwise ...”], to prevent mishaps by uninformed grantors.

SECTION 211. PROTECTION OF BONA FIDE PURCHASERS OR ENCUMBRANCERS. A bona fide purchaser or encumbrancer to whom a beneficiary transfers
an interest in the property received under a transfer on death deed has the same rights and
protections as if the transfer had been made by a grantee of an inter vivos deed.

Reporter’s Note
The committee observed that it is hard to articulate a substantive rule on bona fide purchasers or encumbrancers (BFPs), because some jurisdictions are notice jurisdictions (protecting BFPs regardless of when the BFP files), some are race-notice jurisdictions (protecting only BFPs who file first), and a few are race jurisdictions (protecting anyone who files first). Instead, the committee decided to articulate the rule that a BFP from the beneficiary of a transfer on death deed is in the same position as a BFP in the standard inter vivos transaction.

SECTION 212. PROOF OF DEATH. Proof of the death of a transferor or a beneficiary of a transfer on death deed must be established in the same manner as proof of the death of a joint tenant [under [cite state statute]].

Reporter’s Note

The committee was initially uncertain whether a Uniform Act should spell out a procedure for the proof of death. The Uniform Probate Code, for example, refers in §6-223 and §6-307 to “proof of death” without elaboration.

The committee decided to incorporate the state’s existing procedures for proving the death of a joint tenant, essentially tracking Colo. Rev. Stat. §15-15-413: “Proof of the death of the owner or a grantee beneficiary shall be established in the same manner as for proving the death of a joint tenant.”

SECTION 213. PROCEEDING TO CONTEST TRANSFER ON DEATH DEED.

(a) After the transferor’s death, the transferor’s personal representative or an interested person may contest the validity of a transfer on death deed on the basis of fraud, undue influence, duress, mistake, or other invalidating cause.

(b) A contest proceeding under this section must be brought in the [ ] court in the [county] where [the administration of the transferor’s estate would be proper][the property that is the subject of the transfer on death deed is located].

(c) A contest proceeding under this section must be commenced within the earlier of:

(1) [three years] after the transferor’s death; or

(2) [one year] after the beneficiary establishes the transferor’s death.
[(d) Upon initiation of a contest proceeding, the contestant may record a notice of lis pendens in the [county] where the transfer on death deed is recorded.]

**Reporter’s Note**

The grounds of contest in subsection (a) are drawn from §5696 of the California draft statute: “Nothing in this chapter limits the application of principles of fraud, undue influence, duress, mistake, or other invalidating cause to a transfer of property by a revocable transfer on death deed.”

Subsection (b) will be accompanied by a Legislative Note explaining that the blank in brackets should be filled in, as appropriate, by each enacting state.

Subsection (c) is drawn from §§5690(c) and 5692(b) of the California draft statute. Section 5690(c) provides: “On commencement of a contest proceeding, the contestant may record a lis pendens in the county in which the revocable transfer on death deed is recorded.” Section 5692(b) provides: “A contest proceeding shall be commenced within the earlier of the following times: (1) Three years after the transferor’s death. (2) One year after the beneficiary establishes the fact of the transferor’s death....”

Subsection (d): A Legislative Note will explain that subsection (d) is in brackets so that it can be deleted by states not using, or not wishing to refer to, the notice of lis pendens.

The Comment will emphasize that the limitations period for commencement of the contest should be the same as for other nonprobate transfer contests (if state law already provides a limitations period for such contests) or (if not) for will contests.

The Comment will also cross-reference the rule governing bona fide purchasers or encumbrancers in Section 211 and the provision on proof of death in Section 212.

**SECTION 214. LIABILITY OF A BENEFICIARY FOR CREDITOR CLAIMS AND STATUTORY ALLOWANCES.** A beneficiary of a transfer on death deed is liable for allowed claims against the transferor’s probate estate and statutory allowances to the extent provided in [cite state statute or Section 6-102 of the Uniform Probate Code].

**Reporter’s Note**

This section defers to other law, such as Uniform Probate Code §6-102, to establish the liability of a beneficiary of a transfer on death deed for creditor claims and statutory allowances. For these purposes, the committee believes as a matter of policy that a state should treat a beneficiary of a transfer on death deed the same as a beneficiary of any other nonprobate transfer
outside of trust, for example a beneficiary of a pay on death bank account. The state’s approach
to such beneficiaries should be consistent.

Uniform Probate Code §6-102 was added in 1998 to establish the principle that recipients
of nonprobate transfers can be required to contribute to pay allowed claims and statutory
allowances to the extent the probate estate is insufficient. The fundamental rule of liability is
contained in §6-102(b): “Except as otherwise provided by statute, a transferee of a nonprobate
transfer is subject to liability to any probate estate of the decedent for allowed claims against the
decedent’s probate estate and statutory allowances to the decedent’s spouse and children to the
extent the estate is insufficient to satisfy those claims and allowances. The liability of a
nonprobate transferee may not exceed the value of nonprobate transfers received or controlled by
that transferee.” The other provisions of UPC §6-102 implement this liability rule.

For states not favoring UPC §6-102 in its entirety but wishing to adopt a simple statement
of a liability rule, the drafting committee is considering providing an Alternative that would
largely track language from Uniform Trust Code §505(a)(3). This alternative would provide:
“After the transferor’s death, the property that is the subject of an effective transfer on death deed
is subject to claims of the transferor’s creditors, costs of administration of the transferor’s estate,
the expenses of the transferor’s funeral and disposal of remains, and statutory allowances to a
surviving spouse and children to the extent the transferor’s probate estate is inadequate to satisfy
those claims, costs, expenses, and allowances.”
[ARTICLE] 3

FORMS

Reporter’s Prefatory Note

These forms are drafts, designed to provide a basis for discussion. Suggestions for improving the forms are encouraged.

Legislative Note: An enacting jurisdiction should review its statutory requirements for deeds and for acknowledgments and amend the statutory forms provided in Sections 301 and 302 where necessary for conformity with those requirements.

SECTION 301. FORM OF TRANSFER ON DEATH DEED. A document substantially in the following form satisfies the requirements for a transfer on death deed under this [act]:

(front of form)

TRANSFER ON DEATH DEED

NOTICE TO OWNER

You should carefully read all information on the other side of this form. You may want to consult a lawyer before using this form.

This form must be recorded before your death, or it will not be effective.

IDENTIFYING INFORMATION

Owner or Owners Making This Deed:

_________________________________________  _______________________________________

(printed name)  (mailing address)

_________________________________________  _______________________________________

(printed name)  (mailing address)

Provide the legal description of the property:
I revoke all my previous transfer on death deeds affecting the described property, and designate the following beneficiary or beneficiaries who survive me to receive the property (in equal and undivided shares with no right of survivorship between them, unless I say otherwise in this deed):

**Primary Beneficiary or Beneficiaries – include mailing addresses if available**

____________________________________________________________

____________________________________________________________

____________________________________________________________

**Alternate Beneficiary or Beneficiaries – Optional**

If no above beneficiary survives me, I designate the following alternate beneficiary or beneficiaries who survive me to receive the property (in equal and undivided shares with no right of survivorship between them, unless I say otherwise in this deed):

**Alternate Beneficiary or Beneficiaries – include mailing addresses if available**

____________________________________________________________

____________________________________________________________

____________________________________________________________

**Transfer on Death**

I transfer my interest in the described property to the beneficiary or beneficiaries on my
death.

Before my death, I have the right to revoke this deed.

SIGNATURE OF OWNER OR OWNERS MAKING THIS DEED:

_____________________________[(SEAL)] _________________

(signature) (date)

_____________________________[(SEAL)] _________________

(signature) (date)

ACKNOWLEDGMENT

[insert acknowledgment here]

(comback of form)

COMMON QUESTIONS ABOUT THE USE OF THIS FORM

WHAT DOES THE TRANSFER ON DEATH (TOD) DEED DO? When you die, the beneficiaries will become owners of the property described in the TOD deed, subject to any debts or liens or mortgages (or other encumbrances) you have put on the property during your lifetime. Probate is not required. The TOD deed has no effect until you die. You can revoke it at any time. If you transfer the property to someone else during your lifetime, the beneficiary under this deed will not receive it.

HOW DO I MAKE A TOD DEED? Complete this form. Have it acknowledged before a notary public or other individual authorized to take acknowledgments. Record the form in each [county] where any part of the property is located. The form must be acknowledged and recorded before your death or it has no effect.

HOW DO I FIND THE “LEGAL DESCRIPTION” OF THE PROPERTY? This information may be on the deed you received when you became an owner of the property. This information may also be
available in the office of the [county recorder] for the [county] where the property is located. If
you are not absolutely sure, consult a lawyer.

**HOW DO I “RECORD” THE TOD DEED?** Take the completed and acknowledged form to the
[county recorder] for the [county] where the property is located. Follow the instructions given by
the [county recorder] to make the form part of the official property records. If the property is in
more than one [county], you must record the deed in each [county].

**CAN I REVOKE THE TOD DEED IF I CHANGE MY MIND?** Yes. The TOD deed is revocable.

No one, including the beneficiaries, can prevent you from revoking the deed.

**HOW DO I REVOKE THE TOD DEED?** There are two ways to revoke a recorded TOD deed:

1. Complete and acknowledge a revocation form, and record it in each [county] where the
   property is located. (2) Complete and acknowledge a new TOD deed that disposes of the same
   property, and record it in each [county] where the property is located. In addition, you can
   transfer the property to someone else during your lifetime.

**I AM BEING PRESSURED TO COMPLETE THIS FORM. WHAT SHOULD I DO?** Do not complete
this form under pressure. Seek help from a trusted family member, a friend, or a lawyer.

**DO I NEED TO TELL THE BENEFICIARIES ABOUT THE TOD DEED?** No, but it is
recommended. Secrecy can cause later complications and might make it easier for others to
commit fraud.

**WHAT IF I NAME MORE THAN ONE BENEFICIARY?** You may name more than one
beneficiary. Unless you say otherwise in the deed, the primary beneficiaries who survive you (or
if none survives you, the alternate beneficiaries) will become co-owners in equal shares.

**Reporter’s Note**

This form is based on the California proposed form, with modifications.
SECTION 302. FORM OF REVOCATION.

A document substantially in the following form satisfies the requirements for a form of

revocation under this [act].

(front of form)

REVOCATION OF TRANSFER ON DEATH DEED

NOTICE TO OWNER

This revocation must be recorded before you die or it will not be effective. This

revocation is effective only as to the interests in the property of owners who sign this revocation.

IDENTIFYING INFORMATION

Owner or Owners of Property Making This Revocation:

_____________________________  _______________________________

(printed name)  (mailing address)

_____________________________  _______________________________

(printed name)  (mailing address)

Provide either (1) the legal description of the property or (2) the recording information of the

transfer on death deed:

_____________________________

_____________________________

_____________________________

_____________________________

REVOCATION

I revoke all my previous transfer on death deeds affecting this property.

SIGNATURE OF OWNER OR OWNERS MAKING THIS REVOCATION
ACKNOWLEDGMENT

[insert acknowledgment here]

(COMMON QUESTIONS ABOUT THE USE OF THIS FORM)

HOW DO I USE THIS FORM TO REVOKE A TRANSFER ON DEATH (TOD) DEED? Complete this form. Have it acknowledged before a notary public or other individual authorized to take acknowledgments. Record the form in each [county] where the property is located. The form must be acknowledged and recorded before your death or it has no effect.

HOW DO I FIND THE “LEGAL DESCRIPTION” OF THE PROPERTY OR THE “RECORDING INFORMATION” OF THE TOD DEED TO BE REVOKED? This information may be on the TOD deed. It may also be available in the office of the [county recorder] for the [county] where the property is located. If you are not absolutely sure, consult a lawyer.

HOW DO I “RECORD” THE FORM? Take the completed and acknowledged form to the [county recorder] for the [county] where the property is located. Follow the instructions given by the [county recorder] to make the form part of the official property records. If the property is located in more than one [county], you must record the deed in each of those [counties].

I AM BEING PRESSURED TO COMPLETE THIS FORM. WHAT SHOULD I DO? Do not complete this form under pressure. Seek help from a trusted family member, a friend, or a lawyer.

Reporter’s Note
This form is based on the form in Section 301.
[ARTICLE] 4

MISCELLANEOUS PROVISIONS

SECTION 401. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among the states that enact it.

Reporter’s Note

This provision is standard in all uniform acts.

SECTION 402. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001, et. seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

Reporter’s Note

The NCCUSL Drafting Rules state: “If an act contains a provision requiring a notice or other record or a signature, whether electronic or written, [this] section should be included” (emphasis supplied).

A Legislative Note will explain that jurisdictions with the Uniform Electronic Transactions Act do not need this section.

SECTION 403. REPEALS. The following acts and parts of acts are hereby repealed:

(1) ........................................

(2) .......................................

(3) .......................................

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There will be a Legislative Note, either here or at the beginning of the Act, drawing states’ attention to the growing harmonization of the rules governing probate and nonprobate transfers. The Legislative Note will encourage states enacting this Act to consider extending probate rules to transfer on death deeds and other nonprobate transfers, with respect to the following: (1) ademption of specific devises; (2) antilapse; (3) revocation by divorce; (4) revocation by homicide (also known as the “slayer rule”); (5) survivorship and “simultaneous death”; and (6) the elective share of a surviving spouse.

SECTION 404. EFFECTIVE DATE. This [act] takes effect ......................
Astleford v. Commissioner

Tier Discounts Allowed; Substantial Lack of Control and Marketability
Discounts Recognized for Parent and Subsidiary Real Estate
Partnerships, Astleford v. Commissioner, T.C. Memo. 2008-128

May 2008
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Synopsis:
This gift tax case allows lack of control and marketability discounts for tiered partnership interests. An FLP owned a 50% interest in a real estate general partnership and various other real estate tracts. An approximate 20% absorption discount was allowed for valuing a 1,187 acre tract in the general partnership. The FLP’s 50% interest in the general partnership was valued as a partnership interest rather than as an assignee interest. Even so, a 30% combined discount for lack of control and marketability was allowed for the 50% interest in the general partnership. An approximate 17% lack of control and 22% lack of marketability discount (for a seriatim discount of about 35%) was allowed for valuing gifts of 90% of the limited partnership interests (three 30% gifts in 1996 and 1997).

Basic Facts:
1. Mr. Astleford owned a 50% interest in a real estate general partnership that, among other things, owned a 1,187 acre tract of farmland.
2. Mr. Astleford died in 1995 and left his 50% interest in the real estate general partnership and a number of other real estate properties to a Marital Trust for Mrs. Astleford.
3. In 1996, Mrs. Astleford formed an FLP with her interest in an assisted living facility, and simultaneously made gifts of 30% limited partnership interests to each of her three children, retaining the 10% general partnership interest in the FLP. [The purpose of the FLP does not seem particularly relevant in this case that does not involve §2036, but the purposes were to facilitate the continued ownership, development, and management of the real estate investments and to facilitate gifts.] Terms of the FLP that might potentially affect value of the limited partnership interest gifts are that the agreement required the annual distribution of net cash flow, limited partners could not vote on management matters, and without the general partner’s consent, no outside party could become a partner, a limited partner could not sell its interest, and real property in the partnership could not be partitioned.
4. In 1997, Mrs. Astleford contributed her “entire right and interest” in the 50% interest in the real estate general partnership (the opinion does not indicate how she came to own that interest rather than the Marital Trust) together with 14 other real estate properties that she owned. This increased her percentage interest in the partnership, and Mrs. Astleford simultaneously made additional limited partnership gifts to her three children to bring her general partnership percentage interest in the FLP back down to 10%. (The opinion does not indicate how the parties documented the transaction or treated the values and the capital accounts in the contribution and subsequent gifts of limited partnership interests.)
5. Mrs. Astleford filed gift tax returns for 1996 and 1997, reporting gifts of $277,441 and $3,954,506, respectively. The IRS audit asserted values of $626,898 and $10,937,268, respectively. (The court eventually ended up at values of $517,575 and $6,565,215, respectively.)

**Analysis:**

1. **Value and Absorption Discount for 1,187 Acre Tract.** The taxpayer’s expert applied a value of $3,100 per acre and contended that a 41.3% absorption discount should apply in valuing the 1,187 acre tract because a sale of the entire tract would flood the local market for farmland. The taxpayer’s expert assumed that the land would sell over four years, would appreciate at 7% per year, and that a 25% present value discount rate was appropriate (based on the return on equity rate expected by real estate developers). The IRS’s expert valued the tract at $3,500 per acre and maintained that no absorption discount should be applied.

As to the per acre value, the court said that the IRS’s expert “was particularly credible and highly experienced and possessed a unique knowledge of property located throughout Dakota County and the surrounding area,” and the court accepted the IRS’s $3,500 per acre value.

As to the absorption discount, the court cited three prior cases that allowed an absorption discount in valuing large parcels of real estate where a sale over a short period of time would reduce the value. Because of the size of the 1,187 acre tract in relation to the number of acres sold each year in that county, the court believed that it was unlikely that all of the property could be sold in one year without a price discount. The court used the taxpayer’s assumption that the tract would sell over four years, but reduced the present value discount rate from 25% to 10%, which is close to the return on equity that farmers actually earned in the locality. “A present value discount rate is a function of the riskiness of a project, and the hypothetical project herein is not land development but the sale of farmland over four years.” The court observed that there was a low level of risk because 75% of the property had been leased, providing a source of income to a prospective purchaser.

The case ended up applying an absorption discount of slightly over 20% (20.396% to be precise).

2. **Value as Partnership Interest, Not Assignee Interest.** The taxpayer treated the 50% interest in the general partnership that was owned by the FLP as an assignee interest, because the other 50% partner (who was not a family member) never consented to the transfer to the FLP. The court agreed with the IRS that the substance over form doctrine applies to gift and estate taxes (citing Haven v. United States, 945
F.2d 359, 363 (10th Cir. 1991) and Estate of Murphy v. Commissioner, T.C. Memo. 1990-472). The court believed that in substance the transferred interest should be treated as a partnership interest, not an assignee interest, for two reasons. First, the donor was the sole general partner of the FLP and therefore held all management rights either by retaining the management rights individually if an assignee interest were transferred to the FLP or by holding the management rights as the sole general partner of the FLP if a partnership interest were transferred to the FLP. Second, the documentation suggested the transfer of a full partnership interest because a resolution of the FLP acknowledged receiving all of the donor’s rights and interests in the general partnership. (The court cited three other cases that valued FLP interest transfers as partnership interests, not assignee interests, based on the documentation [Estate of Jones, Kerr, and Estate of Dailey], and one case that valued the interest as an assignee interest where the documentation did not indicate that a partnership interest was transferred [Estate of Nowell].)

The IRS argued in the alternative that if the transfer were treated as a mere assignee interest, §2704(a) would apply to treat the difference in value between a partnership interest and an assignee interest as a deemed gift. The court did not have to address that argument in light of its refusal to treat the interest as an assignee interest.

3. Tier Level Multiple Discounts. The IRS’s expert did not apply a discount in valuing the 50% general partnership interest, reasoning that applying discounts at the FLP level obviated the need for discounts at the general partnership level. Footnote 5 of the opinion cites four Tax Court and Tax Court memorandum cases that have allowed multi-level discounts where there were minority interests in both levels. (Estate of Piper, Janda, Gow, and Gallun.) However, cases have refused to apply multi-level discounts where minority interests in subsidiaries were a significant portion of the parent entity’s assets (Martin) or was the parent’s “principal operating subsidiary” (Estate of O’Connell). After the court noted that the 50% general partnership interest was only 16% of the FLP’s value and only 1 of 15 real estate investments that the FLP owned, it concluded that lack of control and marketability discounts at both the subsidiary level (i.e., the 50% general partnership interest) and the parent level (i.e., the FLP) were appropriate.

4. Lack of Control and Lack of Marketability Discount.

RELP vs. REIT Comparables. The taxpayer’s expert relied on comparability data from sales of registered real estate limited partnerships (or RELPs). The IRS’s expert used comparability data from real estate investment trusts (or REITs). The court refused to recognize one set of data as always being superior to the other, noting that the RELPs more closely resemble the partnership interests being valued (and finding that the low trading volume of RELPs on the
secondary market is not so low as to render the data unreliable), but observing that the large number of REIT transactions tends to produce more reliable data and that the differences between REITs and the partnership interests being valued can be minimized given the large number of REITs from which to choose comparables. The court ended up using RELP data for valuing the 50% general partnership interest and REIT data in valuing the FLP interests (as discussed below).

50% General Partnership Interest. After eliminating comparables from two years after the valuation date (i.e., 1997), the court observed that the median and mean trading discounts of the RELPs cited by the taxpayer’s expert were 30% and 36%. A total sample of 130 RELPs in 1997 had median and mean trading discounts of 28.7% and 30%, respectively. The court applied a combined 30% discount for lack of control and marketability.

Gifts of FLP Interests; Lack of Control Discount. The taxpayer’s expert (and the court) did not just apply the same RELP analysis to determine a similar combined lack of control and marketability discount for the FLP, but instead analyzed the lack of control and lack of marketability discounts separately. To determine the lack of control discount for the FLP interest gifts, the taxpayer’s expert selected nine (which it further narrowed to four) RELP comparables, which the court rejected because they were substantially more leveraged than the FLP, and because they reflected a lower cash distribution rate than the FLP. The court used a sliding scale approach: “Where the comparables are relatively few in number, we look for a greater similarity between comparables and the subject property” (citing Estate of Heck). In addition to the leverage difference, the court acknowledged the taxpayer’s expert’s comment that higher cash distribution rates suggest lower investor risk and therefore lower trading discounts. The FLP’s cash distribution rate (10%) was significantly higher than the 6.7% average distribution rate for the comparables.

After rejecting the taxpayer’s RELP comparables (which reflected trading discounts of 40-45%), the court used the IRS’s expert’s REIT data. This was more complicated. The REIT comparables traded at a very slight difference to net asset value in 1996 and 1997 (0.1% premium and a 1.2% discount, respectively). However, the court observed that at least two factors are at work, because REITs allow investors to own a minority but at the same time a liquid investment in an otherwise nonliquid asset (e.g., real estate). One factor is positive (the liquidity premium) and the other is negative (lack of control). Therefore, the court tried to identify and reverse out the liquidity premiums associated with the REIT comparables. (Easier said than done.) The IRS’s expert applied a regression analysis to determine that the 1996 and 1997 comparables reflected liquidity premiums of 7.79%. When reversed from the overall slight premium/discounts paid for REITs in 1996 and 1997, this produced lack
of control discounts of 7.14% and 8.34% in 1996 and 1997. The court agreed with the general approach, but observed that the liquidity premiums reflected by the expert’s regression analysis was about half that recognized in other studies that the expert had cited. Furthermore, the court said that the 7.79% liquidity premium resulted in a lack of control discount that “on its face appears unreasonably low.”

To determine the appropriate liquidity premium to apply to the REIT overall trading premiums, the court looked “simply” to the difference in average discounts in private placements of registered and unregistered stock. It reasoned that the difference represents pure liquidity concerns, since a ready, public market is available to owners of registered stock but not to owners of unregistered stock. The court cites the same approach being used in McCord and Lappo. Using that data, the IRS’s expert cited two studies of the registered/unregistered stock data reflecting liquidity premiums of 16.27% that would also be applicable to publicly traded REITs. Using this number as the liquidity premium, the court adjusted the overall small premium/discounts paid for REITs in 1996 and 1997 to reflect lack of control discounts of 16.17% and 17.47% in 1996 and 1997, respectively.

Gifts of FLP Interests; Lack of Marketability Discounts. The IRS’s expert’s lack of marketability discount (21.23%) was somewhat higher than the taxpayer’s expert’s estimate (15%), so the court used the IRS’s expert’s higher number in arriving at a 22% marketability discount. (The court’s calculation actually applied a 21.23% marketability discount in 1996 and a 22.0% marketability discount in 1997.)

Gifts of FLP Interests; 35% Combined Lack of Control and Marketability Discount. The lack of control discount was about 17% in the two years, reflecting a discounted value of 83%. A further 22% marketability discount resulted in a combined discounted value of the limited partnership interests of about 83% (i.e., 100% - 17%) times 78% (i.e., 100%-22%), or 64.7%. Therefore, the combined discount is about 35% for gifts of limited partnership interests in the real estate FLP. (It is actually a combined discount of 33.96% in 1996 and 35.63% in 1997.)

Observations:

1. Substantial Discounts Apply. This case is a continuation of the almost uniform trend of cases that allow substantial discounts for FLP interests. While the IRS has won a number of §2036 cases (that have typically involved pretty egregious fact situations), when courts address the amount of discount for FLP interests, they almost always allow substantial discounts. This case allowed about a 35% discount to value limited partnership gifts in an FLP that owns almost entirely real estate assets.
Furthermore, as to an interest in a general partnership, in which an owner held a 50% interest, the court allowed a 30% combined lack of control and marketability discount.

As to the portion of the FLP represented by an interest in a general partnership within the FLP, the overall discount was about 55% (i.e., the value was 70% x 82.53% x 78%, or 45.06%, representing an overall 54.93% discount).

As to the portion of the FLP represented by the 1,187 acre tract, there were three levels of discounts (including the absorption discount) for a combined discount of about 64%. (The actual value was 79.604% x 70% x 82.53% x 78%, or 35.87%, representing an overall 64.13% discount.)

2. Multi-Level Tiered Discounts. The court allowed full lack of control and marketability discounts at both the subsidiary level and the parent level. The cases cited by the court suggest that this is appropriate when there are minority interests being valued at both levels. One wonders whether there would be some limit to this approach if there are many subsidiary levels. For example, what if there were 10 subsidiary levels, each of which held minority interests? Would 10 levels of full discounts be applied? Or at some point, is lack of control really a total lack of control without any further “degrees” of lack of control, so that there would no longer be higher and higher levels of discounts for greater “degrees” of lack of control?

3. Absorption Discount Analysis Approach. The court reasons that it is appropriate to apply an absorption discount (for stock, this is often referred to as a blockage discount) if the tract is so large, compared with other sales in the locale, that selling the entire tract in one year would likely require a price reduction. The taxpayer’s expert’s 41.3% absorption discount was reduced by the court to about 20%, still a significant discount. The primary factors in determining the discount are the length of time to sell the tracts, the assumed income from the property and sale prices in the future years, and the rate for determining the present values of those future cash inflows. To determine the relevant discounting factor, the court said to use a return on equity rate that is expected by investors in a comparable market, considering the risks inherent in the delayed sales of the tracts.

4. Lack of Control Discount. The analysis seems somewhat convoluted, and far from looking “simply” at anything. However, the approach follows the lead of the McCord and Lappo decisions. Follow the bouncing ball. First, look to the taxpayer’s RELP (i.e., real estate partnerships) data (suggesting a 40% discount), but the comparables are not similar enough. Next, look to the IRS’s REIT (also real estate) data, but the data initially suggests no lack of control discount (because there was very little premium or discount from net asset value in sales of REIT interests for the years in question). The court reasons that this is
because in addition to a lack of control discount there is a liquidity premium associated with the ability to own a liquid interest in a nonliquid asset. How to adjust for that factor? The court looks to stock (NOT real estate) data (sales of registered vs. unregistered stock), which interestingly was also based on data presented by the IRS’s expert. The ball finally stops bouncing after arriving at a control discount of about 17%.

At best, this seems to be a rather convoluted approach. Stock data reflecting the value differences for registered and nonregistered stock reflects something closely akin to a lack of marketability factor. The difference in what someone is willing to pay for registered vs. unregistered stock is largely because the investor can turn around and sell the registered stock on an established market immediately, whereas the investor cannot do that with unregistered stock. (It would seem that another important factor is that the SEC rules on disclosure including Sarbanes/Oxley provide additional comfort regarding financial disclosure that might be another reason for part of the premium for registered vs. unregistered stock.) In effect, data reflecting a lack of marketability discount for stock is used to back into a lack of control discount for real estate.

It seems that the experts and courts search for a rationale to justify what seems like a bottom line reasonable result, even if the rationale may not seem to be directly related just to a lack of control discount. (Indeed, when one approach produced a result that “on its fact appears unreasonably low,” the court in Astleford knew that it was time to use a different approach.)

5. **Tiered Ownership Often Makes Business Sense As Well As Potentially Resulting in Larger Discounts.** Multi-level entities are often used with real estate properties (to insulate each separate real estate investment from liabilities associated with other real estate investments). This kind of master limited partnership approach can achieve sound business purposes as well as affording significant multi-level discounts in appropriate circumstances. However, the court in Astleford did not address a situation where the “master” partnership owns all or most of the interests in the subsidiary entities. (However, it did not focus on the fact that the FLP owned a minority interest in the subsidiary [in this case it held a 50% interest in the general partnership], but rather on the fact that the subsidiary was only 16% of the parent’s net asset value and was just 1 of 15 real estate investments. That same reasoning would apply to many real estate “master” limited partnerships that own a number of separate real estate limited sub-partnerships or LLCs.)

6. **No Application of Indirect Gift Approach to Subsequent Funding.** When Mrs. Astleford made additional contributions to the FLP in 1997, the court did not treat her as making indirect gifts of the additional contributions directly to her three daughters who already owned the
90% limited partnership interests. The IRS has made that “indirect gift” argument in other cases (for example, Shepherd and Senda). The opinion does not suggest that the IRS made the indirect gift argument in this case. In any event, the court treated the donor as receiving additional general partnership interests in return for her additional contributions, and simultaneously making gifts of the limited partnership interests to reduce her general partnership interest back down to the 10% level that she owned before the additional contributions were made. The court does not describe how the 1997 contribution transaction was documented.
1. **Statutory Provision.** Section 675 provides that the existence of various administrative powers will cause a trust to be a grantor trust for income tax purposes. Section 675(4) lists several general powers of administration, which if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment. One of those powers, listed in §675(4)(C), is "a power to reacquire the trust corpus by substituting other property of an equivalent value."

2. **Grantor Trust as to Both Corpus and Income.** Even though §675(4)(C) refers to a power to reacquire "trust corpus," this power causes the grantor to be treated as the owner of trust corpus and income (including ordinary income not allocable to corpus). Treas. Reg. § 1.671-3(b)(3).

3. **Nonfiduciary Capacity Determination.** The regulations provide that "the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." Treas. Reg. §1.675-1(b)(4). The IRS has taken the position in several rulings that whether the grantor holds the power in a nonfiduciary capacity for purposes of section 675 is a question of fact to be determined by the district director after returns have been filed. Ltr. Ruls. 199942017, 9645013, 9525032, 9407014, 9352007, 9352004, 9337011, 9335028, 9248016, 9253010. Other letter rulings have not applied the facts and circumstances requirement, but have held that the substitution power caused the trust to be a grantor trust. Ltr. Ruls. 9451056, 9352017, 9351005, 9345035, 9248016. Some rulings have applied a compromise approach, stating that the grantor trust determination depends on the facts and circumstances but that, assuming exercise of a Section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. E.g., Letter Ruling 9810019 (charitable lead trust).

4. **Trustee Should Not Hold Power.** Because grantor trust status depends upon the power being held in a "non fiduciary" capacity, the power of substitution should not be held by the trustee. Regulation §1.675-1(b)(4) provides that if a power is exercisable by a person "as trustee," there is a rebuttable presumption that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Similarly, a trustee’s approval or consent should not be required (or else the requirement in the initial sentence of §675(4) will not be satisfied.)

5. **Retention of Power by Grantor, Historical Perspective.** Can the grantor retain a nonfiduciary power to substitute assets of equivalent value without causing inclusion in the grantor’s estate for estate tax purposes? (If you’re not interested in the gory
A 1975 Tax Court case is often cited for the proposition that a substitution power will not cause estate tax inclusion. Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975). Interestingly, the facts in Jordahl involved a situation in which the grantor held the substitution power in a fiduciary capacity. Was this difference critical? The reasoning in the Jordahl case would suggest that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

"Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprive the remainder of benefits or to deprive an income beneficiary of property.] Substitutions resulting in shifted benefits would not be substitutions of property 'of equal value.'"

Commentators have generally concurred that the Jordahl result should apply even where the substitution power is held in a nonfiduciary capacity. See Practical Drafting 3753-3757 (R. Covey ed. 1994). In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl): 9227013, and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

PLR 200603040, issued on 1-20-2006, addresses a trust with a substitution power where "the instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity." The PLR concluded that the substitution power would not cause estate inclusion under §§2033, 2036(a), 2036(b), 2038 or 2039. The PLR focused on the fact that the instrument said that the substitution power could only be exercised in a fiduciary capacity. In Jordahl, the decedent was a co-trustee so one might infer that all powers held by the grantor in that case were held in a fiduciary capacity. However, the PLR interpreted Jordahl as follows: "Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries." Under this reasoning, would any substitution power be exercisable only in a fiduciary capacity? That reasoning might suggest why the IRS refuses to rule in PLRs whether a substitution power is held in a nonfiduciary capacity (to
be a grantor trust trigger under §675(4)) even though the instrument specifically says the power is not held in a fiduciary capacity.

Similarly, PLR 200606006 said that §2036 would not apply in a situation where the substitution power was held in a fiduciary capacity. Without changing the trust under state law so that the trustee would hold the substitution power in a fiduciary capacity, the IRS would not give a favorable ruling on §2036. (In the facts of that ruling, there were other grantor trust triggers, so the trust was a grantor trust even without a nonfiduciary substitution power. The substitution power was important to the grantor in that ruling, because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests.) Despite the existence of dozens of previous private letter rulings saying that §2036 does not apply to a substitution power even if it is held in a nonfiduciary capacity, the IRS is no longer willing to grant favorable §2036 rulings to nonfiduciary substitution powers.

Jordahl is often quoted to say that a substitution power does not trigger §2036, but under the facts of Jordahl, the grantor held the power in fiduciary capacity. However, the regulations and other authority under §§2036 and 2038 say that it makes no difference how the power is held. Treas. Reg. §§20.2036-1(b)(3) ("it is immaterial … in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent") & 20.2038-1(a) ("immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent"). If there is a bad power, it does not help that it is held in a fiduciary capacity. So if the substitution power was bad in Jordahl, holding it in a fiduciary capacity would not have helped. Stated differently, if holding a power in a fiduciary capacity does not help to cure a §2036/2038 problem, then holding a power in a nonfiduciary capacity should not hurt in causing a §2036/2039 problem. Therefore, Jordahl does seem to provide protection from §2036 inclusion.

6. Revenue Ruling 2008-22. Revenue Ruling 2008-22, 2008-16 IRB 796, provides very helpful guidance, indicating that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §2036 or 2038. The Ruling cites Jordahl, but says that it did not apply §2038 because the decedent was bound by fiduciary standards. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, “the trustee has a fiduciary duty to prevent the exercise of the power.” The ruling reasons that (1) the trustee “has a fiduciary obligation to ensure that the assets exchanged are of equivalent value,” and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee’s power to reinvest assets and the trustee’s duty of impartiality regarding the beneficiaries.

The precise holding of the ruling states (the indentions and words in ALL CAPS are added for clarity):

“A grantor’s retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate under §2036 or 2038, provided
the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, AND

further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. [The Ruling does not suggest how that might occur, but it does provide some safe harbors against the possible shifting of benefits in the next sentence.]

A substitution power cannot be exercised in a manner that can shift benefits if:

(a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus AND a duty of impartiality with respect to the trust beneficiaries [Observe, state law would generally impose both of these duties unless the trust instrument negates these duties]; OR

(b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income."

Attorneys have differed as to drafting approaches to assure that the trustee must satisfy itself that assets of equivalent value are substituted and that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Some attorneys recommend relying on state law and general fiduciary principles. Other attorneys have suggested drafting those requirements into the trust instrument. In an initial reaction to the ruling, Jonathan Blattmachr and Michael Graham suggest the following:

“Without reducing or eliminating the fiduciary duties imposed upon the Trustee acting hereunder under the terms of this instrument or applicable law, the Trustee shall ensure the Substitutor’s compliance with the terms of this power by being satisfied that the properties acquired and substituted by the Substitutor are in fact of equivalent value within the meaning of Rev. Ryl. 2008-22; further, this power to substitute property shall not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22; without limiting the foregoing prohibition upon shifting benefits among trust beneficiates, the Trustee shall have the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiates at all times while this power of substitution is in effect, within the meaning of Rev. Rul. 2008-22.”

Attorneys have also differed as to whether the trust instrument should give the trustee the power to prevent the substitution if the trustee thinks the value is not equivalent, or if the trustee can merely sue after-the-fact if the substituted assets have a lower value than the assets being reacquired. The rationale for the position that the trustee cannot prevent the sale if the value is too low is that §675 refers to a “power of administration … exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.” On the other
hand, Rev. Rul. 2008-22 specifically says that if a trustee believes that the substituted assets have a lower value, “the trustee has a fiduciary duty to prevent the exercise of the power.” One attorney’s approach is to provide that if the trustee believes the property sought to be substituted is not in fact property of equivalent value, the Trustee shall seek a determination by a court of competent jurisdiction to assure that the equivalent value requirement of the substitution provision is satisfied. Treasury and IRS officials expressed their personal views at the American Bar Association Section of Real Property Trust & Estate Law Section 2008 Spring Meeting that the trustee would exercise its fiduciary duty to question the value issue before the transfer if the trustee believes that the value being substituted was not equivalent, and that is different than requiring “approval or consent” of the trustee.

7. Possible Limitations?

a. Power of Substitution By Insured as an Incident of Ownership. Some planners provide that the substitution power cannot be applied over any life insurance policies on the grantor’s life, out of a concern that despite the holding to the contrary in Jordahl, the IRS may take the position that the power to purchase a life insurance policy is a power that would cause inclusion of the life insurance proceeds under §2042.

A power of substitution held by an insured should not constitute an incident of ownership over a policy owned by an irrevocable life insurance trust. Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975), Letter Ruling 9413045 (citing and relying on Jordahl case). The acquiescence in Jordahl seems to clearly evidence the IRS’s acknowledgement that a substitution power should not constitute an incident of ownership for purposes of §2042. In Action on Decision 1977-129, April 15, 1977, the IRS attorney specifically recommended acquiescence on the IRC 2042 holding in Jordahl as well as on the IRC 2038(a) holding, and that recommendation was approved. Here is what the IRS Action on Decision had to say about IRC 2042:

"Applying the Second Circuit’s rational [sic] in Estate of Hector R. Skifter v. Commissioner, 468 F. 2d 699 (2nd Cir. 1972), aff’d [sic] 56 T.C. 1190 (1971) that it was Congresses [sic] intent that Code [section] 2042 should operate to give insurance policies estate tax treatment roughly parallel to the treatment given other types of property under Code [sections] 2036, 2037, 2038, 2041, it is clear from the court's discussion of the limited rights retained by the decedent over the insurance trust that the proceeds of the policy should not be included in his gross estate."

Under the reasoning of the IRS’s acquiescence, if the right to substitute assets does not cause estate tax inclusion under §§2036-2038 and 2041, it ought not cause estate tax inclusion under § 2042 either.

b. Potential Application of Section 2036(b) Indirect Power to Control Voting of Stock of Controlled Corporation. Similarly, some planners suggest providing that the power could not be exercised to acquire to any voting stock of a “controlled corporation” for purposes of §2036(b). A “controlled corporation” is, generally speaking, a corporation in which the decedent held, at any time after a transfer of stock and within three years of the decedent’s death, the right to vote stock possessing at least 20% of the combined voting power of all classes of stock,
A substitution power might conceivably be treated indirectly as the power to control the voting of the stock under §2036(b). The issue under §2036(b) is whether the power to reacquire stock is a “retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation” within the meaning of §2036(b). Cf. Letter Ruling 200514002 (involving a trust agreement providing that the grantor’s substitution power did not extend to stock of a controlled corporation).] However, the explicit holding of the Revenue Ruling is that a grantor nonfiduciary substitution power by itself will not cause inclusion under §2036 or §2038 (which obviously includes §2036(b)), even though the ruling does not specifically address the reasoning of the potential application of §2036(b). Extending the concept of an indirect power to vote stock to the power to repurchase stock by paying full value for the stock seems a huge stretch. In any event, there should be no necessity of excepting out partnerships from substitution powers (in light of the fact that §2036(b) only applies to corporations and not partnerships).

8. Substitution Power Held By Third Party. Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor’s brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). That concern is greatly diminished, in light of the issuance of Revenue Ruling 2008-22. However, if a planner is concerned about the potential application of §§2036(b) or 2042 (as discussed in paragraph 7, above), a third party substitution power might be used with respect to life insurance on the grantor’s life of stock of a controlled corporation. In addition, allowing a third party to hold the substitution power could create additional flexibility to “turn off” or to “toggle” grantor trust status.

The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power “exercisable in a nonfiduciary capacity by any person”); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by “any non adverse party”). However, the statute refers to the power to “reacquire” trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. (If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under §4941(d).) Letter Ruling 9037011 gave one of the trustees a power to “acquire any property that held in trust by substituting property…”. The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to “reacquire” trust assets.
Observe that the “reacquire” possible IRS argument does not exist if the grantor’s spouse holds the substitution power, because any power or interest held by the grantor’s spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. §672(e). However, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under § 672(e).

The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status.
Holman v. Commissioner

Tax Court Rejects Indirect Gift Theory For Gifts of Partnership Interests After an FLP is Formed and Applies Section 2703 to Transfer Restrictions, Holman v. Commissioner, 130 T.C. No. 12 (May 27, 2008)
**Synopsis:**
A retired Dell employee and his wife created an FLP to hold some of their Dell stock, intending to make gifts of limited partnership (or LP) interests, and they made gifts of most of their LP units six days later. They made subsequent annual exclusion gifts about two months later (at the beginning of the next calendar year) and one year after that. The agreement contained commonly used transfer restrictions, restricting transfers of LP interests without approval of all partners, and giving the partnership the right to purchase non-permitted assignments at the fair market value based on the right to share in distributions (i.e., considering discounts) of those assignee interests. The Tax Court rejected the IRS argument that the gift of LP interests six days after the partnership was created was an indirect gift of a proportionate part of the assets contributed to the partnership (i.e., without a discount). The court also concluded that transfer restrictions in the agreement must be ignored under §2703 in valuing the transfers. (The reasoning as to the bona fide business arrangement test would seem to apply to many FLPs consisting of investment assets and the reasoning as to the “device test” would seem to require ignoring transfer restrictions for valuation purposes in many buy-sell agreements involving family members, even for actively managed businesses). The court valued the transferred LP interests by applying combined lack of control and marketability discounts of 22.4%, 25%, and 16.25% in 1999, 2000, and 2001, respectively.

The case was tried well over two years ago. In light of the long delay, planners have been anxiously waiting to see how the Tax Court deals with the IRS’s “integrated transaction” theory for attacking gifts of LP interests soon after (or in some cases, months after) an FLP has been formed.

**Basic Facts:**

1. On November 2, 1999, parents created an FLP by transferring some of their Dell stock to the partnership. Parents were the general partners (0.89% each) and they owned 98.08% of the FLP as limited partners. (In addition, a trust for children contributed some Dell stock for a very small [0.14%] LP interest.)

2. The parents intended to make gifts of LP interests when they created the partnership. Husband’s primary purpose for the partnership was to preserve his Dell wealth and “disincentivize” his children from spending it. Wife’s primary purpose was to use the partnership to educate children about family wealth. Potential gift tax savings from valuation discounts “played a role” in the decision to form the FLP.

3. The partnership agreement contained transfer restrictions commonly found in partnerships. The agreement prohibited limited partners from transferring “all or part” of their interests without the consent of all partners (paragraph 9.1); however, transfers to certain family members were allowed (paragraph 9.2). If a purported prohibited transfer were deemed to be effective, the partnership would have the...
right to purchase the non-permitted assignment at fair market value based on the right to share in distributions (presumably, taking into account appropriate discounts, and the value based on the right to share in distributions would likely be lower than just "fair market value" (paragraph 9.3)).

4. Six days after the partnership was created (i.e., on November 8), parents made gifts of 70.06% of the LP interests to the trust for their children (and partly to a custodianship for one child, in order to equalize their prior gifts to custodianships for their other children).

5. About two months later (on January 4, 2000), parents made additional annual exclusion gifts of LP interests to the trust for their four daughters (which they thought were worth $80,000, after applying a 49.25% discount).

6. The following year (on January 5, 2001), the parents contributed more Dell stock to the partnership in return for more LP units, and about a month later (on February 2) they made additional annual exclusion gifts of LP units to custodianships for their four daughters (which they thought were worth $80,000, after applying a 49.25% discount).

7. IRS arguments in its explanation of adjustments in gift tax audits for 1999, 2000, and 2001:
   a. The transfer of assets to the FLP is in substance an indirect gift. (The opinion said that the IRS explanations were the same for all three years, but at trial the IRS made the "indirect gift of proportionate assets" argument only to the gifts made in 1999.)
   b. The transfer of LP interests is more analogous to an interest in a trust, and should be valued as such. (The IRS dropped this argument at trial.)
   c. The transferred interests should be valued without regard to "restrictions on the right to sell or use the partnership interest" in the partnership agreement, citing §2703.
   d. Restrictions on liquidation should be ignored for valuation purposes under §2704(b). (The IRS dropped this argument at trial.)
   e. The amount of the overall discount should be 28%, not 49.25%. [Observe, that the court ultimately allowed even lower discounts (i.e., 22%, 25% and 16.25% in the three different years) than the 28% amount that the IRS allowed in the gift tax audit adjustments.]

Holdings:

1. The gifts made six days after the FLP was formed cannot be viewed as an indirect gift of the shares contributed to the FLP under the gift tax regulations or under the step transaction doctrine.
2. Transfer restrictions in the partnership agreement are disregarded for valuation purposes, under §2703(a), and the §2703(b) safe harbor does not apply because the bona fide business arrangements test and the device test are not satisfied. (As to the comparability test, the court acknowledged that the experts agreed that the restrictions are common in agreements entered into at arm’s length. Because the first two tests in the safe harbor were not met, the court said that it did not need to address a novel argument by the IRS that overall circumstances make it unlikely that arm’s length third parties would agree to any of the restrictions because third parties would not “get into this deal with the Holmans, period.”)

3. Appropriate discounts were considered, and the court ended up significantly closer to the IRS’s position, allowing overall discounts of 22.4%, 25% and 16.25% in 1999, 2000, and 2001, respectively.

Analysis:

1. Indirect Gifts

   a. No Indirect Gift Under Shepherd/Senda Cases. Gift tax regulations provide that contributions to a corporation are treated as indirect gifts of a proportionate part of those assets to other shareholders. Similarly, contributions to a partnership will generally be treated as an indirect gift to the other partners.

   In Shepherd v. Commissioner, 115 T.C.376 (2000), aff’d, 283 F.3d 1258 (11th Cir. 2002), the taxpayer transferred assets to a newly formed FLP in which he was a 50% owner and his two sons were 25% owners. Under the agreement, the contributions were allocated pro rata to the capital accounts of each partner, rather than being allocated totally to the capital account of the contributing partner. The contributions were treated as indirect gifts to each of the two sons of an undivided 25% interest in the assets.

   In Senda v. Commissioner, T.C. Memo. 2004-160, aff’d, 433 F.3d 1044 (8th Cir. 2006), contributions to the partnership and gifts of LP interests were made on the same day. The court could not determine that the contribution occurred before the ownership transfer, and concluded: “At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous.” The contributions were treated as indirect gifts to the other partners.

   The Holman court refused to apply those prior cases, because the contributions to the partnership were clearly made six days before the transfer of the LP interests. In Shepherd, the LP units were transferred before the contribution, and in Senda, the contribution and LP transfers were made the same day and were deemed to have occurred simultaneously. "The facts of the
Shepherd and Senda cases are materially different from those of the instant case...”

b. **No Indirect Gift Under Step Transaction Doctrine.** In Senda, the Tax Court concluded that the contribution to the FLP and the transfer of ownership units at best “were integrated (as asserted by respondent) and, in effect, simultaneous.” The Eighth Circuit, in affirming, stated that the key findings of the Tax Court “show that the transactions here were integrated and simultaneous.” The IRS had argued in Senda that even if the contribution had been made (and allocated to the parents’ capital accounts) earlier in the day than the ownership transfer, there should be no difference. The Eighth Circuit responded to an argument by the taxpayers that the order of the transfers did not matter because the partnership agreements credited contributions to the parents’ capital accounts before being credited to the children’s accounts. The Eighth Circuit rejected that argument, stating: “In some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction.” [The Eighth Circuit observed that the Tax Court had reasoned similarly: “The tax court recognizes that even if the Sendas’ contribution would have first been credited to their accounts, this formal extra step does not matter.”]

The IRS tried to extend the Eighth Circuit’s discussion of the step transaction doctrine to a situation in which the ownership transfer clearly occurred after the formation and funding of the partnership. In light of the Senda background, the IRS argued that the formation and funding of the partnership “should be treated as occurring simultaneously with their 1999 gift of the LP units since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no purpose other than to avoid making an indirect gift ...”

The Tax Court in Holman noted that there are three potential situations when the step transaction doctrine might apply (the binding commitment situation, the interdependence situation, and the end result situation.) The court said that the IRS appears to be arguing that the interdependence test applies, and that test requires that the legal relations created by one transaction would have been fruitless without a completion of the series. The court concluded that while the parents intended to make gifts of LP interests when they formed the FLP, it could not conclude “that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift.” Indeed, the court noted that the IRS did not contend that the step transaction or integrated transaction doctrine
applied to the gifts made in early 2000 (two months after the creation of the FLP) and in 2001.

The court gave two reasons for distinguishing the Senda court’s conclusion that transfers to partnerships coupled with transfers of limited partnership interests to their children on the same day were “integrated steps in a single transaction.” First, the transfers in this case were not made the same day. Second, there is a real economic risk of a change in value of the Dell stock (and the value of the LP interests). The court believed that the IRS conceded that a two-month separation is sufficient to give independent significance to the funding and the gift two months later in early 2000, presumably because of the economic risk of a change in value during the two-month period.

The court raises the interesting question of how much delay is needed. A one day delay would satisfy its first reason for distinguishing Senda. Satisfying the second reason would require enough delay to reflect a real economic risk of a change in value:

“We draw no bright lines. Given, however, that petitioners bore a real economic risk of a change in value of the partnership for the six days that separated the transfer of Dell shares to the partnership’s account and the date of the 1999 gift, we shall treat the 1999 gift the same way respondent concedes the 2000 and 2001 gifts are to be treated; i.e., we shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine.”

The court did acknowledge in footnote seven that the “real risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a six-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond.”

2. **Section 2703**

2a. **Statute and Safe Harbor Exception.** Section 2703(a) provides that the value of any property transferred is determined without regard to any right or restriction related to the property. (The parties agreed that the transfer restrictions constitute restrictions on the right of a limited partner to sell or assign her partnership interest.) Section 2703(b) provides a safe harbor from the application of §2703(a) if each of three requirements are satisfied: (i) It is a bona fide business arrangement; (ii) It is not a device to transfer such property to members of the decedent’s family [the regulations refer to “natural objects of the transferor’s bounty” to make clear that §2703 applies to
gifts as well as death transfers] for less than full and adequate consideration in money or money’s worth; and (iii) Its terms are comparable to similar arrangement entered into by persons in an arm’s length transaction.

(The taxpayer argued that the literal language of §2703, which refers to the “decedent’s family,” should not apply to inter vivos gifts. The court rejected that argument, observing that the taxpayers did not object to the validity of the regulation’s reference to “natural objects of the transferor’s bounty.”)

b. **Flunks Bona Fide Business Arrangement Requirement.** The court acknowledges that this test does not necessarily require an actively managed business. However, the fact that this did not involve a closely held business seemed important to the court’s reasoning. The court discussed *Estate of Amlie*, legislative history, and cases recognizing that maintaining control of a closely held business constitute a bona fide business arrangement.

In *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76, the court recognized that the price set in an agreement for selling a minority interest in a bank to an heir would be recognized, even though the heir resold the shares two months after the decedent’s death for a greater price. As to the bona fide business arrangement test, the court recognized that the agreement hedged the risk of the ward’s holdings and was an element of planning for future liquidity needs of decedent’s estate. The court distinguished Amlie because, even though the agreement in that case involved an investment asset, it addressed a conservator fulfilling its fiduciary duties by hedging risks and providing for expected liquidity needs of the ward’s estate; none of those reasons applied to the Holman transfer restrictions.

Legislative history of §2703 includes a Senate Finance Committee Report which observes that buy-sell agreements

> "are common business planning arrangements ... that ... generally are entered into for legitimate business reasons.... Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance." [The italicized words are my emphasis, and they are referred to below.]

Various pre-§2703 cases have recognized that maintaining control of a closely held business constitutes a bona fide business arrangement, which is a requirement that the courts have long required to recognize the price set in a buy sell agreement for
estate tax purposes. The court emphasizes that "[h]ere, however, we do not have a closely held business."

While the transfer restrictions "aid in control of the transfer of LP units, the stated purposes of the partnership, viewed in the light of petitioners’ testimony as to their reasons for forming the partnership and including paragraphs 9.1 through 9.3 in the partnership agreement, lead us to conclude that those paragraphs do not serve bona fide business purposes." The court concluded:

"There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance Report as justifying buy-sell agreements consistent with petitioners’ goals of educating their children as to wealth management and ‘disincentivizing’ them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares."

[Observe: The court did not address why the phrase “to prevent the transfer to an unrelated party” in the Senate Finance Committee report did not apply here.]

c. Device Test. The court observed at the outset that the transaction was not a “device” to transfer the LP units for less than adequate consideration, in effect reiterating that §2703 is not being applied to disregard the entire partnership for valuation purposes. The issue is just whether the transfer restrictions constitute a device to transfer property to natural objects of the transferor’s bounty for less than full consideration.

The court concludes that the transfer restrictions constitute a “device” under rather strange reasoning. The court reasons that the purpose of the transfer restrictions is to discourage the children from dissipating wealth. The transfer restrictions do that by depriving a child of realizing the difference between the fair market value of his LP units and the units’ proportionate share of the partnership’s NAV. Furthermore, if the partnership exercises its right to purchase a non-permitted assignment at the fair market value of the units (i.e., at their discounted value), it would be able to repurchase units at less than the proportionate NAV of the partnership, which, in turn, would increase the value of the interests of remaining partners (who would include natural objects of the parents’ bounty). The court believed that Mr. Holman

“understood the redistributive nature of paragraph 9.3. [i.e., the partnership’s purchase option] and his and Kim’s authority as general partners to redistribute wealth from a child pursuing an impermissible transfer to his other children. We assume, and find, that he intended paragraph
9.3 to operate in that manner, and this intention leads us to conclude, and find, that paragraph 9.3 is a device to transfer LP units to the natural objects of petitioners’ bounty for less than adequate consideration.”

[Observe that because the bona fide business arrangement test is not satisfied, none of the transfer restrictions are considered in valuing the property transfers. However, the court’s analysis of the device test would invalidate just the repurchase option in paragraph 9.3 under §2703, not the general prohibition on transfers in paragraph 9.1 of the agreement.]

[As discussed below in Item 8 of the Observations, observe that the court’s analysis would cause §2703 to apply to this very common provision in most FLPs, and raises an additional possible argument that the IRS might pursue to argue that §2036(a)(2) or §2038 applies if the parents are general partners of an FLP.]

d. **Comparability Test.** It is interesting that planners typically have believed that the bona fide business arrangement test and the device test can be satisfied with careful planning, and that the comparability test is the most difficult test in §2703(b). However, in this case, the court said that the agreement did not satisfy the first two requirements, and did not directly apply the comparability test.

A law professor testified for the IRS and a practicing attorney who has participated in drafting or reviewing more than 300 limited partnership agreements testified for the taxpayer. Both agreed that “transfer restrictions comparable to those found in paragraphs 9.1 through 9.3 are common in agreements entered into at arm’s length.” [Observe that the court did not insist on testimony about actual agreements involving comparable companies, as suggested in Estate of Blount and Smith, discussed below in Item 10 of the Observations.]

The court observed that this would seem to be all that the taxpayers need to show to satisfy the comparability test. However, the IRS’s expert had testified that the fact that these transfer restrictions were common in agreements entered into at arm’s length was irrelevant because “The owners of a closely held business at arm’s length would never get into this deal with the Holmans, period, so the issue [transfer restrictions] wouldn’t come up.” (The expert pointed to the nature of the assets, the non-expertise of the general partner, the 50-year term, and the susceptibility of the single asset.) The IRS apparently argues that even if the specific transfer restrictions are comparable to restrictions in arm’s length arrangements, there is also an “overall circumstances” consideration as to whether arm’s length third parties would agree to any restrictions on sale or use of assets in the situation. In light
of the fact that the court had already determined that the §2703(b) safe harbor did not apply (because neither the bona fide business arrangement test nor the device test were satisfied), the court concluded that “we need not (and do not) decide today whether respondent is correct in applying the arm’s length standard found in section 2703(b)(3) to the transaction as a whole.”

e. Impact on Valuation. Despite all of the analysis and discussion about the transfer restrictions, it appears that ignoring the transfer restrictions in valuing the LP units had little impact on the value of the gifts. The IRS’s expert did not believe that the restrictions had an impact on value beyond its estimated lack of control and lack of marketability discounts. The taxpayer’s expert believed (as reflected in Appendices A-D to the opinion) that taking paragraph 9.3 (i.e., the partnership’s ability to repurchase any non-permitted transfers at the discounted fair market value of the interest) into consideration would only reduce the value by about 2.4%. However, the IRS’s expert would have determined a value about 16% lower if the purchase option in §9.3 were taken into account. Bear in mind, however, that the purchase option in §9.3 of the agreement in Holman allowed purchase at a value “based on the right to share in distributions,” and that might result in a significantly greater valuation adjustment that the more typical transfer restriction that gives the partnership the right to purchase shares at their “fair market value.”

3. Valuation

a. Net Asset Value Determination. The experts disagreed as to the NAV of the partnership for the 2000 and 2001 gifts. The regulations require that transfers of stocks traded on an exchange must be valued at the mean between the highest and lowest quoted selling prices on the date of the transfer. The taxpayers argued that regulation does not apply because the gifts being valued are partnership interests that do not trade on public markets. The court rejected that notion, observing that the taxpayers provide no authority for disregarding the concept of the regulations in this context.

b. Lack of Control Discount. Both experts determined lack of control discounts by reference to the prices of shares of publicly traded, closed end investment funds, which typically trade at a discount relative to their share of fund NAV, reasoning that the discounts must be attributable, at least to some extent, to a minority shareholder’s lack of control over the investment fund. There was a question as to what samples to include in the analysis, and the court used samples from the intersection of the experts’ data sets. There is also an
interesting discussion of how to keep “outliers” in the samples from unduly impacting the conclusion. The taxpayer’s expert dealt with that concern by using the median sample (i.e., the sample for which half the samples had higher values and half the samples had lower values). (The taxpayer’s expert had not calculated whether this produced a different result than use of the mean, and the court concluded that the IRS’s expert’s approach to dealing with outliers was “more thoughtful.”) The IRS’s expert made its determination after calculating both the mean and interquartile mean (i.e., the mean of the 50 percent of the data points falling between the 25th and 75th percentiles).

The taxpayer’s expert applied adjustments for some qualitative factors, including lack of diversification and professional management. The court rejected any such discounts in this particular situation because the lack of diversification negates any need for professional management. No adjustment to the lack of control discount is needed for lack of diversification because the partnership was “transparently, the vehicle for holding shares of stock of a single, well-known corporation.”

The court settled on lack of control discounts that were closer to the discounts suggested by the IRS’s expert. The lack of control discounts for 1999, 2000, and 2001 were 11.32%, 14.34%, and 4.63%, respectively.

c. Lack of Marketability Discount. The court acknowledged that the value being determined was “more pertinently, assignee interests in the partnership,” and that a discount for lack of marketability should be applied after applying the lack of control discount. Both experts looked to studies of discounts in private placement transactions of restricted stock. The court noted that “[t]hey disagreed principally on the likelihood of a private market among the partners for LP units.”

The taxpayer’s expert believed that the discounts in private placement transactions of restricted shares are the starting point for determining the lack of marketability discount, but that further adjustments should be made because there is virtually no ready market. The taxpayer’s expert increased the discount from median and mean discounts of 24.8 and 27.4% from the restricted stock studies to 35%. The court did not accept that he had any quantitative basis for the amount of the adjustment, and that the adjustment to 35% was just a guess.

The court adopted the approach of the IRS’s expert, who looked initially to the difference in private placement discounts in restricted studies for two periods. (i) For the period before 1990 (when there was a two year holding period under Rule 144 for restricted stock and before institutional investors were allowed to buy and sell restricted stock), the average discount was 34%.
(ii) For the period from 1990 to 1997 (when institutional investors were allowed to buy and sell restricted stock, but before the holding period was reduced to one year in 1997), the average discount was 22%. The difference of 12% “would appear to reflect the discount investors required for having virtually no secondary market.” The appraiser considered whether the discount should be increased to reflect ongoing marketability concerns with LP interests vs. the only two-year restriction that applies in the two relevant periods of the restricted stock studies. The court agreed that no significant adjustment should be made for that factor because the partners can agree to dissolve the partnership at any time and there would be an economic interest to both a limited partner wanting to exit the partnership and the remaining partners “to strike a deal at some price between the discounted value of the units and the dollar value of the units’ proportional share of the partnership’s NAV.” [Observation: Does taking into consideration that the remaining owners may have a special incentive to buy the interest violate the general valuation principle to consider only the hypothetical willing buyer-willing seller?] The court observed that the provision in the agreement allowing consensual dissolution indicates that the preservation of family assets is not an unyielding purpose in this fact situation. The court adopted the 12.5% lack of marketability discount suggested by the IRS’s expert for the 1999, 2000, and 2001 gifts.

d. Overall Discounts. The overall seriatim lack of control and lack of marketability discounts reported by the taxpayer on the gift tax returns was 42.5%, and the IRS gift tax audit report allowed a 28% discount. The court ended up with overall discounts of 22.4%, 25% and 16.5% in 1999, 2000, and 2001, respectively. (In this case, much larger gifts were made in 1999, and the determination of the discount in that year was particularly significant.)

Observations:

1. Continued Trend of Allowing Significant Discounts for Marketable Securities FLPs. The overall discount for this FLP, which held only one publicly traded stock, was significant. In 1999, the year in which most of the gifts were made, the court allowed an overall discount of 22.4%. (The discounts allowed for 2000 and 2001 were 25% and 16.5%, respectively; the discount being much lower in 2001 because of the very low discount reflected in studies of closed-end funds for 2001, which resulted in a very low lack of control discount in 2001.) The court’s analysis suggests that obtaining close to 50% discounts for marketable securities FLPs (particularly one that holds only one stock) is not realistic; but this case continues the almost uniform trend of allowing significant discounts for marketable securities
FLPs. (The case obviously does not include a §2036 issue, because this is a gift tax case, and that is the issue that has generated the most success for the IRS.)

2. Rejection of Integrated Transaction Approach Where Gifts of LP Interests Are Made Soon After Creation. One of the most significant aspects of this case is its rejection of the IRS’s “integrated transaction” approach of treating gifts of LP interests within some period after an FLP is created as being indirect gifts of a proportional value of the assets in the FLP (without a discount). The court concluded that there is independent significance to the formation/funding transaction and the gift transaction as long as there is a “real economic risk of change in value of the partnership” during the period of the delay. The court reached this conclusion even though it concluded that the parents clearly intended to make gifts of LP units at the time the FLP was formed.

Two Year Wait. The case was tried well over two years ago (in December, 2005), and the IRS has been making the “integrated transaction” theory attacks on LP gifts during this intervening period. In light of the long delay, planners anticipated that this would be a Tax Court opinion (rather than just a memorandum opinion) and have been anxiously waiting to see how the Tax Court deals with the IRS’s “integrated transaction” theory for attacking gifts of LP interests soon after (or in some cases, months after) an FLP has been formed. It would be very interesting to know what issues caused the very long delay in order for the judges to come to agreement in issuing the opinion. While this case was issued as a Tax Court opinion rather than as a memorandum case, it was not a “reviewed” opinion, thus accounting for the absence of concurring or dissenting opinions.

3. How Long of a Delay is Needed? The court approved a six-day delay where the FLP asset was a “heavily traded, relatively volatile common stock.” The court said that it might view a six-day hiatus differently for other types of investment that do not realistically change much in value over that short of a time frame (it gives the examples of “preferred stock or a long-term Government bond.”) Another example might be for real estate – which may have very little risk of changed value over a short time period (or even perhaps over a period of several months).

Bottom line: For FLPs that have, as a significant portion of their assets, a portfolio of diversified common stocks, a very short time frame (such as the six-day delay in Holman) should have a real economic risk of a change in value, and should satisfy the “independent significance” test. The court’s reasoning, however, raises a fact question as to how much time delay is needed for there to be a real economic risk of a change in value.
4. **Appeal to Eighth Circuit; Significant in Light of Senda Dictum.** It is the dictum in the Eighth Circuit Senda opinion that raised particular concerns about possible court acceptance of an “integrated transaction” approach. Thus, it is particularly relevant that this case is appealable to the Eighth Circuit Court of Appeals.

5. **Planning Pointer: Delay and Documentation.** Following the Eighth Circuit’s Senda case, the IRS apparently began making the “integrated transaction” argument more often in gift tax audits. There was a report several years ago of the IRS making the integrated transaction argument in a situation where the gift of LP units was not made for eight months after the FLP formation.

Planners have adopted varying approaches in light of this argument. Some respected planners just plan to have at least a one day delay between the FLP formation and the gift, to overcome a Shepherd or Senda argument where there is any uncertainty that the ownership might have happened before or simultaneously with the FLP funding. (Indeed, the full Tax Court, in *Estate of Jones*, 116 T.C. 121 (2001) recognized the effectiveness of gifts of partnership interests made on the same day that partnerships were created, where the facts clearly showed that the gift of LP units was made after the funding of the FLP. However, the IRS has argued in subsequent cases that it did not make the “integrated transaction” argument in Jones, so the court obviously did not consider it.) Other planners have been more conservative, and wait at least six months before making ownership transfers.

One respected planner’s recommendation: Make clear that assets are held by the partnership and verify that before making gifts of limited partnership interests. While the planner may discuss with the client the possibility of making gifts, do not discuss with the client how much the client wants to give when the FLP is created. Leave that as an open question so no one can argue that there was a step transaction or prearranged transaction.

In light of the reasoning in Holman, it probably makes sense to wait more than just one day before making gifts of LP units, to leave time for a “real economic risk of a change in value.” However, for an FLP holding a single volatile stock, a delay of as little as one week should be sufficient. For an FLP holding a portfolio of common stocks, there may be less volatility than for a single stock, and query whether a delay of longer than a week would be necessary? However, even diversified stock portfolios can have significant value changes over a week. For an FLP that holds only real estate, planners may want to consider a longer delay, in light of the fact that real estate values typically do not change measurably over a very short period of time.

However, at least before seeing the result of a possible appeal to the Eighth Circuit, conservative planners may want to continue following
the more conservative approach adopted by some planners, as described above.

6. **How to Make Additional Contributions to an Existing FLP.** Shepherd treated additional contributions to an existing FLP as indirect gifts to the remaining partners of a proportional part of the contributed assets (without a discount). However, in that case, the additional contributed assets were allocated directly to all of the partners’ capital accounts proportionately. It is interesting that the IRS did not even argue that additional contributions to the Holman FLP in early 2001 resulted in indirect gifts (without a discount) to the remaining partners, where the parents received new LP units in return for their additional contribution to the FLP.

Planning Pointer: To avoid the indirect gift treatment, it is critical that any additional contribution of assets to a partnership is treated as a contribution in return for additional interests in the partnership to that contributing partner. (However, various private rulings reasoned that merely booking additional contributions to the transferor’s capital account is not sufficient. TAM 200432015 & 200212006.) The additional percentage interest allocated to the partner (and the resulting increase in that partner’s capital account) should be documented carefully in the instrument of conveyance making the contribution to the partnership. A separate instrument should document the subsequent gift of limited partnership interest. (The court in *Senda* gave little weight to gift assignment documents that were not signed for weeks [or even years] later.)

7. **Bona Fide Business Arrangement Test Under §2703 May Be Hard to Meet For Transfer Restrictions in Many FLPs.** For many years, cases involving the effectiveness of the price set in buy-sell agreements have considered a similar bona fide business arrangement test, and have almost uniformly found that planning for continuity of ownership satisfies the bona fide business arrangement test. In *Estate of Amlie*, the IRS argued that the settlement agreement regarding the purchase of the ward’s bank stock at the ward’s death could not meet the bona fide business arrangement test because the bank stock “was not an actively managed business interest but merely an investment asset.” The court rejected that argument, and found that hedging the risk of a fiduciary’s holdings and planning for future liquidity needs constitute sufficient “business purposes” for purposes of this test.

The court also cited legislative history. Interestingly, the court says that “the reasons set forth in the Committee on Finance Report” do not apply, without addressing specifically why the “to prevent the transfer to an unrelated party” phrase does not apply. That seems to be directly related to the purpose of the transfer restrictions.

Despite the decision in *Amlie* finding the existence of a sufficient “business arrangement” in a situation involving investment assets, the full Tax Court here refuses to find a sufficient business purpose,
and emphasizes that there is no closely held business (although the court begins its discussion with an acknowledgement that an “actively managed business” is not required).

The effect of Holman is that providing for continuity of ownership or control of who becomes a successor partner is not a sufficient business purpose for this test where there is not a closely held business. A stricter test is applied where there is not a closely held business. We do not know precisely what the test is in that situation. In Amlie, an agreement that required a sale of stock at a set price to hedge risks and to provide for liquidity was a sufficient business purpose. Even in that situation, if the agreement merely established transfer restrictions, those purposes would not have applied to the transfer restrictions. The court says that the purposes of “disincentivizing” children from getting rid of specific partnership assets, of spending the wealth represented by partnership assets, or feeling entitled to partnership assets, or educating children about family wealth are not sufficient purposes for this test. (This is reminiscent of the position in several cases [before Mirowski] that factors related to facilitating gifts are not sufficient “legitimate and significant non-tax reasons” to apply the bona fide sale exception to §2036.)

As a practical matter, those are the purposes served by having transfer restrictions in an investment FLP that is being owned or transferred to younger family members. The court’s reasoning raises a huge question as to whether transfer restrictions can be considered in valuing shares in many (if not most) FLPs that do not involve actively managed businesses. (However, as discussed in Item 12 below, there may be very little valuation impact by ignoring transfer restrictions in the agreement for valuation purposes.)

8. **Device Test Analysis Seems Misguided; If the Court is Correct, Many Transfer Restrictions and Buy-Sell Agreements Will Not Be Respected Under §2703 Even For Actively Managed Businesses.** The court reasons that transfer restrictions prevent an LP from realizing full value of a proportional part of the FLP’s assets. Furthermore, the entity’s ability to acquire any interest that is purportedly transferred in contravention of the agreement based on the fair market value of the interest (presumably with discounts) means that the value of the remaining partners’ interests will increase in value. Critical to this analysis is that the parents (who are the donors of the gifts) are the ones who can decide on behalf of the partnership to exercise the purchase option, and thereby redistribute value to the other owners for less than full consideration.

An example may help. Assume that an FLP has a NAV of $1,000. Assume that the parents own 10 units of ownership and that three children each own 30 units of ownership. Assuming a 25% discount for the units, each child’s value would be $1,000 x 30% x 75% [reflecting a 25%
discount], or $225. If one child attempts to transfer his units without getting consent, (and if the transfer is deemed to be effective despite the prohibition in the agreement), the partnership could purchase those units, at their discounted value of $225. The partnership would now have a $1,000 - 225, or $775 NAV. After the redemption, there would be 70 ownership units outstanding, and each remaining child would own 30/70, or 42.86% of the partnership units. Each remaining child’s units would be valued at $775 x 42.86% x 75%, or 249.11. Thus, the court’s conclusion is right in that an exercise of the repurchase option would increase not only each remaining child’s proportionate share of the partnership’s NAV but also each remaining child’s fair market value of the LP units themselves.

The purchase option under §9.3 was somewhat unusual in allowing the partnership to purchase the transferred shares at a value based on their right to share in distributions. That provision likely would result in a lower value than a mere purchase option at “fair market value.” However, the court’s analysis of the device test did not refer at all to the special valuation provision in §9.3, but just referred to the ability of the partnership to purchase the units at less than their proportionate share of the net asset value of the partnership (which would apply to most transfer restrictions that give the entity the right to purchase transferred shares at their fair market value [i.e., considering appropriate discounts]).

If the Holman court’s approach is correct, many buy-sell agreements, even for active businesses, would not be respected under the §2703 safe harbor. If the parents hold offices in the entity or own sufficient ownership to control (or perhaps even to impact) the decision to exercise any available purchase option that arises upon a purported transfer that is not permitted under the agreement, the parent could redistribute value for less than full and adequate consideration, which in the court’s opinion would flunk the device test. That would be a huge surprise to planners of buy-sell agreements, and is a totally novel approach to viewing the long held requirement applied by case law of requiring that the agreement is not a device to transfer value to natural objects of the decedent’s bounty for less than full consideration. (That test has historically been applied by looking primarily to the fairness of the purchase price or formula for determining the purchase price that is set in the agreement.)

Perhaps application of the Holman approach to buy-sell agreements would just mean that the transfer restriction and repurchase option would not be given effect for valuation purposes under §2703, but that the requirement of purchasing an interest in the entity at a determined purchase price upon the occurrence of a triggering event (such as death) would be respected. However, even a redemption at death for the fair market value of an owner’s interest rather than at a full proportional value of the entity’s NAV will have the effect of increasing the value of the remaining owners (for no additional
consideration from them), which could arguably invoke the court’s reasoning. If the only restriction in an agreement is a prohibition on transfers that allows the entity to purchase transferred shares at their fair market value, the agreement may have little impact on valuation. In that case, the court’s reasoning could lead to the anomalous result that the §2703(b) safe harbor would not apply [because of failing the device test] even though the agreement had little if any effect on value, so that there would be no valuation difference even if §2703(a) applied.

The court’s reasoning (i.e., that the parents have the power to redistribute wealth among their children for no consideration in the event of an impermissible transfer) raises the specter of whether these types of very common transfer restrictions with purchase options for impermissible transfers might give the IRS an additional argument to cause §2036(a)(2) or 2038 to apply if parents are the general partners (and therefore can control or impact the decision of whether the partnership will exercise its purchase option).

9. Novel Approaches Under §2703; Possible Treatment as Dictum. It is interesting that the analysis under one of the two tests is dictum, in that flunking either test means that the safe harbor is unavailable. Having decided that the bona fide business arrangement test was not satisfied did not keep the court from also finding that the device test was not satisfied either (under a novel theory). Of course, the alternate findings may be important if the appellate court reverses on one of the tests but not the other. However, the Tax Court did not feel similarly inclined to address a novel theory posed by the IRS with respect to the comparability test.

10. Reasonable Approach to Evidence Required to Satisfy Comparability Test Under §2703. Almost all cases that have addressed the §2703(b) safe harbors have ended up having an extended discussion of the comparability test with little discussion of the bona fide business arrangement or device test. This case is the opposite.

The case is a welcome development with respect to the evidentiary standards for satisfying the comparability test, by reflecting a reasonable approach of evaluating opinions of experts as to whether certain types of transfer restrictions (or presumably other provisions in buy-sell agreements) are comparable to provisions in agreements among unrelated parties generally, without requiring expert testimony of specific examples of other agreements. This is a welcome change from the approach of several other cases that have addressed the comparability requirement.

In Estate of Blount v. Comm’r, T.C. Memo. 2004-116, aff’d in part, rev’d in part, 428 F.3d 1338 (11th Cir. 2005), the court applied the comparability test very strictly. To meet the comparability test, the court wanted to see (1) buy-sell agreements actually negotiated in arm’s length situations under similar circumstances and in similar business, and (2) that are comparable (as to term of agreement, present value of property, expected value at time of exercise, and
consideration offered for the option) to the terms of the agreement being tested. The Tax Court found that the estate’s expert testimony was not sufficient. The expert said that a four times earnings multiple is typically used to value construction companies and in three purportedly comparable companies he examined. The court said the companies were not really comparable. Furthermore, the court noted that the expert did not base his opinion on actual agreements involving comparable companies: "He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, actually entered into by persons at arm’s length...Because Mr. Grizzle has failed to provide any evidence of similar arrangements actually entered into by parties at arm’s length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent’s BBC shares was set at fair market value, Mr. Grizzle’s conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm’s length is unsupportable." (emphasis added) Finding comparable buy-sell agreements (which are inherently very private documents) could be very difficult. Furthermore, the court wants evidence that the terms are similar to agreements in the general practice of unrelated parties, and not just isolated comparables. This would seem to be a very difficult evidence burden that the court is imposing. The court found that the comparability test was not met in this situation, where the agreement provided a set price of $4 million compared to a book value (which was the formula price under a prior agreement) of $7.5 million. The price would not be adjusted over time by a formula. The Eleventh Circuit found no error with the lower’s analysis of the comparability factor. Another court similarly refused to accept affidavits of attorneys that the court viewed as being merely conclusory in nature. Smith v. Commissioner, 94 AFTR 2d 5283 (W.D. Pa. 2004). The court suggested a high standard of proof to satisfy the comparability test:

"In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arms' length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties... Nevertheless, Plaintiffs have submitted the affidavits of two attorneys...who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties... Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3)."
11. **Comparability Test; Novel Theory.** The court did not address the novel theory of the IRS that the transfer restrictions did not meet the comparability test because no arm’s length third person would enter the arrangement at all (to tie up an investment for 50 years in a partnership holding one publicly traded stock presenting nothing particularly special to justify such a restrictive investment). The IRS expert testified that the specific transfer restrictions themselves were very commonly used in arm’s length arrangements but “that was beside the point.” The IRS argued that there an “overall circumstances” test that should be applied, rather than just looking to whether particular restrictions themselves are commonly used. The court declined to address that novel theory. However, it is one that is likely to re-appear in future cases.

12. **Refusing to Recognize FLP Transfer Restrictions Under §2703 May Have Little Impact on Value.** The court held that transfer restrictions could not be considered in valuing the gifts of LP units, because of §2703. The transfer restrictions in the agreement added several elements that are not present under state law. The agreement purported to prohibit transfers absolutely without consent of the other partners, rather than just requiring consent of the partners to recognize a successor owner as a full partner rather than just as an “assignee.” Also, the agreement added that the partnership could elect to purchase at fair market value (i.e., the discounted value) an interest that is impermissibly transferred.

The court obviously did allow appraisers to consider the other restrictions on the rights of limited partners under general state law principles, in light of the fact that the court found that significant lack of control and lack of marketability discounts applied. The opinion nowhere suggested what kind of value adjustment would be attributable to the prohibition on transfers under paragraph 9.1 of the agreement. However, as to the repurchase option under paragraph 9.3, the IRS expert believed that the restriction would have no impact at all on value. The taxpayer’s expert believed that considering the paragraph 9.3 provision would reduce the value by about 2.4%. (For example, Appendix B reflects that, for the big gift made in 1999, the value would be $1,096,360 if paragraph 9.3 is considered and $1,123,769 if it is not considered. The percentage difference is 27,409/1,123,769, or 2.4%) The appendices indicate that the IRS’s expert would have valued the shares about 16% lower taking into account the special valuation provision in §9.3.

Of course, a determination that the price set in a buy-sell agreement would not be respected under §2703 can have a huge impact on value. But just ignoring specific transfer restrictions in a limited partnership agreement may have limited significance.

13. **Determine Marketability Discounts Based on Limited Market for “Assignee” Interests.** Several prior cases have had an extended discussion of whether to value transferred interests as mere assignee interests or as full limited partnership interests. Astleford, Estate of Dailey, Kerr, and Estate of Jones all valued the transfers as
limited partnership interests, and Estate of Nowell valued the transferred interest as an assignee interest. The court did not address this issue, but interestingly made the following observation at the beginning of its discussion of the marketability discount:

“The parties agree that, to reflect the lack of a ready market for LP units (or, more pertinently, assignee interests in the partnership) ... an additional discount ... should be applied ....” (emphasis added).

If the marketability discount is determined based on the value of an assignee interest in any event, it would seem to make little valuation difference whether the transferred interest is viewed as a partnership interest or as an assignee interest.

14. Dropped Arguments. Dropped arguments may be very insightful as to what issues that the IRS is continuing to pursue in audits and litigation. The IRS originally argued that an interest in the partnership should be viewed as an interest in the trust. In addition, the IRS originally argued that liquidation restrictions in the agreement should be ignored under §2704(b). The IRS subsequently dropped both of those arguments.
STATUS OF BENEFICIARY’S CREDITORS UNDER THE UTC (ARTICLE 5) AND THE RESTATEMENT 3RD OF TRUSTS
CURRENT NON-TAX DEVELOPMENT
IRS GATEKEEPER INITIATIVES

NON-TAX ESTATE PLANNING CONSIDERATIONS GROUP

PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES

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- American Bar Association
- Vice-Chair ABA Asset Protection Planning Committee
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IN THE NEWS:

- Interviewed and Quoted “Families Increasingly Turn to Trusts to Protect Assets, Inheritances from Ex-Spouses” Wall Street Journal, September 22, 2005.
- Featured in July, 2006 by Forbes In-Flight Radio & Sky Radio as one of “America’s Premier Lawyers.”

SELECTED PUBLICATIONS & PRESENTATIONS:

SELECTED PUBLICATIONS & PRESENTATIONS (CONT.):

**Playing Defense: What Estate Planners Need to Know About Asset Protection**
42nd Annual Southern Federal Tax Institute
Southern Federal Tax Institute
Atlanta, Georgia – October 4, 2007

**Asset Protection Planning for the Family Business Owner**
Estate Planning for the Family Business Owner
ALI-ABA (American Law Institute – American Bar Association)
San Francisco, California – July 12, 2007
Chicago, Illinois - July 21, 2006
Boston, Massachusetts - July 15, 2005
Santa Fe, New Mexico - July 24, 2004

**Wealth Protection Planning in Today’s Litigious Society**
Asset Protection Planning Update
ALI-ABA (American Law Institute – American Bar Association)
Teleconference and Live Video Webcast – June 26, 2007

**Asset Protection Strategies in Today’s Litigious Society**
34th Annual Midwest Estate Tax & Business Planning Institute
Indiana State Bar Association
Indianapolis, Indiana – June 15, 2007

**Consolidating a FLP or FLLC with a Self-Settled Trust to Enhance a Client’s Wealth Preservation Strategies.**
Advanced Estate Planning Techniques
ALI-ABA (American Law Institute – American Bar Association)
Maui, Hawaii – February 24, 2006

**Asset Protection Strategies for Real Estate Owners**
64th Institute on Federal Taxation
New York University School of Continuing & Professional Studies
New York, New York – October 26, 2005

**“Hot Topics” in U.S. Offshore Tax Compliance & Enforcement**
Swiss German & Liechtenstein Branch
Society of Trust and Estate Practitioners (STEP Switzerland)
Zurich, Switzerland – October 5, 2005

**Premarital Planning Without a Premarital Agreement**
Annual Spring CLE Conference
American Bar Association Family Law Section
Austin, Texas – April 14, 2005
# PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES

Mario A. Mata

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PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES

By: Mario A. Mata

I. INTRODUCTION

Most business and estate planning professionals have come to the realization that attempts of Congress to either repeal or drastically modify the existing estate and gift tax law are basically on hold, possibly until after the presidential elections in 2008. However, significant recent developments, most of which have nothing to do with estate planning, could potentially have a significant effect on the clients of estate planning practitioners. In fact, some of the recent events will affect clients who are not subject to gift or estate taxation under the law as it exists today. Yet, these recent developments can have a potential significant effect on the estate planning that is currently undertaken for clients. Three particular areas of law which should be of particular concern to estate planning practitioners involve the following recent developments:

- Recent successful attacks on testamentary and other spendthrift trusts by creditors, divorce courts, bankruptcy trustees and the IRS, a trend that has gained momentum because of recent amendments to the status of a beneficiary’s creditors under the Uniform Trust Code and the Restatement of Trusts, 3d.

- Recent successful attacks on family limited partnerships and family limited liability companies by bankruptcy trustees who have succeeded in ignoring the governing documents and even state law by becoming full voting partners or members upon the bankruptcy filing by what is usually a bankrupt family member.


**Attacks on Spendthrift Trusts.** Although spendthrift trust protection for a beneficiary’s interest in a spendthrift trust is provided by statute or common law in all states, many estate planning practitioners are unaware of the success that creditors have had in piercing structures that have historically been thought to have been immune from third-party attack. Such piercing of the spendthrift trust veil has become so common that they were recently codified into the Restatement of Trusts, 3d, issued in 2003, and more recently, into the proposed Uniform Trust Code, as amended.

This recent trend in successful challenges to spendthrift trusts should be of particular concern to estate planning practitioners who have used such structures for decades without fear of creditors being able to reach the interest of a trust beneficiary. Since all such trusts are typically testamentary or irrevocable inter vivos trusts, it is usually impossible, short of court action, to amend such trusts. Nevertheless, estate planning practitioners should be aware of this recent trend in attacks against spendthrift trusts, particularly when drafting such trusts for existing and future clients. In most cases, proper drafting can help to avoid many of the situations that have resulted in courts piercing a traditional spendthrift trust.

**In Re: Ehmann and its Progeny.** The unexpected success of the Internal Revenue Service in cases such as *Estate of Strangi v. Commissioner* has resulted in estate planning
practitioners having to face the reality that FLP and FLLC planning structures will come under heavy scrutiny in the future. In fact, there is very real likelihood that many of the FLP and FLLC structures formerly organized by estate planning practitioners will no longer achieve their intended benefits when subjected to the stringent requirements of *Stranjan* and its progeny. However, there is another recent threat to such entities.

Although the provisions of Bankruptcy Code §541(c)(1) have been on the books for decades, only recently have bankruptcy trustees used it successfully to avoid the restrictions on ownership usually found in a typical family limited partnership or related entity. As a result, the Bankruptcy Code has rendered such restrictions inapplicable. Specifically, courts have found that a bankruptcy trustee has all of the rights and powers with respect to the estate planning entity that the debtor held as of the commencement of the case. In other words, the bankruptcy trustee stepped into the shoes of the bankrupt debtor member or partner as a *full partner or member* of the FLP or LLC, not as an assignee. As such, the courts have found that the bankruptcy trustee had every right that the partner or member had to complain about those transactions that had occurred within the estate planning vehicle prior to his bankruptcy filing, which is exactly what trustees have attempted to do in some cases by suing the management of the estate planning entity.

**2005 Bankruptcy Reform Act.** Many estate planning professionals have not had an opportunity to fully evaluate the potentially devastating effects that recently enacted bankruptcy reform could have on clients that suddenly find themselves involved as a debtor in bankruptcy proceedings. The Bankruptcy Abusive Prevention and Consumer Act of 2005 ("2005 Bankruptcy Reform Act") should encourage all estate planning professionals to re-evaluate a client’s overall wealth preservation options and strategies, for the benefit of the client and the client’s family, should an unexpected catastrophic financial event occur, something all too common in today’s litigious society.

The bankruptcy reform legislation lingered in Congress for eight years before it finally passed by Congress and eventually signed by President Bush on April 20, 2005. The legislation was heavily promoted by credit card companies, credit unions and banks with the primary goal of forcing debtors to repay a portion of their indebtedness, according to their ability to pay, rather than to automatically allow debtors to discharge their consumer debt by filing for Chapter 7 bankruptcy protection and discharging of their debts (except for those that cannot be discharged in bankruptcy). However, while the legislation was certainly designed by the finance industry to minimize its losses in the consumer debt arena, the primary provisions of the 2005 Bankruptcy Reform Act are equally applicable to high net worth individuals who may find themselves in bankruptcy proceedings as a result of an unexpected financial setback. Should that happen, the unfortunate client, now a debtor in bankruptcy, may be shocked to learn that he will likely be required to pay his disposable income to a bankruptcy trustee for five years, based primarily upon a definition of disposable income using IRS National and Regional Standards. For professionals, executives and other persons at risk with lifestyle commensurate with their earning capacity, the requirement that the bulk of their income be paid to a bankruptcy trustee for five years will leave the individual with only a fraction of the cash flow that they were accustomed to prior to being forced into an involuntary bankruptcy. The net effect will be a drastic lifestyle change that will affect, not only the client in bankruptcy, but his family and other dependants as well.

**Estate Planning includes Asset Protection Planning.** Even before bankruptcy reform, the use of wealth preservation planning to legally maximize the protection of a client’s personal
wealth had already gained new recognition and acceptance as a result of today’s litigious society. Now, more than ever, any business or estate plan requires a careful review and analysis of the risk associated with the client’s activities and business holdings.

Every client, no matter how small, should give serious consideration to wealth preservation planning that maximizes the use of the client’s personal exemptions available in his or her state. Some states, such as Texas and Florida, have historically had very liberal exemptions. The 2005 Bankruptcy Reform Act may make some of those exemptions unavailable to a debtor in bankruptcy. However, other domestic wealth preservation options are available to protect family assets from a variety of potential claims. If properly structured, including the use of favorable law in one of several states that have such legislation, vehicles such as family limited partnerships and limited liability companies can provide a client with a reasonable amount of protection, both for the assets owned by such entities and the ownership interest owned by or for family members. Under certain circumstances, domestic trusts can also provide a significant benefit and advantage in protecting personal assets from creditor claims.

For clients with very significant liquid assets at risk, a client’s advisor and other professionals should consider the benefits, goals, issues and risks involved in establishing a domestic or international wealth preservation trust as part of a comprehensive asset preservation plan for the wealthy client, business owner or executive with significant business holdings or investments. The benefits of a domestic or international wealth preservation trust are all too obvious in those situations when a client without a domestic or international wealth preservation trust, but with substantial assets at risk, becomes a defendant in a serious lawsuit. If such a client has not already protected his or her assets with a domestic or international wealth preservation trust, the client could face financial ruin.

Unfortunately, many clients and their advisors never consider the benefits of comprehensive wealth preservation strategies until it is too late. A client’s advisor should be prepared to adequately advise the client at risk about all of the various asset protection options, both domestic and international, available to the client and the client’s family. The business owner or executive turned defendant by a major lawsuit is unlikely to question the merits or moral significance of protecting one’s assets with a lawfully implemented wealth preservation strategy, whether it be domestic or international. If the client has not already protected assets prior to the threat of litigation arising, the client is more likely to ask why his lawyer did not advise him to at least investigate the merits of using available asset protection strategies to protect the client’s personal assets. In fact, it is this author’s belief that failure to so advise a wealthy or at risk client may constitute malpractice if the client’s assets are needlessly exposed to a subsequent judgment or other legal claim.

This paper will focus on the recent risks to traditional estate planning structures and the primary strategies available to an estate planner to avoid such pitfalls while achieving lawful wealth preservation and tax planning for the client. Also included is an extensive discussion of how existing estate planning strategies, including family limited partnerships (“FLP’s”) and family limited liability companies (“FLLC’s”) can be incorporated with a self-settled trust to maximize the protection of assets by providing several layers of protection for the client at risk while enhancing the estate planning benefits of an existing or proposed estate planning strategy. For wealthier clients, such wealth preservation structuring can be organized offshore where the client can legally maximize the asset protection goals of their overall wealth preservation strategy.
II. DOMESTIC TRUST PLANNING

The domestic trust has been successfully utilized by practitioners as a crucial estate planning and wealth preservation planning tool for decades. Despite restrictions on the ability of a settlor to retain an interest in a trust, a properly structured irrevocable trust, where the grantor has “cut the strings” in terms of benefit and control, has been, and still can be, successfully used to preserve the assets of the grantor for the benefit of his family.

A popular estate planning strategy often involves limited partnership interests that have been gifted to family members. If the family members own the limited partnership interests in their individual capacities, their interests are subject to their own individual creditor claims, although the charging order limitations discussed in this paper certainly provide some protection and relief from such creditor action. However, another insulation of protection for the limited partnership interest can be obtained if the gift of the limited partnership interest is made to an irrevocable domestic trust rather than to the family member directly. There are several advantages to such a strategy.

- **Preservation and Oversight of Interest Gifted to Heir** – The love and affection recited in a gift deed or assignment should not be misconstrued as an endorsement by the parents of a child’s ability to manage large sums of cash and other assets distributed by a family business entity. By gifting the ownership interest into a domestic trust for the benefit of the family member, a trustee, often a trusted family member, can use his or her best discretion in making distributions to the beneficiary-heir while preserving undistributed funds for the benefit of the future needs of the beneficiary or his or her descendants.

- **Asset Protection Claims Against Children** – If the trust is not involved in any other activity that would subject it to litigation risks, the limited partnership interest transferred to the domestic trust for the benefit of the family member can effectively be protected from the potential creditor claims of the donee family member.

- **Protection From Future Spouses** – Likewise, having the trust own the ownership interest transferred to the domestic trust will protect the donee family member from the claims of future spouses or, if clearly structured as a gift intended to be separate property, from the claims of an existing spouse. This is particularly true in approximately 12 “equitable distribution states” where a divorce court has the power to invade an individual’s separate property to award such property to a party in the divorce who the court feels is not at fault in the marriage and will be at an economic disadvantage in attempting to pursue a post-divorce livelihood in light of his or her diminished earnings capacity or net worth. In other words, if a divorce court in such states feels that it is “equitable” to distribute a significant amount of an individual’s separate property to the other spouse, such courts are free to do so if it is necessary in order to reach an “equitable” allocation of assets as part of the dissolution of the marriage. Likewise, in many of those same states, a surviving spouse can “elect” to take against a decedent’s Will by electing to take a percentage of the decedent’s estate in excess of what was provided for in the decedent’s Will, even if that should
mean invading what is clearly the decedent’s separate property in order to fund the “surviving spouse” election.

- **Estate Tax Planning Opportunities** – A properly structured testamentary trust is often provided for in a client’s Will for the benefit of the decedent’s children or other heirs. While such trusts can and often are drafted to terminate once the beneficiary reaches a certain age, a testamentary trust can also be drafted to last for the lifetime of the beneficiary with the intention that the beneficiary exercise a limited power of appointment, upon his or her death, to leave his or her assets of the estate to such heirs as that beneficiary may elect. If properly structured, such an election can be exercised without risking the possibility that the assets of the testamentary trust will be included in the decedent’s taxable estate. Unfortunately, it is in these types of trusts, particularly when a beneficiary can elect to become his own trustee at a particular age, that courts are more likely to find that the trust can be pierced to satisfy creditors or divorce court claims.

While the strategies discussed above assume a simple wealth preservation strategy, designed to protect the donee from a variety of potential claimants, a domestic trust can be structured to include significant estate tax benefits such as the use of a domestic “dynasty trust,” designed to last for generations in a jurisdiction that has abolished or significantly curtailed the Rule of Perpetuities. The benefits are achieved by allocating to the trust a portion of the client’s GST exemption to any gifts to the trust.

- **A. Spendthrift Trust.** One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one that provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The enforceability of a spendthrift trust is usually recognized by state statute which provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a “spendthrift trust” is usually sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary.

Historically, since 1959 until recently, the general rule involving the protection of a beneficiary’s interest in a spendthrift trust was found in the Restatement of the Law, 2d, Trust, published in 1959 by the American Law Institute.

1. **Restraint on Alienation of Income.** The Restatement of Trusts, 2d, provided in §152(1) the right of a beneficiary to receive income from a spendthrift trust was specifically protected from alienation. Specifically it provided that:

   (1) Except as stated in §§ 156 and 157 [of the Restatement], if by the terms of a trust the beneficiary is entitled to the income from the trust property for life or for a term of years and it is provided that his interest shall not be transferable by him and shall not be subject to the claims of his creditors, the restraint on the voluntary and involuntary transfer of his right to the income accruing during his life is valid.

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A trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed is a spendthrift trust.

The sole exceptions to the general restraint on alienation of §152 were found in §156 and §157. Section 156 relates to the situation where the settlor is also beneficiary of the trust, in other words, a “self-settled trust” which, to this day, is not favored by the Restatement, although now recognized in eight states. The second general exception to the general rule of §152 is found in §157 which relates to particular classes of claimants who can reach the interest of the beneficiary of a spendthrift trust. Such claimants generally fall into the category of the wife or child of the beneficiary who pursue a claim for spousal or child support or alimony.

2. Restraint on Alienation of Principal. While §152 of the Restatement of Trusts, 2d addressed a restraint on the alienation of income, §153 addressed the restraint on alienation of principal. Specifically, §153 of the Restatement 2d of Trusts provided that:

(1) Except as stated in §§ 156 and 157, if by the terms of a trust the beneficiary is entitled to have the principal conveyed to him at a future time, a restraint on the voluntary or involuntary transfer of his interest in the principal is valid.

(2) If the beneficiary is entitled to have the principal conveyed to him immediately, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.

(3) If the principal is not to be conveyed to the beneficiary during his lifetime, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.

The two referenced exceptions to the general rule are identical to those found in §152. Thus, subject to the exceptions of §§ 156 and 157, a trust beneficiary was entitled to have the beneficiary’s interest in the principal of the trust protected against voluntary or involuntary transfer if by the terms of the trust the beneficiary was entitled to have principal conveyed to him or her at a future time. Such a principal would essentially ensure that the corpus of the trust that, at some future point in time, might become available to the beneficiary, was protected against alienation prior to the occurrence of that event.

Under a discretionary trust, the beneficiary is entitled only to the income or principal that the trustee, in her discretion, shall distribute to him. G. Bogert, The Law of Trusts and Trustees § 228 (2d ed. 1979). The beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for his use any part of the trust property, nor can a creditor of the beneficiary reach any part of the trust property until it is distributed to the beneficiary. Id.

B. Discretionary Trust. A discretionary spendthrift trust provides even greater protection to its beneficiaries than a regular spendthrift trust. In a discretionary trust, the trustee has sole and absolute “discretion” to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the
creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors.\(^1\) However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process.\(^2\) Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute “property” within the normal meaning of state statutes defining property which is available for execution.\(^3\)

In *First Northwestern Trust Co. v. IRS*, infra, the Eighth Circuit Court of Appeals declined to allow the claim of the Internal Revenue Service to reach the interest of beneficiaries in a family trust where the trustee had broad discretionary powers. The court held that the rights of the beneficiaries were contingent upon the discretionary authority of the trustee. The trust agreement gave the trustee the authority to distribute the trust funds in unequal amounts, and the agreement specifically provided that the trustee was only obligated to disburse “such amounts as in the sole discretion of the Trustee as necessary, reasonable and proper, to such members of the [settlor’s] family requiring such funds upon proper proof of such need to the satisfaction of the Trustee . . . The court found that there was no identifiable or ascertainable interest or right in the income until those two contingencies were met.

C. Disadvantages of Domestic Trust. Despite their relatively good track record for asset protection purposes, there are two significant problems associated with the use of domestic trusts.

1. Rule Against Self-Settled Trust. One of the reasons why so many domestic trusts are established for the benefit of a grantor’s family is directly attributable to statutes found in most states prohibiting a settlor from establishing a valid spendthrift trust for his own benefit. For example, in Texas the prohibition against self-settled trust is found in §112.035 of the Texas Property Code. It provides that, “If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate.” While the foregoing language prohibits a settlor of a trust from protecting his interest in the trust against his creditors, some consolation can be taken by the settlor in the fact that language such as the foregoing has been regularly interpreted to mean that a creditor can only reach the settlor’s interest in the trust. Thus, if the settlor is entitled to receive a distribution of income from the trust, a creditor will be successful in reaching such income distributions. However, if properly structured, a self-settled trust may be able to protect its remaining corpus, theoretically for the benefit of future contingent beneficiaries of the domestic trust.

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\(^1\) *First Northwestern Trust Co. v. IRS*, 622 F.2d 387 (1990).

\(^2\) *First Northwestern Trust Co. v. IRS*, *infra* at 391.

\(^3\) *First Northwestern Trust Co. v. IRS*, *infra* at 392.
2. **Domestic Trusts Are Subject to U.S. Jurisdiction.** The fact that a domestic trust is located within the United States makes it a natural and easy target for creditor lawsuits. There are a variety of reasons why a settlor might want to avoid locating a trust within the United States.

   a. **Personal jurisdiction.** If a domestic trust is already here, it is impossible for it to avoid becoming a target of litigation. Unlike a foreign situs trust with no presence in the United States, it is impossible for a domestic trust to claim that a court in the United States does not have jurisdiction over its assets or the trustees. Thus, even if a lawsuit is frivolous, the trustees of the domestic trust have no choice but to incur the expenditures necessary to defend the trust.

   b. **Confidentiality.** Secrecy should never be a necessary part of a successful wealth preservation plan. Nevertheless, the high financial profile of most clients involved in wealth preservation planning makes confidentiality an important goal of many potential settlors. If a domestic trust is sued, literally all of its records and communications, except items privileged by law, are subject to discovery.

3. **Trust Assets Are Subject To Court Control.** A domestic trust, its trustees, and its assets, are subject to the whims of state and federal judges. In some cases, U.S. courts have been known to instruct trustees to take actions which are clearly in contravention of the well-documented wishes of the settlor.

III. **ATTACKS ON SPENDTHRIFT TRUSTS BY CREDITORS, DIVORCE COURTS, AND THE IRS**

   As indicated above, the protection afforded the beneficiary’s interest in a non self-settled spendthrift trust is provided by statute in most states and common law in the remaining states. It is a concept that, until recently, has been unchanged since the initial adoption of the English common law rule. However, a small but growing number of disturbing cases reflect a growing willingness by the courts to disregard the spendthrift protections provided by state law thus allowing a creditor or divorcing spouse to reach the assets of a spendthrift trust.

   To make matters worse, the concepts that have developed in case law which allow the piercing of a spendthrift trust have now actually found their way into the newly issued Restatement of Trusts, 3d, issued in 2003, and the recently proposed Uniform Trust Code. While trust and estate practitioners can take note of this disturbing trend when drafting their testamentary or inter vivos trust documents, the problem typically arises in trusts that have been in existence for several years or were established prior to the recent disturbing trend in case law that has been recently codified into the Restatement of Trusts. With respect to those preexisting trusts, many unsuspecting beneficiaries are likely to place themselves in a position where their spendthrift trusts, previously thought to be immune from creditor or divorce court attack, are suddenly successfully pierced by third-party claimants. Of course, in some cases, the error occurred when the trust document was first drafted without taking into account the rights that creditors have had for decades. In the discussion below, several examples of faulty drafting or trust operation which resulted in the piercing of the trust, will be discussed.
Although the Restatement of Trusts 3rd does not have the force of law, it is intended to reflect the state of generally accepted legal principals throughout the United States. The fact that the Restatement of Trusts 3d has adopted §60 is indicative of what the Restatement felt was a trend in case law to allow for the expanded ability of a creditor to reach the interest of a trust beneficiary notwithstanding longstanding spendthrift protections that have existed in law of all 50 states for decades. In fact, many of the principals supported by the Restatement of Trusts 3rd can now be found in the newly drafted and proposed Uniform Trusts Act which has already been adopted in a handful of states.

A. Restatement of Trusts, 3d. The 3d Restatement of Trusts, issued in 2003, generally acknowledges the validity of a spendthrift trust, subject to certain exceptions, although it specifically provides that a “restraint on the voluntary and involuntary alienation of a beneficial interest retained by a settlor of a trust is invalid.” Restatement §59 does provide that the interest of the beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against he beneficiary for:

(a) support of a child, spouse, or former spouse; or

(b) services or supplies provided for necessities or for the protection of the beneficiary’s interest in the trust.

However, the most significant change in the Restatement’s protection of spendthrift interest in trust is found in the new §60 of the Restatement 3d. It provides that:

Subject to the rules stated in §§58 and 59 (on spendthrift trusts), if the terms of a trust provide for a beneficiary to receive distributions in the trustee’s discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment. The amounts a creditor can reach may be limited to provide for the beneficiary’s needs, or the amounts may be increased where the beneficiary either is the settlor or holds the discretionary power to determine his or her own distributions.

1. Scope of New Section 60. In the Comments to the rule, the Restatement states that the rule stated in §60 and its commentary allows a beneficiary’s assignee to receive discretionary distributions to which the beneficiary would otherwise be entitled, and allows creditors of the beneficiary to attach his or her discretionary interest. The rule does not apply if the beneficiary’s interest is subject to a valid spendthrift restraint under the rules of §58 unless the situation falls within an exception under § 59.

Section 60 recognizes special rules for discretionary interests retained by a settlor and for trusts in which the beneficiary, as trustee or otherwise, holds the discretionary authority to determine his or her own distributions. These new rules (in Comments f and g, respectively) expand the amount such a beneficiary’s creditors may reach.

The rules stated in the new Restatement §60 and its commentary apply to whatever extent a beneficiary’s interest is discretionary. Thus, if the beneficiary is entitled to all of the trust’s net income but only to principal in the trustee’s discretion, the Section applies to the provision for
invasion of principal but not to the income interest. Also, the Section prevents the trustee not only from making payments to the beneficiary but also from making “distributions” by applying funds directly for the beneficiary’s benefit contrary to the rights of the transferee or creditor.

2. **Rights of Creditors.** In Comment e to §60, the Restatement states the rule that, in the absence of a valid restraint on involuntary alienation (under §58 or a statute), the creditors of the beneficiary of a discretionary interest may attach that interest and may subject it to the satisfaction of enforceable claims by appropriate process as described in §56, Comment e. The interest, however, is not subject to execution sale. Furthermore, if an expressed or implied purpose of the discretionary interest is to provide for the beneficiary’s support, health care, or education, in establishing the portion of each distribution allocated to the payment of claims the court is to take account of the beneficiary’s actual needs in maintaining a reasonable level of support, care, and education.

If the trustee has been served with process in a proceeding by a creditor to reach the beneficiary’s interest, the trustee is personally liable to the creditor for any amount paid to or applied for the benefit of the beneficiary in disregard of the rights of the creditor, in the absence of a valid spendthrift provision (§58) applicable to the creditor (see §59).

3. **Creditor Ability to Compel Discretionary Distributions.** In Comment e to Restatement §60, the Restatement acknowledges that a transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so. It is rare, however, that the beneficiary’s circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless. The exercise or nonexercise of fiduciary discretion is always subject to judicial review to prevent abuse. What might constitute an abuse, however, is not only affected by the extent of the trustee’s discretion, standards applicable to its exercise, and purposes of the trust, but also by the beneficiary’s circumstances and the effect discretionary decisions will have on the discretionary beneficiary and on others in relation to the fulfillment of trust purposes.

The rights of a discretionary beneficiary’s assignee or creditor are also entitled to judicial protection from abuse of discretion by the trustee. On the other hand, a trustee’s refusal to make distributions might not constitute an abuse as against an assignee or creditor even when, under the standards applicable to the power, a decision to refuse distributions to the beneficiary might have constituted an abuse in the absence of the assignment or attachment. This is because the extent to which the designated beneficiary might actually benefit from a distribution is relevant to the justification and reasonableness of the trustee’s decision in relation to the settlor’s purposes and the effects on other beneficiaries. Thus, the balancing process typical of discretionary issues becomes, in this context, significantly weighted against creditors, and sometimes against a beneficiary’s voluntary assignees.

4. **Compelling Distributions Where Beneficiary Holds Discretionary Power.** Sometimes a beneficiary is trustee of the discretionary trust, with authority to determine his or her own benefits. In such a case, a rule similar to that of Comment f applies, with creditors able to reach from time to time the maximum amount the trustee-beneficiary can properly take. As in other nonsettlor-beneficiary situations, the court may reserve a portion of that amount for the beneficiary’s actual needs for reasonable support, health care, and education (Comment c). The beneficiary’s rights and authority represent a limited form of ownership equivalence analogous to
certain general powers under the rule of §56, Comment b; thus the rule of this Comment is similarly unaffected by a purported spendthrift restraint.

The special rule of §60, Comment e also applies to the discretionary right of a beneficiary who is not a trustee but is given power to demand trust distributions pursuant to an expressed or implied standard, whether or not the standard is an objective one (e.g., “support”).

The rule does not apply, however, if the discretionary power is held jointly with another person who, in exercising the discretionary authority, has fiduciary duties to other beneficiaries of the trust. Nor does this rule apply on behalf of transferees of the beneficiary’s interest, although a purchaser who is entitled to restitution based on fraud or mistake, or the like, is a creditor of the beneficiary and may attach the beneficiary’s interest for satisfaction of that claim.

5. **Self-Settled Trust.** Where the trustee of an irrevocable trust has discretionary authority to pay to the settlor or apply for the settlor’s benefit as much of the income or principal as the trustee may determine appropriate, creditors of the settlor can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor. Where the beneficiary is the settlor of only a portion of the trust, the amount the creditor can reach under this rule is limited to that portion of the trust estate.

The special rule of §60, Comment f normally does not apply to the settlor-beneficiary’s transferees. A purchaser who is entitled to restitution based on fraud or mistake, or the like, however, is a creditor of the beneficiary and may thus attach the settlor-beneficiary’s interest for the satisfaction of that claim.

B. **Beneficiary Becomes the Trustee.** A common scenario where a court might be inclined to disregard the traditional protection of a spendthrift trust provision is a trust which has a common trustee and beneficiary. This situation commonly occurs when the beneficiary is an heir to the settlor who established a trust for the benefit of various heirs. It is not uncommon for such a testamentary disposition to provide that the beneficiary may become the trustee of his or her own trust at a specified age. Another common and even more disturbing example of a trust with a common trustee and beneficiary is a “marital deduction” trust.

As indicated above, the historical exception to the protections afforded a spendthrift trust is the rule against self-settled trusts which provides that if the settlor is also a beneficiary of the trust, a provision retaining the voluntary or involuntary transfer of his beneficiary interest does not prevent his creditors from satisfying claims from his or her interest in the trust estate.

Historically, the foregoing principals have served to protect the interest of a beneficiary in a trust established by someone other than the beneficiary. An irrevocable trust established by the settlor for the benefit of someone other than the settlor has historically been a bulletproof asset protection strategy. However, in recent years, several cases have allowed a creditor to pierce a spendthrift trust to reach the assets of the trust where the beneficiary had the ability to control distributions to him or herself. Not surprisingly, most of the cases in which a debtor’s interest in a spendthrift trust has been pierced have been cases involving a debtor in bankruptcy. In all such cases, it is the ability of the trustee/debtor/beneficiary of the trust to exercise dominion

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4 This assumes no fraudulent transfer has occurred.
and control over the trust property that is eventually found fatal. Even more disturbing is that some of the trusts involved were “marital deduction” trusts, established by the beneficiary’s deceased spouse, to benefit from certain estate tax deductions expressly sanctioned by the Internal Revenue Code to reduce and, in most cases, totally eliminate estate taxes upon the death of the first spouse to die. Examples of cases where spendthrift trusts have been pierced include the following:

1. **In Re: McCoy**

   In *McCoy*, the debtor in bankruptcy, George R. McCoy, was the sole trustee of the Judith McCoy Family Trust established upon the death of Mrs. McCoy. He was also the beneficiary. The trust was established pursuant to the last will and testament of Mrs. McCoy. Although the will did not give the debtor any express power of appointment or trust assets, nor the express right to revoke or amend the trust, it did give him free discretion to spend all trust assets for any purpose he desired. While the trustee’s discretionary power to make distributions included the usual “health, maintenance and support” standards, it also provided that such distributions could be made in such amounts as might be “required or desirable.” It is the use of the words “required or desirable,” which the court found fatal. The court found that, taken as a whole, the terms of the trust were such that the debtor, in his capacity as trustee, could make payments to himself from the corpus to any extent that he alone determined “desirable.” Therefore, the only reasonable interpretation was that the settlor intended the debtor/beneficiary, as sole trustee, to have unfettered dominion and control over the trust. As such, the assets of the trust were includable in the assets of the bankruptcy estate available to pay creditor claims.

2. **In the Matter of: Warren and Brenda Bierman**

   Warren and Brenda Bierman became Chapter 11 bankruptcy debtors on December 16, 1996. The principal issue in the case was whether the assets of The Brenda Bierman Trust were part of the bankruptcy estate. The trust had been established by Mrs. Bierman’s mother in 1986. From the inception of the trust to the date following the filing of the bankruptcy case, Brenda Bierman was a beneficiary of the trust and the sole trustee of the trust. She resigned as trustee approximately six months after the commencement of the bankruptcy case. One of Mrs. Bierman’s daughters and beneficiary of the trust, Tammy Gregerson, was named as successor trustee of the trust. The issue before the court was whether Mrs. Bierman, on the date of her bankruptcy petition, held the power to exercise dominion and control over the trust corpus, thereby negating the “spendthrift clause” of the trust and causing the corpus to become part of the bankruptcy estate.

   After reviewing the details of the trust agreement, the court had no problem in concluding that, on the date of the bankruptcy petition, Mrs. Bierman held the power to exercise dominion and control over the trust corpus and, therefore, the trust corpus was property of the bankruptcy estate. The key to the court’s finding was the provision governing the distribution of income and principal to Brenda Bierman during her life. The trust agreement provided that:

   “During the lifetime of Brenda Bierman, the TRUSTEE shall pay or apply the net income and principal of the trust estate as she may direct from time to time; but until otherwise directed, the Trustee shall pay the net income to Brenda Bierman at least annually.”

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The court found that the above referenced language gave Brenda Bierman the ability to compel the trustee to pay or apply interest and/or principal in any manner Brenda Bierman selected. To make matters worse, the trust agreement further provided, that as trustee, she could encroach upon the principal of the trust to provide for the support, care and comfortable maintenance of Brenda J. Bierman, it being the intent of the trust that she receive sufficient funds to provide the same standard of living as she then maintained, including necessary expense of healthcare. The court thus held that Brenda Bierman, as beneficiary and trustee, had complete control over the trust. She had the ability to direct the trustee, whether it be herself or a subsequent trustee, to pay over the trust income and the entire corpus at any time. She controlled the investing of the trust assets and was able to divest the interest of any or all other beneficiaries by her actions. Since Brenda Bierman had complete control and dominion over the trust corpus, the assets of the trust were not afforded the protection of a spendthrift trust thus resulting in the entire trust corpus becoming property of her bankruptcy estate.

C. Excessive Beneficiary Powers. Attorneys familiar with the drafting of asset protection trusts will know that a court can force a beneficiary of a trust to exercise any power that the beneficiary may have with respect to that trust. It is therefore extremely important that the beneficiary be given little or no unilateral rights to control any aspect of the trust. To the extent that any such controls are granted, the beneficiary of a spendthrift trust can be forced to exercise those powers in favor of his or her creditors. Failure of a debtor to comply with a court’s order to exercise such powers can subject a debtor to a “contempt of court” action.

Regrettably, some estate planning practitioners will sometimes draft a trust that grants significant powers to the beneficiary without taking into account the potential adverse consequences that holding such powers may cause to the beneficiary in the event that the beneficiary of the trust becomes a judgment debtor or, even worse, is involved in bankruptcy proceedings as a debtor in bankruptcy.

Typically, the rights of a debtor in a traditional spendthrift trust are not property of the debtor’s bankruptcy estate. Section 541(c) of the Bankruptcy Code provides that:

“A restriction on the transfer of a beneficial interest of the debtor in the trust that is enforceable under applicable non-bankruptcy law is enforceable in a case made under this title.”

Thus, if the interest of the debtor in a trust is protected under state law, it will likewise be protected in any bankruptcy proceedings. If the interest of the debtor is not protected from creditor claims under applicable state law, it will not be protected in bankruptcy proceedings.

In the New York bankruptcy case of In Re: James M. Herzig\(^7\), the bankruptcy court was required to analyze provisions in a testamentary trust, established by the debtor’s father, that granted significant powers to his son, a beneficiary of the trust. In the Last Will and Testament of the debtor’s father, the decedent appointed his two sons, William and James, as executors and trustees under his Will. James renounced his appointment as an executor and trustee of the Will less than two months after his father’s death. As a result, his brother William acted as the sole executor of the Will and sole trustee of the testamentary trust provided in their father’s Will.

\(^7\) In Re: James M. Herzig, 167 B.R. 707 (1994).
Among the powers that were granted to the trustees of the testamentary trust were:

- Any trustee could at any time resign and designate a successor trustee by written instrument.

- In the event William Herzig, the debtor’s brother, should ever be unable or unwilling to serve as trustee, any attempt to appoint a successor trustee to William would not be valid unless it was approved by the debtor, James Herzig. If James Herzig did not approve of the appointment of the successor trustee, the trust would terminate and the assets remaining in the trust would be distributed to James Herzig unless his wife Margaret was willing to qualify and act as successor trustee.

- James Herzig had the right, at any time, to require his brother William, to resign as trustee in which event, he would be succeeded as trustee by the debtor’s wife, Margaret, but only if she was then living with James.

In analyzing the case, the bankruptcy court admitted that the debtor would not be deemed to have any control over the assets of the trust so long as his brother William remained as the sole trustee. However, the debtor was given the express power to require his brother William to resign. William would have the right to appoint his successor but only if such successor was approved by the debtor, James. If not, the trust would terminate and assets distributed to James unless his wife Margaret was willing and qualified to become trustee. However, to qualify as a successor trustee, she was required to “be living with debtor” at the time of her qualification as trustee.

Although the debtor and his wife Margaret were living together at the time, the court noted that the debtor could, theoretically, take up residence elsewhere, and require his brother William to resign and refuse to agree to the appointment of a successor to William, thus obtaining the trust assets. As the Court noted:

“Termination of this Trust does not require drastic action on Debtor’s part. He can, under the scenario outlined above, and with minimal inconvenience to himself, cause the corpus of the Trust to be distributed to him. Debtor could move back home and resume his normal life, since the will language does not require either a separation of a specific duration or an intent to remain apart for the indefinite future. This possibility destroys the spendthrift aspect of the Trust and Debtor’s interest becomes property of his estate. The issue is not, as Debtor would have it, the ability of a bankruptcy trustee to exercise the options available to Debtor. It is that the mere existence of the power described causes the spendthrift provision to fail. This is true as to both the statutory and common law elements.”

D. Retained Interest in Tax Motivated Trust. Estate planners are suddenly realizing that the mere fact that a trust or similar structure has been expressly sanctioned by the Internal Revenue Service does not necessarily prevent it from surviving a creditor attack based upon well recognized concepts under common law or state law, particularly the general

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8 In Re: James M. Herzig, 167 B.R. 707, 711 (1994)
prohibition against protecting a settlor’s interest in a “self-settled trust.” Such retained interests are common in a Grantor Retained Annuity Trust (“GRAT”), a Qualified Personal Residence Trust (“QPRT”), Charitable Lead Trust and Charitable Remainder Trust (“CLUT,” “CLAT,” “CRUT,” and “CRAT”).

The common law prohibition against protecting the interest of a settlor in a self-settled trust became painfully evident in the recent bankruptcy case of In Re Mack 9 which involved a Charitable Remainder Unitrust (the “CRUT”). In the Mack case, the debtor has established a Charitable Remainder Unitrust wherein he named himself as the income beneficiary of the CRUT for his life. Because of the nature of a CRUT, the income interest which the settlor retained in the CRUT was a self-settled interest. As a result, when the matter came before the U. S. Bankruptcy Court for the District of Minnesota, Judge Nancy Dreher identified the issue as whether the facts of the case required the Court to determine whether the debtor’s interest in the CRUT, as well as his rights as income beneficiary to remove and replace trustees and to amend the trust to protect its tax benefit status, were property of the estate. Many of the issues which had originally also been raised by the bankruptcy trustee were eventually dropped. Therefore, the only remaining issues upon trial were to determine (a) whether the bankruptcy trustee was entitled to the income from the trust which, by the terms of the CRUT, were to be distributed to the debtor annually over his life and (b) whether the trustee could step into the settlor’s shoes as income beneficiary and thereby control who managed the trust assets.

In reading the opinion, the reader gets a hint at the direction that Judge Dreher was heading when she posed one of the issues in front of her as whether or not Congress and the state of Minnesota “in passing CRUT-governing statutes, intended not only to encourage charitable giving by allowing tax avoidance or deferral, but also to create a new protection from creditors to those wealthy enough to give away the remainder interest in assets. In other words, do we have a new bankruptcy planning tool for the wealthy?”10

After noting that Federal Courts have consistently concluded that Minnesota courts would not recognize a spendthrift trust where the trust was self-settled, Judge Dreher went on to also note that the rule that a settlor cannot protect his interest in a CRUT through a spendthrift provision was also clear in the common law:

“(1) Where a person created for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interests, (2) Where a person created for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.”11

After an exhausting examination of the history of both common law, state law, and Congressional intentions regarding tax favored structures such as a Charitable Remainder Unitrust, the court nevertheless determined that the income interest of the debtor in bankruptcy and settlor of the trust, Jeffrey C. Mack, was property of the bankruptcy estate, together with a

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9  In Re Mack, 269 B.R. 392 (2001)
10 In Re Mack, supra, at 17.
11 In Re Mack, supra, at 22.
power to appoint or discharge trustees of the trust and power to amend the trust to preserve its tax
qualified status. Thus, the court ordered the trustees of the CRUT, together with any successor
trustees, to recognize the bankruptcy estate as a holder of the lifetime income interest and powers
held by the settlor of the trust, Mr. Mack, and to pay future distributions payable to Mr. Mack
pursuant to the CRUT to the bankruptcy trustee.

E. Divorce Setting. In a divorce setting in a community property state such as
Texas, the problem of dominion and control can also lead to piercing of a trust. Some Texas
courts have held that trust income, accumulated in a Texas trust, may be subject to division upon
divorce in those situations where the beneficiary was entitled to withdraw the income but instead
elected to allow the trust to retain it. This issue can be problematic in a situation where the
beneficiary of the trust is also the trustee. In a divorce setting in a community property state such
as Texas, the spouse can allege that the trustee elected not to distribute income from the trust in
order to avoid having it become part of the community property estate divisible upon divorce. If
the beneficiary, in his or her capacity as trustee, had the power to distribute the income for his
own benefit, but elected not to, there is sufficient case authority for the proposition that such is
community property subject to division upon divorce. A similar result will result if the
beneficiary has the right to receive income but elects to leave it in the trust. An excellent example
of a case where that occurred is a 1977 Texas divorce case where the beneficiary husband the
beneficiary husband had an absolute right to receive the income from the trust but had elected to
allow the income, which he had the right to receive, to remain within the trust. In those cases,
accumulated income in the trust, to the extent that it is under the “control” of the beneficiary, will
likely be treated as community or marital property and, therefore, subject to division upon
divorce.12

F. Levy on Trust Distributions and Liability of Trustee for Indirect
Distributions to Beneficiary. In a Chief Counsel Advice Memoranda issued on November 30,
2005, the Internal Revenue Service reiterated the rule that it may levy a taxpayer’s fixed right to
trust income and the taxpayer’s fixed right to obtain a future distribution from corpus. However,
and even more relevant, the Internal Revenue Service restated its position that when a trustee
distributes funds that the trustee knows are encumbered by a federal tax lien, the trustee is
personally liable for tortious conversion, specifically, intentionally impairing the rights of the
Internal Revenue Service.13

Spendthrift provisions, which are self-created exemptions, cannot defeat a federal tax
lien. In Leuschner v. First Western Bank & Trust, the Ninth Circuit affirmed that a taxpayer’s
interest in a trust could be reached by the federal tax lien, observing that “there is no doubt that
the paramount right to collect taxes of the federal government overrides a state’s statute providing
for exemptions.”14 Thus, the spendthrift provision of a trust, however effective against certain
creditors’ claims, is ineffective at insulating assets of the trust from levy by the IRS, provided that
such assets are first found to constitute the “property” or “right to property” of the taxpayer.

12 In the Matter of the Marriage of Long, 542 S.W.2d, 712, 718 (Tex. Civ. App. – Texarkana, 1976, no
writ).

13 IRS CCA 2006 14006

14 Leuschner v. First Western Bank & Trust, 261 F.2d 705, 708 (9th Cir. 1958).
In the facts of CCA 2006 14006, the taxpayer was, apparently, both the beneficiary and trustee of a trust established by a then-deceased family member. The trust provided that the taxpayer was entitled to receive, at a minimum, all current income of the trust. The distribution of current income to the beneficiary was mandatory and not subject to the exercise of discretion on the part of the trustee. As a result, such mandatory distribution of current income was a property right of the taxpayer that could be levied by the IRS and collected as payable. Pursuant to Revenue Rule 55-210, an IRS levy could seize the entire stream of income payments, namely, the income payments currently due in all future income payments to the indebted beneficiary.

Although most of the specific facts of IRS CCA 2006 14006 were redacted before publication, the trustee of the trust, who was apparently also the beneficiary, apparently attempted to make indirect payments for his benefit once his regular distributions were levied by the IRS. In the Chief Counsel’s Advice, the government offered, as an alternative or supplement to a suit to enforce a levy, the right of the federal government to sue the holder of the taxpayer’s property for tortious conversion of the federal tax lien. Thus, as an alternative to the levy, the federal government could also sue the trustee-taxpayer if he or she intentionally made distributions of funds encumbered with a federal tax lien and, as a result, the funds disappear into the stream of commerce.

G. Annuities & Life Insurance – Case Law Exceptions To State Exemption Statutes. Employment-related retirement plans in the United States generally enjoy good protection from creditor claims either under Federal law or under most state laws. Any employment-related retirement plan that is covered under the U.S. Employment Retirement Income Security Act (“ERISA”) provides strong “anti-alienation” provisions to protect those plans against the claims of creditors of plan participants. However, employment-related retirement plans that do not qualify for Federal law protection are typically protected by state law in most states. However, the foregoing protections apply only to employment related retirement and similar plans, whether in the form of annuities or otherwise. Only a handful of states provide protection for annuities and life insurance policies that are purchased by an individual to supplement their income upon retirement or provide for their families upon their premature death.

1. Protection of Annuities Under State Law. As of the writing of this paper, only ten states provide for unlimited protection of annuities and the proceeds from those annuities against the creditor claims of the annuity owner.15 A total of 16 states, including Colorado, Connecticut, Iowa, Massachusetts, Rhode Island, and Virginia, provide for no protection whatsoever against creditor claims against an annuity or annuity payments received by an annuitant. Of the remaining states, the bulk of the remaining states provide for limited protection for annuity payments or policy proceeds. In some cases, the amount of annuity payment that is protected from creditor claims is a very small amount, typically varying from $350 to $500 per month; although, states like Pennsylvania limit to $100 the amount of the monthly annuity payments that are exempt from creditor claims. In other states, annuity payments of a limited amount enjoy similar protections but only if such payments are being made to the dependents of


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the annuity owner, such as a dependent’s spouse and children. As discussed below, that is similar to the protection afforded annuities in Switzerland, but without any limitation on the amount of the benefits protected from a creditor’s claim.

2. **Life Insurance Protection Under State Law.** Like their annuity counterparts, life insurance policies are fully protected in the hands of their owners in only ten states. Likewise, many states provide limited or no protection whatsoever to the owner of a life insurance policy. However, unlike annuities, many states do provide that the proceeds of a life insurance policy, meaning that the insured individual has died, are fully protected from creditor claims if such proceeds are paid to, typically, family members and other dependents of the insured. However, even in most of those states, should the owner of the policy be subject to creditor claims that are reduced to judgment prior to the death of the policy owner, a judgment creditor could seize the policy while the owner-insured is still alive and, in most cases, redeem the policy for its cash surrender value. In any event, if the intention of the owner-insured was to own a policy to provide for his dependents upon his death, irrespective of potential financial misfortunes, the ability to achieve that goal cannot be realized in the majority of states if the owner-insured owns that policy when claims against him or her are reduced to judgment.

3. **Judicial Exceptions to State Exemption Statutes.** Despite the fact that some states have provided generous and sometimes unlimited protection for annuities and life insurance policies, a definite trend has developed in some states that has resulted in courts adopting judiciary mandated exceptions to otherwise favorable state exemption laws. In other words, despite the protections provided by some state laws for annuities and life insurance policies, some courts have unilaterally decided that such protections should not be available in all cases, notwithstanding the clear language of state law providing for such unlimited protection.

In most cases where courts have ignored the unlimited exemption available under state law, the courts have found that the annuity or life insurance policy that the debtor sought to protect had characteristics that made the policies look more like sophisticated investment products rather than traditional annuities or life insurance policies that were intended to provide a reasonable basis of support during retirement or provide adequate life insurance proceeds for the individual’s family upon his death.

In the case of *Dona Anna Savings & Loan Association, F.A. vs. Dofflemeyer*,\(^16\) the language of the New Mexico exemption statute at that time provided that “any interest in or proceeds from a pension or retirement fund of every person supporting only himself is exempt from . . . attachment, execution or foreclosure by a judgment creditor.”\(^17\) At that time, New Mexico law clearly provided for the unlimited protection of annuities and life insurance policies. In its analysis, the court took note of the accepted use and definition of an annuity when the exemption statute was first adopted in 1887 by the New Mexico legislature. The court reasoned that, in 1887, the exemption was ostensibly adopted to provide an exemption statute to “protect families from becoming destitute as a result of misfortunate through common debts which are generally unforeseen.”\(^18\) In the time period of over 100 years since the exemption statute had

\(^{16}\) *Dona Anna Savings & Loan Association, F.A. vs. Dofflemeyer*, 115 N.M. 590, 855 P.2d 1054 (1993)


\(^{18}\) *Thomson vs. Lerner*, 25 T.2d 209, 210-11
been adopted, the Legislature had never attempted to change the definition or the amount that is protected from creditor claims of the owner of the annuity. In fact, some annuities had essentially become sophisticated agreements that, in many cases, provided significant tax deferral to high net worth individuals. Thus, pursuant to the court’s analysis, a high net worth individual purchasing a $5 million annuity in a state such as Texas, where annuities are fully exempt from creditor claims, could, using the New Mexico court’s rationale, find that a $5 million annuity was far in excess of what the Legislature had in mind when it first adopted the unlimited exemption for annuities for the purpose of protecting an individual’s retirement savings thus enabling him to provide for his family upon his disability or retirement. In any event, the New Mexico court held that, despite the state’s unlimited exemption of annuities, the annuity would not be entitled to the exemptions against creditor claims available under state law if the annuity was nothing more than a tax advantaged investment contract even though it was technically an annuity.

A similar situation occurred in the bankruptcy case of In re Payne19 this time involving life insurance. The bankruptcy proceedings were commenced in the state of California where a debtor attempted to claim an exemption of his annuity under state law while the bankruptcy trustee argued that the annuity was merely an investment vehicle and therefore did not qualify as an annuity or life insurance under relevant California exemption laws. At the time, California law provided that an annuity would be exempt from creditor claims only if it is qualified as a life insurance policy. After reviewing the history of the exemptions available under California law for annuities and life insurance, the court ruled that where the annuity contains some attributes of insurance and some of investment, the analysis must include a determination of the primary purpose of the annuity. If the primary purpose of the annuity was investment, then the annuity would not qualify as life insurance for purposes of the exemption statute. After reviewing the facts, the Ninth Circuit Court of Appeals held that the annuity contract was primarily an investment contract and, therefore, not entitled to exemption and protection from claims of creditors under California law.20

4. The Concern Over Continued Erosion of Existing U.S. Protections. While very few court have addressed this issue in the United States, many professional advisors are concerned with the increasing trend by courts to unilaterally reclassify as an "investment contract", a policy, issued by an insurance company, that is structured either as an annuity or a life insurance policy.

Likewise, it is not difficult to see that insurance products, particularly annuities, that may enjoy protection from creditor claims by statutes in a handful of states adopted over 100 years ago, bear little resemblance to tax advantaged annuities and complex variable life insurance products that are now available in today’s market. Thus, while annuities purchased by Americans from their earnings with the primary goal of supplementing their retirement income will likely continue to enjoy applicable state protections, if any, modern annuity and life insurance products offered to high net worth individuals are likely to run the risk that, in the event of creditor attack, a court may find that the contract is nothing more than an investment contract rather than a traditional annuity or life insurance policy entitled to whatever exemption or protections that might be available under state law. Nevertheless, as will be discussed below, this problem can possibly be avoided for annuities and life insurance, when integrated into an estate planning or

19 In re Payne, 323 B.R. 723, (9th Cir. 2005)
similar wealth preservation structure as such are now available in 13 states of the United States, including the state of Delaware.

H. Piercing the Irrevocable Life Insurance Trust (“ILIT”). A typical irrevocable life insurance trust will have nominal value during most of the life of the insured. Contributions are usually used to pay premiums on the life insurance policy held by the ILIT. As the age of the insured increases, the value of the life insurance policy owned by the ILIT also increases. However, upon the death of the insured, the value of the ILIT will grow substantially. When that happens, the assets of the ILIT could be seen by a creditor of a trust beneficiary as a potential source of recovery for claims against such beneficiary. However, in a recent California case where an attempt was made to pierce an ILIT to reach the assets of the trust, the creditor was actually a creditor of the insured who established the trust.

In the 2006 California case of Laycock v. Hammer, the settlor and insured, Spearl Ellison, created an irrevocable life insurance trust wherein Ellison, as settlor, specifically declared that the trust was irrevocable, and that after the execution of the trust, the settlor would have no right, title, or interest in, or power, privilege, or incident of ownership in regards to any of the property of the trust and no right to alter, amend, revoke or terminate the trust or any of the provisions.

Shortly after establishing the trust, on September 29, 1989, Ellison assigned to the trust all of his “rights, titles, interest, and incidents of ownership” in a policy issued by Southwestern Life Insurance Company. On October 13, 1989, the trustee of the trust was designated as the beneficiary of the policy.

In 1992, the Resolution Trust Corporation (“RTC”), as successor to a failed savings & loan association, obtained a judgment against Spearl Ellison and his wife totaling $735,000.00. The judgment grew out of the default by the Mr. and Mrs. Ellison on two promissory notes secured by mortgages on commercial property in Kansas. The judgments were later acquired by Leonard Hammer, the current claimant.

On April 23, 2003, Mr. Ellison died. Linda Laycock, in addition to the role as trustee of the ILIT, served as trustee of the family trust. Hammer then sought to attempt to reach the assets of the life insurance trust. As trustee of the ILIT, Ms. Laycock filed a petition for a determination that the insurance trust was exempt from Hammer’s claims. In response to the motion, Hammer produced evidence which allegedly supported the following factual findings:

- Ellison acted as a co-trustee of the trust
- Funds from the trust were distributed to his great grandchildren
- He communicated about the insurance policy with his insurance agent and insurance company
- Ellison borrowed funds from the policy
- Laycock used funds from the family trust to repay the amounts Ellison borrowed from the insurance policy because she believed the loan were Ellison’s debts
- Other trust beneficiaries advised Ms. Laycock that they believed Ellison should be permitted to do as he pleased with money he earned in his lifetime

Notwithstanding the foregoing, the trial court ruled in favor of Ms. Laycock’s motion for summary judgment. The trial court found that under prevailing California law, all the acts
Hammer relied upon would not have converted the trust from an irrevocable trust to a revocable trust. The court found that California law did not recognize any doctrine of implied revocation of an irrevocable trust and, in any event, the evidence Hammer presented did not raise any material inference that Ellison had control or ownership of the trust.

On appeal, the California Court of Appeals evaluated California law and determined that, contrary to Hammer’s argument, a settlor’s conduct after an irrevocable trust had been established will not alter the nature of such a trust. Interestingly, the Court of Appeals relied, in part, on Federal estate tax cases that, after applying a broader incidence of ownership test, had found that breaches of the terms of a trust by a trust settlor will not make a settlor the owner of trust property for purposes of applying the federal estate tax.

In the view of the Court of Appeals, the terms of the Ellison ILIT, as well as the terms by which he transferred the policy to the trust, were unambiguous. The trust was irrevocable and the transfer of the policy was similarly irrevocable. Thus the policy proceeds were the property of the trust and not a part of Ellison’s estate. More importantly, the court did not agree with Hammer’s interpretation of the facts that Hammer alleged evidenced ownership of the trust by Ellison. The only document that was found that could potentially raise an inference of control or ownership over the trust was documents which listed Mr. Ellison as a co-trustee of the insurance policy account. However, the Court of Appeals held that, even if they were to accept as truth the fact that the insurance company treated Mr. Ellison as a co-trustee, this in itself would not help the creditors’ cause because there was no law prohibiting settlors of a trust from being trustees or co-trustees of an irrevocable trust. Thus, transfers to the life insurance trust were irrevocable and, consequently, the assets of the trust were not available to the creditors of Mr. Ellison, the settlor of the trust, upon his death.

Since the trust was established as an ILIT for estate planning purposes, Mr. Ellison obviously could not exercise incidents of ownership over the policy without jeopardizing the intended tax benefits of the trust. More importantly, the court’s decision is clearly based upon its conclusion that the acts of Mr. Ellison were not sufficient to evidence dominion and control over the assets of the trust.

What this author finds is the most interesting aspect of this case is the court’s reliance, by analogy, to federal estate tax cases which, applying a broader “incidence of ownership test”, have found that breaches of the terms of a trust by a settlor will not make the settlor the owner of trust property for purposes of applying the federal estate tax. This is based upon the premise that incidence of ownership denotes the legal power to exercise ownership, not a decedent’s practical ability to do so.

Notwithstanding the decision in Laycock, settlors of a life insurance trust should always strive to avoid any indication of dominion and control over the trust to avoid any attempts to pierce the trust after the decedent’s death, particularly in those cases where the alleged dominion and control would jeopardize the tax benefits for which the ILIT was designed. If the trust is found to be a sham, the assets of the trust could also be at risk from the claims of creditors of a trust beneficiary. After all, as with any legal entity, a court is less likely to respect a trust as a separate and distinct legal structure if the settlor or trustee of the trust do not treat the trust with the same deference that is expected from a settlor in an arms length transaction and, more importantly, a trustee with fiduciary duties to the trust and the beneficiaries of the trust.
I. Fraudulent Transfer Issues. The wealth preservation planning strategies referenced in this paper assume that the attorney and client are both satisfied their activities do not involve any attempts to hinder, delay, or defraud any existing creditor of the debtor. However, if the client has been less than honest to the attorney, or if the attorney has totally failed to dissuade the client from engaging in fraudulent transfers, a multitude of tools are available to both a creditor and a bankruptcy trustee, to set aside an alleged fraudulent transfer conveyance. The bankruptcy and fraudulent conveyance remedies available to creditors and bankruptcy trustees all have strict statute of limitation restrictions that are applicable under U.S. law. In the event that the conveyances have been made to an offshore entity, it will be necessary to look at the applicable fraudulent conveyance provisions of that jurisdiction to determine whether it will be possible to enforce a fraudulent conveyance action in the United States against an individual or entity located in a foreign jurisdiction, particularly when the U.S. court does not have personal jurisdiction over the foreign entity.

1. Uniform Fraudulent Transfer Act. All but a handful of states have adopted the Uniform Fraudulent Transfer Act. In reviewing the provisions of the Act, it is important to note that relief under the act may be sought by either a creditor or a trustee in bankruptcy. More importantly, different types of creditors have different standing to bring an action under the act. The statute of limitation applicable to transfers also varies depending on the nature of the transfer.

a. Transfer Fraudulent as to Present and Future Creditors. The Act provides that a transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

i. with actual intent to hinder, delay, or defraud any creditor of the debtor; or

ii. without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

- was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

- intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor’s ability to pay as they became due.

In determining actual intent under the Act, consideration may be given, among other factors, to whether:

- the transfer or obligation was to an insider;

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21 Those states that have not adopted the Uniform Fraudulent Transfer Act follow the old Uniform Fraudulent Conveyance Act originally adopted in 1918.
the debtor retained possession or control of the property transferred after the transfer;

- the transfer or obligation was concealed;

- before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

- the transfer was of substantially all the debtor’s assets;

- the debtor absconded;

- the debtor removed or concealed assets;

- the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

- the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

- the transfer occurred shortly before or shortly after a substantial debt was incurred; and

- the debtor transferred the essential assets of the business to a lien or who transferred the assets to an insider of the debtor.

b. **Statutory Remedies of Creditors.** Assuming a fraudulent conveyance has occurred, the Act provides that an aggrieved creditor may obtain:

i. avoidance of the transfer or obligation to the extent necessary to satisfy the creditor’s claim;

ii. an attachment or other provisional remedy against the asset transferred or other property of the transferee in accordance with the applicable Texas Rules of Civil Procedure and the Civil Practice and Remedies Code relating to ancillary proceedings; or

iii. subject to applicable principles of equity and in accordance with applicable rules of civil procedure;

- an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property;

- appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or

- any other relief the circumstances may require.
iv. If a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset transferred or its proceeds.

2. Bankruptcy Fraudulent Transfer Provisions. Section 548 of the United States Bankruptcy Code provides that the trustee may set aside any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the Petition (assuming the case is commenced after October 17, 2005), if the debtor voluntarily or involuntarily—

   a. made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

   b. [1] received less than a reasonably equivalent value in exchange for such transfer or obligation; and

      [2] (a) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

      (b) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

      (c) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured.

Section 548(b) provides that the trustee of a partnership debtor may avoid any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the Petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

If a transfer is made or obligation incurred more than two years prior to bankruptcy, the trustee must rely upon his/her rights under the fraudulent conveyance statutes of the debtor’s home state. The trustee is entitled to rely on such state provisions under §544(b) of the U.S. Bankruptcy Code. This is particularly helpful to a U.S. Bankruptcy Trustee since most fraudulent transfer state statues provide for a four-year statute of limitation period, rather than the two-year period provided by bankruptcy law.

3. Estate Tax Motivations vs. Intent to Defraud Creditors. As discussed in Article 2 above regarding the provisions of the Bankruptcy Reform Act of 2005, the bankruptcy trustee has gained an incredibly powerful tool in new section 548(e)(1)(A) of the Bankruptcy Code which allows the trustee up to ten (10) years to target a transfer made to “a self-settled trust or similar device” although no definition of a self-settled device is provided. Fortunately, the provisions of the newly enacted legislation require that the trustee must prove that such transfers were made “with actual intent to hinder, delay, or defraud” a creditor. Inclusion of the words “actual intent” is a much higher standard to prove in attempting to prove that a transfer to a “self-settled trust or similar device” was made to “hinder, delay, or defraud” a creditor. However, and
more importantly, estate planners must now be aware of the fact that transfers into estate planning structures, especially in light of the ambiguity regarding the definition of a “self-settled trust or similar device” may result in owners or beneficiaries of the structures being subject to attack by a bankruptcy trustee long after the drafting lawyer has discarded his files and most documentation regarding the original transaction has been lost or discarded. In this author’s view, in light of the ambiguities of what is covered by the new “ten-year look back” rule, it is prudent that estate tax practitioners document the solvency and reasons behind a transfer at the time that it is actually consummated, much the same way as a debtor’s solvency is documented at the time that he or she establishes a foreign trust. In this way, should a bankruptcy trustee decide to challenge a transfer nine years later, after the drafting lawyer has discarded his file in the normal course of business, the beneficiaries of the structure should have in their files contemporaneously prepared documents that enable them to prove that the original transfer into the estate tax structure that is now under bankruptcy court scrutiny was done at a time when the settlor or transferor was fully solvent and not done with the purpose of delaying or hindering his or her creditors.

While recent court cases have criticized entities that have been formed merely for tax reasons, there are times when proving the tax motivation behind forming an entity will actually be crucial in a court’s decision to respect the structure. Of course, this requires the drafting attorney to consider multiple issues that might arise in connection with the formation of the entity and the financial solvency of the parties involved.

a. **In Re: Earle.** An excellent example of where tax motivations were successful in defeating an allegation that a transfer was a fraudulent one was the somewhat recent case of **In Re: Thomas J. Earle, Jr. et al.,** 307 B.R. 276 (2002). In the Earle case, the debtors in bankruptcy filed a petition for relief under Chapter 13 of the U.S. Bankruptcy Code which one of the debtor’s creditors attempted to convert to a Chapter 7 bankruptcy proceeding on the basis that the debtor’s transfer of certain real estate into a trust was a fraudulent transfer done “with actual intent to hinder, delay, or defraud creditors” in violation of Alabama’s fraudulent transfer statute. Ala. Code §8-9 A-4(a).

Mr. and Mrs. Earle had initially filed a Chapter 13 case on November 26, 2001. The Earles had lived in a home located in Stockton, Alabama since the 1970s. The home was lost pursuant to a tax sale in June 1994. However, Mrs. Earle successfully redeemed the property from the purchaser in December 1997.

On June 26, 1998, Mrs. Earle formed a Qualified Personal Residence Trust (“QPRT”) as provided for in Internal Revenue Code §2702. She transferred the entire home into the QPRT which granted her a life estate and the exclusive right to live in the home, rent free, up until the earlier of her death or the expiration of 20 years.

At the time that the Earle QPRT was created, the Stockton property was her primary asset. No other significant assets existed. As a result, when Mr. and Mrs. Earle sought bankruptcy protection less than four years later, a creditor filed an adversary proceeding to set aside the transfer of the residence to the QPRT as a fraudulent transfer under Alabama law.

Although Mr. and Mrs. Earle had experienced multiple financial difficulties, it is the testimony of the professionals who arranged for the transfer that was crucial to the ultimate outcome of the case. Specifically, although the court did an exhaustive analysis of the application of the various “badges of fraud” to the facts of this case, what was extremely significant to the
court in its decision was the fact that Mrs. Earle had been speaking to a local accountant, well before the transfer, in connection with her own mother-in-law’s estate which had incurred significant estate taxes. The accountant was the accountant for Mrs. Earle’s mother-in-law’s estate. The estate tax return for the debtor’s mother-in-law was due in January 1998, a few months before the Earle QPRT was formed. The attorney of the estate testified that significant concerns existed in January, 1998, regarding the estate tax liability that was going to be generated by the filing of the estate tax return and the lack of liquidity from which to pay those estate taxes. During those discussions, in an effort to avoid a similar fate for the debtor, the same attorney for the estate suggested to the debtor that she seriously consider the estate tax benefits of a Qualified Personal Residence Trust in order to reduce her potential estate tax liability. It was extremely important to the court to note that it was the attorney’s suggestion, not that of the debtor, that Mrs. Earle form a QPRT trust, although the idea of a QPRT trust had also been “planted” in the debtor’s head by the accountant for the estate.

In the court’s view, this was a very significant fact. It showed that the Earle QPRT was not created in a vacuum; the debtor, Mary Earle and her accountant, had seen her mother-in-law incur estate tax liability that caused problems for the entire family. The idea of a QPRT was not the idea of the debtor but that of the accountant, presumably in an effort to keep the debtor Mary Earle from experiencing problems similar to those experienced by her mother-in-law’s estate. The fact that the debtor’s accountant, and not the debtor herself, had arrived at the idea of forming a QPRT was another strong indication that the debtor, Mary Earle, did not actually intend to defraud creditors in conveying her Stockton home to the QPRT (citing In Re: Mark, 88 B.R. 436, 438-39) Bankr. S.D. Fla. 1988) in which the court held that no fraudulent intent was found where a trust and annuity were proposed by an estate planning attorney unrelated to the debtor and the trust and annuity were designed solely for estate planning purposes to minimize estate taxes.

All of the foregoing estate tax reasons for forming the QPRT at the time that they did helped to overcome the allegation that the home was transferred into the QPRT primarily for the purpose of delaying, hindering, and defrauding the creditors of the bankrupt debtor. The court therefore held that the creditor had failed to prove that the real property was transferred to the trust “with actual intent to hinder, delay, or defraud creditors.”

IV. THE NEW UNIFORM TRUST CODE (2005)

In the year 2002, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Trust Code as a first national codification of the law of trusts. The Act was drafted in 2000 and amended in 2002 and 2005. The primary stimulus to the Commissioners’ drafting of the Uniform Trust code was the greater use of trust in recent years, both in family estate planning and in commercial transactions, both in the United States and internationally. This greater use of the trust, and consequent rise in the number of day-to-day questions involving trusts, led to recognition that the trust law in many states was thin. It had also led to a recognition that the existing uniform acts relating to trusts, while numerous, were fragmentary. Thus, the Uniform Trust Code was drafted to provide states with what was intended to be precise, comprehensive, and easily accessible guidance on trust law questions.

A principle concern to estate planning practitioners has been Article 5 of the Uniform Trust Code. Article 5 addresses the rights of creditors in spendthrift and discretionary trusts. Article 5 addresses the validity of a spendthrift provision and other issues relating to the rights of
creditors to reach the trust to collect a debt. To the extent a trust is protected by a spendthrift provision, a beneficiary’s creditor may not reach the beneficiary’s interest until distribution is made by the trustee. To the extent not protected by a spendthrift provision, a creditor can reach the beneficiary’s interest, subject to the court’s power to limit the award. Certain categories of claims are exempt from a spendthrift restriction, including certain governmental claims and claims for child support or alimony. Other issues addressed in this article include creditor claims against discretionary trusts; creditor claims against a settlor, whether the trust is revocable or irrevocable; and the rights of creditors when a trustee fails to make a required distribution within a reasonable time.

A. Rights of Beneficiary’s Creditor or Assignee. Section 501 of the UTC provides that:

“To the extent a beneficiary’s interest is not subject to a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary’s interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means. The court may limit the award to such relief as is appropriate under the circumstances.”

This section applies only if the trust does not contain a spendthrift provision or the spendthrift provision does not apply to a particular beneficiary’s interest. A settlor may subject to spendthrift protection the interests of certain beneficiaries but not others. A settlor may also subject only a portion of the trust to spendthrift protection such as an interest in the income but not principal. For the effect of a spendthrift provision on creditor claims, see Section 503.

Absent a valid spendthrift provision, a creditor may ordinarily reach the interest of a beneficiary the same as any other of the beneficiary’s assets. This does not necessarily mean that the creditor can collect all distributions made to the beneficiary. The interest may be too indefinite or contingent for the creditor to reach or the interest may qualify for an exemption under the state’s general creditor exemption statutes. See (Third) of Trusts §56 (2003); Restatement (Second) of Trusts §§147-149, 162 (1959). Other creditor law of the State may limit the creditor to a specified percentage of a distribution. See, e.g., Cal. Prob. Code Section 15306.5. This section does not prescribe the procedures (“other means”) for reaching a beneficiary’s interest or of priority among claimants, leaving those issues to the enacting State’s laws on creditor rights. The section does clarify, however, that an order obtained against the trustee, whatever state procedure may have been used, may extend to future distributions whether made directly to the beneficiary or to others for the beneficiary’s benefit. By allowing an order to extend to future payments, the need for the creditor periodically to return to court will be reduced.

Because proceedings to satisfy a claim are equitable in nature, the second sentence of this section ratifies the court’s discretion to limit the award as appropriate under the circumstances. In exercising its discretion to limit relief, the court may appropriately consider the circumstances of a beneficiary and the beneficiary’s family. See Restatement (Third) of Trusts Section 56 cmt. e (Tentative Draft No. 2, approved 1999).

B. Spendthrift Provision. Under the spendthrift provision of the Uniform Act, a settlor has the power to restrain the transfer of a beneficiary’s interest, regardless of whether the beneficiary has an interest in income, in principal, or in both. Unless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest
PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES

and may only attempt to collect directly from the beneficiary after payment is made. This section is similar to Restatement (Third) of Trusts § 58 (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts §§ 152-153 (1959). Section 502 of the UTC provides that:

(a) A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary’s interest.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a “spendthrift trust,” or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary’s interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

For a spendthrift provision to be effective under this Code, it must prohibit both the voluntary and involuntary transfer of the beneficiary’s interest, that is, a settlor may not allow a beneficiary to assign while prohibiting a beneficiary’s creditor from collecting, and vice versa. See Restatement (Third) of Trusts § 58 cmt. b (Tentative Draft No. 2, approved 1999). See also Restatement (Second) of Trusts § 152(2) (1959). A spendthrift provision valid under this Code will also be recognized as valid in a federal bankruptcy proceeding. See 11 U.S.C. § 541(c)(2).

Subsection (b), which is derived from Texas Property Code § 112.035(b), allows a settlor to provide maximum spendthrift protection simply by stating in the instrument that all interests are held subject to a “spendthrift trust” or words of similar effect.

C. Discretionary Trusts. Section 504 addresses the ability of a beneficiary’s creditor to reach the beneficiary’s discretionary trust interest, whether or not the exercise of the trustee’s discretion is subject to a standard. Section 504 of the UTC provides that:

(a) In this section, “child” includes any person for whom an order or judgment for child support has been entered in this or another State.

(b) Except as otherwise provided in subsection (c), whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion, even if:

(1) the discretion is expressed in the form of a standard of distribution; or

(2) the trustee has abused the discretion.

(c) To the extent a trustee has not complied with a standard of distribution or has abused a discretion:

(1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary’s child, spouse, or former spouse; and
the court shall direct the trustee to pay to the child, spouse, or former
spouse such amount as is equitable under the circumstances but not more
than the amount the trustee would have been required to distribute to or
for the benefit of the beneficiary had the trustee complied with the
standard or not abused the discretion.

(d) This section does not limit the right of a beneficiary to maintain a judicial
proceeding against a trustee for an abuse of discretion or failure to comply with a
standard for distribution.

(e) If the trustee’s or co-trustee’s discretion to make distributions for the trustee’s or
co-trustee’s own benefit is limited by an ascertainable standard, a creditor may
not reach or compel distribution of the beneficial interest except to the extent the
interest would be subject to the creditor’s claim were the beneficiary not acting
as trustee or co-trustee.

This section, similar to the Restatement, eliminates the distinction between discretionary
and support trusts, unifying the rules for all trusts fitting within either of the former categories. See
Restatement (Third) of Trusts Section 60 Reporter’s Notes to cmt. a (Tentative Draft No. 2,
approved 1999). By eliminating this distinction, the rights of a creditor are the same whether the
distribution standard is discretionary, subject to a standard, or both. Other than for a claim by a
child, spouse or former spouse, a beneficiary’s creditor may not reach or compel distribution of the beneficiary’s interest. Eliminating this distinction affects only the rights of creditors. The affect of this change is
limited to the rights of creditors. It does not affect the rights of a beneficiary to compel a
distribution. Whether the trustee has a duty in a given situation to make a distribution depends on
factors such as the breadth of the discretion granted and whether the terms of the trust include a
support or other standard. See Section 814 comment.

Subsection (e), which was added by a 2004 amendment, acknowledges that trusts are
frequently drafted in which a trustee is also a beneficiary. A common example is what is often
referred to as a bypass trust, under which the settlor’s spouse will frequently be named as both
trustee and beneficiary. An amount equal to the exemption from federal estate tax will be placed
in the bypass trust, and the trustee, who will often be the settlor’s spouse, will be given discretion
to make distributions to the beneficiaries, a class which will usually include the spouse/trustee. To
prevent the inclusion of the trust in the spouse-trustee’s gross estate, the spouse’s discretion to
make distributions for the spouse’s own benefit will be limited by an ascertainable standard
relating to health, education, maintenance, or support.

The UTC, as previously drafted, did not specifically address the issue of whether a
creditor of a beneficiary may reach the beneficial interest of a beneficiary who is also a trustee. However, Restatement (Third) of Trusts §60, comment g, which was approved by the American
law Institute in 1999, provides that the beneficial interest of a beneficiary/trustee may be reached
by the beneficiary/trustee’s creditors. Because the UTC is supplemented by the common law (see
UTC Section 106), this Restatement rule might also apply in states enacting the UTC. The
drafting committee has concluded that adoption of the Restatement rule would unduly disrupt
standard estate planning and should be limited. Consequently, Section 504 is amended to provide
that the provisions of this section, which generally prohibit a creditor of a beneficiary from
reaching a beneficiary’s discretionary interest, apply even if the beneficiary is also a trustee or co-
trustee. The beneficiary-trustee is protected from creditor claims to the extent the beneficiary-
trustee’s discretion is protected by an ascertainable standard as defined in the relevant Internal Revenue Code sections. The result is that the beneficiary’s trustee’s interest is protected to the extent it is also exempt from federal estate tax. The amendment thereby achieves its main purpose, which is to protect the trustee-beneficiary of a bypass trust from creditor claims.

The protection conferred by this subsection, however, is no greater than if the beneficiary had not been named trustee. If an exception creditor can reach the beneficiary’s interest under some other provision, the interest is not insulated from creditor claims by the fact the beneficiary is or becomes a trustee.

D. The Inadvertent Settlor – Crummey Powers. Since the Uniform Trust Code rejects the concept of a self-settled trust, this presents a problem when a beneficiary is treated as a settlor of a trust without having contributed assets. Section 505 of the Uniform Trust Code governs “Creditor’s Claims Against Settlors.” It provides that:

(a) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(1) During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor’s creditors.

(2) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor’s benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor’s interest in the portion of the trust attributable to that settlor’s contribution.

(3) After the death of a settlor, and subject to the settlor’s right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor’s death is subject to claims of the settlor’s creditors, costs of administration of the settlor’s estate, the expenses of the settlor’s funeral and disposal of remains, and [statutory allowances] to a surviving spouse and children to the extent the settlor’s probate estate is inadequate to satisfy those claims, costs, expenses, and [allowances].

For purposes of Section 505 of the Uniform Trust Code, section 505(b) provides that:

(1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and

(2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount
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specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on [the effective date of this [Code]].

As discussed in the comments to Section 505 of the Uniform Trust Code, subsection (b)(1) treats a power of withdrawal as the equivalent of a power of revocation because the two powers are functionally identical. If the power is unlimited, the property subject to the power will be fully subject to the claims of the power holder’s creditors, the same as the power holder’s other assets. For powers limited either in time or amount, such as a crummy power to withdraw the annual exclusion contribution within 30 days, subsection 505(b) would limit the creditor to the amount of the crummy withdrawal right and require the creditor to take action prior to the expiration of the 30-day period.

Upon the lapse, release, or waiver of a power of withdrawal, the property formerly subject to the power will normally be subject to the claims of the power holder’s creditors and assignees the same as if the power holder were the settlor of a now irrevocable trust. Pursuant to subsection (a)(2), a creditor or assignee of the power holder generally may reach the power holder’s entire beneficial interest in the trust, whether or not distribution is subject to the trustee’s discretion. However, following the lead of Arizona Revised Statutes Section 14-7705(g) and Texas Property Code Section 112.035(e), subsection (b)(2) creates an exception for trust property which was subject to a Crummey or five and five power. Upon the lapse, release, or waiver of a power of withdrawal, the holder is treated as the settlor of the trust only to the extent the value of the property subject to the power at the time of the lapse, release, or waiver exceeded the greater of the amounts specified in IRC Sections 2041(b)(2) or 2514(e) [greater of 5% or $5,000], or IRC Section 2503(b)

E. Overdue Distribution. The concept of an overdue distribution, codified in Section 506 of the UTC, is something that has been recognized by the courts for years. The concept was codified in Section 506 provides that

(a) In this section, “mandatory distribution” means a distribution of income or principal which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust. The term does not include a distribution subject to the exercise of the trustee’s discretion even if (1) the discretion is expressed in the form of a standard of distribution, or (2) the terms of the trust authorizing a distribution couple language of discretion with language of direction.

(b) Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the beneficiary within a reasonable time after the designated distribution date.

The effect of a spendthrift provision is generally to insulate totally a beneficiary’s interest until a distribution is made and received by the beneficiary. See Section 502. But this section, along with several other sections in this article, recognizes exceptions to this general rule. Whether a trust contains a spendthrift provision or not, a trustee should not be able to avoid
creditor claims against a beneficiary by refusing to make a distribution required to be made by the 
express terms of the trust. On the other hand, a spendthrift provision would become largely a 
nullity were a beneficiary’s creditors able to attach all required payments as soon as they became 
due. This section reflects a compromise between these two competing principles. A creditor can 
reach a mandatory distribution, including a distribution upon termination, if the trustee has failed 
to make the payment within a reasonable time after the designated distribution date. Following 
this reasonable period, payments mandated by the express terms of the trust are in effect being 
held by the trustee as agent for the beneficiary and should be treated as part of the beneficiary’s 
personal assets.

V. STATUTORY EXCEPTIONS TO SPENDTHrift TRUST PROTECTION AND 
ATTEMPTS TO CREATE EXCEPTIONS FOR INTENTIONAL TORTS.

The issue of the ability of an individual to protect the assets in a spendthrift trust has 
recently been heavily debated as a result of the trend of individual states to allow for “self-
settled” asset protection trusts. In fact, the issue of the ability to use such “self-settled” trust to 
protect the assets of a settlor-beneficiary was hotly debated in 2005 by the U.S. Senate when 
Despite the many ethical and moral issues involved, attempts to limit the use of “self-settled” 
trusts, particularly asset protection trusts, failed in the U.S. Congress. In fact, since the trend first 
 began in 1987, approximately 13 states have adopted legislation designed to protect the interest of 
a settlor-beneficiary in a “self-settled” trust.

Part of the debate over the ethicacy of such trusts goes to the issue of whether such trust 
should provide any type of protection to an individual who has caused serious personal injury or 
financial harm, whether or not the trust is self-settled. In fact, during the debates surrounding the 
Restatement of Trusts, 3d as well as the Uniform Trust Code, the issue of the extent to which 
exceptions would be made to the general spendthrift trust protection rule was heavily debated. In 
fact, some individuals are claiming that such protections violate public policy in, at least, 
egregious situations.

A. Restatement and Uniform Trust Code. Both the Restatement of Trusts, 3d as 
well as the new Uniform Trust Code provide certain exceptions for particular types of claims 
which are allowed to reach the beneficial interest in a spendthrift trust notwithstanding a well-
drafted spendthrift trust provision. The general rule is best illustrated by Section 503 of the 
Uniform Trust Code which provides that:

(a) In this section, “child” includes any person for whom an order or judgment for 
child support has been entered in this or another State.

(b) Even if a trust contains a spendthrift provision, a beneficiary’s child, spouse, or 
former spouse who has a judgment or court order against the beneficiary for 
support or maintenance, or a judgment creditor who has provided services for the 
protection of a beneficiary’s interest in the trust, may obtain from a court an 
order attaching present or future distributions to or for the benefit of the 
beneficiary.

(c) A spendthrift provision is unenforceable against a claim of this state or the 
United States to the extent a statute of this State or federal law so provides.
The exception in subsection (b) for judgments or orders to support a beneficiary’s child or current or former spouse is in accord with Restatement (Third) of Trusts § 59(a) and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge. The effect of this exception is to permit the claimant for unpaid support to attach present or future distributions that would otherwise be made to the beneficiary. Distributions subject to attachment include distributions required by the express terms of the trust, such as mandatory payments of income, and distributions the trustee has otherwise decided to make, such as through the exercise of discretion. Subsection (b), unlike Section 504 of the UTC, does not authorize the spousal or child claimant to compel a distribution from the trust. Section 504 authorizes a spouse or child claimant to compel a distribution to the extent the trustee has abused a discretion or failed to comply with a standard for distribution.

Subsection (b) refers both to “support” and “maintenance” in order to accommodate differences among the States in terminology employed. No difference in meaning between the two terms is intended.

The definition of “child” in subsection (a) accommodates the differing approaches states take to defining the class of individuals eligible for child support, including such issues as whether support can be awarded to stepchildren. However the state making the award chooses to define “child” will be recognized under this Code, whether the order sought to be enforced was entered in the same or different State.

Interestingly, the Uniform Trust Code provides an express exception for the superior claims of a state or the United States to the extent that a statute of the state or federal law otherwise provides. This contrasts with the approach taken in Section 59 of the Restatement of Trusts, 3d, which does not specifically address the statutory claims of states or the federal government. Instead, the comments to the Restatement simply provide that implicit in the rule of Section 59 of the Restatement, as a statement of common law, is that government claimants, and other claimants as well, may reach the interest of a beneficiary of a spendthrift trust to the extent provided by federal law or an applicable state statute. An obvious example of such an exception would be the Supremacy Clause found in the U.S. Constitution. In any event, the Uniform Trust Code expressly makes an exception for claims of a state or the United States but only to the extent that the operative statute in question grants the governmental authority the ability to reach the interest of the beneficiary in the trust.

B. Debate Over Exceptions for Tort and Other Claims. The Reporter’s Notes to Section 59 of the Restatement of Trusts, Third, indicates that the basic rationale for the protections found in a spendthrift trust provision is based on the premise that freedom of disposition in this country allows a property owner to impose conditions and limitations on beneficial interests he or she creates in a trust, but only to the extent they are not illegal or contrary to public policy. Thus, the Restatement provides for the exceptions found in Section 59 and expanded upon in Section 503 of the Uniform Trust Code. While this author has not undertaken a state-by-state examination of the extent to which the exceptions provided by Section 59 of the Restatement or Section 503 of the Uniform Trust Code have been followed, as a general rule, it does appear that many states, including some that have not adopted the Uniform Trust Code, have nevertheless adopted the exception for child support payments. However, the claims of former spouses do not seem to have been generally incorporated into most state laws.
Notwithstanding the exceptions articulated in the Restatement and Section 503 of the Uniform Trust Code, an exception which is not found in either the Restatement or the UTC is an exception for tort claims. However, that has not prevented some claimants from attempting to create a common law exception for tort claims.

Possibly one of the first attempts to carve an exception to the general rule was found in the Mississippi case of Sligh v. First Nat'l Bank, 704 So. 2d 1020 (Miss. 1997). In Sligh, William B. Sligh was involved in an auto accident with Gene Lorance, an uninsured motorist who was operating a vehicle while intoxicated. As a result of the accident, Mr. Sligh suffered a broken spine and resulting paralysis, including loss of the use of both legs, loss of all sexual functions, and loss of the ability to control bowel and urinary functions. Lorance was convicted of the felony of driving under the influence and causing bodily injury to another, for which he was sentenced to serve ten years in prison, with six years suspended.

Shortly after the accident, Mr. Sligh and his wife filed a lawsuit against Lorance alleging gross negligence which resulted in the injuries to Mr. Sligh. As a result of that lawsuit, a $5 million judgment for compensatory and punitive damages was rendered against Mr. Lorance in favor of the plaintiffs William Sligh and his wife, Lucy Sligh.

As it turned out, Mr. Lorance had no assets other than his interest as beneficiary of two spendthrift trusts established by his mother in 1984 and 1988, respectively, before she died in 1993. First National Bank of Holmes County was the trustee of both trusts.

The trust agreements both included spendthrift provisions which specifically provided that “no part of this Trust, either principal or income, shall be liable for the deaths of said Gene Lorance, nor shall the same be subject to seizure by any creditor of his . . .”

On June 29, 1994, Mr. and Mrs. Sligh filed a separate lawsuit in an effort to seize the assets of the trusts, to the extent of their judgment. The plaintiffs alleged that the settlor of the trust, Edith Lorance, had actual knowledge of her son’s habitual drinking habits and the fact that he had been unsuccessfully treated for alcoholism and that he was mentally deficient and had been previously committed to mental institutions. He had impaired facilities due to his alcoholism and mental disorders, and that he regularly operated motor vehicles while intoxicated. The complaint went on to allege that despite her actual knowledge of these facts, Ms. Lorance established the two trusts as part of her intentional plan and design to enable her son to continue to lead his “intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trust from the claims of his involuntary tort creditors.” As a result, the Slighs alleged that it would be a violation of public polity to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary. They urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors by subjecting Lorance’s beneficial interest to the payment of their tort judgment in one or more of several equitable ways suggested in their complaint.

The Supreme Court of Mississippi held that, “as a matter of public policy . . . a beneficiary’s interest in spendthrift trust assets is not immune from attachment to satisfy the claims of the beneficiary’s intentional or gross negligence tort creditors.” In arriving at its holding, the court acknowledged the four exceptions to the rule prohibiting the invasion of a spendthrift trust enumerated in the Restatement, i.e., claims: for support of child or wife; for necessaries; for “services rendered and materials furnished which preserve or benefit the interest
of the beneficiary; for State or federal taxes, Id. at 1026, quoting Restatement (Second) of Torts, § 157, and a fifth, when the trust is “a self-settled trust, i.e., where the trust is for the benefit of the donor,” it had itself recognized Id., citing Deposit Guaranty Nat’l Bank v. Walter E. Heller & Co., 204 So. 2d 856, 859 (Miss. 1967). Conceding that § 157 of the Restatement does not list an exception for involuntary tort creditors, the court found support for its position in Comment a to that section, which, as we have seen, admits of the possibility of a tort claimant with a claim against the beneficiary of a spendthrift trust being able to reach that beneficiary’s interest. Sligh, supra, 704 So. 2d at 1026. It also was persuaded by those portions of Scott, The Law of Trusts and Bogert, Trusts and Trustees, quoted herein and to which the appellant referred us. Id. at 1027. Finally, the court rejected the three public policy considerations it identified from its own precedents upholding the validity of spendthrift trust provisions: “(1) the right of donors to dispose of their property as they wish; (2) the public interest in protecting spendthrift individuals from personal pauperism, so that they do not become public burdens; and (3) the responsibility of creditors to make themselves aware of their debtors’ spendthrift trust protections.” Id. at 1027.

Thus, the court found, in a 7-2 decision, that, as a matter of public policy, a beneficiary’s interest in spendthrift trust assets was not immune from attachment to satisfy the claims of the beneficiary’s intentional or gross negligence tort creditors, and that such claims took priority over any remainder interest in such assets. However, the dissenting justices, while numbering only two, wrote a two-paragraph dissent which, in the long run, had a farther reaching effect than anyone could have ever contemplated. In the dissent written by Justice Prather, and joined by Justice J. Smith, Justice Prather wrote:

“I must respectfully dissent to the limitations placed by the majority on the exempt status of spendthrift trust benefits. The majority acknowledges that Louisiana is the only other State to place such limitations on spendthrift trust benefits for tort creditors, and said limitations were implemented by the Louisiana legislature rather than the courts of said state. This Court is thus, apparently, the first to so limit the exempt status of spendthrift trust benefits. I am aware of the public policy considerations which motivated the majority’s decision, but, in my view, the general rule favoring the exempt status of spendthrift trusts benefits is a sound one which is in no need of revision.

“Spendthrift trusts provide a means for a parent or other concerned party to provide for the basic needs of a beneficiary, and the largely exempt status of the trust benefits has given comfort and support to countless settlors and beneficiaries. The facts of the present case are tragic, but this Court should, in my view, avoid changing longstanding precedent based on the fact pattern of a particular case. Creditors in this state have at their disposal a number of means of collecting judgments, and I fear that the majority opinion signals the start of a gradual decline of the spendthrift trust in this state. I would affirm the ruling of the trial court, and I must accordingly dissent.”

The concise and accurate articulation of historical spendthrift trust protection offered by the dissent in the Sligh case apparently was not lost on many in Mississippi and, in particular, the Mississippi Legislature. A mere five months after the decision in Sligh, effective March 23, 1998, the Mississippi Legislature passed the Family Trust Preservation Act of 1998. Miss. Code Ann. § 91-9-503 (2003), effectively overruling the decision in Sligh by providing that:
“Beneficiary’s Interest not subject to transfer; restrictions on transfers and enforcement of money judgments.

“Except as provided in Section 91-9-509, if the trust instrument provides that a beneficiary’s interest in income or principal or both of a trust is not subject to voluntary or involuntary transfer, the beneficiary’s interest in income or principal or both under the trust may not be transferred and is not subject to the enforcement of a money judgment until paid to the beneficiary.”

The speed at which the Mississippi Legislature moved to overturn the decision in Sligh did not go unnoticed. In an article appearing in the California Law Review shortly after the decision was rendered, an article on the overall trend in this area of the law wrote:

“An almost amusing reversal of direction was the prompt 1998 legislation in Mississippi to overturn the widely acclaimed Sligh v. First National Bank. Sligh had introduced a policy-based spendthrift exception for the benefit of victims of a beneficiary's gross negligence or recklessness. Furthermore, lengthy and vigorous debates in the last few years have eventually led to no significant changes or trends in rules identifying privileged claimants who can penetrate the spendthrift shield. This is particularly so with reference to privileged status that applies to certain governmental claimants, and often applies to alimony and the support claims of children and spouses and to certain claims for necessities and for protection of a beneficiary’s trust interest.”

A similar attempt to pierce a spendthrift trust was attempted in the New Hampshire case of Laurie Scheffel, individually and as next friend of Cory C. v. Kyle Krueger, et al. In the Scheffel case, Ms. Scheffel alleged that the defendant, Kyle Krueger, had sexually assaulted her minor child. The same conduct that the plaintiff alleged in the tort claim also formed the basis of criminal charges against the defendant. The court entered a default judgment against defendant and ordered him to pay $551,286.25 in damages. To satisfy the judgment against the defendant, the plaintiff sought an attachment of the defendant’s beneficial interest in the Kyle Krueger Irrevocable Trust. The trust had been established by the defendant’s grandmother in 1985 for the defendant’s benefit. The trust agreement included a spendthrift trust provision which prohibited the beneficiary from making any voluntary or involuntary transfers of his interest in the trust. Specifically, Article VII of the trust agreement provided as follows:

“No principal or income payable or to become payable under any of the trusts created by this instrument shall be subject to anticipation or assignment by any beneficiary thereof, or to the interference or control of any creditors of such beneficiary or to be taken or reached by any legal or equitable process in satisfaction of any debt or liability of such beneficiary prior to its receipt by the beneficiary.”

The trial court had dismissed the plaintiff’s claim for relief, holding that the spendthrift provision was enforceable against the plaintiff’s claim under state law. Nevertheless, the plaintiff on appeal, argued that the legislature did not intend for state law to shield the trust assets from tort creditors, especially when the beneficiary’s conduct constituted a criminal act.

At the time, the statute in New Hampshire provided only two exceptions to the enforceability of spendthrift provisions. Specifically, state law provided that spendthrift trust protection “shall not apply to a beneficiary’s interest in a trust to the extent that the beneficiary is the settlor of the trust and the trust is not a special needs trust established for a person with disabilities”, and “shall not be construed to prevent the application of [fraudulent transfer laws].” Since it was clear that neither of the two foregoing exceptions applied to the plaintiff’s case, the plaintiff’s sole recourse was to argue that public policy required the court to create a tort creditor exception to the statute.

After reviewing the history of the spendthrift trust exceptions under state law, the New Hampshire Supreme Court held that the state legislature had enacted a statute specifically providing for only two exceptions, thereby repudiating any other exceptions to the law. Thus, the statutory enactment could not be judicially overruled because “it is axiomatic that courts do not question the wisdom or expediency of a statute.” citing Brahney, 87 N.H. 298. Therefore, no rule or public policy was available to overcome this statutory rule.

VI. THE DOMESTIC ASSET PROTECTION TRUST (“DAPT”)

Historically, while trusts have been very popular and widely used in the United States for a variety of purposes, a “self-settled” trust, that is, one that is established for the benefit of the settlor, have been seen as being against public policy and therefore, until recently, prohibited in all 50 states. The general rule against self-settled trusts was found for many years in the Restatement of Trusts, 2nd §156, which provided that:

1. Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

2. Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

The comments to the rule made it clear that the §156 prohibition against a self-settled trust was applicable even if the transfer into the trust was not a fraudulent conveyance. The interest of the settlor/beneficiary could therefore be reached by subsequent creditors as well as by those who were creditors at the time of the creation of the trust. It was immaterial that the settlor/beneficiary had no intention to defraud his or her creditors.

The rule against self-settled trusts was re-established in the recently published Restatement of Trusts, 3rd §58, which provides that:

“A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.”

The foregoing restriction of §58(2) actually appears in the section of the Restatement which, with some exceptions, specifically protects a spendthrift trust that provides by its terms that a beneficiary’s interest shall not be transferable by the beneficiary or subject to claims of the beneficiary’s creditors.
In the Restatement’s comments on the recodification of the rule against self-settled trusts in §58(2), it indicates that “occasional suggestions that the self-settled trust rule be re-examined have been uninfluential, and policy and rules in other areas of the law have been consistent with the rule here.” The Restatement did acknowledge limited exceptions such as in the area of pension fund planning, particularly under ERISA.

Notwithstanding the historical rule against self-settled trusts in the United States, the trend to effectively eliminate the common law doctrine against self-settled trusts has followed the trend to reexamine and modify or abolish longstanding common law rules that, in a modern society, are deemed obsolete or no longer necessary.

The first state to go against the traditional prohibition against self-settled trusts was the state of Alaska. On April 1, 1997, Alaska adopted the Alaska Trust Act, House Bill 101. Upon its enactment, the Alaska State Legislature issued a press release entitled “Measure to Strengthen Family Trust Becomes Law.” The legislation was ostensibly designed to provide an “onshore” alternative to international trusts.

Not to be outdone, the state of Delaware almost immediately thereafter adopted its own legislation on July 9, 1997, when it adopted the Delaware Qualified Dispositions in Trust Act. Since its initial adoption, Delaware has been quite aggressive in regularly amending its statute in an effort to stay one step ahead of its growing competition. Since Alaska started the trend in 1997, seven additional states, thus bringing the overall total to eight states, have adopted legislation that effectively eliminated the common law rule against self-settled trusts and, in its place, adopted asset protection trust legislation expressly sanctioning the Domestic Asset Protection Trust (“DAPT”). The eight states, in order of adoption, are: Alaska (1997), Delaware (1997), Nevada (1999), Rhode Island (1999), Utah (2004), Oklahoma (2004), Missouri (2004), and, effective July 1, 2005, the state of South Dakota. Thus, despite the so-called “public policy” against self-settled trusts, the trend in the United States is following the well-established trend in offshore jurisdictions. Specifically, jurisdictions are finding that, for a qualified settlor who is not using such structures to defraud creditors, a self-settled trust is a valid and legitimate structure entitled to the benefits historically granted a non self-settled spendthrift trust.

A. Typical DAPT Statute. Although all DAPT statutes have the same goal, they are by no means identical or even similar. For example, a glaring limitation of the Oklahoma statute is the $1 million “cap” that can be protected in an Oklahoma self-settled trust pursuant to that state’s legislation. Also varying from state to state is the statute of limitations on fraudulent transfers (2 years versus 4 years) and the type of assets that can be held in a DAPT and even the location of those assets. Nevertheless, generally speaking, all of the domestic asset protection trust statutes have similar characteristics which include:

- **Self-Settled Trusts Permitted.** State law has been amended by statute to specifically allow the establishment of a “self-settled trust” wherein the settlor can also be a beneficiary of the trust, can receive benefits from the trust and yet protect those benefits from the claims of future creditors. By eliminating the rule against self-settled trust, DAPT states have theoretically eliminated one of the major obstacles to using a domestic trust for asset protection purposes.
• **Rule Against Perpetuities Abolished.** Admittedly, the Rule against Perpetuities is probably an anachronism that has outlived its usefulness. Most of the offshore jurisdictions have eliminated the Rule against Perpetuities as have some states. Thus, with the elimination or limitation on the Rule against Perpetuities, a DAPT can theoretically continue for several generations and, in some states, forever.

• **Secrecy and Confidentiality Protection.** Some states, such as Alaska, have attempted to adopt strong “secrecy” provisions into their asset protection trust legislation in an effort to protect the confidential nature of the trust and any related information including the identity of the beneficiaries of the trust and the assets of the trust. Of course, such legislation can only go so far. It can defend against the premature disclosure of information relating to the trust while litigation is still pending. Such information is obviously discoverable in a post-judgment environment and certainly discoverable by state and federal authorities. Nevertheless, states like Nevada have extended the right of privacy to the corporate arena by providing, for example, that the officers and directors of a Nevada based company can be “nominees,” persons who are disclosed as having and exercising their legal capacity for the company when in fact they are acting on behalf of undisclosed principals. This allows an individual to serve as an officer, manager, or director of a Nevada company without having his or her name disclosed on public documents such as contracts or other documents that might be entered into as part of a business transaction or might actually be even available in the public records.

• **Retained Powers.** Many DAPT statutes allow the settlor of the trust to retain certain powers such as the power to veto distributions, to appoint advisors or trust protectors to the trust, or to retain the power to direct investments or appoint investment advisors to the trust. Some states even allow the settlor to remove and replace a trustee. The foregoing powers are essentially a retained control over the affairs of the trust which, in an offshore setting, would be an invitation to a court to force the settlor holding such powers to exercise them in favor of a creditor. However, in states that have adopted DAPT legislation, these powers are expressly sanctioned by law.

• **Redomiciliation to Offshore Jurisdiction.** As will be discussed below, there is great uncertainty associated with the effectiveness of domestic asset protection trusts. As a result, some states have adopted legislation that expressly allows a trustee of a DAPT to redomicile the trust to a foreign jurisdiction if such redomiciliation is in the best interest of the beneficiaries and consistent with the planning goals of the settlor. By expressly providing in state law that such offshore redomiciliation is sanctioned, the trustee can take steps to effectively remove the trust and its assets from “harms way” by moving the trust offshore without fear of civil liability to the trustee since the redomiciliation is expressly sanctioned by statute.
B. Delaware Asset Protection Trusts. Shortly after Alaska adopted the first domestic asset protection trust legislation in the country, the state of Delaware adopted the Delaware Qualified Dispositions in Trust Act (“Delaware APT Statute”) effective July 9, 1997, allowing the formation of a Delaware asset protection trust similar to that found in offshore jurisdictions containing statutory asset protection legislation. As with most Delaware business statutes, the Delaware legislature has continued to modify and refine the legislation since its initial adoption.

1. Qualified Dispositions A “qualified disposition” under Delaware law is nothing more than a disposition by or from a transfer to a qualified trustee or trustees, with or without consideration, by means of a trust instrument. A qualified trustee is typically a person:

- who is licensed to act as a trustee by the state of Delaware; or is an individual resident of the state of Delaware;
- maintains or arranges for custody in Delaware of some or all of the property that is transferred to the trust; or
- is not the transferor or a non-resident of the state.

Property that may be transferred to a Delaware trust includes real property, personal property, and interest in real or personal property.

2. Retained Powers of Settlor. The Delaware law provides that a Delaware asset protection trust shall be governed by a “trust instrument” which is an instrument appointing a qualified trustee or qualified trustees for the property that is subject of the disposition. The trust instrument must specifically incorporate the law of the state of Delaware to govern the validity, construction, and administration of the trust. However, what is quite appealing to many individuals are the powers that may be retained by a settlor of a Delaware trust. Of course, to be effective from an asset protection trust, the trust must be irrevocable. However, Delaware law provides that a trust instrument shall not be deemed revocable on account of its inclusion of one or more of the following:

- A transferor’s power to veto a distribution from the trust;
- A power of appointment (other than a power to appoint to the transferor, the transferor’s creditors, the transferor’s estate or the creditors of the transferor’s estate) exercisable by will or other written instrument of the transferor effective only upon the transferor’s death;
- The transferor’s potential or actual receipt of income, including rights to such income retained in the trust instrument;
- The transferor’s potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust as such terms are defined in §664 of the Internal Revenue Code of 1986 [26 U.S.C. §664] and any successor provision thereto; and the transferor’s right, at any time and from time to time by written instrument delivered to the trustee, to release such transferor’s retained interest in such a trust, in whole or in part,
in favor of a charitable organization that has or charitable organizations that have a succeeding beneficial interest in such trust;

• The transferor’s receipt each year of a percentage (not to exceed 5) specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument or of a fixed amount that on an annual basis does not exceed 5% of the initial value of the trust assets;

• The transferor’s potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of a qualified trustee’s or qualified trustees’ acting:

  a. In such qualified trustee’s or qualified trustees’ discretion;

  b. Pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal; or

  c. At the direction of an adviser described in Section 3570(9)(c) of the Delaware APT Statute who is acting (a) in such adviser’s discretion; or (b) pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially unfettered right to the receipt of or use of principal.

For purposes of the above paragraph, a qualified trustee is presumed to have discretion with respect to the distribution of principal unless such discretion is expressly denied to such trustee by the terms of the trust instrument.

• The transferor’s right to remove a trustee or adviser and to appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the transferor within the meaning of §672(c) of the Internal Revenue Code of 1986 [26 U.S.C. §672(c)] and any successor provision thereto);

• The transferor’s potential or actual use of real property held under a qualified personal residence trust within the meaning of such term as described in §2702(c) of the Internal Revenue Code of 1986 [26 U.S.C. §2702(c)] and any successor provision thereto or the transferor’s possession and enjoyment of a qualified annuity interest within the meaning of such term as described in Treasury Regulation §25.2702-5(c)(8) 26 C.F.R. 25.2702-5(c)(8)] and any successor provision thereto;

• The transferor’s potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and if such potential or actual receipt of income or principal would be the result of a qualified trustee’s or qualified trustees’ acting:
a. In such qualified trustee’s or qualified trustees’ discretion; or

b. At the direction of an adviser described in the Delaware APT Statute who is acting in such adviser’s discretion.

Distributions to pay income taxes made under discretion included in a governing instrument may be made by direct payment to the taxing authorities.

3. **Trust Protector.** The Delaware APT Statute allows for the concept of a trust protector similar to that found in offshore jurisdictions. Although the statute provides that only a “qualified trustee” may serve as a trustee of a Delaware asset protection trust, Section 3570(9)(c) provides that while neither the transferor nor any other natural person who is a nonresident of Delaware nor an entity that is not authorized by the law of this State to act as a trustee or whose activities are not subject to supervision as provided in the statute shall be considered a qualified trustee; however, nothing in the Delaware APT Statute precludes a transferor from appointing one or more advisers, including but not limited to:

- Advisers who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisers;
- Advisers who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust; and
- Advisers described in §3313 of the “Decedents Estates and Fiduciary Relations” provisions of the Delaware Code, whether or not such advisers would qualify as a “Qualified Trustee”.

For purposes of the Delaware APT Statute, the term “adviser” includes a trust “protector” or any other person who, in addition to a qualified trustee, holds one or more trust powers.

It should be noted that use of a Trust Protector who in an independent professional fiduciary or an individual who takes the role seriously, can go a long way in helping avoid many of the trust piercing problems that can occur when a domestic trust had a trustee who is an individual who is not knowledgeable about his or her responsibilities as a trustee or in those situations where the trustee and the beneficiary have a conflict of interest of some kind, especially in those situations where the trustee is also the beneficiary. A significant number of states have now adopted state law, such as what Delaware did, that adopts international style trust protector legislation into their state trust codes. Moreover, the trust protector does not need to be one entity or individual. It is not uncommon to have a “committee” of three (3) individuals who serve as a protector committee. These individuals usually consist of one or two professional advisor as well as close family friends who know the settlor well. A sample form of language than can be used to incorporate a trust protector into a domestic trust agreement is included herein as an Exhibit to this paper.

4. **Fraudulent Transfers.** Any transfer into a Delaware trust is subject to the fraudulent transfer provisions found in the Delaware APT Statute which incorporate many of the state’s normal fraudulent transfer provisions. However, there are significant exceptions. Section 3572 of the Delaware APT Statute provides that no action of any kind, including, without limitation, an action to enforce a judgment entered by a court or other body having adjudicative authority, shall be brought at law or in equity for an attachment or other provisional remedy
against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action shall be brought pursuant to the provisions of §1304 or §1305 of the Delaware Fraudulent Transfers Statute. The Delaware Court of Chancery has exclusive jurisdiction over any action brought with respect to a qualified disposition. However, in any action described in the foregoing sections, the burden to prove the matter by clear and convincing evidence is upon the creditor.

Section 3573 of the Delaware APT Statute provides that, notwithstanding the limitations imposed by §3572, the limitations on actions by creditors to avoid a qualified disposition shall not apply:

- To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt. However, the foregoing exception does not apply to any claim for forced heirship, legitime or elective share; or

- To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the tortious act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable but only to the extent of such claim against such transferor or other person for whom such transferor is or was vicariously liable.

C. Potential Pitfalls and Unresolved Issues. Notwithstanding the obvious advantages of domestic “onshore” asset protection trusts, several obvious issues and many potential pitfalls still exist. The effectiveness of DAPT legislation is not without its share of intelligent and articulate proponents and equally qualified critics. For example, the federal bankruptcy law that has been relied upon to protect a “spendthrift trust” has been cited for the authority that a domestic DAPT will even be recognized in a bankruptcy setting. Bankruptcy Code §541(c)(2) provides that a “restriction on the transfer of a beneficial interest of a debtor in a trust that is enforceable under applicable non-bankruptcy law” is to be honored in bankruptcy. While the foregoing legislation was adopted when all states had a general prohibition against protecting a self-settled trust, even some bankruptcy judges have recently acknowledged in unofficial settings that the foregoing language may require a bankruptcy court to give deference to a domestic asset protection trust. Others would argue that a bankruptcy judge is already required, like a federal judge, to apply the law of the jurisdiction in which the proceedings are pending for purposes of identifying the debtor’s interest in property. Thus, if bankruptcy proceedings are commenced by or against a debtor in a state that does not recognize self-settled trusts, it could be argued that the trust is not entitled to the protection of §541(c)(2) since it is not an enforceable trust under the non-bankruptcy law of the state in which the proceedings are pending. Of course, such argument would not be available in a state that actually sanctions domestic asset protection trusts.

There are other disadvantages to a DAPT under current law.

23 “Legitime” is a child’s equivalent to the “elective share” of a surviving spouse in a decedent’s estate.
Subject to U.S. Jurisdiction. Trusts and assets located within a DAPT state are still within the jurisdiction of U.S. federal courts. Federal courts have nationwide jurisdiction which is superior to that of any state court. A trustee in a DAPT state will be hard pressed to avoid responding to a federal court’s claim of jurisdiction.

Full Faith and Credit Clause. Possibly the biggest legal hurdle to domestic asset protection trusts is the “full faith and credit” clause of the U.S. Constitution which requires that each state of the Union is required to recognize the judgments rendered by the courts of another state. In fact, Alaska and other DAPT states have previously adopted the Uniform Foreign Money Judgments Act.

Supremacy Clause. While federal judges are bound by state law on most matters of substantive law, that certainly does not apply in the case where federal law has preempted state law including (1) matters of federal income taxation and (2) the power and the extent of the jurisdiction and authority of the bankruptcy court and bankruptcy trustee. Clearly assets transferred into a DAPT by a settlor should be reachable by the Internal Revenue Service or other agencies of the federal government to the extent of the settlor’s interest in the trust.

D. Future of Domestic Asset Protection Trusts. The mere fact that eight states have effectively abolished the common law rule against self-settled trusts, with more states considering doing so, is evidence of the fact that today’s litigious society is moving more and more towards allowing a solvent individual to take steps to protect his or her assets, so long as such action is not being done to delay, hinder, or defraud creditors. In fact, as discussed in the section on Bankruptcy Reform above, Congress clearly had before it the opportunity to effectively eliminate the growing trend toward the use of self-settled trusts both domestically and offshore. Yet, Congress expressly declined to do so, instead electing to allow a bankruptcy trustee to set aside transfers into such trusts when they are made with actual intent to delay, hinder or defraud creditor. While domestic asset protection trusts still face many unresolved issues, they are certainly an alternative that should be considered for asset protection purposes, particularly those not inclined to pursue an offshore solution. However, it is too early to tell whether domestic asset protection trusts will be as effective as their proponents hope they are.

Individuals living within states that have actually adopted domestic asset protection trust legislation certainly stand a much better chance of being able to protect their structure than those individuals who reside outside of those states but nevertheless form a DAPT in the hopes that such trusts will eventually be recognized by the U.S. courts. Nevertheless, while there have been at least two cases involving litigation where the validity of a DAPT was placed into question, both cases were settled before trial. Thus, to date, there is no authoritative case law to support the proposition that domestic asset protection trusts will ultimately receive the same level of respect and recognition that is currently available to non self-settled spendthrift trusts.

VII. ATTACKS ON DOMESTIC FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES.

The family limited partnership (FLP) is the traditional workhorse of gift and estate tax practitioners. It has many advantages over other less flexible alternatives. Unlike an irrevocable
trust, the FLP can be amended to respond to changing business, family, and legal needs. From a tax standpoint, the ability to make special allocations of income and deductions presents significant income tax planning possibilities. However, that same flexibility allows the FLP to be drafted to facilitate the preservation and orderly transition of family wealth and managerial control from one generation to the next. While family limited partnerships are probably best known for the valuation discounts available when valuing an undivided interest in an FLP for federal gift and estate tax purposes, a less publicized advantage of an FLP is the asset protection’s feature available under the law of many domestic and international jurisdictions that can be just as important as tax savings to the overall goal of family wealth preservation.

The asset protection attributes of a family limited partnership derive from statutory as well as non-statutory sources. The limitations and restrictions found within the partnership agreement itself provide various tools that can be used to preserve partnership assets and the interest of the family members in the partnership. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to and held by a family limited partnership. Assuming the partners have respected the family limited partnership as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the partnership are owned by the partnership, not the individual partners.\(^\text{24}\)

Moreover, should the creditor attempt to instead seize the debtor partners’ interest in the family limited partnership, the “charging order” limitation found in virtually all state limited partnership laws will likewise frustrate a creditor’s efforts. The charging order limitation, discussed in detail below, is made available by state statute and significantly limits the recourse available to a creditor seeking recourse against a judgment debtor’s interest in a partnership. Generally speaking, the partnership interest cannot be seized or sold, unlike other non-exempt personal assets. Instead, the “charging” creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. State law generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the “charged” interest. These limitations on the rights of a partner’s creditors enhance the value of the family limited partnership as an important family wealth preservation vehicle.

Notwithstanding the popularity of FLPs, the use and popularity of the domestic limited liability company (LLC) has also increased since it was first introduced to this country in 1976. The domestic LLC is designed to bring together in a single business organization the best features of all other business forms. Properly structured, its owners obtain both a corporate styled liability shield for its members and the pass-through tax benefits of a partnership.\(^\text{25}\) However, despite its unique background and purpose, the LLC has yet to gain the widespread use and acceptance enjoyed by the traditional FLP for gift and estate tax planning purposes. However, its asset protection benefits, especially when combined with an FLP, makes the domestic LLC a very valuable asset protection tool when structuring a family wealth preservation plan.

While the FLP and LLC have multiple business and tax benefits associated with their use, this paper will focus on the asset protection benefits available under state law, especially when

\(^{24}\) Revised Uniform Partnership Act (1994) (RUPA) §203 and 501.

they are used together in designing a client’s wealth preservation structure. However, it should be noted that the planning techniques discussed in this paper assume that the transfer of assets to the FLP or LLC do not involve fraudulent transfers under state law or federal bankruptcy law. Moreover, since some of the techniques described in this paper are, by their own admission, effective to thwart the collection efforts of the Internal Revenue Service, it is particularly important for the client’s professional advisor to document and be satisfied that the transfer of assets to a FLP or LLC do not violate federal law prohibitions against actions designed to defeat the collection of tax imposed by the Internal Revenue Code.26

A. The “Charging Order” Limitation. The charging order limitation found in most state partnership laws derives from Section 703 of the Revised Uniform Limited Partnership Act (the RULPA) which has been adopted, in one form or another in virtually all states.27 The comments in RULPA regarding charging orders are unusually brief. However, the underlying history and roots of the charging order limitation were discussed at length in the oft-quoted California case of Taylor v. S & M Lamp Co.28

“Prior to California’s adoption of the Uniform Partnership Act (Corp. Code, §15001 et seq.), a judgment creditor of a partner whose personal debt, as distinguished from partnership debt, gave rise to the judgment, could cause a sale at execution of partnership assets, including specific items of partnership property, to satisfy his judgment...

Lord Justice Lindley gave the following reason for the English rule forbidding execution sale of a partner’s interest in the partnership to satisfy his non-partnership debt:

When a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a fi. fa., and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and caused the execution creditor to bring an action in Chancery in order to get an injunction to take an account and pay over that which was due the execution debtor. A more clumsy method of proceeding could hardly have grown up.

26 Federal law provides that anyone who “removes, deposits or conceals” assets with intent to evade or defeat the collection of any tax imposed by the Internal Revenue Code shall be guilty of a felony and, upon conviction, fined $100,000 or imprisoned for not more than 3 years, or both. I.R.C. § 7206(4).

27 Revised Uniform Limited Partnership Act (1976) (RULPA) §703. “On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only its rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest.”

It was to prevent such “hold up” of the partnership business and the consequent injustice done the other partners resulting from execution against partnership property that the quoted code sections and their counterparts in the Uniform Partnership Act and the English Partnership Act of 1890 were adopted. As we view those code sections they are not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served.”

Thus, the charging order evolved as a way to divert the debtor’s share of the partnership profits and surplus to his creditors without disrupting the ongoing partnership. The charging order operates, in effect, as a substitution for execution on a partner’s interest in the limited partnership. Once charged, the judgment creditor has only the rights of an assignee of the partnership interest. As an assignee, a creditor has the right to receive distributions to which the debtor partner would have been entitled; however, the charging order does not entitle the creditor to become or to exercise any rights of a partner. As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur. The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law. Moreover, in a family limited partnership, the general partner will likely be a family member sympathetic to the plight of the partner who has been subject to the creditor’s charging order. Thus, it is unlikely that the general partner would elect to make a cash distribution to partners which would entitle the creditor/assignee to a distribution.

B. The Limited Liability Company Alternative. The domestic limited liability company was first introduced into the United States in 1976 by Wyoming and has since been adopted by all 50 states and the District of Columbia. Unfortunately, state limited liability company statutes display what the National Conference of Commissions on Uniform State Laws called a “dazzling array of diversity.” In an effort to promote uniformity among the states, the Conference in 1996 adopted the Uniform Limited Liability Company Act (ULLCA).

Since one of the stated purposes of the Act was to incorporate the best features of other business forms, the ULLCA incorporated the concept of the charging order limitation into the

31 RULPA §703.
32 RULPA §702.
33 RULPA §704(a). An assignee may also become a partner if the assigning partners grant the assignee that right in accordance with the partnership agreement, something which is unlikely to be given the assignor is an uncooperative judgment debtor.
34 RULPA §305.
35 See Footnote 2.
Act. Section 504 of the ULLCA, while providing for the concept of a charging order, further provides that a limited liability membership interest may be subject to judicial foreclosure by order of a court. However, not all states have adopted this broad language in their state laws. For example, Section 4.06 of the Texas Limited Liability Company Act adopts that portion of the ULLCA which allows a creditor of a member of a limited liability company to obtain a charging order against that member’s membership interest. However, the Texas legislation excludes all of the language found in the ULLCA which outlines the various remedies of a creditor holding a charging order, including the remedy of foreclosure. Curiously, the foreclosure language is found in the language governing a charging order against a limited partnership under the Texas Revised Uniform Limited Partnership Act. The fact that the foreclosure remedy is found in the Texas Uniform Limited Partnership Act but not in the Texas Uniform Limited Liability Company Act is clearly strong evidence of the legislative intent on the part of the Texas legislature to exclude the foreclosure remedy to a creditor holding a charging order against a member’s interest in a limited liability company.

Whether or not foreclosure is available to a creditor, many state LLC statutes provide that a judgment creditor has only the rights of an assignee of the LLC interest so charged. For example, in Delaware, an assignee of a member’s limited liability company interest has no right to participate in the management of the business and affairs of the limited liability company except as provided in the LLC operating agreement and upon (a) the approval of all of the members of the LLC other than the member assigning his LLC interest or (b) compliance with any procedure provided for in the LLC operating agreement. However, since the judgment creditor, as an assignee, is entitled to the member’s share in the profits and gains of the LLC, the judgment creditor may be taxable on its pro rata share of taxable income from the LLC. As with a limited partnership interest, a creditor who utilizes a charging order to attach the membership interest of a debtor member will not welcome the prospect of having to report taxable income on income that has probably not been distributed to the creditor.

Assets transferred to an LLC are also protected from member’s creditors. Members of an LLC are neither co-owners of nor have a transferable interest in, property of an LLC. Thus assets transferred to an LLC become the property of the LLC and not subject to the creditor claims of its individual members. Since a creditor’s recourse against a member is limited to a

36 ULLCA §504.

37 Texas Revised Limited Partnership Act § 7.03.

38 See i.e. Del. Code title 6, §18-703.


40 Id., §18-702(b)(1).


42 This assumes that the transfer is not subject to attack as a fraudulent conveyance under state law should the transferring member already be insolvent.

43 ULLCA §501(a).
charging order, assets transferred to an LLC can be effectively protected against levy and seizure by a creditor. This concept was recently illustrated in a IRS Chief Counsel advisory which held that the IRS may not levy on the assets of a single member LLC in order to satisfy the individual tax liability of the sole member-owner. The mere fact that the entity was disregarded as a separate entity under IRS “Check the Box” Regulations did not legally justify an IRS levy on the assets of the LLC since property rights in those assets are governed under state law. Since state law provided that the assets sought to be levied upon were the property of the LLC and not the individual member, the individual taxpayer-member did not have a property interest in those assets that the IRS could levy upon.

The Chief Counsel did note that the IRS had other collection options available including a levy against distributions from the LLC to the individual member. However, even the IRS must wait until those distributions are made. Moreover, state law does not usually provide creditors with the same collection remedies available to the IRS, particularly if the distributions from the LLC are classified as wages or salary exempt from creditor attachment under state law.

C. Delaware Adopts Unambiguous Charging Order Protection. Unfortunately, over a course of several years, many courts have interpreted state law to allow a creditor to also seek a foreclosure of a partner’s interest in a partnership. Once a foreclosure occurs, the partner loses his or her interest in the partnership. This remedy came about primarily because of ambiguous language in the Uniform Limited Partnership Act which implies, without specifically stating so, that foreclosure was a remedy to a creditor with a charging order against a partner’s interest in a partnership when such interest is subject to a charging order. Therefore, effective August 1, 2005, the state of Delaware amended its limited partnership law to prevent such foreclosures. In the language which accompanied the amendment to the statute that was eventually adopted, the sponsors of the amending legislation stated that the purpose of the proposed amendments was:

“to clarify the nature of a charging order and provide that a charging order is the sole method by which a judgment creditor may satisfy a judgment out of the partnership interest of a partner or partner’s assignee. Attachment, garnishment, foreclosure or like remedies are not available to the judgment creditor and a judgment creditor does not have any right to become or to exercise any rights or powers of a partners (other than the right to receive the distribution or distributions to which the partner would otherwise have been entitled, to the extent charged”.

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44 Regs. 301.7701-3(b).
45 CCA 199930013.
46 Wages payable in Texas are fully exempt from creditor claims, except for child support claims, and may not be attached or garnished by a creditor. Tex. Prop. Code Ann. §42.001(b)(1).
47 Del. Code title 6, §17-703.
PIERCING OF SPENDTHRIFT TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND OTHER THREATS TO ESTATE PLANNING STRUCTURES

The 2005 amendments to the Delaware Revised Uniform Limited Partnership Act also provide that the Court of Chancery of the State of Delaware has exclusive jurisdiction to decide all matters pertaining to charging orders involving a Delaware limited partnership.48

The amendments pertaining to charging order protection that were made to limited partnership law in Delaware were also added to the Delaware Limited Liability Company Act.49 Therefore, the state of Delaware has specifically provided that a creditor may not seize the interest of a partner in a limited partnership or a member in a limited liability company. The creditor’s sole recourse is the charging order. Thus, should a partner find themselves in this unfortunate situation, these limitations on creditors under Delaware law should help to induce a settlement of an outstanding claim that a creditor might not otherwise be inclined to accept. The foregoing asset protection features of your family limited partnership are an essential part of the design that has been incorporated into your family limited partnership.

D. Beware of Single Member LLCs. Asset protection planning is only one of several very important issues that should be considered when choosing the appropriate entity for a client. However, if asset protection is one of the principal goals of the planning process, single member LLCs should be avoided.

In the recent U.S. bankruptcy case of In Re: Albright,50 the debtor filed a Chapter 13 petition under the bankruptcy code that was later converted to a Chapter 7 liquidation. One of the assets of the estate was a single member LLC of which the debtor was the sole member and manager. The Chapter 7 bankruptcy trustee argued that because the debtor was the sole member and manager of the LLC at the time she filed bankruptcy, the Chapter 7 trustee had effectively stepped into the shoes of the debtor. Hence, the Chapter 7 bankruptcy trustee had become the “substituted” sole member of the LLC and, as such, could appoint new managers and/or vote to liquidate the LLC in its entirety. The debtor argued that the sole remedy of the trustee was to seek a charging order against distributions made on account of her LLC membership interest.

The court agreed with the trustee’s position and held that the debtor’s bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate pursuant to 11 USCS §541, and that the trustee thereby obtained all of the debtor’s rights, including the right to control the LLC management, since applicable law51 provided that the members, including the sole member of a single member LLC, had the power to elect and change managers. Since the trustee became the sole member of the LLC upon the debtor’s bankruptcy filing, then the trustee controlled all governances of the LLC, including all decisions related to a liquidation of the LLC’s assets. This finding is particularly important since the LLC law of several offshore jurisdictions has been modeled after existing U.S. statutes.

48 Del. Code title 6, §17-703(f).
49 Del. Code title 6, §18-703.
50 In Re Albright, 291B.R. 558; (Bankr. D. Colo. 2003).
Interestingly, notwithstanding its finding, the court admitted that under applicable law\(^\text{52}\) the result would have been different had there been other non-debtor members in the debtor LLC.

“Where a single member files bankruptcy while the other members of a multi-member LLC do not, and where the non-debtor members do not consent to a substitute member status for a member interest transferee, the bankruptcy estate is only entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled.”\(^\text{53}\)

Many in the asset protection community had predicted the result in Albright years before it actually occurred. Now that it has, the decision underscores the importance of incorporating multiple members in an LLC if asset protection is an important goal in forming the entity, whether domestically or offshore. Moreover, as implied in Albright, the interest of the members should be more than \textit{de minimis}. If the LLC is formed as part of the comprehensive business and estate plan, such a membership allocation should not be difficult. More importantly, any offshore structure should be avoided if there is a reasonable likelihood that the client will soon become a debtor in bankruptcy proceedings.

E. Exposure of FLP Partners & FLLC Members to Bankruptcy Trustee

\textbf{Superior Federal Powers.} Just as the Strangi case provided an unexpected weapon to the Internal Revenue Service to attack family limited partnerships and family limited liability companies, U.S. Bankruptcy Trustees have found and have recently been successful in utilizing the provisions of § 541 of the U.S. Bankruptcy Code to disregard all restrictions against the transfer of a partnership or membership interest, including those provided under state law, thus enabling the bankruptcy Trustee to step into the shoes of a bankrupt debtor who owns an interest in such an entity at the time of the filing of his bankruptcy Petition. Moreover, since the bankruptcy Trustee becomes a “substituted partner” or “substituted member” whether or not the entity or any of his partners concur, the bankruptcy Trustee becomes a “full member” in the estate planning structure, with any and all rights that the bankrupt debtor had in the estate planning structure before seeking bankruptcy protection. The result is a very powerful weapon in the arsenal of the bankruptcy Trustee, particularly when the bankrupt debtor might have a cause of action against the estate planning structure or any of its owners, typically, the matriarch and patriarch of the family for which the estate planning structure was created.

1. \textbf{In Re: Ehmann.} As quoted above in the section discussing the Albright case, the bankruptcy court acknowledged that the result of that case would have been different had the LLC not been a single member LLC. Specifically, the court acknowledged that that the bankruptcy trustee would \textit{not} step into the shoes of the debtor in bankruptcy if non-debtor members did not consent to substitute member status for a member’s interest transferred as a result of a bankruptcy filing by the member/debtor. However, a different bankruptcy court reached an opposite conclusion in the 2005 case of In Re: Ehmann.\(^\text{54}\)

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\footnotesize
\textit{Id., §7-80-702.}
\textit{In Re Albright, supra} note 40, at 540.
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In *Ehmann*, the bankruptcy trustee in the Chapter 7 bankruptcy proceedings of debtor Gregory L. Ehmann, filed a lawsuit against Fiesta Investments, LLC, an Arizona limited liability company of which the debtor was a member when his bankruptcy case was filed. The trustee’s lawsuit sought a declaration that the trustee had the status of a member in Fiesta, a determination that the assets of Fiesta were being wasted, misapplied or diverted for improper purposes, and for an order dissolving and liquidating Fiesta or the appointment for a receiver for Fiesta. In response, Fiesta filed a motion to dismiss the complaint arguing that, under Arizona law and the Operating Agreement governing Fiesta, the trustee was a mere “assignee” and, as such, had rights that were limited to receiving a distribution that might have been made to the defendant if and when Fiesta decided to make such a distribution.

Critical to the resolution of *Ehmann* was two significant Bankruptcy Code provisions, §§541(c)(1) and 365(e)(2). Bankruptcy Code §365(e)(2) basically provides that a bankruptcy trustee may not assume or assign any “executory contract” whether or not such contract prohibits or restricts assignments of rights or delegation of duties, if:

- applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract prohibits or restricts assignment of rights or delegation of duty; and
- such other party does not consent to such assumption or assignment.

Although the Bankruptcy Code contains no definition of an “executory contract,” the court essentially adopted the “Countryman” definition formulated by the Ninth Circuit which describes a contract as being executory if “the obligation of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.” Thus, if the operating agreement with Fiesta was found to be an “executory contract,” the restrictions in that operating agreement would be binding on the bankruptcy trustee.

However, after having examined all of the arguments made by Fiesta supporting the notion that the operating agreement was an “executory contract,” the bankruptcy court found that the members had no binding unfulfilled obligations to the Fiesta, thus rendering the operating agreement a non-executory contract. Having made that finding, the bankruptcy court determined that Bankruptcy Code §541(c)(1) governed the status of the bankruptcy trustee in Fiesta.

Bankruptcy Code §541(c)(1) expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. The court found that all of the limitations in the operating agreement, and all of the provisions of Arizona law on which Fiesta relied upon, constituted conditions and restrictions upon the member’s transfer of his interest. Since Bankruptcy Code §541(c)(1) rendered those restrictions inapplicable, the court found that

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this necessarily implied that the trustee had all of the rights and powers with respect to Fiesta that
the debtor held as of the commencement of the case. In other words, the bankruptcy trustee
stepped into the shoes of the bankrupt debtor member as a full member of the LLC, not as an
assignee. As such, the court found that the bankruptcy trustee had every right that the member
had to complain about those transactions that had occurred within Fiesta prior to his bankruptcy
filing, which is exactly what the trustee was attempting to do in its lawsuit against Fiesta.

On December 7, 2005, the Bankruptcy Court issued a ruling on the relief sought by the
Chapter 7 trustee in its original motion. The court found that the debtor’s parents, the parties who
formed Fiesta for estate tax purposes, had operated Fiesta “as if it were a revocable living
spendthrift trust.” The Bankruptcy Court therefore granted the trustee’s motion to appoint a
receiver “to operate (or dissolve and liquidate) the LLC in accordance with its business purposes,
its operating agreement, and state law.”

The Ehmann opinions were both issued in 2005 and have not yet been thoroughly
examined by leading commentators in the bankruptcy and LLC/partnership arena. Moreover, by
motion of the parties, the Court’s opinion dated December 7, 2005 was withdrawn, at the request
of the parties, after the parties to the litigation settled their dispute and entered into a settlement
agreement which was conditioned upon the Court’s withdrawal of its December 7, 2006 opinion.
The Court was reluctant to do so but nevertheless withdrew its opinion in the interest of not
prolonging the dispute for the unsecured creditors. However, the problems that occurred in
Ehmann will likely resurface can be avoided if the operating agreement, and the obligation of the
members to the LLC, is structured in such a way as to render the operating agreement an
executory contract under bankruptcy law. Moreover, if family members are to receive an interest
in an FLLC or an FLP as part of a client’s estate planning objectives, the Ehmann problems can
also be avoided if the gifts are made to a spendthrift trust or trusts for the benefit of the family
members rather than to have the gift be made directly to that family member. If properly
structured, such spendthrift trust will not be a part of the family member’s bankruptcy estate
pursuant to the provisions of §541(c)(2) of the Bankruptcy Code.

2. In Re: Baldwin. The Strangi and Kimball cases, as well as several other recent
cases, have helped to underscore the importance of properly documenting the multiple tax and
business goals of a wealth planning structure. Regardless of the reasons for the structure, it
would appear that the more valid purposes that an entity will serve its owners, the more likely it is
to withstand court scrutiny. This became evident in the very recent bankruptcy case of In re:
Trenton J. Baldwin, an Oklahoma bankruptcy case where the Chapter 7 Bankruptcy Trustee
sought the dissolution of the family limited partnership in which the debtor had an interest. His
primary authority for making such a request was the court’s decision in In Re: Ehmann, together
with language under Oklahoma law that specifically allowed a limited partner to seek dissolution
of a partnership whenever it was no longer reasonably practical to carry on the business of the
partnership.


57 The Bankruptcy Code excludes from the “bankruptcy estate” property of the debtor that is subject to a
restriction on transfer enforceable under “applicable non-bankruptcy law.” 11 U.S.C. §541(c)(2).
In the Baldwin case, the debtors Frank and Carolyn Baldwin filed a Petition for Chapter 7 Bankruptcy relief in August 2004. Carolyn was a sole limited partner in a partnership created by her parents in 1994, pursuant to the Oklahoma Uniform Limited Partnership Act, Okla. Stat. tit. 54 §§ 141-171(2002). At the time of the filing of the Petition, Carolyn Baldwin owned a 99% interest in the partnership. The partnership’s sole general partner was a trust consisting of Carolyn’s parents as sole trustees. The Partnership Agreement granted exclusive management and control of the partnership and its assets to the general partner, which owned a 1% interest in the partnership. Further, the Partnership Agreement provided that “the limited partner shall not take any part in or interfere in any manner with the conduct or control of the business of the partnership as a defined term or have any right or authority to act for or on behalf of the partnership.” The Partnership Agreement further provided that the partnership was to dissolve 50 years after execution of the Partnership Agreement unless dissolution occurred with the consent of the general partner or the general partner’s death, incapacitation, insolvency or bankruptcy.

The partnership assets consisted of approximately 200 acres of undeveloped land that was partly timber and partly pasture, and a house that the partnership constructed on the land, in which the bankrupt debtor resided. The debtors maintained the house and paid the costs associated with it, including mortgages, taxes and utilities. They used the land, in part, for the grazing of cattle. The property had an estimated value of approximately $400,000.

Following the initiation of the bankruptcy proceedings, the Trustee filed the necessary proceeding against the partnership and the general partner seeking a declaration that Carolyn Baldwin’s interest in the partnership now belonged to the bankruptcy estate and, therefore, the bankruptcy Trustee. The bankruptcy Trustee further requested that the bankruptcy court find that continuation of the partnership is in fact due to the general partner’s refusal to recognize the estate’s interest. At the trial, the bankruptcy court ruled in favor of the Trustee on both of these issues. The matter was thus appealed by the bankrupt debtor to the U.S. Bankruptcy Appellate Panel for the 10th Circuit.

On appeal, the 10th Circuit Bankruptcy Appellate Panel upheld the lower bankruptcy court’s ruling with respect to the issue of whether or not the debtors’ interest in the family limited partnership became property of the bankruptcy estate upon filing of the bankruptcy Petition. Although the debtor had argued that the Trustee’s sole remedy was that of a Charging Order pursuant to Oklahoma partnership law, the Court of Appeals agreed with the bankruptcy Trustee that the facts of the case were factually similar to two other cases which had held that a debtor’s rights pursuant to a family limited partnership or limited liability company become property of the bankruptcy estate and may be exercised by the Trustee. Specifically, the appellate court cited the case of Samson v. Prokops (In re: Smith), in which the court held that “limited partner has contractual rights arising from the partnership” that are “legal or equitable interest of the debtor within in the ambit of Section 541(a)(1) of the Bankruptcy Code and, as a result, become property of the bankruptcy estate.” However, more relevant was the court’s reliance on Mobitz v. Fiesta Investments (In re: Ehmann) in holding that the lower court had concluded

correctly that the “Trustee has all the rights and powers with respect to [the company] that the debtor held as of the commencement of the bankruptcy case.”

Interestingly, the court acknowledged in a footnote that both the Smith and Ehmann cases discuss whether limited partnership agreements were “executory contracts” governed by 11 U.S.C. § 365, and concluded that unless a debtor owed such a material obligation to the partnership that the failure to perform it would relieve the partnership of its obligations to debtor, the debtor’s limited partnership interest was a “property interest” governed by § 541, rather than by § 365 of the Bankruptcy Code.

Therefore, the appellate court in In re: Baldwin concluded that the bankruptcy Trustee stepped into the shoes of the debtor with respect to the family limited partnership interest and could assert whatever rights the bankrupt debtor had as a partner under the Partnership Agreement and state law, including, under Oklahoma Law, the right to seek dissolution.

The Baldwin appellate court then focused on the issue of whether the bankruptcy Trustee, having stepped into the shoes of the debtor, could now exercise its right to require the dissolution of the family limited partnership pursuant to Oklahoma law.

In ordering the dissolution of the family limited partnership, the lower bankruptcy court had relied on Oklahoma law which specifically allows limited partners to seek dissolution of a partnership “whenever it is not reasonably practical to carry on the business [of the partnership] in conformity with the Partnership Agreement.” From the evidence at trial, the lower bankruptcy court had found that the general partner “does not recognize the [Trustee’s] interest in the partnership as Trustee of the bankruptcy estate.” Further, it found that the partnership no longer served any estate planning purpose. However, at trial, the bankrupt debtor’s father had testified that the partnership was established in 1994 as part of his effort to remove assets from his estate for estate tax purposes. The debtor’s father characterized the primary and continuing purpose of the partnership as estate planning, with the intent he would retain full management and control of the partnership assets during his lifetime. He further testified that the partnership had at one time invested in mutual funds for a small profit, that lumber from the property had been sold at a profit to his lumber company, and that the expected the property to appreciate in value, at which part the partnership might sell lots out of the 200 acres and/or develop a subdivision for profit. All of the partnership profits were put back into the partnership property. Thus, it was the opinion of the debtor’s father that the partnership was part of his ongoing estate planning strategy.

After reviewing the record, the Court of Appeals stated that it was “left with a definite and firm conviction” that the lower bankruptcy court was mistaken in finding that the partnership no longer served an estate planning purpose. As was the limited liability company in Ehmann, the limited partnership was established to allow Mr. Bailey to retain complete control of the partnership assets during his lifetime, while at the same time removing them from his estate for estate tax purposes. This purpose was still being served and would continue to be served even if the partnership were to become totally inactive. In addition, at various times, the general partner had made, or attempted to make, profits for the partnership that were then reinvested in the property. Moreover, the partnership had, in the past, invested in real estate and other assets and contemplated continuing to do so at a profit.

The appellate court also noted that the Oklahoma statute on which the lower bankruptcy court had relied upon in dissolving the partnership required a finding that it was no longer “reasonably practical to carry on the business [of the partnership] in conformity with the Partnership Agreement.” The lower bankruptcy court’s rationale for finding this provision applicable was the fact that the general partner did not recognize the Trustee’s interest in the partnership. However, the debtor’s father had not testified that he could not or would not continue to carry out his duties as general partner in the event that the Trustee was found to have an interest in the partnership, nor did he testify that he would refuse to recognize the court determination of the Trustee’s interest. Since, the Trustee held the bankrupt debtor’s right with respect to the partnership, and since the bankrupt debtor had neither management power under the Partnership Agreement, nor any present right to dissolve or liquidate the partnership, then the bankruptcy Trustee could not either. Thus, since the partnership was continuing to operate as a allowed under the Partnership Agreement and Oklahoma law, the Court of Appeals concluded that the Trustee had no present right to force either dissolution of the partnership or liquidation of its assets.

Estate planners not familiar with the Baldwin case should review it carefully to consider language and duties that can be incorporated into the existing FLP and FLLC documents to help document the purpose of the partnership and the obligation of the general partners and the partnership to continue with the general purpose of the partnership, notwithstanding any future adverse events. Moreover, for purposes of protecting the interest of the partners in a partnership or members in a limited liability company, the estate planning benefits associated with the structure should not be hidden when combined with other valid business purposes for having the structure in place.

F. Drafting Strategies. In addition to the benefits provided by applicable law, multiple planning and drafting options are available to the client’s advisors to further protect the interest of the client and the client’s family in the wealth preservation structure to be implemented to achieve these goals.

1. Protective Language In Partnership Agreement. Although applicable state law is important in identifying the remedies available to a creditor of a FLP partner, the planner should not overlook the significant benefits associated with including protective language in the FLP’s partnership agreement. Generally speaking, the terms and conditions of the partnership agreement will be binding upon assignees of a partner. This includes creditors who obtain a charging order on the partnership interest of a partner. A properly drafted partnership agreement should provide that the partnership or partners who are not affected by the creditor action would have the option to purchase the interest of a partner whose interest is subjected to a charging order. The partnership agreement can also provide that the purchase price shall be payable over an extended term of years at a favorable interest rate.

62 The drafting strategies discussed in this section of this paper are equally applicable to LLCs.

63 RULPA §704(b).

64 RULPA §703.
In addition to incorporating the right to purchase the interest of the charged partner, the partnership agreement should provide for a quick, simplified, and favorable method of valuing the interest of the charged partner. One method of accomplishing this is to provide for mandatory mediation and binding arbitration of any valuation dispute. The partnership agreement can go so far as to provide for the selection of arbitrators that are familiar with the proper valuation of a limited partnership interest in a FLP. The typical family limited partnership interest for which there is no ready market is often subjected to severe transfer restrictions or prohibitions that in turn severely depress the value of the charged partnership interest. All of the foregoing will serve to further diminish the value of the seized partnership interest to the creditor of the unfortunate partner who, in many cases, continues to enjoy the support of the partnership and its partners, particularly in a family setting.

As discussed above, the partnership agreement can further provide that any disputes regarding the valuation of the interest to be acquired shall be resolved by binding arbitration to be conducted by arbitrators familiar with the proper valuation of a limited partnership interest in a closely held FLP governed by a restrictive partnership agreement.

2. **Use of an LLC as FLP General Partner.** When using a FLP for wealth preservation planning purposes, further asset protection is available by using a limited liability company as the general partner of the limited partnership. In a limited partnership, the general partners are jointly and severally liable for all of the debts and obligations of the limited partnership. This personal liability to the general partner can be avoided by using a limited liability company as the general partner rather than the client in an individual capacity. Before the advent of limited liability companies, it was customary to use a regular corporation or Subchapter S corporation as the general partner of a limited partnership to avoid personal liability to shareholders of the corporate general partner. However, this left the shares of the corporate general partner subject to seizure and execution by a creditor of the corporate general partner shareholder. Assuming a creditor was able to obtain control of the corporate general partner, the creditor could theoretically gain control of the family limited partnership in its capacity as general partner. However, if the general partners consisted of one or more limited liability companies, a creditor’s sole recourse, under Texas, Delaware and comparable state statutes, is a charging order against the general partner’s LLC interest. Thus, while the general partner’s LLC interest would be subject to the charging order, the general partner’s interest would not be subject to seizure and potential corresponding loss of control of the limited partnership. From an asset protection standpoint, it is clear that a properly structured LLC is usually the preferred entity to act as general partner of an LP or FLP.

3. **Use of a Domestic Trust as Limited Partner.** The use of a family limited partnership usually involves limited partnership interests that have been gifted to family members. If the family members own the limited partnership interests in their individual capacities, their interests are subject to their own individual creditor claims should they arise, although the charging order limitations discussed in this paper certainly provide some protection and relief from such creditor action. However, another insulation of protection for the limited partnership interest can be obtained if the gift of the limited partnership interest is made to an

65 RULPA §403(b).

irrevocable domestic trust rather than to the family member directly. If the trust was not involved in any other activity which would subject it to litigation risks, the limited partnership interest transferred to the domestic trust for the benefit of the family member can effectively be protected from the potential creditor claims of the donee family member.

The domestic trust has been successfully utilized by practitioners as a crucial estate planning and wealth preservation planning tool for decades. Despite restrictions on the ability of a settlor to retain an interest in a domestic trust, a properly structured irrevocable trust, where the grantor has “cut the strings” in terms of benefit and control, has been, and still can be, successfully used to preserve the assets of the grantor for the benefit of his family.

One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one which provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The legality of the spendthrift trust is recognized in virtually all states. For example, Chapter 112.035 of the Texas Trust Code provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a “spendthrift trust” is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted by §112.035 of the Texas Trust Code.

A discretionary spendthrift trust provides even greater protection to its beneficiaries than a spendthrift trust which calls for specified distributions. In a discretionary trust, the trustee has sole and absolute “discretion” to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors. However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process. Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute “property” within the normal meaning of state statutes defining property which is available for execution.

67 Tex. Trust Code §112.035


69 First Northwestern Trust Co. v. IRS, infra at 391.

70 First Northwestern Trust Co. v. IRS, infra at 392.
In First Northwestern Trust Co., the Eighth Circuit Court of Appeals declined to allow the claim of the Internal Revenue Service to reach the interest of beneficiaries in a family trust where the trustee had broad discretionary powers. The court held that the rights of the beneficiaries were contingent upon the discretionary authority of the trustee. The trust agreement gave the trustee the authority to distribute the trust funds in unequal amounts, and the agreement specifically provided that the trustee was only obligated to disburse “such amounts as in the sole discretion of the Trustee as necessary, reasonable and proper, to such members of the [settlor’s] family requiring such funds upon proper proof of such need to the satisfaction of the Trustee . . .” The court found that there was no identifiable or ascertainable interest or right in the income until those two contingencies were met.

VIII. OFFSHORE FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES - ENHANCED ASSET PROTECTION

As previously discussed, family limited partnerships are probably best known for the significant discounts available when valuing an undivided interest in a family limited partnership for federal gift and estate tax purposes. A less publicized advantage of a family limited partnership is the asset protection features available under the law of many states in the United States. When the goal of the structure is comprehensive wealth preservation, such asset protection features can be just as important as the potential tax savings resulting from the structure. However, what is even less publicized is the fact that virtually all of the foregoing advantages are also available and often enhanced under the laws of several offshore jurisdictions. Thus, a wealth preservation planner seeking to achieve traditional wealth preservation goals with a family limited partnership and related entities can typically achieve those same goals, while achieving a better level of protection for family assets, through the use of offshore limited partnerships and limited liability companies.

As with domestic entities, the asset protection attributes of a family limited partnership derive from statutory as well as non-statutory sources. The limitations and restrictions found within the partnership agreement itself provide various tools that can be used to preserve partnership assets and the interest of the family members in the partnership. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to and held by a family limited partnership, particularly an offshore FLP. Assuming the partners have respected the family limited partnership as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the offshore partnership are owned by the partnership, not the individual partners.71

Moreover, should the creditor attempt to instead seize the debtor partners’ interest in the family limited partnership, the “charging order” limitation found in several offshore limited partnership laws will likewise frustrate a creditor’s efforts. The charging order limitations discussed in this paper are made available by statute in several offshore jurisdictions. They significantly limit the recourse available to a creditor seeking recourse against a judgment debtor’s interest in a partnership. Generally speaking, the partnership interest cannot be seized or

sold. Instead, the “charging” creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. Like many of the domestic counterparts, the partnership law of several offshore jurisdictions generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the “charged” interest. These limitations on the rights of a partner’s creditors enhance the value of the offshore family limited partnership as an important family wealth preservation vehicle.

Although relatively new to the offshore arena, the limited liability company (“LLC”) is now also available in several offshore jurisdictions. Like its domestic counterpart, the offshore LLC is designed to bring together in a single business organization the best features of all other business forms. Properly structured, its owners obtain both a corporate styled liability shield for its members and the pass through tax benefits of a partnership. However, its asset protection benefits, especially when combined with a FLP, makes the offshore LLC a very valuable asset protection tool when structuring a family wealth preservation plan.

A. **The “Charging Order” Limitation.** Like its domestic counterparts, the primary asset protection benefit of offshore charging order limitations found in several offshore jurisdictions has its roots in the English Partnership Act of 1890. The Act was adopted to prevent the disruption of partnership business and the consequent injustice done the other partners resulting from execution against partnership property. As Lord Justice Lindsey observed, the English Partnership Act of 1890 not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served. Thus, the charging order evolved as a way to divert the debtor’s share of the partnership profits and surplus to his creditors without disrupting the ongoing partnership. The charging order operates, in effect, as a substitution for execution on a partner’s interest in the limited partnership. Once charged, the judgment creditor has only the rights of an assignee of the partnership interest.

B. **The Consequences of “Assignee” Status.** As with domestic LPs, a partner in an offshore LP typically may not freely transfer their interest in the entity to a third party without first obtaining the consent of the other partners of the partnership. If not prohibited outright, governing law typically provides that an attempt by a limited partner to transfer his or her interest in the partnership without obtaining the necessary consent will result in the transferee being relegated to “assignee” status. As in domestic law, an assignee of an offshore LP or LLC is relegated to a lower status of recognition in the entity, typically with little to no rights in the entity except to receive his or her pro rata share of distributions from the entity.

Under the law of most, if not all, offshore jurisdictions, a creditor that obtains a charging order against a partner’s interest is treated as an “assignee” of that interest. As an assignee, a creditor has the right to receive distributions to which the debtor partner would have been entitled; however, the charging order does not entitle the creditor to become or to exercise any rights of a partner. As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur. The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the

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general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law. Moreover, in a family limited partnership, the general partner will likely be an entity controlled by a family member sympathetic to the plight of the partner and family member whose interest in the partnership has been subjected to the creditor’s charging order. Thus, it is unlikely that the general partner would elect to make cash distributions to partners that would entitle the creditor/assignee to a pro rata distribution.

C. The Offshore Family Limited Partnership. The asset protection features found in the limited partnership statutes of several offshore jurisdictions provide the planner with multiple planning opportunities. Because these jurisdictions are, for the most part, present or former members of the British Commonwealth, the limited partnership law of these jurisdictions is often very similar to comparable law found in the United States. Hence, it is possible to draft a limited partnership agreement or operating agreement that will be familiar to U.S. practitioners and their clients. Moreover, many offshore jurisdictions have adopted modern limited partnership legislation that is specifically designed to address the legal and tax needs of United States citizens. Virtually any kind of provision typically drafted into a complex domestic limited partnership agreement can also be drafted into the agreement of an offshore limited partnership with virtually the same legal and tax results being achieved.

On the other hand, significant differences in the ownership structure will exist when the offshore limited partnership is formed for asset protection purposes. For example, the managing general partner is often a foreign limited liability company or international business corporation formed in a jurisdiction different from the jurisdiction in which the limited partnership is formed. Additionally, the offshore limited partnership can be formed in a jurisdiction that limits the creditor’s remedies to a “charging order” against the limited partnership interest. If the general partner is a foreign limited liability company formed in Nevis, the general partner will enjoy the same charging order protection under the Nevis Limited Liability Company Ordinance of 1995 as the limited partnership. If an international trust owns the limited partnership interest, it is possible that a creditor may be forced to consider filing a lawsuit in three different jurisdictions, assuming the creditor has reason to believe it can reach trust assets in the first place.

Unlike uniform laws found in the United States, offshore jurisdictions do not have an organized effort to promote uniformity in legislation similar to those promulgated in the U.S. by the National Conference of Commissioners on Uniform State Laws. Nevertheless, it is not uncommon for offshore jurisdictions to adopt legislation modeled after the law of a fellow offshore jurisdiction. An excellent example is the charging order protection found in the acts of the Bahamas, Cayman Islands, and several other jurisdictions. In those jurisdictions, the language providing for the charging order protection is very similar.

An excellent example of a foreign jurisdiction with U.S. style limited partnerships with charging order protection is The Bahamas. The Bahamas have been a traditional favorite of Americans primarily because of its proximity to the United States. The Bahamas is a group of 700 islands stretching in a 600-mile arc which begins approximately 40 miles east of Palm Beach, Florida, and extends to just north of Haiti. The capital of the Bahamas is Nassau which is located

74 Bahamas Partnership Act §32.(1).
on New Providence Islands, where approximately one-half of the people of the Bahamas live. The Bahamas are an independent member of the British Commonwealth of Nations.

The Bahamas are an excellent example of a jurisdiction that has good limited partnership legislation with favorable asset protection features. In the Bahamas, limited partnerships are governed by the Exempted Limited Partnership Act, 1995. However, to the extent that it is not inconsistent with the Limited Partnership Act, Section 3.(1) of the Limited Partnership Act incorporates the provisions of the general Partnership Act. It is in the Partnership Act that charging order protection is found.

Section 24.(1) of the Partnership Act specifically provides that “a writ of execution shall not issue against any partnership property except on a judgment against the partnership itself.” In other words, a creditor holding a judgment against a partner may not seize partnership assets to satisfy a judgment against a partner. Thus, assets held inside the partnership itself are protected from claims against any of its partners.

The charging order limitation itself is found in Section 24.(2) of the Partnership Act which provides that the court may …

“on the application by summons of any judgment creditor of a partner, make an order changing that partner’s interest thereon, and may by the same or a subsequent order appoint a receiver of that partner’s share of profits (whether already declared or accruing), and of any other money which may be coming to him in respect to the partnership, and direct all accounts and inquiries, and give all other orders and directions which might have been directed to given if the charge has been made in favour of the judgment creditor by the partner, or which the circumstances of the case may require.”

Section 24.(3) of the Partnership Act further provides that the other partner or partners are at liberty at any time to redeem the interest charged.

D. The Offshore Limited Liability Company. Like a limited partnership, an offshore limited liability company can be used as an asset protection vehicle if it is supported by appropriate legislation. However, while several offshore jurisdictions have adopted LLC legislation, only a handful of offshore jurisdictions have incorporated the concept of charging order protection into their LLC legislation.

Many offshore LLC statutes provide that a judgment creditor has only the rights of an assignee of the LLC interest so charged.75 For example, in Anguilla, an assignee of a member’s limited liability company interest has no right to participate in the management of the business and affairs of a limited liability company except as provided in the LLC operating agreement and upon (a) the approval of all of the members of the LLC other than the member assigning his LLC interest or (b) compliance with any procedure provided for in the LLC operating agreement.76

75 See, i.e., Anguilla Limited Liability Act, §47.(2).

76 Id., §48.(1).
Assets transferred to an LLC are also protected from member’s creditors.\textsuperscript{77} Members of an LLC are neither co-owners of nor have a transferable interest in, property of an LLC. Thus assets transferred to an LLC become the property of the LLC and not subject to the creditor claims of its individual members. Since a creditor’s recourse against a member is limited to a charging order, assets transferred to an LLC can be effectively protected against levy and seizure by a creditor.

Of course, if the member is a U.S. citizen, resident, or is otherwise located in the United States, it is preferable, although not always necessary, that control of the offshore limited liability company remain offshore for all purposes. This can be particularly facilitated if the offshore limited liability company is wholly owned by an international trust that has exclusive control of the limited liability company for all purposes. In fact, many U.S. practitioners prefer a structure that provides for an international trust whose assets are held by an offshore limited liability company in one of the jurisdictions discussed below.

The Island of Nevis is considered by many to have the best LLC charging order protection. The Caribbean island of Nevis has been described by one commentator as the “Jewel of the Caribbean.” Although the popularity of Nevis can be credited to its excellent asset protection law, its “U.S. style” corporate law has also made Nevis very popular with many U.S. practitioners. Nevis is located in the Leeward Islands in the Eastern Caribbean approximately 1200 miles southeast of Miami and 225 miles southeast of Puerto Rico. The island has a current population of 9,500. English is the official and commercial language.

In the view of many practitioners, Nevis is an example of a jurisdiction that has excellent asset protection features incorporated into its LLC legislation. Nevis adopted its Limited Liability Company Ordinance in 1995. The Act is modeled after the Delaware Limited Liability Company Act and is considered by many practitioners as the most modern offshore limited liability legislation of its kind.

Section 43 of the Nevis Limited Liability Company Ordinance, 1995, as amended, 1999, governs the right of a judgment creditor of a member. The Act provides that:

“On application to a court of competent jurisdiction by any judgment creditor of a member of a limited liability company, the court may charge the member’s interest with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member’s interest.”

Unless otherwise provided in the operating agreement, a member’s interest charged may be redeemed by either the other members of the LLC of the LLC itself.\textsuperscript{78} If redeemed by one or more members, the redemption must be made with the personal assets of the redeeming members.\textsuperscript{79} However, the LLC itself may use LLC assets to redeem the charged interest of a

\textsuperscript{77} This assumes that the transfer is not subject to attack as a fraudulent conveyance under state law should the transferring member already be insolvent.

\textsuperscript{78} Nevis Ltd Liab Co Ordinance §43(2)

\textsuperscript{79} Id., §43(2)(b)
member provided such redemption is approved by either (a) the consent of the members, whose interest are not charged, if all members are responsible for the management of the LLC, or (b) by the managers, whose interest are not charged, if the managers are responsible for the management of the LLC.

Equally as important as the charging order limitation is Section 43.(3) of Nevis’ Limited Liability Company Ordinance which specifically provides that the remedies provided by Section 43 of the Act “shall be the sole remedies available to any creditor of a member’s interest.”

E. Redomiciliation of a Domestic LP or LLC. A typical U.S. client that is a candidate for offshore wealth preservation planning is likely to already own a significant interest in a domestic limited partnership that was initially established for estate planning purposes. Such a domestic partnership is typically controlled by a general partner that is a limited liability entity owned and controlled by the client and various members of his family. Often, assets to be protected are owned by the limited partnership.

Seeking the benefits of an offshore limited partnership does not necessarily require the liquidation of the domestic limited partnership. Doing so may have adverse tax consequences and could result in the transfers to the new FLP being challenged as a fraudulent transfer if one or more partners are subject to legal claims at the time. However, if the domestic limited partnership can be redomiciled to an offshore jurisdiction, most, if not all of the foregoing potential problems, can be avoided. An excellent example of offshore legislation that allows for redomiciliation is found in the Bahamas Limited Partnership Act is Section 21.(1) of the Act. The Act allows the registration in the Bahamas of an existing limited partnership formed under the laws of a jurisdiction other than the Bahamas. Thus, by way of example, a U.S. limited partnership, formed for either estate planning or asset protection purposes, can be redomiciled to the Bahamas by registering the partnership in the Bahamas as provided by the Exempted Limited Partnership Act. Section 21.(2) specifically provides that registration of a partnership under the circumstances shall not operate:

- to create a new legal entity;
- to affect the property previously acquired by or on behalf of the exempted limited partnership;
- to affect any act or thing done prior to such registration or the rights, powers, authorities, functions or obligations of the exempted limited partnership, any partner or any other person prior thereto;
- to render defective any legal proceedings by or against the exempted limited partnership or any partner or any other person and any legal proceedings that could have been continued or commenced by or against the exempted limited partnership or any partner or any other person before its registration hereunder may notwithstanding such registration be continued or commenced after such registration and in respect of which such Acts or laws of such other jurisdiction shall be of application.

This provision in Bahamian law is extremely useful as it allows the transfer to the Bahamas of a pre-existing partnership formed in the United States without the need of dissolving and liquidating the partnership. Doing so allows the partnership to continue as a legal entity,
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without interruption, from both a legal and tax standpoint. This is particularly important if the transfer is being undertaken at a time when one or more of the partners have encountered legal issues. By avoiding the dissolution and liquidation of the partnership, transfers that occurred to the partnership prior to the individual partner or partners encountering legal problems should not be subject to challenge as fraudulent transfers.

The Cayman Islands has similar legislation which is found in Section 21.(1) of the Exempted Limited Partnership Law (2001 Revision). The law allows the “re-registration” in Cayman of a limited partnership then existing outside of Cayman, after which the limited partnership will be deemed a Cayman limited partnership for all purposes after the date of “re-registration.” However, the “re-registration of the limited partnership in Cayman will not be considered the creation of a new entity. Moreover, the law governing the limited partnership prior to re-registration shall continue to govern events that occur prior to redomiciliation to the Cayman Islands.

Some offshore jurisdictions similarly allow the redomiciliation of an LLC. For example, as in the Bahamas, Nevis law accommodates the redomiciliation into Nevis of a LLC formed under the laws of a jurisdiction other than Nevis so long as the law of that jurisdiction does not prevent such a redomiciliation. The redomiciliation process is commenced by filing an “Application to Transfer Domicile” with the Registrar of Companies.\(^{80}\) Once the LLC is redomiciled to Nevis pursuant to the Nevis Limited Liability Company Ordinance, the entity is treated for all purposes as the same entity that existed before the redomiciliation.\(^{81}\)

F. Drafting Strategies. U.S. practitioners are often surprised to learn that the law of several offshore jurisdictions easily accommodate U.S. style partnership agreements for LPs and operating agreements for LLCs.\(^{82}\) Often, it is not uncommon for a practitioner to be able to use an agreement format that is familiar to the practitioner but is modified to conform to local law. Hence, virtually all planning strategies that can be incorporated into a domestic limited partnership agreement or operating agreement can likewise be incorporated into an offshore LP or LLC agreement including:

- **Protective Language in Governing Documents.** Although the applicable law of the offshore jurisdiction is important in identifying the remedies available to a creditor of a FLP partner or LLC member, the planner can and should incorporate protective language in the partnership agreement of an offshore FLP or operating agreement of an offshore LLC, similar to that usually drafted into its domestic counterpart and discussed above.

- **Offshore LLC as General Partner.** As with its domestic counterpart, enhanced asset protection is available by using a limited liability company as the general partner of a limited partnership. Before the advent of LLC’s, it was customary to

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\(^{80}\) Nevis Ltd Liab Co Ordinance §66

\(^{81}\) Id., §70(1)

\(^{82}\) LLC’s are known as limited duration companies in some offshore jurisdictions such as the Cayman Islands.
use a regular corporation or International Business Corporation (“IBC”) as the
general partner of an offshore limited partnership. This left the shares of the
corporate general partner subject to seizure and execution by a creditor of the
corporate general partner shareholder. However, if the general partners consisted
of one or more LLC’s organized in Nevis, the Marshall Islands, or other offshore
jurisdiction with favorable legislation, a charging order against the general
partner’s LLC interest would be a creditor’s sole recourse. Thus, while the
general partner’s LLC interest would be subject to the charging order, the general
partner’s interest would not be subject to seizure and potential corresponding loss
of control of the limited partnership. From an asset protection standpoint, it is
clear that a properly structured offshore LLC is usually the preferred entity to act
as general partner of an offshore LP.

- International Trust as Limited Partner. - A preferred but more sophisticated
planning technique incorporates the use of an offshore asset protection trust in
conjunction with the formation of an offshore limited partnership. The different
variations of such a structure are discussed below in the section of this paper
describing different strategies available when designing an offshore wealth
preservation trust.

G. U.S. Tax Treatment of the Offshore LP and LLC. - The popularity of limited
partnerships in the United States is due, in no small part, to the conduit or “flow-through” tax
attributes of the entity for U.S. income tax purposes. A limited partnership is required to file an
information tax return with the IRS but partnership income is reported pro rata by partners.
Likewise, a domestic LLC with two or more members is typically treated as a partnership for
U.S. tax purposes. However, while such treatment of domestic LPs and LLCs is automatic in the
U.S., the exact opposite is true when dealing with offshore LPs and LLCs.

Great care must be undertaken when seeking conduit tax treatment in the U.S. for a
foreign limited liability company or limited partnership. Under U.S. tax law, a foreign limited
partnership or limited liability company will automatically be taxed as a corporation unless the
entity affirmatively elects to be treated as a conduit entity for U.S. tax purposes. The election is
made pursuant to the IRS “check-the-box” regulations by timely filing Form 8832 with the
Internal Revenue Service. If the proper and timely election is made, a foreign single member
LLC may elect to be treated as a disregarded entity, or as a partnership if the LLC has more two
or more members. A foreign limited partnership must likewise file an election to be treated as a
partnership for U.S. tax purposes.

From a federal income tax reporting standpoint, assuming all required IRS elections for a
foreign limited partnership are timely and correctly made:

- The offshore limited partnership will file a U.S. partnership return, Form 1065, on
  which it will report its worldwide income.

83 Treas. Regs. 301.7701-3.
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- The partnership will also be required to file Form 8865 - Return of U.S. Persons with Respect to Certain Foreign Partnerships, which is typically filed with the partnership’s Form 1065.

- If properly structured and maintained, the limited partnership interest should be eligible for valuation discounts for gift and estate tax purposes.

Significant adverse tax consequences or tax penalties are possible if elections or tax returns for offshore entities are not correctly prepared or timely filed. Therefore, a professional tax advisor experienced with the reporting requirements of offshore entities, should always be included as part of the client’s planning and compliance team.

IX. INTEGRATING A FLP OR FLLC WITH A SELF-SETTLED TRUST TO ENHANCE A CLIENT’S ESTATE PLANNING STRATEGIES

This paper has attempted to show how the traditional FLP or FLLC, historically an estate planning vehicle, can also be used as a reasonably effective asset protection vehicle. However, while FLPs and FLLCs have historically been used successfully to obtain valuation discounts for federal gift and estate tax purposes, such strategy has recently been successfully challenged by the Internal Revenue Service in a series of successful attacks on the use of FLPs and FLLCs for estate planning purposes.

For years, the IRS has attempted to challenge the use of FLPs and FLLCs for estate planning purposes on a variety of theories. Until recently, except in those situations where the entity was not respected nor properly operated by the decedent, virtually all such challenges have heretofore been unsuccessful. However, in the recent tax court case of Estate of Strangi vs. Commissioner, discussed below, the Internal Revenue Service won an unexpected and incredibly significant challenge to the use of an FLP or FLLC to obtain valuation discounts for gift and estate tax purposes. In fact, the decision in Strangi suggests that any FLP or FLLC formed prior to the Strangi decision should be reevaluated in light of the strict requirements that would seem to have been imposed by the Fifth Circuit’s affirmation of the Tax Court decision in Strangi. Nevertheless, both Strangi and other cases decided prior to that time provide practitioners valuable guidance on how to modify existing FLPs or FLLCs or organize new ones in the future.

As mentioned above and discussed in more detail in the tax section below, a typical international trust established by a U.S. person is intentionally drafted to qualify as a “grantor trust” for U.S. tax purposes. Failure to do so will result in a transfer to the trust being treated as (i) a taxable gift, and (ii) a taxable “sale or exchange” of the asset transferred to the trust. However, if established as a grantor trust, any assets held by the trust will be subject to estate tax upon the settlor’s death. Thus, even if the primary goal of establishing the trust is the settlor’s desire to achieve asset protection for the client and the client family and heirs, the client’s planner should consider and integrate into the international trust structure estate planning strategies that will help reduce the estate tax burden of assets held within the trust upon the settlor’s death. However, to enhance the likelihood that such planning will succeed, it is important, particularly in an offshore setting, that the resulting structure be established as part of an arm’s length transaction with an independent trustee and minimal retained controls on the part of the settlor.
A. **Estate of Strangi.** In the recent Tax Court case of *Estate of Strangi vs. Commissioner*, the estate sought to support valuation discounts, claimed on the decedent’s estate tax return, for his interest in the Strangi Family Limited Partnership (“SFLP”). The decedent had transferred virtually all of his wealth to SFLP. After the transfers, Mr. Strangi owned a 99% limited partnership interest in SFLP and a 47% interest in the corporate general partner that owned a 1% general partnership interest in SFLP. The remaining 53% ownership of the corporate general partner was initially owned by the decedent’s children although, apparently, a 0.25% interest in the corporate general partner was subsequently transferred to a charity, apparently under the belief that such action would help improve the asset protection attributes of the family limited partnership.

1. **Section 2036(a)(1) Possession or Enjoyment Issues.** Section 2036(a) of the Internal Revenue Code provides that transferred assets of which the decedent retained *de facto* possession or control prior to death are included in the taxable estate of the decedent. Specifically, Section 2036(a)(1) provides that a decedent’s estate shall include property over which the decedent retained the “possession or enjoyment” of property or the right of income from property. At the trial court level in *Strangi*, the Tax Court found that the decedent had retained “possession or enjoyment” of the property he transferred to the SFLP or the right to designate who would possess or enjoy it. Judge Mary Cohen found that the facts supported a finding that after the formation and funding of SFLP, the decedent, as a practical matter, retained the same relationship to his assets as before formation of the SFLP and its corporate general partner. In so finding, Judge Cohen remarked:

> “the crucial characteristic is that virtually nothing beyond formal title changed in decedent’s relationship to his assets.”

The U.S. Fifth Circuit Court of Appeals upheld Judge Cowen’s ruling in an opinion issued on July 15, 2005. In its ruling, the Fifth Circuit agreed with Judge Cohen’s finding that the transfer of substantially all of the decedents assets into the FLP, leaving few assets available outside the FLP to pay the decedent’s living expenses and post-mortem expenses, supported a finding of an implied agreement that allowed the decedent, Mr. Strangi, to retain *de facto* control and/or enjoyment of the transferred assets.85

One of the arguments made by the estate upon appeal was that the “bona fide sale” exception to Section 2036(a) was applicable in this case, even if Strangi had retained possession or enjoyment of the assets. In describing the “bona fide” sale exception, the Fifth Circuit noted that:

> “We think that the proper approach was set forth in *Kimbell*, in which we held that a sale is bona fide if, as an objective matter, it serves a ‘substantial business [or] other non-tax purpose.’” *Id.* at 267. As noted supra, Congress has foreclosed the possibility of determining the purpose of a given transaction based on finding as to the subjective motive of the transferor. Instead, the proper inquiry is

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84 *Estate of Strangi vs. Commissioner*, T.C. Memo 2003-145, (2003). The case was affirmed on appeal to the Fifth Circuit Court of Appeals. See footnote 97.

85 *Estate of Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. July 15, 2005)
whether the transfer in question was objectively lively to serve a substantial non-tax purpose. Thus, the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception. We review such a determination only for clear error."

The court analyzed multiple “non-tax” purposes offered by the estate for having formed the family limited partnership. Among those were the asset protection benefits of the SFLP. In Strangi, the alleged need for asset protection was justified as a result of the potential claim of a specific creditor. In analyzing the claim, the trial court discounted the asset protection purposes of the SFLP since the potential claim never materialized into an actual claim. However, in the opinion of this author and other commentators, the proper test should be whether the FLP or FLLC was formed for the legitimate goal of general asset protection. In fact, during oral argument before the Fifth Circuit, at least one justice on the court acknowledged that, in today’s litigious society, asset protection strategies are a legitimate goal of an entrepreneur or other high net worth individual.

Unfortunately, the few cases that have addressed the issue of asset protection as a “non-tax” purpose for an FLP or FLLC have dealt with structures with less than ideal asset protection attributes. However, it is this author’s belief that a properly structured family limited partnership or family limited liability company, drafted pursuant to ideal asset protection legislation found in states like Delaware and many offshore jurisdictions, will ultimately help support the argument that the asset protection goals of the FLP or FLLC were sufficiently achieved to support the proposition that the asset protection provided by such a structure is a legitimate “non-tax” purpose for forming the structure in the first place.

2. **Section 2036(a)(2) Power to Designate Enjoyment.** Although the trial court in Strangi held that Section 2036(a)(1) require that the estate include the value of the transferred assets in the gross estate for federal estate tax purposes, the trial court went on to address the application of Section 2036(a)(2) to the Strangi case. Section 2036(a)(2) requires inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income.

The IRS argued in Strangi that the decedent had legally enforceable rights based upon the relevant agreements, not mere de facto control or influence over the family limited partnership. As a result, the decedent, the IRS argued, had the power and influence to designate persons who shall enjoy the property or its income.

The estate disagreed with the government’s contention that the decedent had retained unrestricted control of the FLP. In fact, as the estate pointed out, state law required that any power which the decedent might have retained would have been subject to state law fiduciary duties. By analogy, the estate pointed to the U.S. Supreme Court case in United States vs. Byrum86, where the IRS argued that by retaining voting control over the corporations in question, Mr. Byrum was in a position to select the corporate directors and thereby to control corporate dividend policy. That, in turn, gave Mr. Byrum the ability to regulate the flow of dividends. However, the U.S. Supreme Court noted in Byrum that “a majority shareholder has a fiduciary

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86 United States vs. Byrum, 408 U.S. 125 (1972)
duty not to misuse his power by promoting his personal interest at the expense of corporate interest” and the directors of a corporation “have a fiduciary duty to promote the interest of the corporation.” *Id.* a 137-138. Such duties were legally enforceable by means of, for example, a derivative lawsuit.

However, in the *Strangi* case, the Tax Court rejected the analogy of the *Strangi* case to the facts in *Byrum* by pointing out, among other things, that the power to control the flow of income from the corporation by influencing the directors of the corporation nevertheless did not give Mr. Byrum the “right” to designate who was to enjoy income since such dividends were payable to a trust, established for the benefit of his children, which was controlled by an independent corporate trustee. Thus, as the U.S. Supreme Court noted in the *Byrum* case, even if Mr. Byrum had managed to flood the trust with dividends, he had no way of compelling the trustee to pay out or accumulate that income. *Id.* at 144. As a result, Mr. Byrum was found not to have retained the right to designate the persons who shall possess or enjoy property or its income, thus mandating inclusion in the estate under Section 2036(a)(2).

What these and other cases suggest is that, from both an estate planning standpoint and an asset protection standpoint, the ideal wealth preservation structure is one established at “arms-length” with an independent trustee and established for multiple purposes including estate planning, asset protection, investment diversification and long term preservation and holding of family assets.

**B. Settlor as General Partner of a “Drop-Down” FLP.** A common planning technique popular with many practitioners incorporates the use of an offshore asset protection trust in conjunction with the formation of a domestic limited partnership. The client initially transfers the assets to be protected to a domestic limited partnership and retains both a general partnership interest and the limited partnership interest. Shortly thereafter, the client transfers the limited partnership interest to an irrevocable international trust. However, by retaining the general partnership interest, the client maintains managerial control over the assets transferred to the family limited partnership while protecting the limited partnership interest from the client’s individual creditor claims. A similar strategy can be undertaken utilizing the enhanced benefits available through the use of an offshore LP or LLC. Nevertheless, whether using a domestic FLP or offshore FLP, such a strategy contemplates that the settlor will retain control of the FLP through the settlor’s ownership and control of the general partner entity.

There are many reasons why a planner may design such a structure for the client. In many circumstances, such a structure may be the only strategy that the client feels comfortable with. In other situations, the assets held by the FLP, such as real estate developments or closely held business interests, may require the active involvement of the settlor in the day-to-day affairs of the entity. Thus, as in *Strangi*, the client retains control of the FLP even though some or all of the limited partnership interest has been transferred to an international trust. In any event, the foregoing strategy may be problematic if estate planning is one of the client’s overall planning goals.

**C. Consolidated Ownership and Control of FLP by Trust.** A more conservative approach, one preferred by this author, provides for both the general and limited partnership
interest to be transferred to the international trust. In such cases, the new general partner is typically a new entity, owned and controlled by the international trust. Control of the general partner entity, which in turn controls the entire limited partnership, is then vested in managers appointed and controlled by the offshore trustee, thus stripping the settlor of any direct or indirect control over partnership assets. The resulting structure is one where the ownership and control of the FLP has been totally integrated and combined with the international trust. The resulting consolidated wealth preservation trust provides significantly enhanced estate planning benefits and asset protection to the client.

As discussed in the section of this paper on “Redomiciliation of a Domestic LP or LLC,” if the client already has a domestic FLP or LLC, particularly one established for estate planning purposes, it is possible to redomicile the entire entity to an offshore jurisdiction that provides enhanced protection for the interest of the partners or members in the entity. Even if part of the ownership interest of the FLP or LLC is already held by other family members, such as domestic trusts established for the benefit of the client’s children and grandchildren, redomiciliation can still be achieved. The client’s entire remaining interest in the structure, either before or after redomiciliation, can then be transferred to an international trust established by the client.

The advantages of such a strategy are significant. From an estate planning standpoint, such a structure, if properly designed, implemented and operated, avoids the estate planning problems so often faced by taxpayers in cases such as Strangi and others. Of course, the operative requirements are a properly designed, implemented and operated structure drafted with estate planning goals in mind. If done correctly, such a structure will significantly enhance the discounts valuations available to the client, for estate planning purposes, upon his or her death. From an asset protection standpoint, such a structure, again assuming it is properly designed, implemented and operated, will also optimize the asset protection benefits available to the client.

X. THE INTERNATIONAL WEALTH PRESERVATION TRUST

The inherent problems associated with domestic trusts, aggravated by outrageous jury judgments and, in some cases, result oriented courts, have prompted many individuals to seek asset preservation strategies beyond the borders of the United States. Although transfers of assets offshore have traditionally been associated with illegal attempts to evade tax or conceal assets, international trusts have become generally acceptable throughout the world as a legitimate means to deal with the many uncertainties in today’s world that can result in threats to wealth.

A. Benefits of an International Trust. There are numerous benefits available to using an international trust as part of a legitimate asset preservation plan for a client. This is an area of the law that is constantly changing as a result of (i) modernized and progressive asset protection trust legislation enacted by multiple offshore jurisdictions and (ii) constantly changing

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Before adopting such a strategy, the transfer must be planned in a way that does not result in the inadvertent termination of the FLP for tax purposes. A typical asset protection trust is usually drafted to qualify as a tax neutral “grantor trust,” resulting in the individual grantor of the trust being treated as the owner of the trust assets for income and estate tax purposes. Thus, if the settlor-beneficiary of the trust is, in an individual capacity, also serving as general partner of a FLP to be transferred to an international trust, a new general partner, one that will be recognized as a separate “person” for tax purposes, must be designated as general partner of the FLP.
U.S. laws and court decisions which make it critical that any offshore planning be fully compliant with applicable U.S. tax law and a plethora of federal laws which might be applicable to any proposed transaction. Failure to take into account all possible issues could quickly result in the client not benefiting from the many advantages of an international wealth preservation trust. Nevertheless, the following is a brief summary of the advantages of using an international wealth preservation trust for the high net worth client or family.

1. **Self-Settled Trust Permissible.** Most offshore jurisdictions will permit a settlor to establish a self-settled trust wherein the settlor retains beneficial enjoyment or control over the trust assets and/or the administration of the trust, something which is typically not possible in the U.S. Although it is typically a better planning strategy to avoid any unnecessary control on the part of a settlor, the fact that the settlor has retained a beneficial interest in the trust or has a right to exercise certain defined powers in the trust has, in many jurisdictions, been expressly permitted by statute.

2. **Chilling Effect of International Trust.** A potential creditor and his/her attorney will not welcome the news that a debtor’s assets have been sheltered in a foreign trust. A foreign trust constitutes an additional hurdle which the creditor will have to overcome. The mere logistical obstacles presented by the distance of some of these offshore jurisdictions is enough to drive plaintiffs to the settlement table.

3. **Non-recognition of Foreign Judgments.** Even if a Plaintiff were to obtain a judgment against a Defendant, most offshore jurisdictions will not recognize a foreign judgment. Under the law of most offshore jurisdictions, a creditor must file suit in the jurisdiction in which the trust is located if a creditor intends to enforce a judgment against assets of the trust. Plaintiffs and their attorneys are sometimes surprised to learn that contingency fee arrangements are unique to the United States and, in some offshore jurisdictions, outright illegal.

4. **Confidentiality.** A legitimate wealth preservation plan contemplates that a debtor will be prepared to make full and complete disclosure, if compelled to do so, regarding the transfers that were made into an international trust. Secrecy should never be a necessary element of a legitimate wealth preservation plan. Nevertheless, the traditional cloak of secrecy that is found in most offshore jurisdictions is a benefit which is valued by many U.S. clients who wish to keep a low profile for a variety of reasons. Typically, unless the debtor has committed a crime that is also a crime in the jurisdiction in which the trust is located, an offshore jurisdiction will not provide confidential information about the debtor’s affairs without the debtor’s consent. Since most offshore financial centers are tax havens with no income or estate taxes, no “tax crimes” are legally possible. Thus, almost all offshore jurisdictions will decline to cooperate with criminal tax investigations of the United States or United Kingdom.

5. **Unambiguous Fraudulent Transfer Laws and Statute of Limitations.** Few offshore jurisdictions condone a fraudulent conveyance. However, most offshore jurisdictions have attempted to clarify the issue of fraudulent conveyance by drafting clearly defined fraudulent conveyance legislation. This modern legislation has attempted to eliminate many of the ambiguities and unpredictable results that have caused uncertainty for both debtors and creditors alike, both in the United States and in the United Kingdom. Likewise, most jurisdictions have acted to shorten the statute of limitation periods applicable to fraudulent conveyances. (Contrary to popular belief, the Cayman Islands, commonly thought as a debtor haven, has a six-year statute of limitations!)
6. **Avoids Need For Pre-Marital Agreements.** Regrettably, the sacrament of marriage is not as sacred as it once was. It is not uncommon to have a U.S. client that is working on his third marriage. If the client has begun to accumulate wealth, notwithstanding prior divorces, future marriages can continue to be problematic when the issue of prenuptial agreements is first discussed. The need for a pre-marital agreement can be avoided altogether through the establishment of an international trust prior to marriage. It not only avoids the unpleasant task of asking a future spouse to sign a pre-marital agreement, it also prevents the need to make the vast financial disclosure that is required under most state laws to make such agreements enforceable. In fact, the future spouse does not even need to know about the existence of the international trust. Upon divorce, the assets in the trust are safely and legally outside the jurisdiction of a divorce court.

7. **Marital Property and Forced Heirship Laws Overridden.** A settlor may be surprised to learn that in most states he will not be able to freely dispose of his property through his Will at the time of his death. Forced heirship laws throughout the United States grant spouses and children of the decedent certain heirship rights in the decedent’s estate. These types of problems can be properly addressed through the use of an international trust established in a jurisdiction that has adopted legislation to prevent the application of forced heirship laws and forced marital property laws in the debtor’s home jurisdiction.

B. **The Consolidated Wealth Preservation Trust.** A typical international trust established by a U.S. person is intentionally drafted to qualify as a “grantor trust” for U.S. tax purposes. Failure to do so will result in a transfer to the trust being treated as (i) a taxable gift and (ii) a taxable “sale or exchange” of the asset transferred to the trust. However, if established as a grantor trust, any assets held by the trust will be subject to estate tax upon the settlor’s death. Thus, even if the primary goal of establishing the trust is the settlor’s desire to achieve asset protection for the client and the client family and heirs, the client’s planner should consider and integrate into the international trust structure estate planning strategies that will help reduce the estate tax burden of assets held within the trust upon the settlor’s death. However, to enhance the likelihood that such planning will succeed, it is important, particularly in an offshore setting, that the resulting structure be established as part of an arm’s length transaction with an independent trustee and minimal retained controls on the part of the settlor.

XI. **SUMMARY OF PRINCIPAL OFFSHORE JURISDICTIONS**

Possibly the most important decision to be made in establishing an international trust is the selection of a home jurisdiction for the trust. All offshore jurisdictions that are active in seeking wealth preservation trusts have also been active in modernizing the law governing such trusts. However, there still exists a broad range of options and differences amongst the various jurisdictions.

Traditional offshore havens, such as the Bahamas and the Cayman Islands, continue to offer a multitude of advantages. However, they are not necessarily the most advantageous jurisdictions, from a trust legislation standpoint. On the other hand, many jurisdictions that have favorable legislation are small and have new but untested legislation. On the other side of the scale, jurisdictions such as New Zealand are not typically considered “offshore havens” and, in the case of New Zealand, do not even have a codified trust law. Instead New Zealand relies instead on the common law concepts of trust law although they do recognize a “self settled trust.”
More importantly, many individuals, especially foreign individuals, are attracted to New Zealand since the country is not on any type of “watch” or “black list.” As a result, it is a jurisdiction that has become popular in recent years with high net worth individuals.

Finally, although extremely new to the foreign trust jurisdiction competition, Switzerland has now become a viable option for an international trust in light of its ratification of the Hague Convention on Trusts which took effect on July 1, 2007. Thus, even though Switzerland is well known for its laws on banking secrecy, it is arguably the financial capital of the world, and despite what some would call its obsessive commitment to “banking secrecy,” Switzerland continues to enjoy an excellent reputation with the international financial community. Of course, because the law is extremely new and not very well understood by most practitioners, including Swiss professionals, it will be some time before viable trust structures are available in Switzerland.

The summary below attempts to very briefly outline the various categories of jurisdictional options available to a typical planner. However, due to its potential effect on the international trust community, the discussion on the concept of trusts in Switzerland is discussed in a separate section following this section.

A. Best Jurisdictions to Use for Establishing an International Trust. As with any legal issue, the ideal jurisdiction for establishing an international trust for one an individual or family will be affected by multiple issues too numerous to discuss in detail here. There is a wide range of jurisdictions from which to select a situs for the client’s trust. The trust law in these jurisdictions can vary significantly.

In recent years, some jurisdictions have adopted very “specific” asset protection trust legislation that is expressly drafted to aggressively protect the assets transferred to a trust by a solvent debtor. Alternatively, other more “traditional” jurisdictions have intentionally decided to avoid such a strategy and, instead, rely upon the common law that has developed over many years within those jurisdictions. Other jurisdictions, sometimes described as “middle of the road” jurisdictions, have elected to adopt moderately debtor friendly legislation to complement their existing common law that has been extensively developed over many years.

The client’s individual needs and realities may also affect the choice of jurisdiction. For example, individuals who are on the board of directors of an SEC reporting publicly held company may prefer to use a more traditional or contemporary jurisdiction rather than to use a jurisdiction with more aggressive legislation. On the other hand, most professionals and other individuals involved in high-risk endeavors usually prefer to use a jurisdiction that has very favorable asset protection legislation. In the end, it is the client’s advisor who must carefully evaluate the goals and needs of the client when recommending an appropriate jurisdiction for the client.

B. Jurisdictions with “Specific” Asset Protection Legislation. A handful of jurisdictions have adopted legislation specifically designed to provide statutory clarity in the area of asset protection trusts. In those jurisdictions that have “specific” asset protection legislation, the jurisdictions have attempted to incorporate into their statutes very specific language regarding virtually every part of an international trust established for any reason but, primary if established for asset protection purposes. For example, while virtually all of these jurisdictions are traditionally “common law” jurisdictions such as the United States, most of these jurisdictions,
such as the Cook Islands, have placed great emphasis on overruling certain common law concepts which are typically used to pierce a self settled trust. Thus, although the concept of a “sham trust” is recognized in virtually all, if not all of these jurisdictions, “specific” asset protection legislation jurisdictions will, by way of example, address specific common law concepts that are expressly permitted under local law but might not otherwise be found in the traditional common law jurisdiction, such as the right to form a “self settled trust” where the settlor of the trust can also be a beneficiary of the trust.

Likewise, these jurisdictions will typically outline specific powers held by certain individuals, including the settlor/beneficiary of a trust, which are deemed by statute not considered to be a “badge of fraud” which, under common law, would typically be one of many badges of fraud. Lastly, while such jurisdictions will incorporate the ability of a creditor to set aside a transfer to a trust that is considered to be a fraudulent transfer, strict statutes of limitations exist governing the ability of a creditor to challenge a transfer to an asset protection trust. Although such jurisdictions typically do have fraudulent transfer statutes, a creditor must typically prove, beyond a reasonable doubt, that a transfer to the trust was done with fraudulent intent.

Jurisdictions with specific asset protection legislation include the Cook Islands in the South Pacific, Nevis in the Caribbean, and St. Vincent and the Grenadines in the South Caribbean.

C. Traditional and “Middle of the Road” Jurisdictions. Several jurisdictions that have historically relied on traditional notions of trust law have, in recent years, “modernized” their trust law to incorporate the realities of self-settled wealth preservation trusts. However, these “middle of the road” jurisdictions have adopted legislation that, while debtor friendly, is not necessarily as aggressive as that found in jurisdictions such as the Cook Islands. Thus, while these jurisdictions can be considered to have very good asset protection legislation, they have nevertheless retained, for the most part, fundamental common law trust concepts which are considered to be indispensable in many Commonwealth jurisdictions, notwithstanding the modification of the common law by modern trust legislation. Jurisdictions that can be considered to fall into this category include Bermuda, the Bahamas, and the Cayman Islands.

The Channel Island has historically been a favorite of individuals in Europe, particularly the United Kingdom. The Channel Islands include the Isle of Man, Jersey, and Guernsey. The trust law in the Channel Islands relies, to a large extent, on the common law adopted by those jurisdictions from the United Kingdom. Nevertheless, some of these jurisdictions have recently adopted legislation to modernize their existing trust law.

Certain “middle of the road” jurisdictions have, in past, been criticized for literally accepting anyone as a client without too many questions asked. In fact, one could argue that, by way of example, the Isle of Man, which was once the prime jurisdiction of choice for individuals in the United Kingdom, was built by funds siphoned out of the United Kingdom by individuals desiring to avoid the extremely high income tax rates in that country. Likewise, the Cayman Islands was well known at one time as the ideal jurisdiction for Latin American individuals, and even many Americans, desiring to establish with funds from questionable sources. After all, it is not a coincidence that the Cayman Islands, a small Caribbean island with a mere 31,000 residents is the 5th largest financial center in the world and, at last count, has close to 700 banks or similar financial institutions on the island.
In an effort to reflect their commitment to the strict demands of internationally accepted KYC (“Know Your Customer”) guidelines, both the Isle of Man and the Cayman Islands adopted very strict KYC legislation at a very early stage, well before most other jurisdictions. In retrospect, the legislation in the Cayman Islands was found to be overly burdensome and has now been ever so slightly modified to prevent the choking effect that it had on business. On the other hand, the Isle of Man, which is heavily influenced by the United Kingdom and desirous of becoming a member of the European Union, continues to abide by a very strict code of ethics and KYC requirements which includes concepts which were rejected by jurisdictions such as the United States. One specific KYC requirement which was adopted in the Isle of Man but not in the United States was one known as part of the “Gatekeeper Initiative” which essentially requires attorneys and other professionals to disclose to tax and law enforcement officials information which might come to their attention regarding past or contemplated tax evasion schemes or intentions even before the professional advisor has had an opportunity to warn the client against such actions. Thus, jurisdictions such as Isle of Man, can be burdensome to work with in light of their very strict KYC requirements which many practitioners consider to be burdensome. Nevertheless, the Isle of Man continues to be extremely popular with “traditionalist” professional advisors who prefer to use a foreign jurisdiction that has trust law based strictly on common law concepts and has a large array of professional trust companies to assist the client with such planning.

XII. ASSET PROTECTION THROUGH SWISS ANNUITIES AND PRIVATE PLACEMENT LIFE INSURANCE

Possibly the hottest trend in wealth preservation planning is the use of offshore life insurance products for both asset protection and income tax planning. The use of life insurance as an investment vehicle is not new. A typical whole life insurance policy has an investment element to it that grows with the policy. While policies sold in the U.S. are not necessarily the greatest investment options available, income earned or generated by the investment element of a life insurance policy is tax-free. Thus, income earned by the life insurance policy is able to grow “tax-free” much the same as a 401(k) retirement policy. Investments held by the policy can also grow tax-free.

A life insurance policy sold by an offshore insurance carrier can be structured similar to policies sold in the U.S. As such, income earned by the offshore life insurance policy is tax-free. However, unlike policies sold in the United States, policies sold offshore have very significant financial benefits and investment options that are not available in the United States. These advantages has resulted in offshore private placement life insurance policies becoming a very popular investment and source of tax-free income. However, such policies must be properly structured to comply with U.S. income tax laws regarding insurance policies. Moreover, since these policies are not registered in the United States, these policies are typically not available to United States person. However, they can be sold to an international trust established by a U.S. citizen.

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This part of the paper focuses primarily on the use of the Swiss annuities and Swiss life insurance products by U.S. citizens to achieve both asset protection and, in some cases, significant tax planning opportunities.

A. **America’s Attraction to Swiss Annuities and Life Insurance Products.** Swiss annuities and life insurance products have recently enjoyed a significant increase in popularity with American citizens as a result of the increasingly litigious nature of the U.S. legal system. Historically, Americans have sought the benefits of annuity contracts to provide for their long-term retirement benefits. Life insurance has been used to provide both to financially support an individual’s family, in the event of the insured’s premature death and to integrate into a well-drafted wealth preservation strategy that minimizes estate taxes and maximizes the amount of wealth that could be transferred to subsequent generations.

The fact that minimal protection from outside creditor claims is available for annuities and life insurance policies in most states has exposed such policies to creditor claims that an insured is unable to protect against. In fact, even in those states where annuities and life insurance policies have enjoyed unlimited protection from creditor claims, courts have recently embarked on a trend that essentially denies the unlimited creditor protection to such policies that are deemed to be more of an “investment product” than a traditional annuity or life insurance policy. As a result, Americans have sought to identify annuity and life insurance products and strategies that will help protect these very significant parts of their overall wealth preservation planning.

For many Americans, one solution has been the Swiss annuity, which enjoys significant asset protection benefits as a result of Swiss insurance law. However, Swiss life insurance policies also have increased in use in recent years as high-net-worth individuals become familiar with the significant protection available to Swiss insurance products under Swiss law.

Variable life insurance policies issued by Swiss insurance carriers typically require a significant minimum premium investment—typically no less than $1 million to $2 million paid over a five- to seven-year period. Swiss annuities have been particularly popular with Americans of all income groups because of the minimal investment, often as low as $250,000, that is necessary to acquire a Swiss annuity and thus enjoy its numerous benefits.

B. **Lack of Uniform Protection in the United States for Annuities and Life Insurance.** Employment-related retirement plans in the United States generally enjoy good protection from creditor claims under federal law and under most state laws. Any employment-related retirement plan that is covered under the U.S. Employment Retirement Income Security Act (ERISA) provides strong “anti-alienation” provisions to protect those plans against the claims of creditors of plan participants. Employment-related retirement plans that do not qualify for federal law protection typically are protected by state law in most states. However, these protections apply only to retirement and similar plans, whether in the form of annuities or otherwise, that are directly related to an individual’s employment. Only a handful of states provide protection for annuities and life insurance policies that individuals purchase to supplement their income upon retirement or to provide for their families upon their premature death.

1. **Annuity Protection Under U.S. Law.** As of the writing of this paper, only 10 states provide for unlimited protection of annuities and the proceeds from those annuities against creditors.

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the creditor claims of the annuity owner.89 A total of 16 states, including Colorado, Connecticut, Iowa, Massachusetts, Rhode Island, and Virginia, provide no protection whatsoever against creditor claims against an annuity or annuity payments received by an annuitant. The bulk of the remaining states provide for limited protection for annuity payments or policy proceeds. In some cases, the amount of annuity payment that is protected from creditor claims is a very small amount, typically varying from $350 to $500 per month; some states, such as Pennsylvania, limit to $100 the amount of the monthly annuity payments that are exempt from creditor claims. In other states, annuity payments of a limited amount enjoy similar protections but only if such payments are being made to the dependents of the annuity owner, such as a dependent’s spouse and children. As will be discussed, that is similar to the protection afforded annuities in Switzerland, but without any limitation on the amount of the benefits protected from a creditor’s claim.

2. Life Insurance Protection Under U.S. Law. Like annuities, life insurance policies are fully protected in the hands of their owners in only 10 states. Many states provide limited or no protection whatsoever to the owner of a life insurance policy. However, unlike annuities, many states do provide that the proceeds of a life insurance policy (i.e., the insured individual has died) are fully protected from creditor claims if such proceeds are paid to, typically, family members and other dependents of the insured. However, even in most of those states, should the owner of the policy be subject to creditor claims that are reduced to judgment prior to the death of the policy owner, a judgment creditor could seize the policy while the owner-insured is still alive and, in most cases, redeem the policy for its cash surrender value. If an owner-insured’s intent is to own a policy to provide for dependents upon his or her death, irrespective of potential financial misfortunes, that goal cannot be realized in the majority of states if the owner-insured owns that policy when claims against him or her are reduced to judgment.

3. Court Trend to Circumvent Exemption Statutes. Despite the fact that some states have provided generous and sometimes unlimited protection for annuities and life insurance policies, a disturbing trend in some states has resulted in courts adopting mandated exceptions to otherwise favorable state exemption laws. In other words, despite the protections provided by some state laws for annuities and life insurance policies, some courts have unilaterally decided that such protections should be not be available in all cases, notwithstanding the clear language of state law providing for such unlimited protection. In most cases where courts have ignored the unlimited exemption available under state law, they have found that the annuity or life insurance policy that the debtor sought to protect had characteristics that made it look more like a sophisticated investment product than a traditional annuity or life insurance policies intended to provide a reasonable basis of support during retirement or provide proceeds for the individual’s family upon his or her death.

In the case of Dona Anna Savings & Loan Association, F.A. v. Dofflemeyer,\(^90\) the language of the New Mexico exemption statute at that time provided that “any interest in or proceeds from a pension or retirement fund of every person supporting only himself is exempt from... attachment, execution or foreclosure by a judgment creditor.”\(^91\) New Mexico law clearly provided for the unlimited protection of annuities and life insurance policies. In its analysis, the court took note of the accepted use and definition of an annuity when the exemption statute was first adopted in 1887 by the New Mexico legislature. The court reasoned that, in 1887, the exemption was ostensibly adopted to provide an exemption statute to “protect families from becoming destitute as a result of misfortune through common debts which are generally unforeseen.”\(^92\) In the years since the exemption statute had been adopted, the legislature had never attempted to change the definition or the amount protected from creditor claims of the owner of the annuity. In fact, some annuities had essentially become sophisticated agreements that, in many cases, provided significant tax deferral to high-net-worth individuals. Thus, pursuant to the court’s analysis, a high-net-worth individual purchasing a $5 million annuity in Texas, for example, where annuities are fully exempt from creditor claims, could, using the New Mexico court’s rationale, find that a $5 million annuity was far in excess of what the legislature had in mind when it first adopted the unlimited exemption for annuities for the purpose of protecting an individual’s retirement and enabling the person to provide for his or her family upon disability or retirement. In any event, the New Mexico court held that, despite the state’s unlimited exemption of annuities, an annuity would not be entitled to the exemptions against creditor claims available under state law if it was nothing more than a tax-advantaged investment contract even though it was technically an annuity.

A similar situation occurred in the state of California, where a debtor attempted to claim an exemption of his annuity under state law while the bankruptcy trustee argued that the annuity was merely an investment vehicle and therefore did not qualify as an annuity or life insurance under relevant California exemption laws. At the time, California law provided that an annuity would be exempt from creditor claims only if it was qualified as a life insurance policy. After reviewing the history of the exemptions available under California law for annuities and life insurance, the court ruled that where the annuity contains some attributes of insurance and some of investment, the analysis must include a determination of the primary purpose of the annuity. If the primary purpose of the annuity was investment, then the annuity would not qualify as life insurance for purposes of the exemption statute. After reviewing the facts, the Ninth Circuit Court of Appeals held that the annuity contract was primarily an investment contract and, therefore, not entitled to exemption and protection from claims of creditors under California law.\(^93\)

4. **Concern Over Continued Erosion of Existing U.S. Protections.** While very few court have addressed this issue in the United States, many professional advisors are concerned about the increasing trend to reclassify as an “investment contract” a policy, issued by

\(^{90}\) 115 N.M. 590, 855 P.2d 1054 (1993)


\(^{92}\) *Thomson vs. Lerner*, 25 T.2d 209, 210-11

\(^{93}\) *In re Payne*, 323 B.R. 723, (9th Cir. 2005)
an insurance company, that is structured either as an annuity or a life insurance policy. This paper does not discuss the intricate Internal Revenue Service (IRS) rules governing the taxation of investments inside such products, but it is important to recognize that the IRS in its regulations and rulings has made it clear that, before a life insurance policy can enjoy the tax-free accumulation of investment income inside the policy, it must first qualify as a true life insurance policy. Among other factors, a true life insurance policy includes an element of risk that has been assumed by an insurance carrier in exchange for a premium paid. Thus, if a life insurance policy does not meet the necessary “risk” requirements of the Internal Revenue Code, the tax law will not consider it to be a life insurance policy entitled to tax benefits associated with the deferral of income from investments held by the policy itself.

Likewise, it is not difficult to see that insurance products, particularly annuities, that may enjoy protection from creditor claims by statutes adopted over 100 years ago bear little resemblance to tax-advantaged annuities and complex variable life insurance products available today. Thus, while annuities purchased by Americans from their earnings with the primary goal of supplementing their retirement income will likely continue to enjoy applicable state protections, if any, modern annuity and life insurance products offered to high-net-worth individuals are likely to run the risk that, in the event of creditor attack, a court may find that the contract is nothing more than an investment contract rather than a traditional annuity or life insurance policy entitled to whatever exemption or protections that might be available under state law. As will be discussed, this problem can be avoided through the use of Swiss annuities and Swiss life insurance products that benefit from significant protections against creditor claims pursuant to Swiss law, in addition to any additional protections that might be available to such policies when integrated into an estate planning or similar wealth preservation structure such as an international trust or a self-settled state trust such as those now available in 13 states of the United States, including Delaware.

### C. Swiss Asset Protection Benefits versus Vulnerable U.S. Annuities

Most annuities available in the United States are issued by heavily regulated but well-capitalized domestic insurance companies. As a result, a U.S. person acquiring a policy issued by a major U.S. company can find peace of mind in knowing that the annuity will pay its benefits as provided for in the contract. However, the principal risk to the owner of a U.S. annuity comes not from the potential financial failure of the issuing company but from the threat of potential creditor claims, which, in most states, allow a successful claimant to reach most, if not all of the intended benefits of the annuity policy. In the United States, the level of creditor protection afforded an annuity is governed by the law of 50 individual states. Swiss annuities, however, are governed by federal Swiss law. In Switzerland, the protection afforded to annuities and life insurance policies is found in the Swiss Insurance Act, which applies equally to annuities and life insurance policies issued in Switzerland. However, Swiss law does differentiate between situations where a third party has been named the beneficiary of the policy and those situations where a spouse and/or descendants of the insured have been named as beneficiaries.

If the policy holder has irrevocably designated a third party as a beneficiary of a policy, such policy may not be seized by the creditors of a policy owner. In interpreting Article 79, paragraph 2 of the Swiss Insurance Act, the Federal Supreme Court of Switzerland has held that in the case of enforcement measures against the policy owner, there is in the estate of the policy owner no insurance claim, and the policy owner has no right to revoke the beneficiary’s rights as normally would be the case. Therefore, the creditors of the policy owner may not seize, have levied, or have otherwise seized the insurance policy. The Federal Supreme Court has also held
that this principle was expressed in Article 79, paragraph 2 of the Swiss Insurance Act. According to that article, if a policy owner has waived his or her right to revoke the designation of beneficiaries of a policy, any rights emanating from such designation may not be seized by the policy owner’s creditors.

If the owner of the policy, whether it is an annuity or a life insurance policy, has designated his or her spouse and/or descendants as beneficiaries of the policy, an even more protective rule applies. Articles 80 and 81 of the Swiss Insurance Act provide that where the spouse and the descendants of the policy owner are the named beneficiaries of an insurance policy, whether such designation is revocable or irrevocable, the policy may not be seized by the creditors of the policy owner. Moreover, even if the policy owner were to be declared bankrupt, the designation of the beneficiaries may no longer be revoked by the policy owner. Instead, pursuant to Article 81 of the act, the spouse and/or descendants of the policy owner automatically become the owner of all rights and duties of the policy owner as provided for in the relevant insurance policy.

It is a foregoing provision that is well known within the United States as providing protection for annuities. If the annuity is subjected to a creditor’s claim, or if the owner of the annuity is declared to be bankrupt, the designation of the spouse and/or dependents of the annuity owner essentially becomes irrevocable, thus insuring that the annuity will not become an asset that is subject to seizure by creditors or part of the policy owner’s bankruptcy estate. Instead, the spouse and/or dependents of the policy owner automatically inherit any and all rights that the policy holder held in the annuity or life insurance policy, even if the owner of the policy still held the right to revoke the beneficiary designations. Assuming that the acquisition of the annuity or insurance policy does not constitute a fraudulent conveyance, a subject discussed next, the provisions of Articles 79, 80, and 81 of the Swiss Insurance Act basically insure that, with proper planning, the owner of an annuity or life insurance policy will always be able to protect his or her interest in it even if he is the beneficiary of the policy, or the ownership and benefits of the policy will accrue to the policy owner’s spouse and/or dependents, thereby protecting the policy from the claims of creditors. Nevertheless, as with any transaction in the United States and most jurisdictions of the world, the initial acquisition can not be a fraudulent conveyance under Swiss law.

1. **Consequences of Fraudulent Transfer.** As in the United States, Swiss law provides that a transfer that is deemed to be fraudulent against creditors can be set aside or certain actions of the annuity or life insurance holder, such as beneficiary designations, will be ignored if they fall within the parameters stipulated by the Swiss Debt Collection and Bankruptcy Act. Article 82 of the Swiss Insurance Act specifically provides that the protections otherwise provided by the act will not protect a policy holder against creditor claims if, for example, the irrevocable designation of a third party or the designation of a spouse and/or descendant of beneficiaries of a policy are in violation of the Swiss Debt Collection and Bankruptcy Act. Therefore, if the policyholder is declared to be bankrupt or the policy is seized by a creditor within one year of the designation in question, the purchase of such policy and/or the designation of beneficiaries would be considered to be a transaction voidable by creditors. As a result,

94 For U.S. citizens, the irrevocable designation of the annuity holder’s spouse and/or dependents as beneficiaries and owners of the policy may have adverse gift tax consequences. However, such adverse tax consequences can be avoided if the annuity is owned by a foreign grantor trust that is not subject to the jurisdiction of the U.S. courts or under the control of the policyholder.
creditors would be able to seize the policy or, in the event of bankruptcy, the policy itself would become part of the bankrupt estate.

2. **Court-Ordered Revocation of Beneficiary Designation.** Most professional advisors in the United States who are familiar with U.S. insurance products are also aware of the power of U.S. courts, particularly federal and bankruptcy courts and their judges. It is not unusual, given the appropriate fact pattern, for a U.S. judge to order a debtor or bankrupt to take certain actions to recover assets from a third party that is holding assets that a U.S. court might consider assets of the U.S. debtor. However, because of the way that Swiss insurance law is written, by the time that such orders are issued by a U.S. court, the debtor subject to creditor claims or the debtor in bankruptcy will have, under Swiss law, already irrevocably lost the power to request action regarding the Swiss insurance policy, even if ordered to take such action by a U.S. judge. No Swiss insurance company will comply with the request of such former policy owner since, under Swiss law, such owner automatically loses the right to own or control any rights he or she may have once held under the policy.

Assuming a fraudulent acquisition and/or designation has not occurred, Article 81 of the Swiss Insurance Act provides that the owner of an annuity that has designated a spouse or dependents as beneficiaries loses the right to change that beneficiary designation upon any attempted seizure of the policy by a creditor or the owner of the policy being declared a bankrupt. Thus, at the moment of such an occurrence, all rights formally held by the owner of the annuity or life insurance policy automatically pass to the spouse and/or dependents of the formal annuity owner under Swiss law. Thus, should an insurance company receive an order by a foreign court to change a beneficiary designation that the owner of the annuity or policy might have made prior to being declared a bankrupt or having the policy seized, the Swiss insurance company would not legally be able to abide by such foreign court orders since, under Swiss law, the former owner of the policy no longer has the right to exercise such powers. Instead, such powers have automatically passed to the spouse or dependent beneficiaries of the policy holder. Of course, if the annuity or policy holder has made an irrevocable designation of a third party as policy beneficiary, the Swiss insurance carrier must ignore a court order by a foreign court to disregard such designation, assuming the designation was not fraudulently made under Swiss law.

Thus, a Swiss annuity or life insurance company that has been properly structured and not purchased as part of an effort to evade creditor claims will essentially guarantee that the intended beneficiaries of the policy are able to benefit from the policy, notwithstanding creditor actions abroad. Moreover, as previously mentioned, additional insulation from creditor claims can be achieved if the annuity or life insurance policy is owned by an international trust that is established by the policy holder or intended policy holder well before any actual or potential client claims accrue.

3. **Use of an International Trust to Own Swiss Annuity or Life Insurance Policy.** There are numerous benefits to using an international trust as part of a legitimate asset preservation plan for a client. This area of law is constantly changing as a result of modern and progressive asset protection trust legislation enacted by multiple offshore jurisdictions and constantly changing U.S. laws and court decisions which make it critical that any offshore planning be fully compliant with applicable U.S. tax law and a plethora of federal laws that might be applicable to any proposed transaction. Failure to take into account all possible issues could quickly result in the client not benefiting from the many advantages of an international wealth preservation trust.
A comprehensive discussion of the issues involved in the use of international trusts by U.S. persons is beyond the scope of this paper. However, most of the advantages that a U.S. person can derive from using an international trust are applicable to any high-net-worth individual in the world. It is important to note, for purposes of this chapter, that an international trust established by a U.S. person can be a tax-neutral “grantor” trust or a “non-grantor trust.” If the U.S. person is interested primarily in asset protection, with potential estate planning benefits integrated into the structure, it is likely that he or she will want to establish an international trust that is considered to be a “grantor trust” for U.S. tax purposes. In a nutshell, a U.S. “grantor trust” is basically a tax-neutral trust for purposes of U.S. income, gift, and estate tax purposes. As a result, if the trust is properly structured as a U.S. grantor trust, the trust itself does not provide the settlor of the trust with any tax benefit, nor does the settlor of the trust incur any additional tax liabilities. Nevertheless, there are multiple benefits associated with the use of an international trust, even if it is considered a grantor trust for U.S. tax purposes. In fact, it is usually mandatory to have a foreign structure in place for a U.S. person to acquire a foreign insurance policy, since such foreign insurance company is, by definition, not licensed to do business in the United States. Thus, in virtually any case where a U.S. person seeks to purchase a life insurance policy from a foreign insurance carrier, including all major Swiss insurance companies, it will be necessary to establish a foreign structure, preferably a tax-neutral structure such as an international “tax-neutral” trust, in order to allow the foreign insurance company to sell the policy insuring the life of the U.S. person. In those circumstances, an international wealth preservation grantor trust that is tax neutral for U.S. tax purposes is the ideal vehicle for acquiring a Swiss life insurance policy or a Swiss annuity.

4. **Tax Planning with Variable Offshore Life Insurance Policies.** Possibly the hottest trend in wealth preservation planning for high-net-worth individuals in the United States is the use of Swiss life insurance products for both asset protection and income tax planning. The use of life insurance as an investment vehicle is not new. A typical whole life insurance policy has an investment element to it that grows with the policy. Although policies sold in the United States do not necessarily offer the greatest investment options available, income earned or generated by the investment element of a properly structured life insurance policy is tax-free. Thus, income earned by the life insurance policy is able to grow “tax-free” much the same as a 401(k) retirement plan. Investments held by the policy can also grow tax-free. Tax-free accumulation of income is best suited for those interested in building a retirement nest egg or simply accumulating assets that can be passed to the next generation. However, should the policy owner have an unexpected need for cash, he or she can simply borrow against the policy. Thus, the policy can earn income tax-free, then make the funds available to the insured through tax-free loans if necessary.

A life insurance policy sold by a Swiss insurance company can be structured similar to policies sold in the United States. As such, income earned by the Swiss life insurance policy is tax-free. However, unlike policies sold in the United States, policies sold offshore have very significant financial benefits and investment options that are not available in the United States. These advantages have resulted in offshore life insurance policies becoming very popular investment products in the United States as well as a source of tax-free income. Although not every Swiss insurance company offers a U.S.-tax-compliant life insurance policy, some of the larger Swiss insurance companies will do so through a privately placed Swiss life insurance policy.
Such policies must be structured properly to comply with U.S. income tax laws regarding insurance policies. Moreover, since these policies are not registered in the United States, typically they are not available to U.S. persons. However, as discussed, they can be sold to an international trust established by a U.S. citizen.

5. **Other Advantages of Swiss Policies.** Other significant advantages to the use of offshore life insurance policies make them significant planning opportunities for the high-net-worth individuals and their advisors.

a. **Cost.** One of the principal advantages of offshore life insurance is its reduced cost compared to domestic policies. Policies sold in the United States typically are sold by commissioned agents who command significant up-front commissions that are paid out of the policy’s premium dollars. In order to support such commission payments, domestic insurance companies must set premiums that are higher than those of insurance companies that do not need commissioned agents to sell their policies. Likewise, the heavy regulation associated with the U.S. insurance industry results in significantly higher overhead costs, which have a direct effect on the cost of policies. However, in jurisdictions that specialize in insurance products, such as Switzerland, overhead and administrative costs are significantly lower. The cost savings realized by Swiss insurance companies is reflected in their lower insurance premiums.

b. **Private Placement.** A typical life insurance policy placed with a Swiss insurance carrier is essentially a privately negotiated contract between the insured and the carrier. Because of the size of the policy and premiums involved, a Swiss life insurance carrier is willing to negotiate a policy that incorporates significant provisions that might be relevant or important to the insured individual. In other words, a life insurance policy—which is nothing more than a contract between the insurance company and the insured—can be negotiated much the same way as an arm’s-length contract that is negotiated between two parties. This flexibility provides the insured the ability to address specific issues that might be important to him or her.

c. **Asset Management.** In addition to the tax benefits associated with such policies, Swiss life insurance products offer significant flexibility in the management of policy investments, much the same way as 401(k) retirement plans do. The insurance company can place the investment portion of an insurance policy with any qualified asset manager in the world, even one suggested by the insured. The Swiss insurance company will open an account with the investment manager in its own name. In this segregated account, the client’s assets can be managed by the asset manager selected by the Swiss insurance company, even if such asset manager was originally suggested by the insured or the insured’s financial advisors. Although the insured cannot have day-to-day control of the assets in the segregated account, he or she can approve a proposed asset manager before deciding to fund the international trust that will purchase the policy. Thus, the insured has the benefit of knowing that the assets are being managed by a money manager that he or she has approved of in advance. However, only the insurance company can actually select the asset manager or have any input into day-to-day investment decisions although they can delegate that investment management authority to a qualified third party asset manager.

6. **Tax Treatment of Insurance Policy Income.** As indicated, income earned by the investment portion of the life insurance policy, properly structured, is free from taxation in the United States. The laws governing these rules are quite complex. However, in order to enjoy tax-free status, it is critical that the policy have a life insurance element that is actuarially
consistent with the amount of the premium paid and the insurability of the insured. In other words, the life insurance portion of the investment must be “true” life insurance; otherwise its status as a life insurance policy will be totally ignored. The U.S. federal tax rules that govern the taxation of investments owned by any life insurance policy domestic or foreign, are beyond the scope of this paper. However, prospective purchasers of Swiss insurance policies must retain the services of a qualified U.S. tax advisor to insure that any life insurance policy issued by a Swiss insurance company is compliant with U.S. tax laws.

7. **Ultimate Tax Deferral Using Foreign Non-Grantor Trusts.** A significant exception to the “tax-neutral” treatment of an international trust is a foreign “non-grantor” trust. A foreign non-grantor trust is one that is established outside the United States by a U.S. resident or citizen. It is an irrevocable trust in which the grantor makes a “completed gift” for gift and estate tax purposes. However, in order to achieve the tax benefits associated with a foreign non-grantor trust for U.S. tax purposes, the trust must not have any U.S. beneficiaries during the life of the settlor and the settlor’s spouse and for a period of one year thereafter. During this time period, the foreign non-grantor trust may have foreign beneficiaries and typically will have at least one foreign charitable organization as a beneficiary. However, during the life of the settlor and the settlor’s spouse and for a period of one year after their death, a foreign non-grantor trust will almost always accumulate all income and capital gains from non-U.S. sources and not make any distributions until such time as U.S. beneficiaries are eligible to receive distributions, beginning one year after the last to die of the settlor and the settlor’s spouse.

The income and estate tax advantages of a foreign non-grantor trust are significant. The foreign non-grantor trust is treated as a “non-resident alien” for U.S. income tax purposes. Therefore, as such, the foreign non-grantor trust will be taxed only on its U.S. source income. Moreover, if the non-grantor trust is not active in a U.S. trade or business, the capital gains generated within the United States will not be taxable to the trust. If the foreign non-grantor trust has no U.S. source income, it is possible to accumulate income and capital gains from foreign sources tax-free (assuming the income is earned in a tax-free jurisdiction).

Once the foreign non-grantor trust is eligible to have U.S. beneficiaries, distributions made to those beneficiaries are taxable in the same manner as distributions from a domestic non-grantor trust. However, any appreciation in the value of the foreign non-grantor trust will have been excluded from the settlor’s estate for federal estate tax purposes. Possibly the most efficient use of a foreign non-grantor trust by a U.S. citizen is the establishment of a foreign irrevocable life insurance trust.

8. **Foreign Irrevocable Life Insurance Trust.** All experienced estate planning professionals are familiar with the multiple benefits of an irrevocable life insurance trust, commonly referred to as an ILIT. A properly structured ILIT will allow a U.S. citizen to establish a trust that will own life insurance upon the life of the insured who is usually the settlor of an ILIT trust. Assuming that the ILIT is properly structured and maintained, the death of the insured settlor will not have any tax consequences in the United States. Specifically, the proceeds from the life insurance policy will not be taxable to the owner of the policy, the ILIT, nor will the proceeds from the policy be includable in the taxable estate of the now-deceased insured settlor who formed the trust. The benefits of such a structure are obvious and extremely advantageous. However, significantly greater benefits can be achieved if the ILIT is established as a foreign non-grantor ILIT.
As discussed, a foreign non-grantor trust is an irrevocable foreign trust where the settlor has established a trust that, for U.S. income, gift, and estate tax purposes, the settlor has retained no rights whatsoever in the trust. As a result, the trust is treated as a non-resident alien for U.S. tax purposes and is taxable only on its U.S. source income. However, unless gifts to the trust are exempt from the generating-skipping tax (GST)\textsuperscript{95}, subsequent generations of beneficiaries would pay such tax, essentially a form of estate tax, upon the death of a beneficiary. However, with proper planning, even this tax can be avoided and significant tax benefits gained through the use of a properly structured foreign ILIT.

Under such a strategy, the settlor of the foreign ILIT typically will make gifts of cash to the foreign irrevocable life insurance trust much the same way as is done with a domestic insurance trust. The cash is used to pay policy premiums. The transfer of cash to the foreign ILIT will constitute a taxable gift. If the individual establishing the trust has not fully utilized his or her gift tax exemption, he or she will be able to transfer as much as $1 million in cash to the foreign ILIT without incurring any actual out-of-pocket gift tax expense. At the same time, the settlor would allocate the $2 million generation-skipping tax exemption to the insurance premiums.\textsuperscript{96} Upon the death of the settlor, the entire insurance proceeds will be excluded from the settlor’s estate for estate tax purposes. However, if the settlor allocated a portion of the GST exemption to all of the gifts made to the foreign ILIT, the life insurance proceeds themselves will also be free from GST tax in perpetuity. Thus, no tax would be payable upon the death of any beneficiaries and the trust would not be subject to taxation in the United States except for any of its U.S. source income.

**E. Summary.** While annuities and life insurance policies are both good investments and crucial to part of any long-term financial planning strategy, the extent of protection available to an annuity or life insurance policy owner in the United States varies according to the state in which the policy holder resides. However, the overwhelming majority of states in the United States provide little or no protection to the owners of annuities and only slightly better protection for the proceeds from life insurance policies, although not to the actual policies themselves during the lifetime of the insured owner.

Conversely, Swiss federal law specifically incorporates protections into its law governing Swiss insurance products and life insurance policies. Under Swiss law, Swiss annuities and life insurance policies are expressly protected against creditor claims or bankruptcy proceedings, assuming the acquisition or other action taken by the owner of the policy does not constitute a fraudulent conveyance under Swiss law. As a result, any attempt by a creditor to seize the policy will, in many cases, automatically prevent the policy holder from making any beneficiary changes or, in those cases where the actual or contingent beneficiaries are the spouse and dependents of the policy owner, such policy automatically is converted into a policy for the benefit of such spouse and dependents.

\textsuperscript{95} The U.S. generation skipping tax (GST) is a complex topic that is beyond the scope of this paper. In summary, in lieu of an estate tax, it is a tax that is designed to apply upon the death of subsequent generations of beneficiaries in what is typically a perpetual trust. The net effect of the GST tax is to tax each generation of beneficiaries of a trust upon their death.

\textsuperscript{96} The GST exclusion amount will remain $2 million until 2009 when it increases to $3.5 million.
In light of the lack of uniformity in U.S. state law regarding the extent to which annuities and life insurance policies are protected, depending on the size of the investment in the Swiss annuity or life insurance product, an increased level of protection against creditor claims can be achieved by having the Swiss annuity or Swiss life insurance policy owned by an international trust that has no ties to the United States. Such a trust would need to be irrevocable, and, except in rare circumstances where specific tax planning is contemplated, the trust would be established as a tax-neutral grantor trust. In any event, by having the Swiss annuity or Swiss life insurance policy owned by the international trust, a significant amount of additional insulation from potential creditor claims is achieved.

As with any type of investment, it is important that a U.S. citizen seek the advice of competent tax counsel before pursuing any type of investment, particularly one that has significant foreign elements associated with it, such as a Swiss insurance product or an international trust. Nevertheless, with proper planning, an individual can establish a wealth preservation structure that can provide maximum preservation of assets, including Swiss annuities and life insurance policies, which will withstand creditor challenges, thus allowing the structure ultimately to provide for the financial security of the individual and his or her heirs.

XIII. THE BANKRUPTCY REFORM ACT OF 2005

After eight years of fierce debate and near misses, Congress finally passed the most sweeping overall of bankruptcy law when, on April 15, 2005, by a vote of 302–126, the U.S. House of Representatives passed the Bankruptcy Abuse Prevention and Consumer Act of 2005. The House vote came approximately one month after the Senate voted 74-25 to pass the Bill. All proposed amendments to the proposed legislation were summarily defeated in the House of Representatives as part of a concerted effort to pass the legislation without any amendments to the version passed by the Senate one month earlier. President Bush signed the 2005 Bankruptcy Reform Act into law on April 20, 2005. The reforms take effect on October 17, 2005, although some parts of the legislation became effective immediately upon the President signing it.

As discussed earlier, bankruptcy reform had lingered in Congress for eight years before it was finally passed by Congress and signed by the President. The legislation was heavily promoted by credit card companies, credit unions and banks with the primary goal of forcing debtors to repay a portion of their indebtedness, according to their ability to pay, rather than to automatically allow debtors to discharge their debt by filing for Chapter 7 bankruptcy protection and easily discharging their debts (except for those few debts that cannot be discharged in bankruptcy).

While the legislation is certainly designed by the finance industry to minimize its losses in the consumer debt arena, the primary provisions of the 2005 Bankruptcy Reform Act are equally applicable to high net worth individuals who may be forced into an involuntary bankruptcy situation as a result of an unexpected financial setback. Should that happen, the unfortunate client, now a debtor in bankruptcy, may be surprised to learn that he or she will be required to pay his or her disposable income if in a Chapter 13 proceeding, to a bankruptcy trustee for five years, based primarily upon a definition of “disposable income” determined using IRS National and Regional Standards.

Although provisions of the 2005 Bankruptcy Reform Act can also present problems for professionals and other high income earners who suddenly find themselves in bankruptcy.
Among those are the $125,000 limitation on the homestead exemption, the new $1 million cap on individual retirement accounts, and the ability of a bankruptcy trustee to set aside certain transfers to “self settled trusts or similar devices” which occurred ten years of a bankruptcy filing.

A. “Means Testing” or “Everyone Must Pay According to Their Means.” One of the principal goals of bankruptcy reform has always been to force debtors to pay a portion of their debts according to their individual ability to pay, thus the term “means testing.” The process contemplates a two-part test to determine whether an individual is truly entitled to seek a Chapter 7 liquidation of his or her debts. However, while the two tests are primarily mathematical in nature, they are not necessarily absolute. Thus, an individual who would, on the basis of available data, technically qualify for a Chapter 7 liquidation, may nevertheless be required to undergo a Chapter 13 reorganization if the bankruptcy filing is found to be “abusive.” Likewise, someone who, according to the two-part test, does not qualify for a Chapter 7 liquidation and discharge may, under special circumstances, be allowed to seek a “fresh start” by allowing the individual to pursue a Chapter 7 liquidation and discharge of all debts.

1. **Median Income Test.** The first test is a “median income test.” If a debtor’s current month income, averaged over the prior six months, exceeds the “state median income” for a family of the same size, a Chapter 7 filing is presumed to be abusive or, to put it another way, the debtor’s only bankruptcy relief is a Chapter 13 reorganization. In a Chapter 13 reorganization, a debtor makes monthly payments to a bankruptcy trustee for a period of up to five years. While the sum of all such payments are rarely sufficient to liquidate 100% of the debtor’s indebtedness, it is nevertheless favored by creditors over a Chapter 7 liquidation and discharge.

2. **Means Test.** The second part of the two-part test, the “means test,” is basically designed to calculate the individual’s “disposable income” available for payment to creditors. If the debtor’s current monthly income, again averaged over six months, reduced by “allowable expenses,” exceeds that amount which is allowed under the new legislation for a family of the same size, assuming the debtor passes the “median income test,” the debtor would be required to pay such disposable income to a bankruptcy trustee for a period up to five years.

While such a requirement might seem reasonable on its face, the required payment of an individual’s monthly disposable income to a bankruptcy trustee takes substantially increased significance when taking into account how “allowable expenses” are determined. Specifically, the new legislation defines allowable expenses as those determined using the “National and Local Standards, and Other Necessary Expenses” as provided in Collection Financial Standards issued by the Internal Revenue Service, without regard for debt payments. Anyone who has experience in working with IRS disposable income calculations knows that the amounts allowed as reasonable living expenses by the IRS are minuscule compared to the amounts that professionals, executives, and other high income earners are accustomed to spending, based upon their available income. In the foregoing example, the net affect will require such debtor to pay most of his income to a bankruptcy trustee, thus substantially changing the lifestyle of himself and his family.

B. **$125,000 Homestead Exemption Limitation.** One provision that was controversial when first offered but unchanged during the last four years of debate on bankruptcy reform was the $125,000 cap on the homestead exemption available to a debtor in bankruptcy. When first suggested during earlier versions of reform legislation, the limitation was intended to be a universal limitation applicable to all bankruptcy filings in all situations. However, after the
election of Texas Governor George W. Bush as President, President Bush, along with the efforts of Texas Senator Kay Bailey Hutchinson and others, were able to convince Congress to limit the exemption limitation to those who abuse the homestead exemption statutes available in some states by relocating to those states just prior to a bankruptcy filing.

In the end, the legislation that was adopted by Congress allows a debtor to benefit from the liberal homestead exemptions available in some states, such as Texas and Florida, who have unlimited homestead exemptions, provided that the debtor has resided in his or her homestead for 1215 days prior to the filing of a bankruptcy petition. In calculating the 1215-day requirement, a debtor is allowed to “tack on” any holding period associated with the debtor’s prior homestead so long as both homesteads are located within the same state. If the debtor does not meet the 1215-day residency requirement, the homestead exemption will be limited to $125,000. Even if the debtor meets the 1215-day residency requirement, the debtor will nevertheless be limited to the $125,000 homestead exemption limitation if the debtor is indebted for debt arising from violations of certain federal securities laws, RICO civil penalties or a criminal act, intentional tort or willful or reckless misconduct causing serious physical injury or death to an individual.

Even if the debtor otherwise qualifies to claim his or her entire homestead as exempt, the debtor will nevertheless be limited to a maximum $125,000 homestead exemption, no matter how long the debtor has resided in the state or in his homestead, if the debtor is indebted as a result of:

- Violation of federal securities laws or similar state laws;
- RICO civil penalties; or
- A criminal act, intentional tort or willful or reckless misconduct causing serious physical injury or death to an individual.

The foregoing exemptions were not coincidental. They were a direct result of the Enron and WorldCom scandals, among others, where many of the individuals accused of wrongdoing within those companies also had the benefit of living in luxurious homes which were exempt from creditor claims under state law. The foregoing exceptions prevent such individuals from benefiting from liberal state exemptions, no matter how long they have lived in their home or resided in the state.

Although bankruptcy reform is but a few months old, the legislation has already generated significant litigation and court decisions, particularly in the area of the homestead exemption.

1. **Equity Which Accrues Within 1215-Day Period.** In the Texas case of *In Re Blair*\(^7\), the Bankruptcy Court for the Northern District of Texas addressed an attempt by a bankruptcy trustee to object to that portion of a debtor’s home equity that had accrued within the 1215-day period prior to the debtor filing a voluntary Chapter 7 petition. In *Blair*, the debtors had claimed as exempt equity in their homestead valued at $688,606. The homestead had been acquired 1,773 days prior to the petition date. The home was located in University Park, an upscale subdivision in the Dallas, Texas area.

\(^7\) *In Re Blair*, 334 B.R. 374 (Bkrtcy. N.D. Tex. 2005).
Southwest Security Bank, an unsecured creditor, filed an objection to the debtors’ exemption of their $688,606 homestead equity. Specifically, Southwest objected to the exemption to the extent that it claimed as “any and all interest that the debtors acquired between January 27, 2002 (“1215 days prior to the petition date)” and the petition date which exceeds $125,000” citing 11 USC §522(p).

Southwest based its objection upon the wording in the revised §522(p), that provides that:

“A debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate $125,000 in value.”

Unfortunately, the term “interest,” which must be acquired by the debtors during the 1215-day period to trigger the new homestead cap, is not defined. Southwest Bank argued that the debtor’s equity in the homestead was in excess of the $125,000 cap and that the increase in the equity position in the house during the 1215-day period above $125,000 was subject to the statutory cap and was therefore not exempt.

The court addressed the matter by noting that one does not actually “acquire” equity in a home. One acquires title to a home. The “interest” that the debtors had acquired was the actual purchase of the home, which was completed well before the 1215-day period mandated by the new bankruptcy law in order to take advantage of the liberal homestead exemptions available under Texas law. Thus, the court held that the “interest” held by the debtors in their homestead was outside the 1215-day period and not subject to the $125,000 cap.

2. “Trading Up” to Higher Value Home. In the Blair case discussed above, the court, in rationalizing its decision, noted that the new §522(p) did not attempt to exclude from a state’s favorable homestead exemption “any amount of such interest does not include any interest transferred from a debtor’s previous principal residence (which was acquired prior to the beginning of such 1215-day period) into the debtor’s current principal residence, if the debtor’s previous and current residences are located in the same state.”98 Thus, Congress essentially allowed for rollover by debtors of the equity in one home to another home located in the same state. In other words, a debtor is not subject to the homestead cap if he takes the proceeds of his first residence and reinvests them in a second residence even within the prescribed period of the 1215-day period of §522(p). In Blair, had the court adopted the creditor’s interpretation of §522(p), the result would have been at odds with the language which allows a debtor to “rollover” his equity into a new residence even if such new residence was purchased within the 1215-day period prior to the filing of a bankruptcy petition.

In the Florida case of In Re Wayrinen99, the court was faced with the issue where the debtor had acquired a previous residence outside of the 1215-day safe harbor period but, had acquired a new one within the 1215-day period. The trustee claimed that, since the new residence was acquired within the 1215-day safe harbor period, the debtor was strictly limited to the $125,000 homestead limitation provided by §522(p)(1)(A). Since the value of the new residence


99 In Re Wayrinen, 332 Br. 479 (Bkrtcy. S.D. Fla. 2005)
was listed at $150,000 on the debtor’s bankruptcy schedules, the value exceeded the $125,000 exemption for a residence thus resulting in a differential of $25,000 which represented “non-exempt property.” However, the court felt that such analysis misconstrued §522(p)(2)(B), noting that:

“The statute is clear that the limitation contained therein applies to that portion of the value of a debtor’s residence, acquired within 1215 days of the petition date, which exceeds $125,000. In addition, however, the extent of the limitation is determined only after deducting from the value of a debtor’s current residence that portion of the property’s value attributable to the debtor’s ownership of a previous residence, provided that the previous residence is located within the same state as the current residence and was acquired in excess of 1215 days before the petition date.”

In analyzing the specific transaction in Wayrynen, the court concluded that the “interest” transferred from the debtor’s previous residence into his current residence amounted to $150,500. Since the amount of the “interest” transferred from the debtor’s previous principal residence ($150,500) which is excluded in calculating the “interest” of the debtor subject to being exempted, actually exceeded the value of the debtor’s present principal residence ($125,000), there was no portion of the value of the debtor’s present principal residence which constituted non-exempt property.

While the debtor in Wayrynen was able to exempt the entire amount of equity in the second home, the case nevertheless supports the proposition that a substantial “upgrade” in homes within the 1215-day safe harbor period will not exempt the whole of the debtor’s equity in the new home to the extent that the debtor’s overall equity in the new homestead exceeds $125,000 after deducting the amount of exempt equity rolled into the new home from a prior residence.

In essence, the court’s holding makes clear that an individual with an otherwise exempt home will not be able to succeed in substantially “upgrading” his position by taking the equity in their old home and rolling it into a new home, within the 1215-day period, if the debtor acquires a substantial increase in equity by investing into the new home significant amounts of excess cash that would clearly not be exempt under bankruptcy law. While the equity which had accrued in the prior residence will always be protected, any equity in excess of the already exempt preexisting equity will be subject to a new 1215-day holding period in order to be exempt from the $125,000 cap found in §522(p).

C. **$1 Million Cap on IRA’s.** Early versions of proposed bankruptcy reform during the Clinton administration actually included a $1 million “cap” on the amount of retirement benefits that could be protected in bankruptcy proceedings, regardless of the type of plan involved. Thus, under legislation that was actually passed by Congress but never became law, all retirement plans, including those governed by ERISA, would have been capped at $1 million in bankruptcy proceedings. However, by the time that the 2005 Bankruptcy Reform Act was enacted, the only significant limitation that remained was that which applied to individual retirement accounts (“IRA’s”) or Roth individual retirement accounts (ROTH IRA’s) under §§408 or 408A of the Internal Revenue Code. However, in calculating the amount of the IRA or ROTH that is subject to the $1 million cap, there is excluded from the calculation any rollovers which qualified as such under IRC §§402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 403(b)(8). Since most IRA’s with large balances are a result of a qualified rollover, it is ROTH IRA’s that are
more likely to be subject to the $1 million limitation in bankruptcy. Of course, these limitations, as will all exemption limitations in the Bankruptcy Code, are only applicable to the debtors in bankruptcy. If the debtor is not involved in bankruptcy proceedings, state law exemptions can apply. However, these limitations can be forced on a debtor through an involuntary bankruptcy filing by a qualified creditor or group of creditors.

D. Asset Protection Trusts Survive Last Minute Assault. Although the 2005 Bankruptcy Reform Act is basically the same bill that had been debated and had actually passed both houses of Congress in prior years, the issue of asset protection trusts was a last minute issue that arose as a result of a newspaper article that appeared in the New York Times on March 2, 2005. In that article, the New York Times referred to legal specialists who said that the proposed law left open “an increasing popular loophole that lets wealthy people protect substantial assets from creditors even after filing for bankruptcy.” The newspaper article focused on the use of domestic asset protection trusts that, since 1997, had been approved for use in Alaska, Delaware, Nevada, Rhode Island, Missouri, Oklahoma, South Dakota, and Utah. Thus, while Congress had taken action to limit the abuse of unlimited homestead exemptions in states like Florida and Texas, it left untouched what one law professor in the article described as “the millionaire’s loophole.” The fact that the proposed bankruptcy reform has been pending for so many years was cited as one possible reason for this apparent oversight on the part of Congress: “Perhaps because the current bill was written so long ago, some legal authorities say, it does not address the new state laws that have allowed asset protection trusts to flourish.”

New York’s own U.S. Senator Charles Schumer was quick to react by introducing a series of amendments to the proposed bankruptcy bill that specifically targeted asset protection trusts. The amendments would have enabled the bankruptcy trustee to set aside or “void” any transfer of the debtor’s property into an asset protection trust if:

- Such transfer occurred within ten years of filing for bankruptcy;
- The aggregate of all such transfers exceeded $125,000; and
- The trust was a “self-settled trust” in which the debtor had a beneficial interest.

In Senate debate over Senator Schumer’s proposed amendment, supporters of the proposed amendment wisely offered a laundry list of multiple examples of alleged abuses, including WorldCom’s co-founder John Porter, financier Paul Bilzerian and even actor Burt Reynolds who had allegedly abused the bankruptcy system by utilizing local law to shelter millions of dollars in assets. Thus, just as the Senate had placed a $125,000 cap on the homestead exemption in certain cases, Senator Schumer and his supporters argued that a similar $125,000 “cap” needed to be placed on asset protection trusts.

In response to the Schumer amendment, Missouri Senator James Talent offered his own compromise amendment that would have enabled a bankruptcy trustee to set aside only those transfers that were done to defraud creditors, particularly transfers by debtors involved in securities fraud and similar crimes. However, in the opinion of some commentators, including this author, what helped doom the Schumer amendment was the fact that one of the states targeted by Senator Schumer’s proposed legislation was the state of Utah, which was represented by the well respected and powerful chairman of the Senate Judiciary Committee, Senator Orrin
Hatch. The comments by Senator Hatch on the floor of the Senate on March 10, 2005, were short and to the point:

“Mr. President, one can have self-settled trusts. What the amendment of the distinguished Senator from New York does is do away with essentially all self-settled trusts. Frankly, Senator Schumer’s amendment is so broad that it covers all settled trusts, not just fraud.

The amendment of the distinguished Senator from Missouri covers fraud, and he does it in the appropriate way, a legal way, the way it should be done.”

Ultimately, it was Senator Talent’s amendment to the bankruptcy bill that was incorporated into the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. It did so by adding a new paragraph to §548 of the Bankruptcy Code that governs “fraudulent transfers and obligations.” The new language in §548 of the Bankruptcy Code provides as follows:

“(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if-

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by-

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).”

The critical language in the new legislation is that which describes the type of transfer covered by the amendment. As revised, Bankruptcy Code §548(e)(1)(D) will enable a trustee to set aside transfers made “with actual intent to hinder, delay, or defraud” a creditor. It is the inclusion of the words “actual intent” that was severely criticized by Senator Schumer after enactment of the so-called compromised legislation. The requirement that the bankruptcy trustee prove “actual intent” is, in Senator Schumer’s view, an insurmountable obstacle in most cases.
However, other commentators have also been critical of what is clearly less than ideal drafting. For example, the term “self-settled trust” is defined in different ways within the amendment itself. In addition, some practitioners have already taken the position that the language of the amendment itself and its focus of securities law violations, taken together with the debate on the Senator floor, including comments by the author of the amendment, support the proposition that the amendment targets only those transfers that are made in anticipation of a judgment, settlement, civil penalty, equitable order or criminal fine incurred as a result of the various security law violations described in the amendment. Such proponents argue that specifically targeting those types of wrongful acts only serves to underscore the intention of the amendment to apply only to those transfers that are made in response to the securities law violations referenced in the new §548(e)(2). However, a simple review of the “definitions” section of the Bankruptcy Code makes clear that the word “includes” is not intended to be a term of “limitation.” In other words, the mere fact that a portion of the Code describes that which it “includes” does not mean that it is intended to “exclude” other items not listed in the particular part of the Code where the language is used.

A more relevant question is attempting to define the type of structure, other than a self-settled trust, to which the ten-year “look back” is applicable. The new §548(e)(1)(A) specifically targets a transfer made to “a self-settled trust or similar device” [emphasis added]. It is not at all clear what is intended to be included in the definition of a “similar device.” However, the foregoing provision could possibly be interpreted to include any type of structure to which a debtor transfers property, and in which the debtor is a beneficiary of the structure such as an annuity, some life insurance policies and probably an interest in a legal entity, including a FLP or FLLC, since all of the foregoing structures can, if properly designed, provide an element of asset protection to the client who established the structure. This is particularly true in states such as Texas that provide unlimited protection for an individual’s interest in an annuity or life insurance policy, including its cash surrender value.

E. Can the Estate Planner Prove the Settlor was Solvent 10 Years Ago? When doing estate planning for a client, estate planners consider the need to investigate and be prepared to prove the solvency of their client notwithstanding the likelihood that the estate planning strategy adopted for the client involves gratuitous transfers such as a contribution to a trust. Yet, in the opinion of this author, the 2005 Bankruptcy Reform Act makes it prudent, if not highly advisable, to have a client who is involved in estate planning or tax motivated transfers execute an affidavit at the time of the transfer to help document the solvency of the client at the time a significant transfer is made. Such an affidavit, particularly if supported by contemporaneously third party documentation, will be extremely vital should the client-settlor encounter financial difficulties within 10 years after making a large gratuitous transfer or, for that matter, any type of transfer which is considered to be a transfer of the type contemplated under Bankruptcy Code §548(e)(1)(B). In fact, some estate planners fail to take into account the possibility that gratuitous transfers into an estate planning structure can be challenged as fraudulent transfers under the law of all 50 states, most of which have four year statute of limitations. Now, estate planners and other estate planning advisors must take into account the 10 year statute of limitations which the 2005 Bankruptcy Reform Act provides a bankruptcy trustee in which to challenge transfers which a bankruptcy trustee may allege were made with actual intent to hinder, delay or defraud a creditor. Professionals involved in doing international trust work have routinely been accustomed to having such affidavits of solvency executed as part of a client’s overall international wealth preservation plan. In fact, trust companies in states that allow for self settled trusts have also become accustomed to requiring such affidavits from settlors of a self
settled trust. However, in light of the 10 year statute of limitations now found in the Bankruptcy Code, it is probably prudent to have an affidavit of solvency executed by a client that is making any type of significant gratuitous transfer to any type of estate planning or tax motivated structure. An example, such an affidavit of solvency is included herein as an exhibit to this paper strictly for illustrative purposes.

XIV. CONCLUSION

The uncertainties of our judicial system coupled with the increased exposure to seemingly uncontrollable jury awards has resulted in professional advisors re-examining the benefits associated with the implementation of a domestic or international wealth preservation structure with strong asset protection features incorporated into such structure. The growing trend to allow creditors and other claimants to pierce a domestic spendthrift trust, usually established by the parents or grandparents of the beneficiary, is both alarming and, except in rare circumstances, something that could have been avoided though proper planning. The fact that the trend to pierce spendthrift trusts has been recognized by the Restatement on Trusts, 3rd and now the new Uniform Trust Act, is even more disturbing. Even in a divorce setting, it is not surprising to learn that divorce courts have used this growing trend to pierce structures to reach assets in trusts previously thought to be immune from outside threats. What is incredibly ironic about this trend is the fact that twelve (12) states have now abolished the historic prohibition against self-settled trusts and have allowed settlor-beneficiaries of such trusts to benefit from the legal protection previously reserved only to beneficiaries of spendthrift trusts established by a third party.

Likewise, the ownership interest of family members in a family limited partnership or family limited liability company face multiple threats to their ownership interest that can often be easily addressed through careful planning. Such planning should examine the benefits of forming a domestic trust, family limited partnership or limited liability company in a state, such as Delaware, that has incorporated strong wealth preservation protections into its state law. For higher net worth clients, even stronger protection can be achieved by using a foreign trust and even a foreign limited partnership or limited liability company that, in common law foreign jurisdictions such as the Bahamas, have law that often very closely resembles comparable U.S. legislation.

All estate planning professionals should become familiar with all potential threats to the estate planning structures they implement for their clients and, if necessary, take such steps as are necessary to significantly increase the probability that the intended beneficiaries of a trust or other estate planning structure will ultimately be able to benefit from the client’s estate planning strategy. Estate planning, by definition, involves wealth preservation. Thus, estate planning should include protection of the client’s wealth from the litigation and other risks so common in today’s litigious society. With careful planning, an estate planning strategy that includes a domestic or offshore wealth preservation structure can provide the client with significantly better protection against the ever increasing threats to wealth in today’s litigious society. If a client’s wealth is unnecessarily placed at risk with a resulting loss to the client, the estate planning professional might face a malpractice claim for failing to take third party threats into consideration when drafting the estate planning structure for a client. That is why asset protection issues should be an important part of any estate planning structure implemented for a client.
APPENDIX “A” - Sample Domestic Trust Protector Provision

TRUST PROTECTOR

6.01 Appointment of Trust Protector. There shall be a Protector of each trust created by or pursuant to this Trust Agreement. The initial Protector (herein referred to as the Trust Protector, and which term shall include any successor Protector from time to time acting hereunder) shall be ___________________. Should ________________ shall for any reason fail or cease to serve as Trust Protector, then __________ shall serve as the successor Trust Protector. If ______________ shall for any reason fail or cease to serve as a Trust Protector, then _____________ shall serve as the Trust Protector

(a) Every successor Protector shall succeed his or her predecessor in all powers and discretions.

(b) A Trust Protector may resign by written and acknowledged instrument delivered to the Trustee and all then current beneficiaries of the Trust. If the Trust Protector resigns, becomes incapacitated, or otherwise ceases to act as such and no successor Protector is available to assume such role, the Trustee, subject to the consent of the beneficiaries of the subject trust as provided for herein, shall appoint a successor Protector hereto, but may not appoint itself or any party related to or subordinate to itself as Protector.

(c) Any appointment of a Protector by the Trustee as herein provided must be consented to, by majority vote, by the beneficiaries of the applicable trust (or Trust). Failure by the beneficiaries of the applicable trust (or Trust) to consent to such appointment within thirty (30) days after notice of such appointment is given to them by the Trustee, shall be deemed for all purposes hereof as a failure by the necessary beneficiaries to acquiescence to the proposed appointment.

(d) Any appointment of a successor Protector shall be by written instrument delivered to the appointee and shall be effective at the time or under the conditions specified in such instrument and shall be endorsed on or attached to this instrument and signed by the new Protector. Under no circumstances shall any of the following persons be entitled to serve as the Trust Protector: (i) any Settlor, (ii) any Trustee who is removed by a Trust Protector, (iii) a currently serving Trustee (and if a Protector becomes Trustee, such Protector shall resign as the Trust Protector). Notwithstanding any other provision of this Trust Agreement, no person shall be eligible to serve as Trust Protector if such person is a beneficiary of any trust held under this Trust Agreement or if such person is a related or subordinate party within the meaning of Section 672(c) of the Internal Revenue Code with respect to any beneficiary of any trust held under this Trust Agreement.

6.02 Powers of Trust Protector. In addition to other powers and discretions otherwise given to a Trust Protector by this instrument, the Trust Protector for each trust created hereunder shall have the following discretionary powers, to be exercised by written instrument, signed and acknowledged by the Trust Protector and delivered to the then serving Trustee (“Notice”):

(a) Removal / Appointment of Trustee. The power to (i) to remove any person, as a Trustee of such trust at any time and for any reason, or (ii) to appoint a successor

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Trustee for such trust (if no other successor Trustee herein named is willing to serve, or all such named successor Trustees have been removed, deemed unfit to serve, or ceased to serve by action of the Trust Protector or otherwise), or (iii) at any time, to appoint one or more co-trustees for any trust hereunder as to which any individual or entity is serving as sole Trustee. If the Trust Protector intends to appoint an individual as a Trustee or co-trustee hereunder, the Trust Protector shall consider the federal estate and income tax consequences to that individual, the trust and the beneficiaries of such appointment.

(b) **Distributions.** The Power to consent, in writing, to the distribution of all or any part of the Trust Estate to any beneficiary of any trust established hereunder.

(c) **Amendment.** The power to join with the Trustee to jointly amend the trust from time to time, and in such manner, as the Trustee and Trust Protector believe, in their discretion, will facilitate the efficient and effective administration of the Trust in accordance with the intentions of the Settlors, provided however, that no such amendment shall have the effect of changing or altering the beneficiaries of this trust or their beneficial interests.

(d) **Accounts for the Trust Estate.** The power to consent in writing to the establishment or opening of any banking, investment, brokerage, custodial or other financial account into which Trust Assets shall be deposited or managed, provided, however, that no such Protector consent shall be required if any such account is initially funded with funds deposited directly into the account by the Settlors.

(e) **Change of Situs.** The power to designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Trust Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Trust Agreement, whether such jurisdiction is in or outside the United States, and to declare that such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated, the courts of which shall become the forum for the administration of such trust, as well as all matters applicable to the administration thereof. Such a designation and declaration shall be set forth by written instrument which shall contain the powers and provisions which are necessary to enable such trust to be capable of taking effect under the laws of such jurisdiction, and which may also contain such other powers and provisions as the Trust Protector may determine to be in the best interest of the beneficiaries, provided that such powers and provisions do not infringe upon any rule against perpetuities that is applicable to such trust.

### 6.03 Demand Trustee Accounting

The Trust Protector shall be kept reasonably informed by the Trustee regarding the activities, assets, liabilities and income of the Trust, provided however, that the Trust Protector shall have the power, exercisable at any time, to demand an accounting by the Trustee, setting forth the receipts, disbursements, and distributions of both capital and income during the period of accounting and the invested and uninvested capital and undistributed income that is in existence at the beginning and at the end of such accounting period.

### 6.04 Trustee Bond

Notwithstanding the provisions of Section 3.02(e), the Trust Protector shall have the power, exercisable at any time, to require in writing that the Trustee, or any person or entity to whom the Trustee has delegated a power pursuant to any Article of this Trust, be required to give a bond or other security for the faithful administration of its or their duties under this Trust Agreement.
6.05 **Powers Personal.** The duties and powers of the Trust Protector shall be personal and shall cease upon the death of the person holding such office (if an individual) or upon the dissolution of the entity acting as Protector (in the case of a corporation or other entity acting as Protector). The powers of the Trust Protector shall not be capable of being delegated or of being exercised by any representative (whether a personal representative or otherwise), agent, receiver, or liquidator of the Trust Protector.

6.06 **Other Limitations on Protector Powers.** Notwithstanding anything in this Article VI to the contrary, the Trust Protector has no right or authority to take any action that will directly or indirectly benefit any person who is not an intended beneficiary of this trust, or that will be detrimental in any way to the beneficiaries of this Trust or inconsistent with the purposes of this Trust Agreement.

6.07 **Consent by Protector.** Where the Trust Protector must give consent to the exercise of any power or discretion hereunder by Trustee, the Trust Protector may veto the exercise of any such power or discretion, and accordingly the Trustee shall be required to provide the Trust Protector with reasonable prior notice before any such powers or discretions may be exercised so as to allow the Trust Protector reasonable advance opportunity within which to veto or refrain from vetoing the exercise of the power or discretion. The Trust Protector’s exercise or nonexercise of this veto power shall be communicated in writing to the Trustee and failure to so communicate in a timely fashion, provided notice is actually received by the Trust Protector, shall be treated by the Trustee as a veto by the Trust Protector of the proposed exercise of the power or discretion; however, if the Trustee, or in the case of multiple Trustees, one or more of the Trustees reasonably believe that failure by the Trust Protector to so communicate is due to the Trust Protector being restrained or enjoined from doing so, then such failure to communicate shall be treated by the Trustee and deemed for all purposes hereof as acquiescence by the Trust Protector to the proposed exercise of the power or discretion.

6.08 **Compensation.** The Trust Protector, if it is a company, shall be entitled to act as Protector on its usual terms and conditions in force from time to time, including (in addition to reimbursement of such company’s proper expenses, costs, and other liabilities) the right to remuneration. The Trust Protector, if it is an individual, shall be entitled to remuneration for its services as such, including the right to reimbursement of proper expenses, costs, and other liabilities. Notwithstanding the foregoing provisions of this Section 6.08, however, the Trust Protector’s charges and remuneration shall not exceed reasonable and customary charges and remuneration for similar services charged by corporate Protectors in the same geographic area.

6.09 **Removal of Protector.** Notwithstanding the provisions of Section 6.01 above, the beneficiaries of the applicable trust (or Trust) shall have the power to remove a Protector. Any removal of a Protector pursuant to this Section 6.09 shall become effective immediately upon notice of such removal being given pursuant to this Trust Agreement. A Protector removed pursuant to this Section shall not have the power to appoint a successor Protector. When any Protector is removed pursuant to his Section 6.09, a successor Protector shall succeed to the removed protector or, if there is no successor Trust protector, shall be appointed pursuant to the provisions of Section 6.01 above as if the Trust Protector had resigned, become incapacitated, or otherwise ceased to act, and no successor Trust Protector was willing or able to act as Trust Protector. Any successor Protector who replaces a Protector removed pursuant this Section 6.09 shall succeed to all powers and discretions of the Trust Protector under the Trust Agreement.
APPENDIX “B” - Sample Affidavit of Accuracy and Solvency

AFFIDAVIT OF ACCURACY AND SOLVENCY

STATE OF TEXAS §
COUNTY OF DALLAS §

COMES NOW the undersigned, John C. Doe (“Settlor”), who being first duly sworn upon oath, deposes and states, covenants, represents, and warrants as follows:

1. That to the best of my knowledge and belief, the information reflected on the attached Schedule A and all annexures thereto is true and accurate and provides a total picture of my entire financial situation including all claims, debts, loans, lawsuits or contingent liabilities (such as indemnities, guarantees or anticipated lawsuits) immediately prior to any property transfers by me to that certain trust settled by that certain Trust Agreement dated January 1, 2008 by and between John C. Doe, of Dallas, Texas, United States of America, as Settlor, and XYZ Company (Delaware), Inc., of Wilmington, Delaware, as Trustee, settled under the Delaware Qualified Dispositions Trust Act, 12 Del. §3570, et seq. and known as The John C. Doe 2008 Family Trust (“the Trust”) or to any limited partnership or other holding entity in which the Trust has or will have an interest.

2. Where property has already been transferred from me to the Trust or to any limited partnership or other holding entity in which the Trust has or will have an interest I was at that time solvent and able to pay my then reasonably anticipated debts including any claims and existing or anticipated lawsuits against me as they were to come due from the balance of my property after such transfer.

3. I have or will have at the time of transfer full right, title and authority to transfer all assets transferred or proposed to be transfer to the Trust.

4. Following any contemplated or proposed transfer of my property to the Trust or any limited partnership or other holding entity in which the Trust has or will have an interest I will be solvent and able to pay my reasonably anticipated debts including any claims or lawsuits against me as they come due from the balance of my property after such transfer.

5. I have filed all federal and state income tax returns which are required to be filed, and have paid all taxes as shown on said returns and on all assessments received as a result of any of them to the extent that such taxes have become due.

6. Neither the execution nor delivery of this Affidavit of Accuracy and Solvency, the Trust Agreement, or any document executed in connection
therewith, will conflict with, or result in a breach of the terms, conditions or provisions of, or constitute a default under any agreement or instrument to which I am now a party or by which I may be bound.

7. This Affidavit of Accuracy and Solvency and each document executed in connection with or ancillary to the Trust Agreement have each been duly and validly executed, issued and delivered by me and constitute valid and legally binding documents enforceable in accordance with their respective terms.

8. The execution, delivery and performance by me of this Affidavit of Accuracy and each document executed in connection with or ancillary to the Trust Agreement does not and will not require (i) any consent of any other person; or (ii) any consent, authorization or other approval of any court, arbitrator, administrative agency or other governmental authority.

9. All information supplied and statements made to the Trustee or on behalf of me prior to, contemporaneously with or subsequent to the execution of this Affidavit of Accuracy and Solvency are and shall be true, correct, complete, valid and genuine; all financial statements of I have furnished to the Trustee or are attached hereto fairly present my financial condition as of the date thereof and for the period then ended.

10. I am not in default with respect to any order, writ, injunction, decree or demand of any court or any governmental authority.

11. No representation or warranty contained in this Affidavit of Accuracy and Solvency and no statement contained in any certificate, schedule, list, financial statement or other instrument furnished by or on my behalf to the Trustee contains, or will contain, any untrue statement of material fact, or omits, or will omit, any statement of a material fact necessary to prevent the statements contained herein or therein from being misleading.

12. I do not contemplate filing for relief under the provisions of the U.S. Bankruptcy Code, nor am I involved in any situation that I reasonably anticipate would cause me to file for relief under any Chapter of the U.S. Bankruptcy Code in the future.

13. I have read and understand the description of the Money Laundering Control Act, 18 U.S.C. §1956, and confirm and represent that none of the assets which I have transferred or which I may transfer to the Trust have been derived from any of the activities specified in such Act.

14. I will comply with all of the reporting requirements as stipulated from time to time by the United States Internal Revenue Service in respect of the Trust, including reporting the creation of the Trust and any transfers of property to or distributions from the Trust.

15. I am not, to my knowledge, nor do I reasonably expect to be, under investigation by any Federal or State agency, or in violation of any statute
administered by, or empowering the Internal Revenue Service, the Federal Trade Commission, the Securities Exchange Commission, the United States Postal Service, the Drug Enforcement Agency, the Department of Homeland & Security, or the Federal Bureau of Investigation.

FURTHER AFFIANT SAYETH NOT.

SETTLOR:

John C. Doe

This affidavit together with all schedules and annexures to the schedules was SUBSCRIBED AND SWORN to before me, a Notary Public in and for the State of Texas, County of Dallas, by John C. Doe, affiant, this _______ day of __________________, 2008.

Witness my hand and official seal.

________________________
Notary Public - State of Texas
GUARDIANS AT THE GATE:
UPDATE ON THE GATEKEEPER INITIATIVE

DUNCAN E. OSBORNE
Osborne, Helman, Knebel & Deleery, LLP
Austin, Texas
THE FINANCIAL ACTION TASK FORCE
CLASHES WITH THE MODEL RULES

HISTORY OF THE FATF

The Financial Action Task Force (“FATF”) was established in 1989 by the G-7 nations (United States, United Kingdom, Germany, France, Italy, Japan, and Canada), the European Commission, and eight other countries. It was created to combat the money laundering “threat posed to the banking system and to financial institutions.”1 In 1990, within a year of its inception, the FATF issued the original version of its now well-known Forty Recommendations which, as amended in subsequent years, are essentially a comprehensive plan to fight money laundering.

In 2001, the FATF’s mission was expanded to include the fight against terrorist financing (Combat the Financing of Terrorism, or “CFT”). In October 2001, following the events of September 11, the FATF added eight new Special Recommendations to the original forty, and in 2004 added a ninth Special Recommendation. These Recommendations are referred to sometimes as the 40+9 Recommendations. By 2007, there were a total of 34 FATF member countries dedicated to following and taking steps to implement the FATF 40+9 Recommendations.

As a practical matter, the FATF enforcement process, such as it is, works as an international peer pressure system. Delegates to the FATF are not elected, and the FATF has no legislative authority. The FATF member countries voluntarily support and are committed to its principles. The work of the FATF is to make policy recommendations and then monitor the implementation of those recommendations through periodic evaluations of its member countries to measure compliance. As the FATF notes on its website:

“In the self-assessment exercise, every member country provides information on the status of its implementation of the Forty Recommendations and Nine Special Recommendations by responding each year to a standard questionnaire. This information is then compiled and analyzed, and provides the basis for assessing the extent to which the Recommendations have been implemented by both individual countries and the group as a whole.

“The second element for monitoring the implementation of the Forty Recommendations is the mutual evaluation process. Each member country
is examined in turn by the FATF on the basis of an on-site visit conducted by a team of three or four selected experts in the legal, financial and law enforcement fields from other member governments. The purpose of the visit is to draw up a report assessing the extent to which the evaluated country has moved forward in implementing an effective system to counter money laundering and to highlight areas in which further progress may still be required.

“The mutual evaluation process is enhanced by the FATF’s policy for dealing with members not in compliance with the Forty Recommendations. The measures contained in this policy represent a graduated approach aimed at reinforcing peer pressure on member governments to take action to tighten their anti-money laundering systems.”

The United States most recently underwent the mutual evaluation process in 2005-2006, which culminated in the FATF’s issuance of a 300 page long evaluation report containing 6 appendices (annexes). This document concludes with a summary report on the various Recommendations with four “grade” levels of compliance: compliant, largely compliant, partially compliant, and non-compliant. United States lawyers were listed as non-compliant in the areas of customer due diligence, monitoring of customers and filing of suspicious activity reports.

It is important to remember that the delegates sent by each country to the FATF are typically bureaucrats from their nation’s tax policy and tax collection agencies (similar to the U.S. Treasury) and financial crimes enforcement groups (similar to FinCEN). Like all bureaucrats, they come to the FATF with certain perspectives, agendas, objectives, and prejudices.

When it comes to trusts, those perspectives and prejudices can be especially pronounced among delegates from the FATF member states which are not common law states, as their understanding of and experience with trusts are very limited. Trusts are not part of their jurisprudence, they do not readily understand the fundamental trust concept of separation of legal and beneficial ownership, and they typically only encounter trusts (and associate trusts) with tax evasion.

Indeed, the FATF Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing (June 2007, p.24) describes the following services as high risk for money laundering abuses:
“Services that inherently have provided more anonymity or can readily cross international borders, such as online banking, stored value cards, international wire transfers, private investment companies and trusts.” (emphasis added)

To get a grip on what it views as an abused legal structure, the FATF at one time proposed an international registry of all trusts, showing the settlor, trustee and beneficiaries. While this concept was soon discarded as impractical, it nevertheless demonstrates the suspicion with which the FATF regards trusts.

In the United Kingdom, part of the response to the FATF 40+9 Recommendations was the Proceeds of Organized Crimes Act, which among other things, requires attorneys to file Suspicious Activity Reports (“SARs”) on their clients with the additional requirement that attorneys may not tip off clients that an SAR had been filed (the so-called “No Tipping Off” rule, or “NTO”). In the first nine months of 2007, solicitors in the U.K. filed 11,200 SARs on their clients. In a very real way, solicitors in the U.K. have become part of the law enforcement system in that country, which would seem to create an uncomfortable duality with their traditional role in the judicial process.

In the United States, some legislation has been enacted (in at least partial) response to the Recommendations. The Bank Secrecy Act as amended by the USA PATRIOT Act takes some measures toward implementation of the Recommendations. For other examples, see the June 2006 U.S. Mutual Evaluation Report.

As discussed in greater detail below, the FATF has sponsored a series of meetings to engage certain Designated Non-Financial Businesses and Professions (“DNFBPs”), including lawyers, in the anti-money laundering/terrorist financing dialogue. In general, the main objective of these discussions is to have these specifically identified businesses and professions adopt and implement the core anti-money laundering (“AML”) rules that financial institutions have adopted:

- Customer Due Diligence (“CDD”) and Know Your Customer (“KYC”) procedures
- maintain CDD records
- monitor customers on an ongoing basis
- report suspicious transactions

Other FATF goals include: (1) increased transparency of legal persons and arrangements, i.e., the actual ownership or beneficial ownership of LLCs,
corporations, partnerships, trusts, etc. should be reported and available to law enforcement authorities; and (2) increased communication and sharing of information among all these involved in the AML and CFT struggles.

While the FATF has no power to enact law, its power of political pressure and the publication of mutual evaluations will likely produce further compliance with the 40+9 Recommendations by FATF member nations (and those who wish to trade with member nations). The fact that the United States supports the FATF’s AML and CTF goals as part of the War on Terror and has itself pressured other countries to enact legislation to implement the 40+9 Recommendations makes it awkward for the United States to lag in its own compliance. The FATF also has powerful institutional allies in the World Bank and the International Monetary Fund, and the FATF has suggested that the influence of these organizations will be brought to bear against recalcitrant nations worldwide.

The FATF’s meetings with the private sector and with the DNFBPs have been held in:

- Brussels (2005)
- Amsterdam (2006)
- London (2007)
- Berne (2007)

ACTEC Fellows and members of the ABA have attended and participated in all of these meetings. Because of the very high level of suspicion with which trusts are regarded by the FATF and the resulting high level of scrutiny of trust structures, ACTEC has been proactively involved in an effort to impact the FATF process. As part of that effort, in October 2005 ACTEC issued its Recommendations of Good Practices for ACTEC Fellows Seeking to Detect and Combat Money Laundering.

At the 2006 Amsterdam meeting, invitees included lawyers, accountants, notaries, and trust and company service providers. It was the beginning of a dialogue in which various groups took positions on their reaction to the FATF’s proposals affecting DNFBPs. At that time, the ABA expressed its strong resistance to requirements for SARs, NTO, and Suspicious Transaction Reports (“STRs”).

In London in 2007, the invitees included casino owners, dealers in precious metals and stones, real estate agents, accountants, notaries, trust and company
service providers, and lawyers. All DNFBPs are apparently viewed as monolithic by the FATF, which deems them all to be at risk of abuse by money launderers and terrorist financiers. Consequently, the FATF wants all DNFBPs to enact and support the same core AML rules and regulations required of banks and other financial institutions, including:

- CDD and KYC
- Enhanced Due Diligence ("EDD")
- Monitoring of customers and transactions
- SARs and STRs
- NTO

Attorneys consider their profession to be uniquely situated among the various categories of professionals lumped together by the FATF as DNFBPs, and there was considerable resistance at this meeting from attorneys who articulated the special position and protective role that attorneys play in society and within legal systems. Due to the wide range of countries represented at the meeting, there were variations on the theme, but there was also an extraordinary degree of harmony and unanimity from this group in resisting the FATF’s attempts to treat attorneys like every other DNFBP.

In December 2007, the FATF reconvened the same DNFBPs in Berne. The meeting began with a report on the Swiss experience with the Risk Based Approach ("RBA") for DNFBPs. Ms. Dina Beti, Head of the Swiss AML Control Authority, discussed the experience of the public sector in Switzerland with the RBA for DNFBPs. The Swiss RBA was introduced by ordinance in 2003 and obligated all financial intermediaries in Switzerland to comply with the new RBA beginning January 2005. Under the Swiss RBA, all financial intermediaries have the following obligations: (a) establish a list of risk criteria both for customers and transactions, (b) conduct an efficient monitoring of customers and transactions based on these criteria, and (c) increase the level of due diligence in respect of higher risk customers and transactions. (It should be noted that under Swiss law a “financial intermediary” is one who handles or “touches” the money and has the further obligation to file SARs.)

Ms. Beti made clear that the Swiss intended to avoid a “check the box” approach for categorizing risk. She then reviewed the risk categorization for customers and clients. Politically exposed persons ("PEPs") are a mandatory risk criterion. Other risk categories for customers include the nature and location of their business, the absence of personal contact between the financial intermediary and the customer, the type of requested services or products, the amount of the
assets deposited, the amount of incoming and outgoing funds, and countries from which or to which frequent payments are made. The mandatory risk category criteria for transactions center on the amount of a deposit or withdrawal or the amount of a money transfer transaction. Other transactions risk categories include the amount of the incoming and outgoing funds and any significant divergence from the type, volume, or frequency of transactions that would be usual in the context of the business relationship of and with the customer.

Under the Swiss RBA, each of Switzerland’s approximately 6,500 financial intermediaries is subject to an annual audit. Of these financial intermediaries, about 18% are lawyers or notaries. Ms. Beti noted that the first evaluation of the RBA during 2005 revealed that the financial intermediaries had not fully understood their legal responsibilities. For example, some financial intermediaries lacked any risk categorization. Others had vague risk criteria. In 2006, the Swiss experience improved because of increased acceptance and understanding of the RBA. However, the audits continue to reveal systemic issues with the RBA among the DNFBPs. Ms. Beti observed that for small financial intermediaries (i.e., a “one person show”), the RBA is often perceived as artificial and does not necessarily guarantee a more efficient anti-money laundering system.

After Ms. Beti’s presentation, the FATF created breakout groups so that each group could begin to focus on what would be appropriate guidance for its respective business or profession using an RBA. The breakout group for lawyers suggested an RBA to guide attorney conduct in the AML fight which emphasizes the use of good judgment and reason for clients and transactions, as opposed to the implementation of a rigid checklist that is automatically applied to all clients regardless of circumstance.

For example, under an RBA it makes no sense for a lawyer in Great Falls, Montana, to apply a due diligence process to a rancher whom the lawyer has represented for decades. By contrast, from an RBA perspective, it may make sense for that lawyer to make serious inquiries about a stranger from Reno, Nevada who claims to have won $2,000,000 cash at the casinos and wants to create a Montana LLC to purchase various mountain properties. Notwithstanding the foregoing, however, and given its track record thus far, it is likely the FATF will not accept a “good judgment and reason” standard of conduct for attorneys and will insist on substantial detail and formality in the implementation of the RBA for lawyers.

U.S. Treasury officials have been invited to all these meetings and have attended all but the London conference. Treasury is responsible for implementing the FATF Recommendations in the United States and has been in active dialogue
with the ABA. To date, at least, Treasury has been supportive of the ABA’s position on SARs, STRs and NTO.

**RISK-BASED APPROACH GUIDANCE FOR LAWYERS**

A working group of United States lawyers consisting in part of members from the ABA and Fellows from ACTEC, the American College of Mortgage Attorneys, and the American College of Real Estate Lawyers (but without any authority to bind their respective organizations) are engaged with lawyers from other countries and with the FATF to prepare an RBA guidance document for attorneys, notaries, and other designated legal professionals. This work-in-progress is titled Guidance for Designated Legal Professionals on Implementing a Risk-Based Approach (“Guidance”). Participation by other lawyers in this process is typically through an organization such as the International Bar Association (“IBA”), the Council of Bars and Law Societies of Europe (“CBE”), or The Society of Trusts & Estate Practitioners (“STEP”). By June 2008, the FATF wants a final draft of the Guidance which it can adopt at its plenary meeting in London.

The FATF is interacting with the lawyers group through an electronic Working Group Evaluation & Inspection (“WGEI”) headed by Phillip Robinson, UK Financial Crimes Sector, and John Carlson, former prosecutor from New South Wales, Australia. The WEGI oversees a web-based discussion group where the lawyers’ drafts are posted and critiqued. A first draft of the Guidance was posted February 19, 2008, and a revised draft was posted on March 19, 2008.

The Guidance is intended to closely parallel the form and format of the guidance adopted by the FATF for the financial services sector and emphasizes the following concepts:

1. **Particular focus on the following “regulated activities”**:
   a. Buying and selling real estate;
   b. Managing client money;
   c. Organization of contributions to create, operate or manage companies;
   d. Creating, operating, and managing legal entities and arrangements; and
   e. Buying and selling businesses.

2. **Responsibility for monitoring clients and transactions in certain situations.**
3. Importance of non face-to-face interactions.

4. Unusual, risky or suspicious transactions.

5. Implementation of AML policies and procedures to manage and mitigate risk.

6. Responsibility of Self Regulating Organizations (e.g., state bar associations) to educate and regulate.

7. Identification of risks by category. The most commonly used risk criteria are country or geographic risk, client risk, and risk associated with the particular service offered by the legal professional. The weight given to these risk categories (individually or in combination) in assessing the overall risk of potential money laundering or terrorist financing may vary from one client to another, particularly given the size, sophistication, nature and scope of services offered by the legal professional.

   a. Country/Geographic Risk. Factors that may result in a determination that a country or geographic area poses a higher money laundering or terrorist financing risk include:

      • Countries subject to sanctions, embargos or similar measures by the United Nations or other reputable governmental or non-governmental organizations.
      
      • Countries identified by the FATF as generally lacking appropriate AML laws, regulations or other measures.
      
      • Countries identified by credible sources as providing funding or support for terrorist activities or that have terrorist organizations operating within their borders.
      
      • Countries identified by credible sources as having significant levels of corruption or other criminal activity.

   b. Client Risk. Determining the potential money laundering or terrorist financing risks posed by a client, or category of clients, is critical to the development and implementation of an overall risk-based framework. Categories of clients whose activities may indicate a higher risk include:
• Clients conducting their business relationships or requesting services in unusual or unconventional circumstances, such as:

  ▪ Significant and unexplained geographic distance between the client and the location of the organization/subject of the work for which the client has retained the legal professional, and/or where there is no logical nexus among the type of work being undertaken, the client, and that organization.

  ▪ Where a client has instructed the legal professional to undertake a single transaction-based service (as opposed to an ongoing advisory relationship), the instructions from the client are not received face to face, and/or the client has not been referred from a reliable source.

• Clients where the structure or nature of the entity or relationship makes it difficult to identify the true beneficial owner or controlling interests in the transaction.

• Clients that are cash (and cash equivalent) intensive businesses including:

  ▪ Casinos, betting and other gambling-related activities.

  ▪ Unregulated businesses that, while not normally cash intensive, generate substantial amounts of cash.

• Charities and other “not for profit” organizations that are not subject to monitoring or supervision by competent authorities (especially those operating on a “cross-border” basis).

• Clients using intermediaries who are not subject to adequate AML laws and measures or who are not
otherwise adequately supervised by competent authorities.

- Clients who are PEPs or have a criminal record.

**c. Service Risk.** An overall risk assessment should also include a determination of the potential money laundering or terrorist financing risks presented by the services offered by the legal professional. Consideration should be given to such factors as:

- Services where legal professionals acting as financial intermediaries handle the receipt and transmission of cash proceeds on behalf of clients.

- Services to conceal improperly beneficial ownership from competent authorities (as opposed to services intended legitimately to screen ownership from the general public, such as for privacy or other reasons).

- Services requested by the client for which the legal professional does not have the requisite expertise.

- Commercial or real property transactions having structures with no apparent legitimate business, economic, tax or legal reasons or substance.

- Services knowingly designed to illegally evade revenue or other government authorities’ claims concerning an asset or other property.

- Payments received from unrelated third parties and payments of fees in cash.

- Transactions where it is readily apparent that there is inadequate consideration.

- Legal entities and arrangements where a client, controller or significant legal owner cannot be identified in a timely fashion.

- Clients who offer to pay extraordinary fees for services which would not ordinarily warrant such a premium.
8. Variables that may impact risk: e.g., reputation of the client; businesses or companies that are otherwise regulated; lawyer’s prior relationship with client.

9. Controls for higher risk situations, i.e., training and education of professionals and staff, and procedures for CDD, EDD, or periodic reviews of clients.

10. Application of risk-based approach principles, including CDD/KYC procedures.

11. Monitoring clients and activities on an ongoing basis. This could be both internally (e.g., by a law firm) and externally (e.g., by a regulator, like a state bar association).

12. Training and awareness, internally and externally.

13. Internal controls:
   a. Engagement and focus at the partner or management level.
   b. Policies and procedures.
   c. Compliance officer.

14. The notion of “beneficial ownership” of an asset or entity is a recurring term and recurring concept in the Guidance:
   a. It appears in Section 3.20 of the Guidance (dealing with client risk) where the structure or nature of the entity or relationship makes it difficult to identify the “true beneficial owner.”
   b. It is used in Section 3.21 of the Guidance (the service risk section) regarding services “designed to conceal improperly beneficial ownership from competent authorities.”
   c. While the term is not pointedly directed at trusts in the Guidance, for trust lawyers the term “beneficial ownership” has a precise connotation. One should keep in mind that the FATF is convinced that trusts have been and will be used to deliberately “obfuscate ownership.”
d. At this point, the concept of knowing everything about the transaction is not mandated by the Guidance. However, the implication is clear that attorneys had best “know all” about the transaction if it begins to look suspicious or if additional information arouses their suspicion. Willful ignorance isn’t an acceptable excuse for missing AML and CFT problems.

- Consider potential risk in a complex real estate investment where equity and financing are coming from different investors or sources.
- Consider potential risk in preparing a will and revocable trust for an investor who owns varying percentages in a number of corporations, LLCs and partnerships.

**PERSONAL OBSERVATIONS AND PREDICTIONS**

1. The FATF has no authority to make or enact law, but it is unwise to underestimate its power and influence.

2. The FATF has not yet convinced any of the lawyer groups that lawyers are, in fact, being used unwittingly by money launderers and terrorist financiers, although it has probably happened on occasion.

3. The USA PATRIOT Act does not serve as a legal framework for the regulation of lawyers. The Levin bill pending in Congress (Stop Tax Haven Abuse Act) might provide a basis for some regulation of lawyers.

4. A DC Court of Appeals case (2005) sets forth the standard for federal regulation of attorneys.\(^9\)

5. Lawyers certainly have had regulations imposed upon them by the federal government, and examples include the following cases:
   a. Circular 230
   b. Preparer liability – IRC §94-§6696
   c. Sarbanes Oxley – requiring an attorney to report a violation of securities law.
6. There is an interesting dialogue underway among U.S. Treasury, the Department of Justice (“DOJ”), and the Uniform Law Commission (“ULC” – formerly the National Conference of Commissioners on Uniform State Laws) regarding transparency in the formation of new business entities. The ULC suggests the following approaches to create more transparency in partnerships, corporations, limited liability companies, and other business entities.¹⁰

a. Every entity must maintain a list of the names and addresses of its record owners.

b. The list of an entity’s record owners must indicate for an owner that is not an individual:

• if the owner is an entity, the jurisdiction whose laws control its internal affairs;

• if the owner is a testamentary, inter vivos, or charitable trust, the names and addresses of its trustees; and

• if the owner is a decedent’s estate, the name and address of the personal representatives of the decedent.

The theory behind these proposals is to provide a system under which it will be possible to trace the ownership of an entity back to the ultimate beneficial owners. For any entity with 25 or fewer record owners, there must be one individual (whose principal residence is in the United States) who has access to the list of the entity’s owners, and the name and United States address of that individual must be set forth in the public filing that creates the entity.

Treasury would prefer that all this information be maintained by the various Secretaries of State and would include the requirements of photos of all individual owners as well as a photo identification, e.g., driver’s license or passport. Treasury would also add a definition of “beneficial owner”. Treasury does not mention trusts as one of the entities to be covered by these changes, but trusts are in the forefront of the FATF’s concerns, and there is going to be pressure to require some sort of state or federal law mandating transparency of trusts.
Query: What sort of regulation is it if DOJ and Treasury demand that all states adopt the same version of a uniform law? Is that state or federal regulation?

7. The Guidance will continue to evolve and will ultimately be adopted by the FATF, presumably in June 2008. It will deal with STRs, one way or the other. The FATF will undoubtedly use that document to lobby its member states for further action and legislation. The final form of the document is, therefore, extremely important.

8. Predictions:
   a. Efforts to defeat proposals to impose STRs, SARs, and NTO on lawyers in the U.S. should be successful.
   b. There will be some additional regulation of lawyers, hopefully at the state level, only, and largely through the state bar associations.
   c. There will be more CLE on AML and perhaps CFT.
   d. There will be some requirement for education, training and awareness of lawyers and law firm staff with internal control policies and compliance officers for CDD/KYC, EDD and monitoring.\(^1\)
   e. There will be more documents like ACTEC’s “Good Practices.” Treasury really wants to push this approach with other lawyer organizations.
   f. There will be a higher degree of regulation where lawyers “touch the money” or otherwise act as financial intermediaries.
   g. There may be some audit procedure whereby an external auditor tests what a law firm is doing regarding CDD/KYC, EDD, monitoring, training, and adopting/implementing policies and procedures.
   h. There will be transparency legislation on entities and business arrangements.

According to the article “Monitoring the Implementation of the Forty Recommendations”, which can be found on the FATF website (www.fatf-gafi.org), the FATF’s policy for handling non-compliant countries includes steps such as the following: requiring the non-compliant country to submit a progress report; a letter or a high-level mission from the President of the FATF to the country not in compliance; a statement to financial institutions requesting that special attention be given to any transactions involving the non-compliant country; finally, the FATF may suspend the non-compliant country’s membership in the FATF.


According to the FinCEN website (www.fincen.gov), the Financial Crimes Enforcement Network (FinCEN) of the United States Department of the Treasury consists of analysts, administrative and managerial professionals, regulatory specialists, technology experts, federal agents, and other law enforcement agencies that work together to combat domestic and international money laundering through information sharing. See also http://www.fincen.gov/af_organization.html for more information on how the FinCEN is organized.


The three paragraphs summarizing the Swiss experience are taken from Kevin Shepherd’s report to the ABA on this topic.

Examples of financial intermediaries are: professionals acting as board members of an offshore company, protectors, trustees, and attorneys who accept funds from a client with the intention of assisting the client in investing or transferring the funds, or signatories on a financial account on behalf of another person or entity. Under the Swiss federal anti-money laundering law, financial intermediaries’ obligations include, but are not limited to the following: registering with a self-regulatory institution or the federal anti-money laundering authority, identifying the client and beneficial owner of the funds, record-keeping, etc. In the event that a financial transaction overseen by a financial intermediary raises suspicion in terms of compliance with the federal anti-money laundering law, the financial intermediary is then obligated to inquire further with the client or beneficial owner of the funds. If the financial intermediary then has reasonable grounds to suspect that the transaction is connected to a crime, which, under Swiss law, is defined as an offense punishable by imprisonment (tax evasion, for example, is not considered a crime), he must freeze the funds in question, and notify the federal authorities. At that point, only the authorities may remove the freeze on the funds associated with the unlawful transaction.

Am. Bar Ass’n v. Federal Trade Comm’n, 430 F.3rd 457 (D.C. Cir. 2005). The court ruled that nowhere did Congress authorize the Federal Trade Commission (“FTC”) to regulate the legal profession. In response to the FTC’s position that Congress sought to regulate the legal profession by enacting the Gramm-Leach-Bliley privacy legislation, the court noted that “[Congress] does not . . . hide elephants in mouseholes.” Id. at 467. In a metaphor rich passage
supportive of the federalism notion that states, and not the federal government, have historically and exclusively regulated the legal profession, the court remarked:

When we examine a scheme of the length, detail, and intricacy of the one before us, we find it difficult to believe that Congress, by any remaining ambiguity, intended to undertake the regulation of the profession of law—a profession never before regulated by “federal functional regulators”—and never mentioned in the statute. To find this interpretation deference worthy, we would have to conclude that Congress not only had hidden a rather large elephant in a rather obscure mousehole, but had buried the ambiguity in which the pachyderm lurks beneath an incredibly deep mound of specificity, none of which bears the footprints of the beast or any indication that Congress even suspected its presence.

Id. at 469. This case lends strong support to the view that, absent express congressional authority, federal regulators cannot regulate the legal profession. It is undisputed that the regulation of the practice of law is traditionally the province of the states. Federal law “may not be interpreted to reach into areas of State sovereignty unless the language of the federal law compels the intrusion.” City of Abilene v. FCC, 164 F.3d, 52 (D.C. Cir. 1999). Otherwise put, “if Congress intends to alter the ‘usual constitutional balance between the States and the Federal Government,’ it must make its intention to do so ‘unmistakably clear in the language of the statute.’” Will v. Michigan Dep’t of State Police, 491 U.S. 58, 65 (1989) (quoting Atascadero State Hospital v. Scanlon, 473 U.S. 234, 242 (1985)).

10 Memorandum dated January 8, 2008 from William H. Clark, Jr. to the National Conference of Commissioners on Uniform State Laws Drafting Committee on the Record Owners of Business Act. (Note: The National Conference of Commissioners on Uniform State Laws is now known as the Uniform Law Commission.)

11 Suggested CDD/KYC procedures for clients include: (1) Accurint background check on client at http://www.accurint.com; (2) Google search for client; (3) Check client against the SDN list, DPL list and Entity list at http://www.ustreas.gov/offices/eotffc/ofac/sdn/t11sdn.pdf and http://www.bis.doc.gov/dpl/Default.shtm; (4) Obtain copy of client’s passport and a certification of the passport; (5) Affidavit of client’s financial condition; (6) Written personal and business history of client.
THE YEAR IN REVIEW:
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ON RECENT TAX DEVELOPMENTS

by

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INTRODUCTION

The past twelve months have witnessed substantial changes in the estate, gift and generation-skipping transfer taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other IRS and Treasury documents from the past year. Because of publication deadlines, this outline includes only those developments reported publicly from April 1, 2007 through April 1, 2008.

The tax developments in this outline are divided into 5 categories:

(I) Estate taxes,
(II) Gift taxes,
(III) Generation-Skipping Transfer Taxes
(IV) Special Valuation Rules, and
(V) Income Taxes.

Each category is divided generally by Internal Revenue Code section, except that special consolidated discussion examine the various developments relating to the taxation of family holding companies (corporations, limited partnerships, and limited liability companies), and charitable remainder trusts.

There is also an additional section, “Selected Attachments,” that includes sample forms illustrating some of the planning techniques discussed in this outline.
I ESTATE TAXES


Estate Tax Repeal Effort Restarts. H.R. 3170, 110th Cong., 1st Sess. (July 25, 2007),
Sess. (Nov. 15, 2007), H.R. 4242, 110th Cong., 1st Sess. (Nov. 15, 2007); Senate
Finance Committee Hearings, 110th Cong., 2nd Sess. (November 14, 2007; March 12, 2008); S. Con. Res. 70, 110th Cong., 2nd Sess. (March 20, 2008)

3170, which would permanently reform the estate tax and fix the capital gains tax
rate at 15 percent. H.R. 3170 includes the following proposed changes, which are
effective January 1, 2010, except as noted:

- Increasing the unified credit to the equivalent of a $5 million exclusion,
  phased in as follows:
  - $3.75 million in 2010;
  - $4 million in 2011;
  - $4.25 million in 2012;
  - $4.5 million in 2013;
  - $4.75 million in 2014; and
  - $5 million after 2014;
- Reunifying the estate and gift tax exemptions, so that increased unified
  credit applies to the estate, gift and GST taxes;
- Indexing the unified credit and GST exemption for inflation after 2015;
- Reducing the estate and gift tax rates to the top capital gains tax rate (cur-
  rently 15 percent; increasing to 20 percent January 1, 2010) on estates be-
  tween $5 million and $25 million, and twice that rate on estates above $25
  million
- Indexing the $5 million definition of the top rate bracket for inflation after
  2014;
- Reducing the GST tax rate to the same as the top estate tax rate, as phased-
  in;
- Permitting the executor of the estate of a deceased spouse to elect to give
  any unused applicable exclusion amount to the surviving spouse (usable
  for gift and estate tax purposes, but not for GST tax purposes);
- Repealing the state death tax deduction in 2010;
- Eliminating the schedule repeal of the estate and GST taxes; and
- Retaining the present basis step-up rules.
Note. It should be noted that the spouse-to-spouse portable unused applicable exclusion amount was not indexed and that the surviving spouse could take advantage of a carryover of unused applicable exclusion amounts from more than one predeceasing spouse, but not more than a total of $5 million. Also, the carried-over exemption was not available for GST exemption purposes.

H.R. 4172 (Nov. 14, 2007). Rep. Dennis Moore, D-Kan., introduced H.R. 4172, which would permanently reform the estate tax. H.R. 4172 includes the following proposed changes, which are effective for transfers after December 31, 2007:

- Increasing the unified credit to the equivalent of a $3.5 million exclusion;
- Indexing the unified credit and GST exemption for inflation after 2007;
- Eliminating the schedule repeal of the estate and GST taxes; and
- Retaining the present basis step-up rules.

H.R. 4235 (Nov. 15, 2007). Rep. Nita M. Lowey, D-N.Y., introduced H.R. 4235, which would permanently reform the estate tax. H.R. 4235 includes the following proposed changes, which are effective from the date of enactment:

- Increasing the unified credit to the equivalent of a $3 million exclusion for estate and GST tax purposes;
- Indexing the unified credit and GST exemption for inflation after 2006;
- Reducing the estate and gift tax rates to 39.2 percent on estates over $2 million;
- Eliminating the schedule repeal of the estate and GST taxes; and
- Retaining the present basis step-up rules.

H.R. 4242 (Nov. 15, 2007). Rep. Earl Pomeroy, D-N.D., introduced H.R. 4242, which would permanently reform the estate tax. H.R. 4242 includes the following proposed changes, which are effective after the date of enactment:

- Increasing the unified credit to the equivalent of a $3.5 million exclusion for estate and GST tax purposes;
- Indexing the unified credit and GST exemption for inflation after 2006;
- Reducing the estate and gift tax rates to 47 percent on estates over $2 million;
- Restoring the five percent surtax on estates over $10 million;
- Limiting the discount for partial interests in a closely-held business to the extent attributable to non-business assets;
- Eliminating the schedule repeal of the estate and GST taxes; and
- Retaining the present basis step-up rules.
Senate Finance Committee Hearings. The Senate Finance Committee has completed a three-part series of hearings on wealth transfer taxes. The first hearing was held November 14, 2007, and was entitled “Federal Estate Tax: Uncertainty in Planning Under the Current Law.” The speakers at that hearing included Warren Buffett, Chairman and Chief Executive Officer of Berkshire Hathaway, and the richest man in the world, two other business owners and one noted estate tax attorney.

The second set of hearings was held on March 12, 2008, and was entitled “Alternatives to the Current Estate Tax System.” This hearing considered the possibility of replacing our current system with other forms of taxes, such as an accessions tax (similar to a national inheritance tax) or an income inclusion system. It also examined how other countries have approached the taxation of wealth transfer at death. The speakers at that hearing were three law professors. See Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess., “Description and Analysis of Alternative Wealth Transfer Tax Systems” (March 10, 2008) (Committee Print).

The third hearing was held April 3, 2008, and was entitled “Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning.” The speakers at this hearing included a mixture of practitioners, a law school professor and a representative of an organization that represents charities. In preparation for these hearings, the Staff of the Joint Committee of Taxation published a committee print discussing possible reforms in the estate tax. The Joint Committee notes the following possible reforms:

- Completely unifying the unified credit for gift and estate taxes;
- Making the unified credit portable;
- Enhancing the special rules for farms and small businesses held in an estate;
- Limiting perpetual dynasty trusts by making the GST exemption shelter only one generation of skips;
- Eliminating the use of valuation discount planning for investment assets; and
- Eliminating or dramatically limiting the use of Crummey withdrawal powers to qualify gifts for the annual exclusion.

Staff of the Joint Committee on Taxation, 110th Cong., 2nd Sess. “Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform” (April 2, 2008) (Committee Print).

S. Con. Res. 70. The Senate Finance Committee Chairman Baucus added amendment 4160 to the Senate Budget resolution. This was the only estate tax amendment to pass. It would make the 2009 law permanent, with a $3.5 million exemp-
tion and a 45% rate. It was approved 99-1. There were several amendments that were rejected, however, including:

- Graham amendment 4170, which would have raised the exemption to $7.5 million and a 35 percent rate;
- Kyl amendments 4191 and 4372, which would have raised the exemption to $5 million and imposed rates starting at 15% and with a top rate of 35 percent;
- Salazar amendment 4196, which would have raised the exemption to $5 million and imposed a 35 percent rate;
- Landrieu amendment 4378, which would have raised the exemption to $5 million and imposed a 35 percent rate, with a small surcharge for large estates and several special tax breaks for small businesses and family farms.

B Code §§ 2031, 2032, 2032A and 7520. Valuation

**Fifth Circuit Affirms Use of IRS Tables to Value Non-transferable Commercial Annuities. Anthony v. United States, ___ F3d ___, 2008 WL 570811 (5th Cir. March 4, 2008)**

James settled a lawsuit over serious injuries he sustained in an automobile accident by agreeing to receive three annuities issued by three different insurance companies. Each annuity guaranteed monthly or annual payments for a period of at least fifteen years, and precluded transfer of the right to the annuities. When James died, he was scheduled to receive ten more years’ of payments. His estate valued the guaranteed payments at $2,371,409, using the IRS actuarial tables prescribed in Section 7520. Thereafter, the estate filed a claim for refund stating that the “fair market value” of the annuity contracts should be determined without regard to the actuarial tables, because the annuities were nontransferable. The IRS denied the claim, and a U.S. District Court granted summary judgment to the IRS, finding that nontransferability does not render the valuation provided by the actuarial tables unreasonable or unrealistic.

On appeal, the Fifth Circuit affirmed, finding that the annuities must be valued under the actuarial tables, notwithstanding their nontransferability. The court noted that the fair market value of an annuity for estate and gift tax purposes is generally determined by resort to the Section 7520 annuity tables, which admittedly prize certainty over accuracy. The values determined by application of the annuity tables need not be used, however, when the tables result in a value that is unrealistic and unreasonable, other valuation methods should be employed. *Cook v. Comm’r*, 349 F.3d 850, 854 (5th Cir. 2003) (citing *O’Reilly v. Comm’r*, 973 F.2d 1403, 1407 (8th Cir. 1992)). The regulations provide explicit exceptions.
to the tables for “restricted beneficial interests,” which they define as “an annuity, income remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.” Treas. Reg. § 20.7520-3(b)(ii). A restricted beneficial interest is assigned its fair market value without regard to the annuity tables. Treas. Reg. §§ 20.7520-3(b)(ii), 20.7520-3(b)(iii). Cook addressed the proper method for valuing an estate's interest in non-transferable lottery payments, before the current regulations. The court noted that the language of Treas. Regs. § 20.7520-3(b)(1)(ii) broadly states that “[a] restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.” The estate focused on the phrase “any... other restriction,” but the court stated that the regulations must be read as a whole, and that the “other restriction” must be read in light of the two examples that precede it—a contingency and a “power” that might undermine the fundamental assumptions supporting the valuation of an “ordinary beneficial interest.” For example, a right to receive annuity payments that is contingent on the survival of a person who is terminally ill cannot be valued under the actuarial tables. See Treas. Reg. § 20.7520-3(b)(4) (Example 1). Similarly, a right to payments that can be thwarted by a trustee who has a power to invade the corpus and, thereby, exhaust or diminish the income stream, cannot be valued under these tables. See Treas. Reg. § 20.7520-3(b)(2)(v) (Example 4). These types of restrictions are different in character and effect from mere nonassignability, which reduces the marketability of the annuity. Furthermore, the structure of the regulation suggests a narrow definition of “other restriction,” Treas. Regs. § 20.7520-3(b)(1)(ii) defines “restricted beneficial interest,” but Treas. Regs. § 20.7520-3(b)(1)(iii) does not refer to a “restricted beneficial interest,” but rather instructs the taxpayer that “[i]f, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity... the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances. . . .” Treas. Reg. § 20.7520-3(b)(1)(iii) (emphasis added). The estate further argued that even if the “restricted beneficial interest” exception does not encompass a non-marketability exception to valuation under the tables, the result of the tables in this case produces an “unreasonable and unrealistic” result. The district court held that use of the annuity tables did not create an “unrealistic or unreasonable” result, even though the table valuation was approximately double the estate's purported free market valuation. The court noted that the disparity in Cook v. Comm’r was as great, and that the size of the disparity is not alone enough to render the tables inapplicable, when the disparity is attributable solely to reduced marketability.

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Frazier Jelke, Ill=s gross estate included a 6.44-percent interest in a company substantially all of the assets of which were marketable securities. The company had been in existence for many years, was well managed and had a relatively high rate of return in the form of annual dividends coupled with capital appreciation of approximately 23 percent annually for the five-year period before the decedent=s death, and during this same period there was no action taken to liquidate the company. The company=s securities turnover averaged only six percent per year. On the date of death, the company=s net asset value was approximately $178 million and it had a built-in capital gain tax liability of approximately $51 million. The estate valued the decedent=s interest by reducing the company=s net asset value by the entire $51 million potential capital gain, and then applying discounts for lack of control and marketability.

The Tax Court held that the built-in capital gain tax liability must be discounted to reflect the fact that the company was unlikely to be liquidated for many years after the decedent=s death. The court noted that, while the liquidation value of a C corporation should include an offset for the capital gains tax that would be due when the company is liquidated, several courts had disagreed regarding whether a discount was appropriate when the estate could not establish a likelihood of prompt liquidation or sale. Estate of Davis v. Comm=’r, 110 T.C. 530, 552-554 (1998); Estate of Welch v. Comm=’r, T.C. Memo. 1998-167, rev=’d without published opinion 208 F. 3d 213 (6th Cir. 2000); Eisenberg v. Comm=’r, T.C. Memo. 1997-483, rev=’d 155 F. 3d 50 (2d Cir. 1998), acq. 1999-1 C.B. xix; Gray v. Comm=’r, T.C. Memo. 1997-67; Estate of Dunn v. Comm=’r, T.C. Memo. 2000-12, rev=’d 301 F. 3d 339 (5th Cir. 2002); Estate of Jameson v. Comm=’r, T.C. Memo. 1999-43, rev=’d 267 F. 3d 366 (5th Cir. 2001). This case was appealable to the 11th Circuit, which not already addressed this issue. The Tax Court held that the company=s profitability suggested that it would not be liquidated or sold quickly, and reduced the capital gains tax offset for the 16 years it estimated would be required to sell all of the company=s securities, at the present turnover rate. This reduced the capital gains tax offset from $51 million to $21 million for the entire company, and the decedent’s share of that discount from $3,284,400 to $1,352,400. The court also rejected the 25-percent minority discount and 35-percent marketability discount, and allowed a ten percent minority discount and a 15-percent marketability discount (23.5 percent aggregate discount.)

The Eleventh Circuit reversed, finding that the entire tax offset was an appropriate adjustment, though it upheld the Tax Court’s adjustments to the dis-
counts for lack of control and lack of marketability. The court reviewed the entire history of the deduction for the capital gains inherent in a C corporation that was being valued at net asset values. The Eleventh Circuit agreed with the Fifth Circuit, that the value of the corporation must be reduced by 100 percent of the estimated capital gains taxes, regardless of when the liquidation was likely to occur. The court stated:

The Tax Court chose a sixteen-year period to reflect when the corporation would reasonably incur the tax. This distinction is not persuasive to us. We are dealing with hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a “snap shot” of value taken. Whether or not a majority or a minority interest is present is of no moment in an assumption of liquidation setting.


__Negron._ Mary Susteric and Mildred Lopatkovich and others won the Ohio Super Lotto jackpot price, and received a right to 26 annual payments of $256,410.26 from the state. The remaining payments could not be assigned or used as collateral. Mary and Mildred each died after receiving one payment. Both were residents of Lorain, Ohio, and had the same executor. The executor valued each right to receive 15 future payments based on various factors. The valuation of Mary’s rights was based on the nine percent discount rate applied by the State of Ohio in valuing lump sum payments to the winners, because Mary had elected (under then-existing Ohio rules) to receive the rest of her payments as a lump sum. The IRS valued both sets of rights to lottery payments under the relevant actuarial tables under Section 7520. Both parties moved for summary judgment.

The District Court held that a non-marketable, nonassignable right to a series of lottery payments should not be valued under the Section 7520 actuarial tables, because the result would be unreasonable. It granted in part the taxpayer’s motion for summary judgment. The court reviewed the present split in the circuits, and noted that the Zaritsky, The Year in Review – Page 8
Seventh Circuit, to which this case would be appealed, had not yet opined on this issue. The court rejected the view of the Tax Court and the Fifth Circuit, that the annuity should be valued strictly under the Section 7520 actuarial tables. *Gribauskas v. Comm’r*, 116 T.C. 142 (2001); *Estate of Cook v. Comm’r*, 349 F.3rd 850 (5th Cir. 2003), aff’g T.C. Memo. 2001-170. The court was more convinced by the reasoning of the Second and Ninth Circuits, than by that of the Tax Court and the Fifth Circuit, and stated that “it makes fundamental economic sense that the transferability of an annuity would affect its fair market value.” *Estate of Gribauskas v. Comm’r*, 342 F.3rd 85 (2nd Cir. 2003), rev’g 116 T.C. 142 (2001); *Estate of Shackleford v. U.S.*, 262 F.3rd 1028 (9th Cir. 2001), aff’g, 84 AFTR2nd 99-5902, 1999 WL 744121 (E.D. Cal. 1999). The court held that the Section 7520 value of the lottery payments was “unrealistic and unreasonable” and that the parties would be required to hold a hearing to determine the value of the annuity.

**Davis.** Kenneth Freeman won the Massachusetts lottery and received the first of 20 annual payments of $209,220 before his death. At his death, Kenneth was entitled to receive ten more annual payments. Kenneth’s estate valued the remaining ten payments under the Section 7520 actuarial tables, though they erred slightly and undervalued them at $1,584,690, rather than the $1,607,164 that the IRS determined was the correct value. The estate sued for a refund, claiming that the value of the lottery annuity should be reduced to $800,000, to reflect the lack of marketability, because the annuity cannot be assigned, sold, transferred or pledged as collateral. Both sides moved for summary judgment.

In 2005, the District Court denied summary judgment to both sides. The court denied the IRS partial summary judgment because it could not conclude, as a matter of law, that it is either appropriate or inappropriate to use the annuity tables to determine an approximate measure of the fair market value of the annuity in question. It denied the estate its partial summary judgment because the fair market value of the annuity would be a question of fact that was inappropriate for summary judgment.

Ultimately, the district court held that the estate had not proven that the figures reached by the actuarial tables under Section 7520 were unreasonable. The estate’s appraiser claimed a 50 percent discount for lack of marketability, but the court rejected the theory that the estate tax value should assume that the hypothetical buyer would have to rely on the estate to continue receiving the payments.
and remitting them to the buyer. Rather, the court stated, the estate tax determination of fair market value requires the assumption that the contract is assigned to a hypothetical buyer, who then cannot reassign it. Thus, the hypothetical buyer has a highly-secure annuity right that cannot be reassigned. The court held that the greatest discount that would be justified was five percent, which did not render the actuarial valuation unreasonable.

**Points of Note.** If Donovan, Estate of Cook, and the Tax Court view in Gribauskas are wrong, and Davis, Shackleford and the Second Circuit view in Gribauskas are correct, does this preclude the use of the Section 7520 tables to value a private annuity that prohibits assignment, or an interest in a GRAT the spendthrift clause of which prohibits assignment? If so, there may be a substantially increased gift tax associated with both of these transactions.

Also, the district court in Davis stated that the valuation of the annuity was not affected by the lack of transferability, because the tax law should look at what a willing buyer would pay to have all of the rights that the seller holds, rather than just those rights that the seller legally can convey. This analysis would be contrary to all other case law on the willing buyer, willing seller standard.


Lois’s estate included her one-half interest in 16 valuable paintings. (The other one-half interest was held by the nonmarital trust under the will of Lois’s late husband.) The IRS valued the decedent’s one-half interest at 50 percent of the value of the entire collection. The estate had valued the artwork at $1,420,000, after a 44 percent discount for lack of marketability and control. The IRS valued the artwork at $2,766,250 – $1,346,250 more than the value claimed by the estate. This difference reflected both the IRS’s determination that two paintings by Camille Pissarro were undervalued by the estate and the IRS refusal to allow a fractional interest discount. The estate argued that the correct value should reflect a 44 percent discount for lack of marketability of a partial interest. The estate also contended that appraisals it had obtained from Sotheby’s should set the value of the artwork, rather than the valuation proposed by the IRS Art Advisory Panel.

The district court held that a discount was allowed, but that it should be less than the 44 percent claimed, and that the valuation prepared by the
IRS Art Advisory Panel was the more persuasive determination of value. On the basic valuation, the court appeared to be very impressed with the IRS Art Advisory Panel valuation, noting that the panel was a collection of experts who are not paid (except for cost reimbursements), and who are not told whether an item is being valued for a charitable contribution deduction, estate tax valuation, or gift tax valuation. The Art Advisory Panel also does not know the identity of the taxpayer. The panel based its valuation on comparable sales of similar paintings near the date of valuation. The estate, on the other hand, relied on an appraisal by Sotheby’s, that contained no description of how the valuations were determined. The estate failed to introduce any expert testimony to support the Sotheby’s valuations, and the court sustained the government’s objection to the estate’s attempt to introduce the Sotheby’s appraisal into evidence based on lack of foundation. Nonetheless, the court noted, even if the court had considered the Sotheby’s appraisal, it would find it unpersuasive, because of the lack of any basis for its valuations in this particular case. The court also rejected as relevant the values received when one of the two works of art was sold, because the sale occurred six years after the decedent’s death, and because the estate declined to rely on the sales price for the other painting when it was sold at the same time. The IRS had allowed a two percent discount for cost of partitioning the property, but the estate had claimed a 44 percent fractional interest discount. The court held that a hypothetical seller under no compulsion to sell would not accept the 44 percent discount proposed by the estate, but would instead demand a greater discount than the two percent proposed by the IRS. The government’s experts testified that, while they were aware of sales of undivided interests in art occurring, none of these had ever occurred at a discount. The estate’s expert testified that he could find no data regarding sales of undivided interests in art, and so based his valuation in part on data respecting sales of undivided interests in real estate and limited partnerships holding real property. The court rejected the analogy, noting that the art market differs from the real estate or business market, and that the nature of each piece of art means that an investor may not prefer to own 100 percent of a painting of lesser value than a 50 percent interest in another painting of greater value. The court stated that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount. The court further stated that, because an undivided interest holder has the right to partition, a hypothetical seller would not likely accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner. The court noted that the IRS agreed that the estate was entitled to a discount based on the costs to partition and sell the collection. The estate’s expert estimated the cost of partitioning to be 51 percent of the value.
of the artwork, while the IRS estimated it at two percent of the value. The court rejected both that the estate provided a cost of partitioning analysis and that the IRS had not, but the court rejected both the notion of a 51 percent cost of partition and that of a two percent discount. The court stated:

In sum, the Court finds that a hypothetical willing seller who is under no compulsion to sell would seek to gain consent from other co-owners to sell the collection and divide the proceeds or, barring such consent, would bring a legal action to partition. At the very least, a hypothetical seller would consider the potential proceeds from the partition process before agreeing to accept any fractional interest discount when selling his or her partial interest. Because the Court cannot consider whether other co-owners would consent to a sale, a small discount is appropriate to account for legal fees required to enforce the hypothetical seller’s right to partition. No discount is required to account for appraisal fees, but the government’s expert agrees that a 2% discount is appropriate to account for the actual costs of selling the art by an auction house. Finally, some discount is appropriate to account for the uncertainties involved in waiting to sell the art until after the partition action is resolved.

The court directed that the parties meet further and attempt to settle on the amount of the discount.

In a final order issued August 10, 2007, the court noted that the parties were unable to agree on a discount, and it allowed a five percent discount for lack of marketability.

Note. This case is extraordinary because it upholds the IRS attempt to limit the discount for lack of marketability on a partial interest in tangible assets to the costs of partition. The court did not, however, consider the major cases that have denied the legitimacy of this limitation on the discount for lack of marketability. See, e.g., Estate of Baird v. Comm’r, 416 F.3d 442 (5th Cir. 2005), rev’d and rem’d in part, aff’d in part, T.C. Memo. 2002-299; and Williams v. Comm’r, T.C. Memo. 1998-59. Nonetheless, it appears that the IRS is willing to continue to assert this limitation on the discount for lack of marketability with respect to tenancy-in-common interests, at least with respect to artwork and, presumably, such similar assets as antiques and other collectibles.

In *Kohler, Jr. v. Comm’r*, T.C. Memo. 2006–152, the decedent’s estate elected to use the alternate valuation date under Section 2032. After the date of death, and before the alternate valuation date, the estate entered into a reorganization of the family business pursuant to Section 368(a). As part of the reorganization, transfer restrictions and a purchase option were imposed upon the shares, which reduced their market value. The IRS assessed a deficiency of nearly $100 million, claiming that the effects of the reorganization cannot be taken into account in establishing the alternate valuation. The IRS stated that Treas. Reg. § 20.2032-1(d) requires that the value be measured according to stock's pre-reorganization value. The court rejected the IRS position, noting that neither the Code nor the regulations contained a valuation restriction that would require disregard of tax-free reorganization.

The IRS now declared that it does not acquiesce in *Kohler, Jr.*, relating to whether the alternate valuation date allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock pursuant to a post-death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date. The IRS stated in its action on decision that the Tax Court erred in focusing on whether a disposition had occurred, rather than whether it should take into account a change in the character of the property that had occurred during the alternative valuation period, and that the Tax Court should have ignored changes in the character of the stock due to the post-death restrictions in determining the value of the stock on the alternate valuation date.


An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up to $960,000 for estates of decedents dying in 2008.

C **Family Holding Companies (Code §§ 2031, 2036-2038, 2512, et al.)**

Estate of Bigelow. Virginia had created a revocable trust to hold certain real property, naming herself and her son as co-trustees. Two years later, when Virginia was about 85 years of age and in poor health (having suffered a stroke and moved into an assisted-living facility), the trust and her children together created a family limited partnership. The trust transferred to the partnership real property it held, but agreed to hold the partnership harmless on $450,000 of debt for a loan and line of credit, that were secured by the transferred property. The trust was both the sole general partner and a limited partner, and Virginia’s three children were limited partners. The partnership then actively leased and sold the real estate. The transfer left Virginia without sufficient income to meet her living expenses or satisfy her liability on the debt. The reasons for creating the partnership were to facilitate gift giving and to reduce Virginia’s estate tax liability. The partnership directly paid part of the debts of Virginia’s trust and it did not adjust the trust’s capital account for those payments, as required by the partnership agreement. There were also numerous transfers of funds between the partnership and Virginia, and she owed the partnership $3,500 at her death. The decedent made various gifts of limited partnership interests to her children and grandchildren, often through her son, as attorney-in-fact. The partnership did not make any distributions to its partners with respect to their interests in the partnership before Virginia died, and during the year after her death, her trust continued to act as the general partner until the partnership was terminated. The partnership made over 40 transfers to Virginia’s estate, characterized by the estate as loans. Virginia’s estate claimed a 37 percent discount for lack of marketability and control with respect to the partnership interests still owned by her estate at her death.

The Tax Court (Judge Colvin) held that the value of the property transferred by the decedent to the partnership was includible in her gross estate under Section 2036(a)(1), because she had retained a life estate in the transferred assets. The court found an implied agreement for Virginia to retain the beneficial enjoyment of the partnership assets, based on the fact that the partnership did not follow the terms of its agreement with respect to paying Virginia’s debts, and that she had transferred so much of her property to the partnership as to render her unable to support herself. The court also found that there was no non-tax purpose for creating the partnership, noting that the trust gained no creditor protection because it was the sole general partner.
The Ninth Circuit affirmed, rejecting the estate argument that no “cognizable economic benefit” was retained in the properties transferred to the partnership under Section 2036(a)(1). The court inferred an agreement to retain economic benefit of the partnership property from the partnership payments of a debt on which the decedent was personally liable. The failure to transfer the liability for the underlying debt when real property was transferred to the partnership created a retained economic interest, as the partnership paid off the debt. The court stated that the partnership may have had a “practical liability” to pay off the debt and avoid losing the property, but it still created a reserved economic benefit. The court also upheld the Tax Court finding that the other facts disclosed a retained economic benefit, including the fact that the transfers left the decedent with insufficient income to meet her living expenses, frequent partnership “loans” to the decedent, the payment of decedent’s funeral expenses from the partnership, and the failure to follow the partnership formalities, including inconsistent partnership capital account debiting. Citing Estate of Thompson v. Comm’r, 382 F.3d 367 (3d Cir. 2004); and Estate of Korby v. Comm’r, 471 F.3d 848 (8th Cir. 2006). The court also rejected the argument that the transfer of property to the partnership in exchange for partnership interests was a “bona fide sale for an adequate and full consideration.” The court agreed with Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004), that looks at whether (a) the interests credited to each partner was proportionate to the fair market value of the partner’s contributed, (b) each partner’s contributed assets were properly credited to their respective capital accounts, and (c) each partner is, on termination or dissolution, entitled to distributions equal to their respective capital accounts. The court stated, however, that the estate must also show a genuine pooling of assets and a potential for intangibles stemming from this pooling to offset the discounts for lack of control. That requires that there be an arm’s-length transaction with legitimate and significant nontax reasons. The Ninth Circuit agreed with the Tax Court that this was not a bona fide sale for adequate and full consideration, because the transfers impoverished the decedent, the partnership ignored formalities in its operation and the transfer had no nontax benefit to the decedent.

Estate of Mirowski. Anna Mirowski was married to Dr. Michael Mirowski when he invented the automatic implantable cardioverter defibrillator (ICD), which monitored and corrected abnormal heart rhythms. Dr. Mirowski licensed the device and, during his lifetime,
received modest royalties. The Mirowski family held annual family meetings during their vacations, and invited their accountants or attorneys to attend and assist in their discussions of family business and investment matters. Dr. Mirowski died in 1990, leaving the bulk of his assets, including the ICD patents and interests in the licenses, to his wife. Ms. Mirowski maintained a long and continuous history of making charitable gifts and gifts to her daughters, her grandchildren, and six other family members and friends. Ms. Mirowski created an irrevocable spendthrift trust for each of her three daughters and their respective issue in order to provide for each daughter during the daughter’s life and each daughter’s children after the daughter died. Ms. Mirowski named all three of her daughters as cotrustees of each of the daughters’ trusts, because she wanted her daughters to work together and have a close working relationship. Ms. Mirowski funded each trust with part of her interest in the ICD patents licensing agreement. Sales of ICDs increased significantly after Dr. Mirowski died and the royalties received under the license agreement increased from thousands of dollars a year to millions of dollars a year.

Before Dr. Mirowski died, he was primarily responsible for managing the financial affairs of Ms. Mirowski and himself. After Dr. Mirowski’s death, Ms. Mirowski became primarily responsible for managing her own financial affairs. When Ms. Mirowski first started investing, she was a highly conservative investor, and her daughters Ariella Rosengard and Ginat Mirowski began to act as bookkeepers for her, but neither of them made financial decisions for Ms. Mirowski. Ms. Mirowski hired Goldman, Sachs & Co. to assist in managing some of her investments, and ultimately brought all of her investments under Goldman, Sachs management. In May 2000, Ms. Mirowski met with representatives of U.S. Trust, who introduced her to the concept of a limited liability company (LLC). Ms. Mirowski then discussed creating an LLC with her attorney, who then drafted articles of organization and a draft operating agreement for an LLC to be named Mirowski Family Ventures, L.L.C. (MFV). Copies were sent to the daughters for their review and comments. In mid-August 2001, Ms. Mirowski’s daughters and their families took their annual vacation and held their previously planned family annual meeting to which they had invited Ms. Mirowski’s lawyer. At that meeting, they discussed Ms. Mirowski’s plans to form MFV, her plans to make respective gifts of interests in MFV to her daughters’ trusts, the manner in which MFV was to function, and the responsibilities of her daughters with respect to MFV. Ms. Mirowski did not attend this meeting, because she was receiving medical treatment for a non-
terminal problem. After the family annual meeting, Ms. Mirowski’s attorney finalized the documents required to form MFV. Between September 1 and September 7, 2001, Ms. Mirowski made several bona fide, arm’s-length transfers of ICD patents and the licensing agreement, and over $62 million in cash and securities in her Goldman Sachs account, to MFV. After each transfer, Ms. Mirowski was the only member of MFV. Ms. Mirowski always planned on making a gift of an interest in MFV to each of her daughters’ trusts, and she did so later in September, 2001. Ms. Mirowski’s daughters were not aware of specifically how Ms. Mirowski planned to pay the gift tax on those gifts, but they knew that she had retained substantial personal assets outside MFV, including over $3 million in cash and cash equivalents and another $4.5 million in various assets. Ms. Mirowski had retained enough assets to support her lifestyle, but not enough to pay the gift taxes. Ms. Mirowski could pay those taxes by (1) using part of the over $7.5 million of personal assets that she retained and did not transfer to MFV, including cash and cash equivalents of over $3.3 million, (2) using part or all of the distributions that she expected to receive as an interest holder in MFV of the millions of dollars of royalty payments under the ICD patents license agreement that she expected MFV to receive, and (3) borrowing against her retained personal assets and her 52-percent interest in MFV. The operating agreement of MFV stated that Ms. Mirowski’s capital account would be credited with her contributions to MFV and properly maintained thereafter. A share of Ms. Mirowski’s capital account was allocated to each daughter’s trust to which she made gifts of LLC interests. MFV was to be managed by a general manager who could be, but did not have to be, a member of the LLC. Ms. Mirowski was the initial general manager. Although Ms. Mirowski held a 52-percent interest in MFV and was its general manager, she could not sell or otherwise dispose of any of the assets of MFV, other than in the ordinary course of MFV’s operations, without the approval of all the members of MFV. Mirowski also could not liquidate and dissolve or admit additional members without the approval of all the members of MFV. All profit or loss (other than profit or loss derived from a capital transaction) for any taxable year was to be allocated to the interest holders in proportion to their respective percentage interests in MFV, and cash flow was to be distributed annually, within 75 days after the end of each taxable year. Ms. Mirowski died from unexpected complications from treatment for a foot ulcer on September 11, 2001. The IRS contended that the assets of the LLC should be included in Ms. Mirowski’s gross estate under Section 2036(a), assessing a
$14,243,208.37 deficiency.

The Tax Court (Judge Chiechi) held for the estate, that the transfers to MFV were bona fide transfers for full and adequate consideration, not subject to Section 2036(a), 2038(a), or 2035(a), applying the principles set out in Estate of Bongard v. Comm'r, 124 T.C. 95 (2005). The court stated that, while Ms. Mirowski understood that certain tax benefits could result from forming MFV, they were not the most significant factor in her decision to form MFV. Ms. Mirowski formed the LLC (a) to provide joint management of the family’s assets by her daughters and eventually her grandchildren, (b) to maintain the bulk of the family’s assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or their trusts, and (c) to provide for each of her daughters and eventually each of her grandchildren on an equal basis. Based on her experiences with a family business when she was younger and living in Lyons, France, Ms. Mirowski valued the family cohesiveness that joint management of a family business can foster. She wanted her daughters, and eventually her grandchildren, to work together, remain closely knit, and be jointly involved in managing the investments derived from the royalties received from the ICD and the business matters relating to the ICD patents and the ICD patents license agreement, including the litigation arising with respect to those patents and that license agreement. As Ms. Mirowski had hoped, her daughters, in their capacities as officers of MFV and as trustees of MFV’s members, have actively worked together to manage MFV’s assets. Ms. Mirowski’s daughters have held meetings with representatives of Goldman Sachs approximately three to four times a year in order to review MFV’s Goldman Sachs’ account performance and asset allocation and to determine what, if any, changes should be made in the future. For at least one of those meetings each year, all of Ms. Mirowski’s daughters were present in person. For the several other meetings each year, the daughters met together in person or participated by teleconference. All of Ms. Mirowski’s daughters jointly made investment decisions for MFV and planned to have each of their respective children also become involved in such decisionmaking when they reach the appropriate age. In addition, Ms. Mirowski’s daughters have worked together on matters concerning the business of managing the ICD patents, the ICD patents license agreement, and related litigation. At the time of the trial in this case, there was substantial ongoing litigation relating to those patents and that license agreement with respect to which Ms. Mi-
Zaritsky’s daughters communicated several times a week with MFV’s attorney Mr. Silver. With respect to Ms. Mirowski’s intent to maintain in a single pool the bulk of the family’s assets, certain specific investment opportunities at Goldman Sachs would not have been available if Ms. Mirowski had separated her assets among her daughters’ trusts by giving a portion of those assets to each daughter or each trust. At all relevant times, including after Ms. Mirowski’s death, MFV has been a valid functioning investment operation and has been managing business matters relating to the ICD patents and the ICD patents license agreement, including related litigation. The IRS also argued that Ms. Mirowski failed to retain sufficient assets outside of MFV for her anticipated financial obligations, that MFV lacked any valid functioning business operation, and that Ms. Mirowski delayed forming and funding MFV until shortly before her death and her health had begun to fail. The court rejected all three contentions as not supported by the facts. The IRS also argued that Ms. Mirowski sat on both sides of her transfers to MFV, but the court held that the Section 2036(a) and 2038(a) exception for bona fide sales for adequate and full consideration applied notwithstanding that the transferee was a single-member LLC. The IRS further argued that MFV should be ignored because, soon after Ms. Mirowski’s death, it distributed to her estate over $36 million, which was used to pay estate taxes and expenses. The court rejected this because Ms. Mirowski’s death was unexpected, depriving her of time to plan for the liquidity of her estate. The court also rejected the IRS contention that, because Ms. Mirowski did not at any time contemplate forming and funding MFV without making respective gifts of 16-percent interests in MFV to her daughters’ trusts, she actually received only a 52 percent MFV interest in exchange for Ms. Mirowski’s transfers to MFV of 100 percent of its assets. The court stated that Ms. Mirowski made two separate, albeit integrally related, transfers of property and that the transfer of the property to the LLC were made in exchange for 100 percent of the LLC. With respect to the gifts of interests in MFV, the court noted that there was no understanding, express or implied, that decedent retained any interest in the MFV interests given away, and that this case did not involve the kinds of facts that have led courts to find implied agreements that a decedent has retained an interest in the decedent-transferred property. The court also rejected the argument that the authority Ms. Mirowski held as general manager of the LLC constituted a right to control the beneficial enjoyment of the transferred assets, noting that the operating agreement did not give Ms. Mirowski as MFV’s general manager
the authority to determine the timing and the amount of all distributions from MFV. Any authority that she had under the agreement was in her capacity as the member who owned a majority of the outstanding percentage interests, and that her majority owner authority did not include the authority to determine the timing and the amount of distributions from MFV. The court also rejected the IRS argument that, with the approval of the daughters, Ms. Mirowski had the authority to dispose of assets in other than the ordinary course of business, because she held a majority of the interests of MFV. First, the court noted that Ms. Mirowski’s daughters were not members of MFV after Ms. Mirowski’s gifts; the daughters’ trusts were the members. Second, the court rejected the contention that at the time of Ms. Mirowski’s gifts and at the time of her death she retained, either alone or in conjunction with any person, the right to designate the persons who shall possess or enjoy the respective 16-percent interests in MFV that she gave to her daughters’ trusts or the income from such interests within the meaning of Section 2036(a)(2).

Note. This case is noteworthy for several reasons.

First, the facts of this case appear to be more favorable than those of most of the cases in which taxpayers were unsuccessful, but it more likely reflects a judge with a more favorable eye. It may be noteworthy that Judge Chiechi was also the judge in Estate of Stone v. Comm’r, T.C. Memo. 2003-309, in which a similar favorable estate tax result was achieved.

Second, Judge Chiechi found three significant nontax reasons for creating the family LLC in this case, one or more of which exists in a great many family situations. This suggests that a family limited partnership or LLC may be more useful than other decisions have suggested.

Third, while Judge Chiechi noted that business activities were conducted by the LLC, she rejected the IRS argument that “the activities of MFV had to rise to the level of a ‘business’ under the Federal income tax laws in order for the exception under section 2036(a)…to apply.” This should be contrasted with Judge Laro’s stringent requirement that there be an active business conducted by the entity in Estate of Rosen v. Comm’r, T.C. Memo. 2006-115 and Estate of Rector, below.

Fourth, Judge Chiechi’s rejection of the IRS argument that the LLC had been used to pay the decedent’s estate taxes and, therefore, was serving both personal and business purposes, seems in conflict with the analysis of Judge Kroupa in Estate of Erickson v. Comm’r, T.C. Memo. 2007-107. Judge Chiechi agreed with the taxpayer that...
an obligation that only arises when the decedent dies cannot be deemed a personal obligation of the decedent.

Fifth, Judge Chiechi rejected the IRS argument that the creation and funding of the LLC ought to be combined with the subsequent gifts, and the combination be treated as a constructive gift of the underlying assets. Judge Chiechi explained that the contributions to the LLC and the subsequent gifts were “separate, albeit integrally related.” The IRS argument is a substantial extension of its winning arguments in Senda v. Comm’r, T.C. Memo. 2004-160, aff’d 433 F.3d 1044 (8th Cir. 2006). See Gans & Blattmachr, “Partnership Formation: Dueling Dicta,” 35 Capital Univ. L. Rev. 1 (Fall, 2006).

_Estate of Rector._ Concetta (the decedent) and her two sons, John and Frederic, created the family limited partnership, each communicating with the same attorney who proposed the partnership and drafted the agreement. Concetta transferred to the partnership all of her investment assets, leaving her only a $2.5 million nonmarital trust, from which she received income. Concetta would receive principal from the nonmarital trust only if she first exhausted all of her other assets, including those now held in the partnership. Concetta and her revocable trust were the initial partners, with Concetta holding a two percent general partnership interest and her trust holding a 98 percent limited partnership interest. Concetta later transferred limited partnership interests to her sons. The partnership made distributions to all of the partners, but the distributions to Concetta were disproportionately large. Concetta’s executors claimed a 19 percent discount for lack of marketability and control for her interests in the partnership.

The Tax Court (Judge Laro) held that the value of the assets that Concetta transferred to the partnership was includible in her gross estate under Section 2036(a)(1), because Concetta had made an inter vivos transfer of the property for less than adequate and full consideration and retained the possession or enjoyment of, or the right to the income from, the transferred property. Judge Laro found that Concetta had retained the possession or enjoyment of the partnership income by an understanding or agreement with her sons. The court cited, as evidence of this agreement, the facts that Concetta was the general partner, either directly or through her revocable trust, and she transferred to the partnership so much of her assets that she could not meet her living expenses without partnership distributions, which were in fact made to her in amounts sufficient to meet those expenses. The court held that the transfer of Concetta’s assets to the
partnership in exchange for partnership interests was not a bona fide sale for adequate and full consideration, as demonstrated by the facts that: (a) the sons contributed no assets to the partnership, so that the formation of the partnership entailed no change in the underlying pool of assets or the likelihood of profit; (b) the transaction was not conducted in a manner similar to that of unrelated parties dealing at arm’s length, in that the sons did not have separate counsel, the partnership did not hold regular meetings and the partnership did not issue regular reports of its activities; and (c) there was no legitimate nontax business purpose for forming the partnership.

**Planning Points.** The IRS often has a strong case under the Tax Court’s interpretation of the *bona fide* sale rule in *Estate of Bongard*, and despite the broader interpretation of that rule in *Kimbell v. U.S.* Yet, there are some taxpayer victories that suggest a divided Tax Court and the possibility of substantial tax advantages in appropriate cases. See Abbin, “A Practical Checklist for Planning with Family Limited Partnerships,” 33 Est. Plan. 10 (Oct. 2006); Bogdanski, “Bye Bye Byrum, Bonjour Bongard,” 32 Est. Plan. 47 (June, 2005); Korpics, “How Estate Planners Can Use Bongard to Their Advantage,” 32 Est. Plan. 32 (July 2005); Korpics, “Qualifying New Flps for the Bona Fide Sale Exception: Managing Thompson, Kimbell, Harper, and Stone,” 102 J. Tax’n 111 (Feb. 2005).

Practical estate planners should consider the following steps to minimize or avoid the application of Section 2036(a) to their own family limited partnerships:

**Section 2036(a)(1)**

- **Recordkeeping.** The general partners should keep detailed contemporaneous records of their activities, and send copies to the limited partners (for information purposes, only).

- **Stationery.** The partnership should have stationery that identifies precisely who the general partners are, to assure that the general partner never acts in a different capacity.

- **Commingling.** Never, never, never commingle partnership and personal assets.

- **Personal Expenses.** Never, never, never pay personal expenses from the partnership assets, even if capital account adjustments are made;
Personal Use Assets. Do not transfer personal use assets to the partnership, even if the donor then leases them from the partnership.

Reserve Adequate Assets. Never put too much of the donor’s wealth in the partnerships; the donors should retain enough assets on which to live comfortably.

Active Management Assets. Try to fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets.

Independent Payment for Limited Partnership Interests. Limited partners should pay for their partnership interests with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership.

The General Partner. Donors should not be the general partners, if possible. Rather, family members or trusts to whom the client wishes to pass the bulk of the partnership assets should themselves be general partners and participate in the operations of the enterprises.

Separate Representation. All partners should be represented by counsel and consulted in the preparation of the governing instruments.

Powers of Attorney. Consider a provision, like one used in the Stone documents, that precludes anyone voting for a general partner through a power of attorney (Contrast the emphasis in Strangi that the general partner’s son-in-law ran the partnership under a power of attorney).

Avoid Immediate Pre-Mortem Funding. Create and fund the partnership as early as possible, to minimize any appearance that it is testamentary in nature.

Significant Interests Held by Others. Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees.

Section 2036(a)(2)
No Discretionary Distributions. Eliminate discretion regarding distributions -- either preclude distributions during the donor’s lifetime (preferred), or require distribution of all income.

Multiple Classes of General Partnership Interests. Create two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter. See Gans & Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 Tax Notes 1153 (Sept. 1, 2003). See also sample partnership form in Selected Attachments.

D Code § 2053. Expenses, Indebtedness and Taxes

1 Loan from Disabled Child’s Trust Fund was a Bona Fide Debt for Estate Tax Purposes. *Estate of Hicks v. Comm’r*, T.C. Memo. 2007-182 (July 10, 2007)

Kimberly, while still a toddler, was severely disabled in a collision among a locomotive, another car and a minivan driven by Kimberly’s mother. Litigation resulted in a substantial lump sum payment to Kimberly and a $1.4 million payment to her father, with the expectation that he would immediately lend $1 million to a special trust for Kimberly’s benefit. The loan was made but Kimberly died before she needed the money. The executors of Kimberly’s estate deducted the $1 million debt to Kimberly’s father, and the IRS disallowed the deduction, arguing that the debt was not a bona fide loan.

The Tax Court (Judge Holmes) held that Kimberly’s estate could deduct the amount owed to her father and that the loan was contracted bona fide and for full and adequate consideration. Int. Rev. Code § 2053(c)(1)(A). The IRS argued that there never was a loan because the $1 million was never under the father’s control, and that the probate judge’s allocation of damages effectively transferred the $1 million straight from the guardian’s interim holding account to the trust. The court held, however, that the court’s order decided to whom the award belonged, and that the $1 million belonged initially to the father. The IRS then argued that the allocation was a sham, but the court stated that the question was really whether the parties intended that there be a loan and a right of repayment. Citing *Estate of Ribblesdale v. Comm’r*, T.C. Memo. 1964-177. The court emphasized that the note was executed and admitted into the record, and the father was paid interest every month on the principal amount of the loan. The IRS noted that the parents themselves proposed the allocations, and that Kimberly and her father did not have ad-

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verse interests in how the settlement proceeds were distributed. The court disagreed, stating that the $1 million right to repayment would have been included in the father’s gross estate had he predeceased his daughter, which was actuarially likely. This, furthermore, suggested that there was real economic substance to the transaction.


Wendell Hester was the sole current beneficiary and trustee of a trust created at her death by his wife, Dorothy, which held substantial assets. On February 25, 1998, Wendell transferred all of the trust assets to himself individually, in breach of his fiduciary duties. Wendell then commingled the trust’s cash with his own assets and set out upon several months of “day trading,” that resulted in over $2 million in net losses. Wendell also pledged the distributed trust assets as security for margin loans, withdrew over $450,000 in cash and collected approximately $280,000 of principal and interest from a promissory note held by his late wife’s estate. The commingling was so complete and complicated that it was, at his death, impossible for anyone to determine which interests in the combined whole belonged to the decedent and which belonged to the remainder beneficiaries of the trust. At Wendell’s death on October 12, 1998, his estate was subjected to standard probate pursuant to applicable state law (Virginia), including a “Debt and Demands” hearing in which all persons who had legal claims against Wendell’s estate were required to present them. No one appeared in opposition to the plan of distribution, and the court entered an order of distribution of the estate assets of Wendell’s estate, according to his will. The estate tax return for Wendell’s estate reported as belonging to Wendell the remaining misappropriated assets, and claimed no deduction for the hypothetical claims of the remainder beneficiaries. The estate paid over $2,727,000 in estate taxes. Sometime later, the estate filed a claim for refund, seeking to exclude from Wendell’s gross estate the value of the assets misappropriated by him from his late wife’s trust, or in the alternative, to deduct those amounts as a debt of the estate or a claim against the estate. Wendell’s estate claimed a refund of more than $2.8 million. The IRS denied the claim for refund, and the estate brought suit.

The District Court for the Western District of Virginia held both that the misappropriated funds were properly included in Wendell’s gross estate and that there was no offsetting deduction. The court noted that Wendell had exercised dominion and control over the assets of his wife’s trust as though they were his own, without recognizing any obligation to repay those

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amounts. The court also rejected the estate’s alternate argument that the estate should be allowed an offsetting deduction of equal value under Section 2053(a)(3), either as a claim against the estate, or under Section 2053(a)(4) as a debt of the decedent. The court noted that the trust’s beneficiaries never made a claim against Wendell or his estate, and that no claim was ever reasonably expected. Thus, the amount could not be a deductible claim. The court also noted that any claim that might now arise would be barred by the two-year state statute of limitations on actions against a fiduciary. The court rejected the estate’s argument that the running of the statute of limitations after the death of the decedent could not be taken into account in valuing the claim, relying on the Supreme Court’s opinion in *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929). The court also denied a deduction for the other beneficiaries’ possible claims as indebtedness of Wendell’s estate, noting that “neither Wendell nor the estate had an unconditional and legally enforceable obligation for the payment of money.”

**Note.** The decision of the district court in *Estate of Hester* is reasonable, but not unassailable. The court stated that Dorothy Hester’s trust was a “qualifying income interest for life,” which suggests that it was a deducted QTIP marital trust. If the trust was a QTIP marital trust, then the trust assets would have been includible in Wendell’s gross estate under Section 2044, and allowing any type of exclusion or offsetting deduction would yield Wendell a better estate tax result than would have existed had he not misappropriated the assets. This result would be untenable. If the assets of Dorothy Hester’s trust were not deducted under Section 2056(b)(7), the certainty of the district court’s analysis becomes clear. It is reasonable to hold that the decedent’s gross estate should include the misappropriated funds, but courts are divided regarding whether the IRS may consider *post mortem* events in determining the deductibility and amount of a claim against the decedent’s estate.
E Code § 2055. Charitable Distributions


The Tax Technical Corrections Act of 2007 eliminates the estate tax restriction on charitable bequests of partial interests in tangible personal property. The Pension Protection Act of 2006 provides limits the estate tax charitable contributions for a taxpayer who, after having made an initial fractional contribution, thereafter makes an additional testamentary or inter vivos charitable gift of an interest in that same property (an additional contribution). Int. Rev. Code §§170(o), 2055(g), 2522(e). The PPA stated that the income, estate and/or gift tax deduction for a testamentary transfer of such an additional contribution was limited to the appropriate fractional share of (a) the fair market value of the property at the time of the initial fractional contribution, or if less, (b) the fair market value of the property at the time of the additional contribution. Thus, no income, gift or estate tax deduction would be allowed for any share of the appreciation in the value of the tangible personal property that occurred after the initial fractional contribution.

2 Charitable Deduction Denied Noncomplying Remainder Trust; Doctrine of Substantial Compliance Does Not Apply to Trust Reformation. Estate of Tamulis v. Comm’r, 509 F.3d 343, 2007 WL 4191981 (7th Cir. Nov. 29, 2007)

Father Tamulis, a Catholic priest, died in 2000, leaving an estate of $3.4 million. His will left the bulk of his estate to his revocable living trust, which provided that the trust would continue for the longer of 10 years or the joint lives of Tamulis’s brother and the brother’s wife. During their lives, the brother and sister-in-law would have the right to live in a house owned by the trust and the trust would pay real estate taxes on the house. The remainder of the trust’s net income would be distributed to two of the brother and sister-in-law’s granddaughters, less $10,000 per year, which would be paid to their third child until she graduated medical school. After the 10-year period (or the shorter lifetimes of the brother and sister-in-law), the remaining trust assets would pass to a Catholic diocese. The estate filed a timely estate tax return, claiming a $1.5 million charitable deduction -- the present value of a charitable remainder following a 10 year term certain charitable remainder unitrust at five percent quarterly payments to two grand nieces. The trustee administered the trust from 2001 through 2004, as if it required distribution of a five percent unitrust amount to the grandnieces and the payment of the
real estate taxes on the residence. A petition for state court reformation was drafted but never filed. Thereafter, a proposed nonjudicial reformation was circulated among the beneficiaries, but one of the noncharitable beneficiaries refused to sign, and the trust was not reformed.

The Tax Court (Judge Gale) denied the charitable deduction, noting that the trust was not a charitable remainder unitrust, that the interest left to the various beneficiaries was not a “reformable interest” because certain non-charitable payments (the use of the residence) were not expressed as either a specified dollar amount or a fixed percentage of the fair market value of the trust property, and that no state court reformation was undertaken within 90 days of the date the estate tax return was filed. The Tax Court rejected the trustee’s argument that the administration of the trust as a charitable remainder unitrust should alone satisfy Section 2055(e)(3) under the doctrine of substantial compliance. The Tax Court stated that the doctrine of substantial compliance applies to procedural, rather than substantive, requirements, and the rules on reformation of a charitable remainder trust are substantive.

The Seventh Circuit affirmed, applying an even more restricted reading of the doctrine of substantial compliance than that applied by the Tax Court, stating that the doctrine should apply only in cases in which a taxpayer had a good excuse for failing to comply with either an unimportant or unclear requirement of the statute or regulations. In this case, the executor-trustee was represented by counsel and knew that substantial deductions depended upon reforming the trust within the required time. The failure to do so may have been caused by an intransigent beneficiary, but that did not itself constitute cause to apply the doctrine of substantial compliance.


The IRS published sample testamentary charitable lead trust forms and guidance. Among the more interesting aspects of this very useful procedure are the following:

- **Defining the Annuity.** The sample trusts define the annuity interest as a percentage of the initial value of the trust funds, but provide alternate language to specify the dollar amount in the governing instrument.

- **Measuring the Annuity Term.** The sample trust forms permit measurement of the annuity period by a fixed number of years or one or more measuring lives. The IRS states, however, that one can use
a measuring life, rather than a term of years, only if the measuring life is the donor or certain related persons.

**Increasing Annuity.** The annotations permit the creation of an annuity interest with increasing annual payments, as long as the annuity has an ascertainable value. This authorizes the use of lower annuity payments in early years, which may be very useful particularly if the measuring life is in poor health (though having a life expectancy of more than 18 months when the trust is created.)

**Commutation Prohibited.** The trustee may not have the right to commute the charitable annuity interest and prepay the charitable distribution. Rev. Rul. 88-27, 1988-1 C.B. 331.

**Excess Business Holdings.** If the charitable interest exceeds 60 percent of the value of the trust fund, the trust instrument must prohibit acquisition and retention of assets that would give rise to a tax on excess business holdings under Sections 4943 or 4944.


**Rule Against Perpetuities.** Any rule against perpetuities savings clause must be based on the common law life in being plus 21 years approach, rather than the Uniform Act’s alternate 90 years approach. Treas. Regs. § 20.2055-2(e)(2)(vi)(a).

**GST Planning.** No GST planning is included. As these are CLATs, rather than unitrusts, the inclusion ratio is calculated under a special set of rules included in Section 2642(e).

**Alternate Charitable Beneficiaries.** The trust may designate an alternate charitable beneficiary or permit the trustee to select one, as long as the trustee’s powers are limited selecting organizations described in both Sections 170(c) and 2055(a).

**Note.** The annotations are particularly useful, highlighting most of the serious issues raised by the use of a charitable lead trust. They may themselves be the most important part of the sample forms. The drafting style is typical IRS, which means that the language is relatively clear, but the
organization can stand some improvement. The practitioner should consider reorganizing the forms to improve readability.


James= revocable trust provided that the residue would pass in four equal shares, with two shares passing to specified individuals and two shares to named charities. The four shares would each be paid out in two installments, with one share being distributed on January 1, 2006, and the other on January 1, 2016, when the trust would terminate. The instrument stated that the share for any individual beneficiary who was not alive on the date of a distribution would lapse and be reallocated among the other surviving beneficiaries. Following James'= death, his executors asked the Pennsylvania tax authorities to calculate the value of the residuary interest, which they set at $690,475, of which $399,079 would be distributed to the charitable entities. The executors deducted $399,079 on the Federal estate tax return. The IRS calculated an estate tax of $168,637, denying the deduction for the charitable remainder. The Estate paid the tax in three installments, and sued for a refund.

The U.S. District Court for the Western District of Pennsylvania held for the IRS, finding that the residuary disposition was a non-qualifying charitable split-interest trust, under Section 2055(e)(2), which denies an estate tax deduction for a charitable split-interest charitable trust, other than a charitable remainder or lead annuity trust or a unitrust, a pooled income fund, and certain other interests. The court stressed that the trust fund was created under one document from one set of property.

The Third Circuit affirmed. The court examined the legislative history of the split-interest rule, noting that the Tax Reform Act of 1969 eliminated the rule by which any charitable remainder interest of ascertainable value was deductible. Now, a deduction is allowed a split-interest in trust only if the trust meets certain specific requirements, which the trust in this case did not meet. The question, therefore, was whether this trust was a split-interest charitable trust at all. The court defined a split interest charitable trust® using the ordinary natural meaning of the terms, as one in which property passes from a decedent both to a charity and a non-charity. This was true in this case, and the court refused to consider the legislative history, finding the Code itself unambiguous.

Note. This disposition looked at first glance like a simple quartile division of the residuary share of the trust, which would have permitted a charitable deduction for the charitable share. In this case, however, the amount

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that the charities would receive depended upon the survival of the individual beneficiaries, and so was part of a true split-interest arrangement. Sadly, in this situation, no deduction is allowed even for the one-half of the residuary estate that the charities would be assured of receiving. Citing Estate of Johnson v. U.S., 941 F.2d 1318, 1321 (5th Cir. 1991) (no deduction for charitable share of trust to support decedent=s three sisters, to maintain the graves of his family members, and to create a charitable trust to pay for religious education in certain Catholic parishes); Zabel v. U.S., 995 F.Supp. 1036 (D. Neb. 1998) (no deduction for trust whose income was to be split between charitable and individual beneficiaries for 21 years, with the remaining corpus to be distributed to the charitable beneficiaries at that time); Estate of Edgar v. Comm'r, 74 T.C. 983 (1980), aff'd, 676 F.2d 685 (3rd Cir. 1982) (no deduction for assets added to trust created by the decedent=s sister, providing for regular payments from income to non-charitable individuals, with the remainder passing to various charities upon the death of the non-charitable beneficiaries, even though the income from the trust to which the estate poured-over would be sufficient to pay all noncharitable amounts.)

F Code §§ 2056, 2044, 2519, 2523, 2207A. Marital Deduction


Tony=s will bequeathed $600,000 to persons other than his widow, Marie, and the residue of his estate to his widow, "if she survives me, and if she does not survive me, or dies before my estate is distributed to her..." The IRS disallowed the estate tax marital deduction, claiming that the condition of survivorship rendered the residuary gift a nondeductible terminable interest. Int. Rev. Code § 2056(b)(3).

The District Court initially held for the estate, applying a state law that requires construction of a bequest that was intended to qualify for the marital deduction in such a manner as to make it so qualify. Rev. Code of Wash. §11.108.020(1). After procedural issues were resolved by an appeal to the Ninth Circuit, the district court heard evidence and concluded that the decedent=s intent was for his residuary gift to qualify for the marital deduction. The court cited the facts that: (a) the decedent was a tax-wise businessman and individual who did not want to pay any more tax than necessary; (b) the decedent died possessed of an article that explained the 1981 enactment of the unlimited marital deduction and state law presupposes a dece-
dent to have known the law on the date of death; (c) the decedent created an irrevocable life insurance trust holding a last-to-die life insurance policy, suggesting that he intended to defer estate taxes until both spouses had died.

The Ninth Circuit affirmed per curiam, in an unpublished opinion.

Points of Note. The same analysis could have been required (and the same result obtained) in a state that lacks such a generous statute, if the decedent=s testamentary instruments contain a statement of the tax objectives, and a requirement that they be construed in such a manner as to achieve those goals. For example, the following language might be included in a conventional marital deduction will or revocable trust:

**Tax Objectives.** I intend that: (a) the Marital Share qualify for the Federal estate tax marital deduction [OPTIONAL FOR QTIP:; except to the extent that my personal representative does not elect for it to be deductible]; (b) the Family Share shall not be includible in the gross estate of my *husband/wife*, if *he/she* survives me. In all matters involving my estate, my will [OPTIONAL FOR REV. TRUST: and revocable trust] shall be construed in such a manner as to effectuate these tax objectives, and my personal representative [OPTIONAL FOR MARITAL TRUST: and trustees] shall exercise no power in a manner that would be inconsistent with these tax objectives.


Kwang Lee died 46 days after his wife, Kyong. Kwang=s estate claimed a marital deduction for property that was transferred to Kyong, as if she had survived him. Kyong=s will stated that Kwang would be deemed to have pre-deceased Kyong for purposes of her will if he died within six months after Kyong=s death. Kwang=s will was silent, but it was shown that he intended, for purposes of his will, that Kyong be deemed to have survived him if he died within six months after her death. Both spouses were suffering from a serious disease when their planning was done, and they both died from that disease. Most of the couple=s assets were titled in Kwang=s name. The IRS disallowed the estate tax marital deduction for the bequest to Kyang.

The Tax Court (Judge Laro) granted summary judgment to the IRS and held that the marital deduction cannot be allowed for a bequest to a spouse who does not actually survive the deceased spouse. The court stated
that the decedent’s intent that he be deemed to have predeceased his wife would not be recognized as qualifying the estate for the marital deduction.

3 IRS Explains Tax Consequences of Nonqualified Disclaimer of QTIP Income Interest. PLR 200801009 (Jan. 4, 2008)

A QTIP trust was created under a revocable trust that became irrevocable on the grantor’s death. The revocable trust created a nonmarital trust (Trust B) for the grantor’s children and more remote descendants, in an amount equal to the grantor’s applicable exemption amount. The residue of the revocable trust assets would be held as a QTIP marital trust (Trust A), giving the surviving spouse all of the net income, payable at least annually and allowing the trustees to distribute principal for the spouse’s support, maintenance and medical care. The revocable trust instrument also authorized the spouse to disclaim her interest in the QTIP trust, in whole or in part, and directed that any disclaimed property would be added to Trust B. The spouse proposed to disclaim her interest in the QTIP trust, and a state court confirmed that any disclaimed portion of the QTIP trust would be added to Trust B as if it were part of that trust’s initial funding. The spouse agreed to pay any gift taxes arising from her disclaimer of the income interest in the QTIP trust, but stated that she would exercise her right of recovery for gift tax relating to the transfer of the remainder interest pursuant to Section 2207A(b). The assets of the QTIP marital trust have fair market values that are less than the trust’s basis in those assets. The ruling does not so state, but based on the tax consequences, the disclaimer was not a qualified disclaimer under Section 2518.

The IRS ruled that the spouse’s disclaimer, when effective, would constitute a completed net gift of the remainder interest in the QTIP trust for federal gift tax purposes, if she exercised her right of recovery under Section 2207A, and that the disclaimer would also constitute a completed gift of the spouse’s income interest in the QTIP trust under for federal gift tax purposes, with the values of the income and remainder interests determined under the actuarial tables promulgated under Section 7520. The IRS further stated that the disclaimed interests in the QTIP would not be includable in the spouse’s gross estate at her death for federal estate tax purposes, that spouse would not recognize gain or loss on the disclaimer, and that the adjusted basis of the marital trust assets, for the purpose of determining gain, in the hands of the persons receiving the property, will be the same as the basis of those assets in the QTIP trust at the time of transfer. For purposes of determining loss, the basis of the QTIP assets would be limited to their fair market value at the time of the disclaimer.
G  Code § 2057. Qualified Family Owned Business Interest

Loans Are Not Interests in Family Owned Business. *Estate of Farnam v. Comm'r*, 130 T.C. ___ (No. 2) (Feb. 4, 2008)

Duane and Lois owned and (with other family members) managed a corporation that operated retail and wholesale stores in Minnesota and the Dakotas, selling automobile parts, retail and wholesale. The family members all lent money to the corporation for use in its business operations. The loans were unsecured and subordinated to claims of outside creditors, and substantiated by written promissory notes. The corporation made repayments of both principal and interest on the loans after 1984, and before that made repayments of principal, but not of interest. The decedents died owning each 50 percent of the voting shares of the corporation, and substantial majority interests in two family partnerships that held two buildings and the decedents’ promissory notes. The executors claimed the estate tax deduction under Section 2057 for the qualified family-owned business interests (QFOBI). The common stock and the notes held by the partnerships were included in the respective decedents’ gross estates and in the calculation of whether more than 50 percent of each adjusted gross estate consisted of QFOBI (the QFOBI 50-percent liquidity test). Int. Rev. Code §2057(b)(1)(C). The IRS disallowed the QFOBI deductions, finding that the promissory notes were not business interests and, therefore, did not qualify for the QFOBI deduction.

The Tax Court (Judge Swift) held for the government, noting that an “interest” in a family business, for purposes of the 50-percent liquidity test includes only equity interests. The court stated that the close proximity of the language "interest in an entity" in section 2057(e)(1)(B) to the explicit equity ownership language of Section 2057(e)(1)(B)(i) and (ii) rendered it illogical to divorce the equity ownership requirements of Section 2057(e)(1)(B)(i) and (ii) from the immediately preceding language.

H  Estate Tax Procedures


Under revised section 6694, a penalty is imposed on the person who prepares a tax return for another or advises in the preparation of the return, for

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an incorrect position, if the preparer did not have a reasonable basis to conclude the position was more likely than not correct. Disclosure on the return (or, in the case of a non-signing practitioner, advice about a given disclosure), limits the penalty to situations in which there is a reasonable basis for the position (the one-in-three formulation under prior law). This rule applies to all tax returns, including estate and gift tax returns. The penalty for preparing or assisting in preparing such returns is $1,000, or if greater, one-half of the income derived (or to be derived) by the tax return preparer with respect to the return. No penalty is imposed if it is shown that there is a reasonable cause for the understatement and the tax return preparer acted in good faith. This change applies to returns prepared after May 25, 2007 (the date of enactment).

Note. A practitioner who gives a legal opinion about a substantial issue on the return will be deemed to be a non-signing preparer, and the fees upon which the penalty is based could be those involved in a larger transaction of which the return is only a modest part. Therefore, these penalties can be a significant issue for even those practitioners who do not prepare returns generally.

See also Notice 2007-54, discussed below, which postpones until January 1, 2008, the application of the new penalty rules for tax return preparers and advisors, continuing to apply the reasonable basis standard (one out of three) instead of the more-likely-than-not standard.


The IRS and Treasury issued final regulations that impose substantial reporting and record-keeping requirements on professionals who advise relating to the filing of estate and gift tax returns. The final regulations largely follow the proposed and temporary regulations. The following are the key points of these regulations.

Transactions of Interest. The final regulations under Section 6011, like the proposed regulations, create a new category of reportable transactions for which the taxpayer or material advisor must file a specific disclosure form and maintain records. A transaction of interest is one that is the same as or substantially similar to a transaction identified in published guidance, that the IRS believes to have a potential for tax avoidance or evasion, but for which the IRS currently lacks adequate data from which to determine whether the transaction should be promoted to a listed tax-avoidance transaction. The IRS
publication that identifies a transaction of interest will also identify the classes of persons who are participants required to file a disclosure statement. Treas. Regs. §§ 1.6011-4(b)(6), 1.6011-4(e)(3)(e); 20.6011-4(a), 25.6011-4(a).

Material Advisor. The regulations impose disclosure and record-keeping requirements on “material advisors.” A material advisor is a person who provides any “material aid, assistance, or advice” regarding the organization, management, promotion, sale, implementation, insurance, or conduct of any reportable transaction, and derives substantial income from that aid, assistance, or advice. Treas. Regs. § 301.6111-3(b)(1). Material aid, assistance or advice is provided by a person who provides or makes a tax statement for the benefit of a taxpayer who is or whom the material advisor knows (or reasonably expects) to be required to disclose the transaction, or another material advisor who is or whom the material advisor knows (or reasonably expects) to be required to disclose the transaction. Treas. Regs. § 301.6111-1(b)(2).

Furnishing Lists. The regulations state that each material advisor must prepare and maintain a list for each reportable transaction, including an itemized statement of the name and identifying data for each person required to be included in the list, the dates on which the persons entered into the transaction, the amount invested in each transaction, a summary or schedule of the tax treatment of each person participating in the transaction, and the name of each other material advisor known to the advisor filing the statement. The material advisor must also file a description of the transaction and copies of the supporting documents. The list must be furnished to the IRS upon its written request. Treas. Regs. § 301.6112-1.

3 IRS and Treasury Re-Propose Regulations on Installment Payment Arrangements. 72 Fed. Reg. 9712 (March 5, 2007)

The Treasury and the IRS re-proposed regulations under Section 6159, explaining how installment payment arrangements are requested, accepted, and administered, and when the IRS can terminate an installment payment agreement and recommence collection proceedings.

• Requesting an Agreement to Pay Tax in Installments. Section 6159(a) authorizes written agreements under which a taxpayer may “make payment on any tax in installment payments if the Secretary
determines that such agreement will facilitate full or partial collection of such liability.” Prop. Treas. Regs. § 301.6159-1(a). The regulations state that a request to pay taxes in installments must be followed by the procedures, and be in the form and manner, prescribed by the IRS, but do not include specific procedures for requesting an installment agreement. The regulations preclude the IRS from accepting a proposed installment agreement for processing after the matter has been referred to the Justice Department. Prop. Treas. Regs. §§ 301.6159-1(b)(1), 301.6159-1(b)(2). A proposed installment agreement remains pending until the IRS accepts it or notifies the taxpayer that it has been rejected or until the taxpayer withdraws it. The IRS will ask the taxpayer for additional information, if a proposed installment agreement accepted for processing lacks sufficient information to enable the IRS to decide whether to accept it. The IRS can reject an agreement if the taxpayer fails to submit the requested additional data within “a reasonable time.” Prop. Treas. Regs. § 301.6159-1(b)(2).

- **Acceptance of a Proposed Installment Agreement.** An installment agreement is “accepted” when the IRS notifies the taxpayer or the taxpayer’s representative of its acceptance. Acceptance of an installment agreement does not alter the amount of a taxpayer’s liability for tax, interest or penalties; penalties may continue to accrue at a reduced rate in some cases. Prop. Treas. Regs. §§ 301.6159-1(c)(1)(i), 301.6159-1(c)(1)(ii). The IRS is not required to accept installment agreements for estate or gift tax, or for fiduciary income taxes; they are required to accept certain agreements relating to individual income taxes. Prop. Treas. Regs. § 301.6159-1(c)(1)(iii).

- **Form and Terms of Installment Agreements.** An installment agreement must be in writing, and it may either be signed by both the IRS and the taxpayer, or sent or delivered by the IRS to the taxpayer as confirmation of an agreement reached by them. Prop. Treas. Regs. § 301.6159-1(c)(2). An installment agreement must include an expiration date, which cannot be later than the statute of limitations period. Prop. Treas. Regs. § 301.6159-1(c)(3)(ii). The IRS may require that the taxpayer agree to a reasonable extension of the statute of limitations, as well as to any other terms that protect the interests of the government. Prop. Treas. Regs. § 301.6159-1(c)(3)(iii). The IRS may request an update on the taxpayer’s financial condition at any time while the agreement is in effect. Prop. Treas. Regs. § 301.6159-1(c)(3)(iv).
• **Rejecting Proposed Agreements.** The IRS may reject an installment agreement by notifying the taxpayer or the taxpayer’s representative of the fact of and reasons for the rejection and the taxpayer’s right to appeal. Prop. Treas. Regs. § 301.6159-1(d)(1). The taxpayer has 30 days from the date of the notice of rejection in which to appeal to the IRS Office of Appeals. The taxpayer must indicate an intention to appeal in the manner that the IRS provides. Prop. Treas. Regs. § 301.6159-1(d)(2).

• **Terminating and Modifying Installment Agreements.** Generally, the IRS may terminate an installment agreement if: (a) the taxpayer has provided inaccurate or incomplete information, (b) collection of any tax to which the agreement relates is in jeopardy, (c) the taxpayer fails to pay any required installment when due, (d) the taxpayer’s financial condition changes significantly, (e) the taxpayer fails to provide a requested financial condition update, or (f) the taxpayer fails to pay any other Federal tax liability when due. Int. Rev. Code § 6159(b); Prop. Treas. Regs. §§ 301.6159-1(e)(1), 301.6159-1(e)(2).

  The Secretary must give the taxpayer 30-days written notice of an intention to terminate an installment agreement, explaining why the agreement will be terminated, unless the collection of the tax to which the agreement relates is in jeopardy. Prop. Treas. Regs. § 301.6159-1(e)(4).

• **Effect of the Agreement on Collection Activity.** An installment agreement suspends the IRS’ right to levy on the assets of the taxpayer in order to collect the tax to which the agreement relates, or to turn the matter over to the Department of Justice for collection. Suspension begins when the agreement is accepted for processing and ends 30 days after the agreement terminates. Collection is also suspended during appeal of a termination notice, if the taxpayer files a timely request for appeal. Prop. Treas. Regs. §§ 301.6159-1(f)(1), 301.6159-1(f)(3)(ii). The IRS can levy on the taxpayer’s assets during this suspension period, if the taxpayer waives the restriction on levy, the proposed installment agreement was submitted merely to delay collection or collection of the tax is in jeopardy by delay. Prop. Treas. Regs. § 301.6159-1(f)(2).

• **Suspension of the Statute of Limitations.** The statute of limitations for collection of a tax liability is suspended during the period that a proposed installment agreement is pending with the IRS (before it is accepted or rejected), for 30 days following rejection of the pro-
posed agreement, and for 30 days following termination of an installment agreement. The statute of limitations is also suspended during a taxpayer’s timely appeal from a notice of termination. Prop. Treas. Regs. §301.6159-1(g).

- **Annual Statements and Biannual Review.** The IRS is required to give each taxpayer who has a currently valid installment agreement an annual statement that includes the initial balance on the first day of the year, the payments made during the year, and the remaining balance at the end of the year. Prop. Treas. Regs. §301.6159-1(h). The IRS is required to review the taxpayer’s financial condition every two years in the case of a partial payment installment agreement, to determine whether the taxpayer’s financial condition has changed so significantly that the value of the payments being made should be changed or the agreement entirely terminated. Prop. Treas. Regs. §301.6159-1(i).

- **Effective Date.** These new rules will apply when final regulations are published in the Federal Register.

**Note.** The IRS is far from powerless during the suspension of its right to levy pending the consideration or operation of an installment agreement. The IRS can still take other actions to improve its position with respect to collection. For example, the IRS could credit an overpayment by the taxpayer against the liability in question, file or refile notices of Federal tax liens, and bring collections proceedings against people who are not named in the installment agreement but who may share the liability. The IRS could also authorize the Department of Justice to file a counterclaim or third-party complaint in a refund suit, or to join the taxpayer in any other proceeding in which the ultimate liability of the taxpayer for the tax may be determined. The government could also file a claim in a bankruptcy proceeding in which the taxpayer in the bankrupt. Prop. Treas. Regs. § 301.6159-1(f)(3).

4 **Title Company Cannot Sue to Contest Estate Tax Assessment.** *First American Title Ins. Co. v. U.S.*, ___ F.3d ___, 2008 WL 795356 (9th Cir. March 27, 2008)

The decedent named her daughter Penny the personal representative of the decedent’s estate, which consisted of three houses and the stock of a corporation that owned a hamburger drive-in (Frisco Freeze, Inc.). The estate filed its federal estate tax return and elected to pay the $144,323 estate tax in installments under Section 6166. Penny then conveyed the three houses to her-

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self and her husband and over the next two years, sold the houses to three different buyers, all of whom were bona fide purchasers for value, and each of whom obtained title insurance from the plaintiffs in this case. Despite their title searches, none of the title insurers discovered that the houses were encumbered by tax liens. On audit, the IRS and the estate agreed that the Frisko Freeze stock was worth more than the estate had claimed. Penny signed an IRS Form 890, waiving restrictions on assessment and collection and agreeing that no Tax Court petition would be filed. Not long after agreeing to the higher assessment, Penny quit paying the estate taxes, and both she and Frisko Freeze eventually filed for bankruptcy. The estate owed $189,372 in estate taxes and the IRS sought to foreclose its liens on the three houses. The buyers made claims on their title insurers, and the title insurers paid off the tax liens under protest and brought this case, challenging the IRS's high valuation of the company. The title companies sued for a refund of the taxes under 28 U.S.C. § 1346, contending that the taxes were “erroneously or illegally assessed and collected.” The district court concluded that the court lacked jurisdiction to decide the title insurers' claims under 28 U.S.C. § 1346.

The Ninth Circuit affirmed, based on *EC Term of Years Trust v. U.S.*, 549 U.S. ___ , 127 S. Ct. 1763, 167 L.Ed.2d 729 (2007), holding that 28 U.S.C. § 1346 does not allow the title insurers to contest the estate tax liability. Section 7426(a) conclusively presumes the assessment of tax upon which a tax lien is based to be valid, making it impossible for the insurers to sue to contest the assessment. Thus, the insurers sued for a refund of the taxes, under 28 U.S.C. § 1346. In *EC Term of Years Trust*, the Supreme Court held that a third party cannot sue under 28 U.S.C. § 1346 because that would be irreconcilable with the general principle that a “detailed statute [Section 7426] pre-empts more general remedies [28 U.S.C. § 1348].” *EC Term of Years Trust* involved a challenge to a tax levy, but the Ninth Circuit held that it applies equally well to a challenge to an assessment.


The decedent, Josephine, owned a 20.57 percent block of the stock of Thomas Publishing Co., Inc. (TPC), a closely-held corporation formed in 1898. The decedent’s block was the largest block of TPC’s common stock held by any one shareholder. Capital Cities/ABC, Inc. owned a 12.656-percent block of the stock, and the rest was owned by various members of Josephine’s extended family. TPC’s primary business is the production and sale of indus-
trial and manufacturing business guides and directories, though it also published and sold a variety of news magazines, software comparison guides, and a magazine relating to factory automation, and it owned a product information exchange service and a custom publishing group. TPC also maintained a leading business-to-business website. TPC had a long history of paying annual cash dividends. The decedent’s estate valued the decedent’s block of stock at $1.75 million, based on an appraisal prepared by an attorney and an accountant, which capitalized TPC’s earnings at a 30.5-percent capitalization rate and claimed a 40-percent minority interest discount and a 45-percent lack of marketability discount. A professional appraiser employed by the IRS valued the decedent’s stock at $35.273 million, using the comparable public company method and the discounted cash flow method, and applying a 30-percent discount for lack of marketability, and no discount for lack of control.

The Tax Court (Judge Swift) valued the block of stock at $13.525 million, and refused to impose a penalty for undervaluation. The court found both parties’ valuations to be “deficient and unpersuasive,” noting that the estate’s appraisers had relatively little valuation experience, that they valued the interest aggressively and overstated the risks associated with the Internet and technology and by applying excessive discounts. The IRS expert, the court noted, used a “sterile approach” that was concerned only with numbers, and that did not value TPC as a real company. The companies selected by the IRS expert as comparable were not, the court stated, very similar to TPC. The court valued TPC by capitalizing its earnings at an 18.5-percent rate, and allowing a 15-percent minority interest discount and a 30-percent lack of marketability discount. The court refused to apply a penalty for substantial valuation understatement, finding that the taxpayer’s valuation was based on reasonable cause and the taxpayer had acted in good faith. The court noted that the valuation of the stock of TPC was particularly difficult, comparable companies did not exist, and capitalization of income and the discounted cash flow methods involved a number of difficult judgment calls.

The Second Circuit agreed that the Tax Court could reasonably adopt its own valuation and deferred to its criticisms of the methodology of both the taxpayer and the government, though it noted a conceded math error that required remand to the Tax Court for correction. The court vacated the Tax Court’s conclusion that the taxpayer had reasonable cause for its understate-ment. The penalty applies automatically, in case of a substantial underpayment, unless it is shown that there was a reasonable cause and that the taxpayer acted in good faith. Int. Rev. Code § 6664(c)(1). Reliance on an appraiser does not necessarily demonstrate reasonable cause, unless reliance was reasonable. The Second Circuit held that the Tax Court’s findings were insufficient to support a determination of reasonable cause, because they included no finding regarding the good faith of the taxpayer—either in assessing its own
liability or in relying on an expert to do so. The court must make a finding as to whether the estate’s reliance on its experts was reasonable and in good faith, or whether the estate knew or should have known that they lacked the expertise necessary to value the company.


This Notice provides interim guidance for estates electing to defer payment of the estate tax attributable to a closely held business under Section 6166, in light of Estate of Roski v. Comm’r, 128 T.C. 113 (2007). The IRS will determine on a case-by-case basis whether security will be required to protect the government’s interest in obtaining full payment of the estate tax and interest when that liability is deferred under Section 6166. The IRS plans ultimately to propose regulations detailing the factors that will enter into its decisions and it requests comments on the relevant factors. A primary factor will be the nature of the business generating the income on which estate taxes are owed, and other considerations will include the company’s assets, relevant market factors affecting the success and survival of the business, recent financial history and the experience of the company’s management. The IRS also expects to consider information about outstanding liens, judgments, pending or anticipated lawsuits, or other claims against the business, as well as all facts tending to show the business’s ability to pay the taxes, including cash flow, assets and liabilities. Compliance history also will play a big part in determining whether IRS will require the outstanding taxes to be secured, the agency said. The notice said the government will look at compliance with federal tax payment and filing requirements by both the business and the estate.

This notice applies to estates that timely elect to pay taxes in installments and timely file returns after November 17, 2007 or that had returns being classified, surveyed or audited as of April 12, 2007. The notice also applies to estates that are currently paying taxes under Section 6166 but that have not yet provided bond or lien, if (1) the general federal estate tax lien will expire within two years from November 13, or (2) the IRS reasonably believes there is sufficient risk to justify requiring the tax payments to be secured.

7 Estate Liable for Addition to Tax for Late Filing Despite Reliance on Counsel. Estate of Zlotowski v. Comm’r, T.C. Memo. 2007-203 (July 24, 2007)
Gertrude, a U.S. citizen domiciled in Germany, died with two wills -- a U.S. will and a later German will, which revoked the U.S. will. Not knowing of the German will, Jacques and Henry qualified as executors of her estate in Surrogate’s Court in New York. They retained an attorney recommended by Gertrude’s former lawyer. The executors received an extension of the filing date that would permit them to file by December 10, 2000, but the return was not actually filed until September, 2001. In 2003, the heirs under the German will hired an American attorney to help with ancillary proceedings in the Surrogate’s Court, and ancillary administrators C.T.A. were appointed in 2004, and the preliminary letters testamentary issued to Jacques and Henry were revoked. Jacques testified that he is 85 years of age, owns real estate and is the head of his own diamond firm, and he agreed to serve because the decedent’s husband was a close business associate. He testified that he knew nothing about the estate and relied fully on the attorneys, who were in charge of the estate. He did not participate in the preparation of the estate tax return and instead relied fully on his counsel. The attorney testified that he did not file in a timely manner because he had learned of the German will and was concerned about meddling in the estate when his clients were not legally personal representatives.

The Tax Court (Judge Halpern) held that the taxpayers were liable for penalties for late filing of the estate tax return, under Section 6651(a)(1). That penalty is imposed unless it is shown that the failure to file a timely return was due to reasonable cause and not due to willful neglect. The court agreed with the IRS assertion that Henry and Jacques failed to establish reasonable cause, and that they failed to show that the attorney gave them any advice upon which they could rely to file a late return.

They have failed to show that he advised them that, as a matter of law, it was not necessary to file timely the estate tax return. Moreover, their reliance on him to file the estate tax return was an impermissible delegation of their responsibility as executors. Respondent adds: “If the executor is unable to obtain complete information about the decedent[’s] assets, he must still file a timely tax return based on the information available at that time.”

The court noted that Henry had died, and Jacques was “almost completely disengaged” from the estate administration.

The IRS stated that, until 2008, preparers and advisors can avoid the new tightened penalties under Section 6694, if the preparer/advisor concludes there is a reasonable basis for the treatment reported on the return or claim, even if the preparer makes no disclosure or the advisor does not advise of opportunities to avoid penalties by disclosure.

Note. See discussion of the new penalties above.


The value of a closely-held business interest, the deferred estate taxes on which bear interest at a two percent rate, is increased to $1,280,000 with respect to estates of decedents dying in 2008.

10 IRS Considers When to Accept Alternate Collateral Under Section 6324A. C.C.M. 2008030126 (Jan. 18, 2008)

The decedent’s executor elected to pay the taxes on the decedent’s interest in an LLC over ten years, under Section 6166. Seventy-five percent of the assets of the LLC were a shopping center. The LLC had 15 or fewer members. The executors consented to the creation of the 15-year estate tax lien under Section 6324A and submitted a proposed Pledge and Escrow Agreement noting that the LLC interest of the decedent is “not registered and readily saleable on the open market and which constitutes an interest in a closely held business as defined by Section 6166. . . .” The estate asked the IRS to accept a pledge of the membership interest in lieu of bond. The agreements of the parties include the following provisions (in part): (1) the estate will hold the LLC interest and assigns its interest to Law-Firm as escrow agent; (2) the estate will provide annual reports or certified financial statements to the IRS on or before April 15 of each year during the term of the agreement; (3) the estate will remain the owner of the LLC interest and will be entitled to income from the LLC interest and to vote the interest; the IRS will not exercise incidents of ownership except after default and delivery of the escrow property to the IRS.

The IRS stated that it can accept the decedent’s LLC interest as collateral for the tax deferred pursuant to a Section 6166 election, if it meets three statutory requirements. First, the collateral must be expected to survive the deferral period, determined after valuing the business and then judging whether the LLC can be expected to survive the deferral period. Second, the LLC interest must be identified in a binding written agreement filed by the executor, showing that all of the persons having an interest in the collateral, i.e.,
the LLC interest, agree to the creation of the special lien. Third, the value of the LLC interest as of the agreement date must be sufficient to pay the deferred taxes plus the required interest, considering all available financial data, as well as all relevant factors affecting the fair market value. Assuming that the IRS’s analysis of the LLC involved a determination that the interest was expected to survive the deferral period and a determination that the value of the interest was sufficient to pay the deferred taxes plus the required interest, then the statutory requirements under Section 6324A have been met, the special estate tax lien arises, and the IRS must accept the LLC interest as collateral.

The IRS also stated that, if it accepts the LLC interest as collateral, it might choose not to enter into the Pledge and Escrow Agreement. Section 6324A(c) requires a written agreement protecting the IRS interest in the collateral securing Section 6324A special lien, signed by all persons having any interest in the collateral securing the lien. The Code does not either require the IRS from entering into or forbid it from entering into any additional agreements, such as a Pledge or Escrow Agreement. The IRS should determine whether the Pledge or Escrow Agreement will provide any additional security. The Chief Counsel’s Office noted that the Pledge and Escrow Agreement reiterated the features of the required Section 6324A written agreement, but also required that the estate provide annual reports or certified financial statements, which would assist the IRS in monitoring whether the LLC interest has maintained its value. The IRS prefers to take possession of stock certificates for shares held as security, but as LLC membership certificates do not exist for the IRS to retain possession, the IRS could request that the estate assign the LLC interest to the IRS in lieu of the Law-Firm acting as escrow agent. Assignment of the LLC interest to the IRS would provide additional security for the government because it would not need to go through a third party in the event that the estate fails to comply with the terms and conditions of Section 6324A.

The IRS also stated that the IRS should perfect its security interest in the LLC by filing a Notice of Federal Tax Lien (NFTL), Form 668-J, for the special estate tax lien in the LLC interest. As the LLC interest is personal property, the NFTL must be filed in the offices based both on the residence of the executor at the time the NFTL is filed, and based on the residence of the decedent at time of death.

When Stock or Other Business Interests Can be Used as Collateral for Special Estate Tax Lien. Chief Counsel’s Memo. 200747019 (Nov. 23, 2007)
The IRS Chief Counsel’s Office addressed several issues regarding when the IRS will accept closely-held stock as collateral for a Section 6324A lien to secure the payment of estate taxes deferred under Section 6166. The IRS stated that, while it was discussing the treatment of closely-held stock, the same rules applied to partnership interests and membership interests in an LLC. The IRS explained that the special section 6324A tax lien comes into existence only if the IRS is satisfied that:

(A) the collateral is expected to survive the deferral period;

(B) the collateral is identified in the special lien agreement; and

(C) the value of the collateral is sufficient to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the deferral period.

When Stock Can be Pledged for a Special Lien. The first issue addressed in the Memorandum was whether, and under what circumstances, closely-held stock is property that can be pledged in support of the election to defer estate taxes. The Office of Chief Counsel noted that although closely held stock may be offered as collateral to secure the Section 6324A lien, the IRS may accept it only when all three of these statutory requirements are met. Thus, both the stock and the corporation must be expected to survive the deferral period and to retain its value during that period.

First, to determine whether a corporation will survive the deferral period, the IRS must value the business, based on all relevant financial information provided by the estate, including appraisals, annual reports, and any other relevant financial document. The IRS must then judge whether the business can be expected to survive the deferral period. The IRS bears whatever risk exists that it will err in its conclusion.

Second, the stock must be identified in the written lien agreement, which must show that all persons having an interest in the stock agree to creating the special lien. The agreement must be binding on all parties that have any interest on the stock.

Third, the value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest.

If all three Section 6324A requirements are met, the special lien arises and the IRS must accept the collateral. The IRS cannot reject collateral proffered by the estate on the grounds that it would be burdensome for the IRS to make the economic or business calcula-
tions to determine the value, or on the grounds that the IRS would prefer other collateral. The Chief Counsel’s Office recognized that taking such business interests as collateral may be risky, but that Congress left that risk with the IRS, rather than the taxpayer.

Criteria Used to Determine the Adequacy of Stock as Collateral. Section 6324A(b)(1)(A) requires that the IRS determine whether the collateral can be expected to survive the deferral period, based on any accepted business criteria. The viability and net worth of the company is reflected in the value of the stock, and whether the stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period. The IRS will not assume that a stock’s failure to retain its value automatically means that a company will not survive the deferral period, however. If stock accepted as collateral decreases in value, the IRS may request additional collateral under Section 6324A(d)(5).

Requirements the IRS May Impose on an Estate that Pledges Stock as Collateral for a Special Lien. The IRS may determine whether there has been a disposition of interest or withdrawal of funds from the company that would trigger the acceleration of payment under Section 6166(g)(1). The IRS may, in so doing, require all relevant financial information from the estate to continue to monitor the value of the accepted stock as collateral during the deferral period. Int. Rev. Code § 6324A(d)(5). The IRS can require that the estate provide annual reports or certified financial statements on or before April 15 of each year during the deferral period, and may require additional collateral if the estate refuses to provide the requested information. If the estate fails to provide the required additional collateral, the IRS can declare an acceleration of all deferred payments under Section 6166(g).

Securing the IRS Interest in the Pledged Stock. Section 6324A(d)(1) provides that the special estate tax lien “shall not be valid as against any purchaser, holder of a security interest, mechanic’s lien, or judgment lien creditor until notice thereof which meets the requirements of Section 6323(f) has been filled by the Secretary.” Thus, the IRS should first file a Notice of Federal Tax Lien (NFTL), Form 668-J, for the special estate tax lien on the stock. Int. Rev. Code § 6324A(d)(1). The lien arises when the executor is discharged from personal liability under Section 2204 and continues until
the liability for the deferred amount is satisfied or becomes unenforceable by reason of lapse of time. Int. Rev. Code § 6324A(d)(2).

Section 6323(f) states that a NFTL must be filed in the office mandated by applicable state law for the state in which the property subject to the lien is situated. Int. Rev. Code § 6323(f)(1)(A)(ii). Stock is personal property, and thus is situated at the residence of the taxpayer at the time the NFTL is filed. Int. Rev. Code § 6323(f)(2).

In addition, if stock certificates exist, the IRS should request that the certificates be given to the IRS, to prevent the sale of the stock to third parties, who might incorrectly believe that they have a right in the certificates superior to that of the IRS. See Int. Rev. Code § 6323(b)(1)(A). The IRS explained that Section 6324A(d)(3) provides that only three of the superpriorities listed in Section 6324(b) qualify as a superpriority against the special estate tax liens, and that there is no superpriority for purchasers of stock encumbered by a Section 6324A special estate tax lien.

Recording the Section 6324A Lien. Recording the Section 6324A lien divests the regular general estate tax lien with respect to the property designated in the special lien agreement. The general estate tax lien expires 10 years from the date of death and cannot be extended. See Int. Rev. Code § 6324(a). The special estate tax lien expires when the deferred estate taxes are paid or the obligation to pay them otherwise is satisfied. Section 6324(d)(1) requires that the Service file a NFTL for the special estate tax lien to give the IRS priority over a purchaser, holder of a security interest, mechanic’s lienor or judgment lien creditor. To protect its interest in the remainder assets of the gross estate more than 10 years after decedent’s death, therefore, the IRS should file a NFTL under Section 6321 (the general estate tax lien), assuming proper procedures for assessment, demand, and refusal or neglect to pay have been met. Whether the IRS should file a NFTL in a particular situation is a business decision to be made by the IRS.

Full Audit Need Not be Required Just Because an Estate Tax Return Proposes Using Closely Held Stock as Security under Section 6324A. The Memorandum states simply that there is no legal requirement to conduct full audits just because an estate proposes to use closely-held stock to secure a special lien under Section 6324A. The decision regarding a full audit is a business decision to be made by the IRS on a case-by-case basis, considering all relevant factors.
_The Proper Procedure to Determine Whether the Stock Adequately Secures the Deferred Taxes and Interest._ The Chief Counsel’s Office stated merely that the IRS should value the closely held business and the business interest based on the relevant financial information provided by the estate. It should also consider all other relevant facts and circumstances of each particular case. If the IRS ultimately decides to reject the stock or the entity interest proffered as collateral, it should detail, in writing, the basis for the rejection.

_The Proper Procedure for Denying or Terminating a Section 6166 Election Because the Property Initially Proffered Ceases to be Sufficient Collateral._ If the value of the property provided to secure the lien for unpaid estate taxes on a business interest, together with required interest, the IRS may require that the estate provide additional security either in the form of assets to secure the lien or a surety bond. If within 90 days after notice and demand the estate does not provide the additional security requested, the estate’s refusal will be treated as an act accelerating payment of the installments under Section 6166(g). Int. Rev. Code § 6324A(d)(5).

Acceleration of the payments under Section 6166(g) is treated as a termination of the Section 6166 election. Section 7479 provides the Tax Court with declaratory judgment jurisdiction with respect to Section 6166, including determinations “whether the extension of time for payment of tax provided in section 6166(a) has ceased to apply” with respect to an estate. The estate may seek relief in the Tax Court by filing a timely petition and must exhaust administrative remedies. Int. Rev. Code § 7479(b). See Rev. Proc. 2005-33, 2005-24 I.R.B. 1231 (administrative procedures when the IRS terminates a Section 6166 election because it is unsecured for a portion of the tax and the executor or a representative of the estate refuses to provide additional security).

_The IRS Review of the Continuing Sufficiency of Collateral Securing a Section 6324A Lien that Already is in Place._ Section 6324A(d)(5) permits the IRS to review the continuing sufficiency of collateral securing a Section 6324A lien agreement, giving it the implicit right to monitor the value of the collateral to determine whether the value has become less than the amount of the unpaid portion of the deferred amount and the required interest amount. Int. Rev. Code § 6324A(d)(5). The Chief Counsel’s Office strongly recommended that the IRS monitor the sufficiency of the collateral securing a Section 6324A tax lien agreement during the deferral period. The IRS...
could, for example, require that the estate provide annual reports or certified financial statements each year during the deferral period, to assist the IRS in determining that the stock has maintained its value.


In generic legal advice, the Service stated that it may assess a gross valuation misstatement penalty against an appraiser for post-May 25, 2007, estate and gift tax appraisals and that these penalties should generally be assessed within three years after the filing of the estate or gift tax return or refund claim. The IRS discussed the new penalty under Section 6695A, as adopted by the Pension Protection Act of 2006. Pub. L. No. 109-280, 109th Cong., 2nd Sess. (2006), 120 Stat. 780. The Small Business and Work Opportunity Tax Act of 2007, Public Law 110-28, 110th Cong., 1st Sess. (2007), 121 Stat. 190, extended the income tax return preparer penalties to all tax return preparers, and defines “return” for purposes of Section 6695A as “any return of any tax imposed by this title,” which clearly includes estate and gift taxes.

**Note.** The penalty is the greater of $1,000 or 10% of the amount of the underpayment attributable to the misstatement (but in no event more than 125% of the gross income received by the appraiser for preparing the appraisal). Int. Rev. Code § 6695A(b). The penalty does not apply if the appraiser establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value. Int. Rev. Code § 6695A(c). Section 6695A is generally effective for appraisals prepared with respect to returns or submissions filed after August 17, 2006.

13 **Section 9100 Relief Not Available for Late Section 6166 Election.** PLR 200721006 (May 25, 2007)

The decedent=s executor filed a timely Form 4768 to request an extension of time to file the Federal estate tax return, and thereafter filed the return with a request to pay the estate taxes in installments under Section 6166. The ruling is redacted, but apparently the return was filed after the date permitted in accordance to the Form 4768 request for late filing.

The IRS denied relief under Section 9100 relief, noting that the Section 9100 regulations apply only to extension of deadlines that are dictated by regulations and rulings, rather than statutory deadlines. Section 301.9100-1(b) of the regulations defines a “statutory election” as one whose due date is prescribed by statute, while a “regulatory election” is one “whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice or announcement published in the
Internal Revenue Bulletin.” Section 6166(d) states that the elective deferral of estate taxes attributable to the value of an interest in a closely held business must be made no later than the time prescribed by Section 6075(a) for filing the estate tax return. This is a statutory requirement, and there are no regulations that can or do vary this statutory requirement. The timeliness requirement is not statutory merely because the regulations refer to the statute. Section 9100 relief is not, therefore, available for an untimely election to defer estate tax payments under Section 6166. The IRS also declined to apply the doctrine of substantial compliance, because Section 6166 contains no “reasonable cause” exception to the requirements for a timely election. See Estate of Boyd v. Comm’r, T.C. Memo 1983-316; and Estate of Gardner v. Comm’r, 82 T.C. 989 (both denying application of the substantial compliance doctrine to elections to value certain farm or small business real estate at its present use, under election rules that are virtually identical to those of Section 6166).

II GIFT TAXES

A Code § 2503. Gift Tax Annual Exclusion


The gift tax annual exclusion is increased to $12,000 per donee per year for transfers made in 2008. The annual exclusion for gifts to a non-U.S. citizen spouse is raised to $128,000 for transfers made in 2008.

B Code § 2511. Transfers in General

IRS Reconsidering Whether Reserved Right to Change Beneficiaries Creates Incomplete Gift to Trust That Shifts Taxable Income. Inf. Rel. 2007-127 (July 9, 2007)

In PLRs 200502014, 200612002, 200637025, and 200647001, the IRS stated that a reserved right to change beneficiaries created an incomplete gift in trust, but that the trusts were completed transfers for income tax purposes. In PLR 200647001, for example, the grantor created a trust with a corporate trustee, and directed that the trust income and principal would be distributed during the grantor’s lifetime to and among a class that includes the grantor, the grantor’s spouse (if and when the grantor marries), the grantor’s parents, the gran-

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or his wife, the grantor’s own descendants, and any “qualified charity” (defined as one to which contributions are deductible for income, gift and estate tax purposes.) The distributions will be made in such proportions as directed by either the unanimous decision of the distributions committee (the “Committee”), or by the decision of the grantor and one or more members of the Committee. At the grantor’s death, the remaining trust principal (including any undistributed income) will be distributed to the persons that the grantor names in the grantor’s last will. The grantor may exercise this power of appointment in favor of anyone other than the grantor, the grantor’s estate, the grantor’s creditors or the creditors of the grantor’s estate. The trust included an alternate disposition in default of the valid exercise of the power of appointment, in favor of the grantor’s siblings and their descendants, with a contingent remainder in certain private foundations. The Committee initially consists of the grantor’s brother and sister, but at all times it must include at least two adult members of the class of potential beneficiaries. Neither the grantor nor the grantor’s spouse may be a member of the Committee. The IRS ruled that The IRS stated that the trust was not a grantor trust for income tax purposes, apparently because any distribution of income or principal to the grantor or the grantor’s spouse could be made only with the consent of an adverse party. Int. Rev. Code §§ 672(a), 674(b)(3), 677(a). The IRS also stated that the grantor’s limited power of appointment gave the grantor the power to change the trust beneficiaries, and caused any gifts to the trust to be incomplete for gift tax purposes. Treas. Regs. § 25.2511-2; Estate of Stanford v. Comm’r, 308 U.S. 39 (1939). Trust distributions are not taxable gifts from the distribution committee, because their power to distribute trust funds to themselves is exercisable only with the consent of an adverse party. Distributions of trust property to a beneficiary other than the grantor, however, or the grantor’s lifetime release of the testamentary power of appointment, would constitute completed gifts by the grantor. The IRS also ruled that distribution of property from trust to the taxpayer by distribution committee would not be a taxable gift by the members of the committee.

In Inf. Rel. 2007-127 (July 9, 2007), the IRS Office of Associate Chief Counsel, Passthroughs & Special Industries, stated that it is considering withdrawing these rulings, because of inconsistency with Rev. Rul. 76-503, 1976-2 C.B. 275 and Rev. Rul. 77-158, 1977-1 C.B. 285. The IRS sought public comments on the subject. Both rulings involved a trust created by three siblings, each of whom named an adult child as one of the three trustees who had complete discretionary power over the assets of the trust and individually had the right to name a relative as successor. In Rev. Rul. 76-503, the trustees acted unanimously; in Rev. Rul. 77-158, by majority vote. The IRS in both rulings stated that the surviving trustees were in no better position to exercise the power after a decedent-trustee’s death than before the
death, so the IRS stated that the interests of the co-trustees were not adverse to exercise of the power in favor of the decedent-trustee. Thus, in both rulings, one-third of the trust fund was includible in a decedent-trustee’s estate as property subject to a general power of appointment under Section 2041. These rulings suggest that the distributions of property from the trusts in the PLRs would be taxable gifts by the trustees. The IRS noted that in the PLRs, the grantor’s gift to the trust was incomplete, because the grantor retains a testamentary special power of appointment. The IRS noted, however, that this might not preclude the application of the two revenue rulings. Citing Treas. Regs. § 25.2514-1(e), Ex. 1 and Rev. Rul. 67-370, 1967-2 C.B. 324.

Note. One may question the IRS interpretation of the incomplete gift rules. The IRS accurately quotes the gift tax regulations, but the donor in the various private rulings gave the trustees the power to distribute principal without the donor’s consent. The IRS could have stated that this deprived the donor of the power to control beneficial enjoyment over the trust assets during the donor’s lifetime. The IRS reliance on Estate of Sanford may be misplaced, because the taxpayer in that case created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust in whole or in part, and to designate new beneficiaries other than him. The taxpayer relinquished the power to revoke the trust six years after creating it, but retained the right to change the beneficiaries. Later, the taxpayer relinquished the right to change the beneficiaries. The Supreme Court held that the taxpayer’s gift was not complete, for purposes of the gift tax, when the taxpayer reserved the power to determine those others who would ultimately receive the property. The Court stated that the taxpayer’s gift was complete only when the taxpayer relinquished his right to change the beneficiaries of the trust. The facts of Estate of Sanford are distinguishable from those in the rulings, because the donor in Estate of Sanford retained the power to change the beneficiaries of the trust during his lifetime, while the donor in the rulings held only a testamentary power to change the trust beneficiaries. The trustees in the rulings could divert the trust funds to the beneficiaries, even over the donor’s objections.

C Code § 2518. Disclaimers


Helen’s last will left all of her estate to her daughter, Christine, after payments of any debts and funeral expenses. The will stated that 25 percent of Zaritsky, The Year in Review – Page 53
any disclaimed assets would pass to a charitable foundation and 75 percent to a 20-year charitable lead annuity trust. Christine disclaimed a fractional share of the estate, equal to the excess of the estate over $6,350,000 (an amount she and her advisers determined would allow the family business to continue, as well as to provide for her and her own family's future.) Christine did not disclaim her contingent remainder in the charitable lead trust; she remained a potential beneficiary of the trust funds remaining after the 20-year annuity term. The disclaimer also contained a savings clause that stated “the extent that the disclaimer set forth above . . . is not effective to make it a qualified disclaimer, Christine . . . hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code.” The estate deducted the amount passing outright to the Foundation as a result of the foundation, and the present value of the annuity in the charitable lead trust. The IRS disallowed both deductions.

The Tax Court (Judge Holmes for a ten-judge majority), held that the disclaimer of the portion of the estate passing to the lead trust was not a qualified disclaimer, and denied the estate tax charitable deduction for that portion of the estate. The estate argued that Christine’s remainder interest in the charitable lead trust was either “severable property” or “an undivided portion of the property,” and that the disclaimer was qualified. The Tax Court majority disagreed. The disclaimer regulations define “severable property” as property that can be divided into separate parts each of which, after severance, maintains a complete and independent existence. Treas. Regs. § 25.25183(a)(1)(ii). The regulations define “an undivided portion of the property” as a fractional or percentile share of each and every substantial interest or right owned by the decedent in the property. Treas. Regs. § 25.2518-3(b). The majority stated that neither definition fit the interests in the charitable lead trust. The estate argued that the savings clause automatically disclaimed a fractional share of the remainder interest in the trust, and that the disclaimant intended to do whatever was required to have a qualified disclaimer. The IRS argued that the savings clause was invalid as a matter of public policy. The majority declined to address the public policy issue, finding that the clause itself would not save the disclaimer from disqualification. The clause might be read in two ways. First, it could be read as a promise that, once the court disqualified the disclaimer, Christine will then disclaim her contingent remainder interest in the charitable lead trust. This analysis, the majority stated, would yield a disqualified disclaimer because the disclaimer would not be timely. Second, the savings clause could be read as meaning that Christine automatically disclaimed the contingent remainder when she signed the disclaimer. Such a disclaimer also would be disqualified because it would not identify the property being disclaimed and would not be unqualified. The
majority stated that such clauses that depend for their effectiveness on a condition subsequent are ineffective for disclaimers, as they are for revocable spousal interests and gift adjustment agreements. See _Estate of Focardi v. Comm’r_, T.C. Memo. 2006-56 (spousal interests); and _Ward v. Comm’r_, 87 T.C. 78, 11011 (1986) (gift adjustment agreements).

The majority also held that the disclaimer of the portion of the estate passing outright to the foundation was a qualified disclaimer for which an estate tax charitable deduction was allowed. The IRS argued that the use of a formula clause to increase the charitable deduction when the valuation of the assets increased was invalid. The majority rejected this notion, because it would have the “remarkable” effect of increasing the estate tax because more property passed to the charity. The IRS argued that any increase in that amount was contingent on a condition subsequent— the IRS challenge to the value of the gross estate—and that the formula adjustment (valuing the disclaimer property “as such value is finally determined for federal estate tax purposes”) was contrary to the requirement that the amount the charity will receive be ascertainable at death. Treas. Regs. § 20.2055-2(b)(1). The majority noted that this was a transfer by disclaimer—not a “testamentary charitable contribution” -- and that the disclaimer relates back to the date of death. The IRS also argued that the increased charitable deduction on account of the revaluation of the assets was contingent, both because it depended on a disclaimer and because it occurred only because the IRS examined the estate tax return and challenged the fair market value of its assets. The majority disagreed, noting that the transfer of property to the foundation was not contingent on any event that occurred after the decedent’s death, other than the execution of the disclaimer which related back to the date of death. The Tax Court also rejected the IRS argument that the disclaimer’s adjustment clause was void on public policy grounds, because it would, at the margins, discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. The court stressed the narrowness of the public policy rule -- the public policy being frustrated must be shown by a governmental declaration, and the frustration that would be caused by allowing the contested deduction must be severe and immediate.

Eight judges agreed to a separate concurring opinion written by Judges Haines and Goeke, which expanded on why Christine's remainder interest in the charitable lead trust and the foundation's 20-year annuity interest were not severable for purposes of the disclaimer. This opinion expressly agreed with the majority’s analysis of the validity of the formula clause and the invalidity of the savings clause. On the disqualification of the disclaimer in favor of the charitable lead trust, the Haines-Goeke opinion explained that Christine did not disclaim her right to receive the remainder of the charitable
lead trust and that her disclaimer was not one of an undivided portion of Christine's entire interest. Treas. Regs. § 25.2518-2(e)(3). Thus, this disclaimer was qualified only if the remainder interest was a severable property interest. In order to be treated as severable property, the foundation's guaranteed annuity and Christine's remainder, after severance, must maintain “a complete and independent existence.” Treas. Regs. § 25.2518-3(a)(1)(ii). The Haines-Goeke opinion noted that an example in the disclaimer regulations specifically stated that a person who is left a fee simple interest could not disclaim the remainder interest and keep the life estate. This, the opinion continued, is directly on point.

Judges Swift and Kroupa each wrote a separate opinion, concurring in part and dissenting in part; and each signed the others opinion. Judge Swift agreed with the majority on the question of the application of the public policy doctrine to the savings clause in the disclaimer, but stated that she believed that the disclaimer in favor of the charitable lead trust was a qualified disclaimer.

Judge Swift believed that the annuity and remainder interests maintained “a complete and independent existence,” primarily because each had an independent ascertainable value. The Haines-Goeke concurring opinion, however, disputed this analysis, because the ascertainable value analysis was based on the charitable deduction regulations, which state that a charitable deduction is allowed for the value of a charitable beneficial interest in a trust “only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest.” Treas. Regs. § 20.2055-2(a). The concurring opinion stated that whether an interest has an ascertainable value is not the proper standard to apply in determining whether that interest is severable for purposes of making qualified disclaimers. The charitable deduction regulations, the concurring judges note, state that a remainder following a life estate or a term of years is ascertainable and thus “severable” for charitable deduction purposes, but the disclaimer regulations state that remainder following a life estate or a term of years or an annuity is not severable for purposes of determining whether a disclaimer is a qualified disclaimer. Treas. Regs. § 25.2518-3(d), Ex. 2.

Judge Kroupa, in his separate opinion, noted that he had been the trial judge, and that he found the decedent’s and Christine’s charitable intent compelling. Judge Kroupa agreed with the majority that the disclaimer in favor of the foundation was qualified, but stated that the estate was entitled to deduct the amounts passing to the charitable lead trust to the extent of the annuity portion. Judge Kroupa argued that the majority’s interpretation of the severability rules were unduly restrictive and that the majority erred when it relied heavily on the statement in the disclaimer regulations that “if a disclaimant who is not a surviving spouse receives a specific bequest of a fee
simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which Christine has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed."

Judge Kroupa stated that reliance on this sentence ignores the regulations focus on whether the property is severable. Judge Kroupa stressed that the other examples in the gift tax regulations more clearly distinguish between severable and nonseverable property. The annuity and remainder interest in the charitable lead trust are distinctly separate interests, both of which were created by the decedent. The disclaimer renounced a fractional portion of the property passing to Christine under the decedent’s will–it did not create or carve out a particular interest for Christine and renounce the rest.

Note. This opinion is useful for its illustration of the problems that may arise in partial disclaimers, but more importantly, for its approval of the formula disclaimer that automatically adjusted for audit changes in the valuation of the estate assets. A fractional disclaimer of an interest in an estate can, the court says, be safely tied to the valuation of the assets as finally determined for Federal estate tax purposes.

Additionally, the dissent may be correct in its assertion that the partial disclaimer in favor of the charitable lead trust was a qualified disclaimer. The fact that the decedent, rather than the disclaimant, created the two distinct interests in the charitable lead trust should have been enough to render the two interests severable for disclaimer purposes. Nonetheless, the majority still refused to distinguish between situations in which the decedent creates the two interests and those in which the disclaimer creates two interests.

D Code § 2522. Charitable Deduction


The Tax Technical Corrections Act of 2007 eliminates the estate tax restriction on charitable bequests of partial interests in tangible personal property. The Pension Protection Act of 2006 provides limits the gift tax charitable contributions for a taxpayer who, after having made an initial fractional contribution, thereafter makes an additional testamentary or inter vivos charitable gift of an interest in that same property (an “additional contribution”). Int. Rev. Code §§ 170(o), 2055(g), 2522(e). The PPA stated that the gift tax deduction for a testamentary transfer of such an additional contribution was limited to the appropriate fractional share of (a) the fair market value of the...
property at the time of the initial fractional contribution, or if less, (b) the fair market value of the property at the time of the additional contribution. Thus, no gift tax deduction would be allowed for any share of the appreciation in the value of the tangible personal property that occurred after the initial fractional contribution. The new law does not eliminate the recapture provisions that recover the gift tax charitable deduction if the donor does not transfer the rest of the tangible personal property to the same charity within ten years or, if earlier, before his or her death.


The IRS published a set of sample inter vivos charitable lead trust forms and guidance, including both grantor and nongrantor charitable lead trusts. Among the more interesting aspects of this very useful procedure are the following:

- **Defining the Annuity.** The sample trusts define the annuity interest as a percentage of the initial value of the trust funds, but provide alternate language to specify the dollar amount in the governing instrument.

- **Measuring the Annuity Term.** The sample trust forms permit measurement of the annuity period by a fixed number of years or one or more measuring lives. The IRS states, however, that one can use a measuring life, rather than a term of years, only if the measuring life is the donor or certain related persons.

- **Increasing Annuity Payments.** The annotations permit the creation of an annuity interest with increasing annual payments, as long as the annuity has an ascertainable value. This authorizes the use of lower annuity payments in early years, which may be very useful particularly if the measuring life is in poor health (though having a life expectancy of more than 18 months when the trust is created.)

- **Grantor Trust Power.** The grantor trust power selected by the IRS is the right to substitute assets. The IRS sample language requires that the person granted the power not be the grantor, the trustee, or a disqualified person as defined in Section 4946(a)(1). Excluding the grantor avoids any questions about the gift being incomplete or includible in the grantor’s gross estate, though such results seem strained and unreasonable. Excluding the trustee may be intended to eliminate the question (at least in a model form) of whether the power
is actually held in a nonfiduciary capacity. Eliminating disqualified persons addresses the fact that exercise of the power by a disqualified person can be an act of self-dealing.

Commutation Prohibited. The trustee may not have the right to commute the charitable annuity interest and prepay the charitable distribution. Rev. Rul. 88-27, 1988-1 C.B. 331.

Excess Business Holdings. If the charitable interest exceeds 60 percent of the value of the trust fund, the trust instrument must prohibit acquisition and retention of assets that would give rise to a tax on excess business holdings under Sections 4943 or 4944.


Rule Against Perpetuities. Any rule against perpetuities savings clause must be based on the common law life in being plus 21 years approach, rather than the Uniform Act’s alternate 90 years approach. Treas. Regs. § 20.2055-2(e)(2)(vi)(a).

GST Planning. No GST planning is included. As these are CLATs, rather than unitrusts, the inclusion ratio is calculated under a special set of rules included in Section 2642(e).

Alternate Charities. The trust may designate an alternate charitable beneficiary or permit the trustee to select one, as long as the trustee’s powers are limited selecting organizations described in both Sections 170(c) and 2055(a).

Note. The annotations are particularly useful, highlighting most of the serious issues raised by the use of a charitable lead trust. They may themselves be the most important part of the sample forms. The drafting style is typical IRS, which means that the language is relatively clear, but the organization can stand some improvement. The practitioner should consider reorganizing the forms to improve readability.
E Gift Tax Procedures


Birnie and Elizabeth, two sisters who lived together much of their adult lives, commingled all of their earnings and assets, pursuant to a long-standing oral agreement. Elizabeth held legal title to the assets but the sisters shared equally in the profits and losses. Each sister filed a separate income tax return reporting her earnings from her job and an equal share of profits and losses from the joint investments. The IRS accepted this split of investment income and expenses throughout numerous audits. Birnie died in 1991, having outlived her sister by eleven years. After Elizabeth’s death, Birnie had given and sold some of these shares to the sisters’ nephews, Gordon and Botefuhr, and niece, Vestal. The gift portion had been a net gift, but the donee, Botefuhr, failed to pay the gift taxes, after which the corporation redeemed his shares for $2,190 per share. When Vestal and Gordon filed Birnie’s estate tax return, they also filed a gift tax return reporting the earlier gift to Botefuhr, which they valued at $804 per share. Botefuhr signed neither the gift tax return nor the estate tax return. On audit of Birnie’s estate, the IRS valued Birnie’s gift of Hondo stock to Botefuhr at $2730 per share rather than $804 per share. They imposed a gift tax deficiency, which was contested unsuccessfully in *Estate of Davenport v. Comm’r*, T.C. Memo. 1997-390, *aff’d*, 1814 F.3d 1176 (10th Cir. 1999).

The Tax Court held, in part, that Birnie made a completed gift to Gordon Davenport, Vestal and Botefuhr, when she made sales and gifts, and that although Birnie lacked legal title to the assets she had equitable title and could convey the stock. The Tax Court also valued the Hondo stock at $2,000 per share, at the time of the gifts. Birnie’s executors still declined to pay the taxes, stating that the tax court lacked the authority to enforce its judgments.

The government brought an action in district court to reduce impose transferee liability on the nephews and niece, as executors. The estate conceded the liability, but the court dismissed the claim for individual liability against the executors personally for having made prior distributions. On appeal, the Tenth Circuit held that the Oklahoma district court did not have jurisdiction over Botefuhr and Gordon after dismissing the claim for personal liability. *U.S. v. Botefuhr*, 309 F.3d 1263, 1274 (10th Cir.2002), *rev’g*, 159 F.Supp.2d 1330 (N.D. Ok. 2001). The case was remanded to the Oklahoma district court, which transferred Botefuhr’s case to the Western District of Texas and Gordon’s case to the Southern District of Texas.

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The Southern District of Texas ruled on multiple motions for summary judgment by Gordon and the government. It held that the statute of limitations barred assessment of the gift tax on the imputed gift arising from the July 1980 installment sale, but that the statute of limitations did not bar assessment of the gift to Botefuhr. It also held that although res judicata and collateral estoppel bound Gordon to the Tax Court’s finding that he was a donee neither doctrine established the value of the gift to him (the Hondo stock) or the amount of his liability. The district court also held that the government failed to provide any evidence on damages, an essential element of its claim, and it granted summary judgment against the government.

On appeal, the Tenth Circuit held that the Tax Court’s findings of the estate’s tax liability, concerning value of conveyed stock, and concerning limitations period, were res judicata in instant action. The court distinguished res judicata, in which final judgment on the merits bars further claims by parties or their privies based on same cause of action, from collateral estoppel, where second action is upon different cause of action and judgment in prior suit precludes relitigation of issues actually litigated and necessary to outcome of first action. The court stated that res judicata applied in this case because the parties were either identical in privity, judgment in prior action was rendered by court of competent jurisdiction, the prior action was concluded to final judgment on merits, and the same claim or cause of action was involved in both actions.

Note. See also Gerzog, “Davenport: Res Judicata Applied,” 115 Tax Notes 1199 (June 18, 2007).

III GENERATION-SKIPPING TRANSFER TAXES

A Code § 2601. Effective Date Provisions


Eleanor died on October 20, 2000, leaving a will that, in applicable part, exercised a broad general power of appointment contained in the marital trust created by her late husband, Benjamin, who died in 1973. No additions were made to the corpus of the marital trust after September 25, 1985. Eleanor appointed the marital trust to a trust for the benefit of her grandchildren and more remote descendants.

The Tax Court (Judge Haines) held that the regulations that treat the exercise of a general power of appointment as a separate constructive addition...
to the pre-September 25, 1985 trust were a reasonable interpretation of the statutory effective date rules. The majority relied on its earlier holding in *Peterson Marital Trust v. Comm'r*, 102 T.C. 790 (1994), aff'd 78 F.3d 795 (2nd Cir. 1996), which involved a lapse of a general power of appointment and an interpretation of the temporary regulations. The court noted that the effective date provisions sought to protect the “reliance interests” of settlors who established trusts before the new GST tax regime was introduced. The majority also noted that the Second Circuit, in affirming the Tax Court, had stressed the fact that a general power of appointment is generally treated like outright ownership, and that one holding such a power had no reliance interest in the earlier trust terms, because the power-holder could vary them in the exercise of the power. The Eighth and Ninth Circuits, however, had disagreed in *Simpson v. U.S.*, 183 F.3d 812 (8th Cir. 1999), *rev'g and rem'g*, 17 F. Supp. 2d 972 (W.D. Mo. 1998), and *Bachler v. U.S.*, 281 F.3d 1078 (9th Cir. 2002), *rev'g and rem'g* 126 F. Supp. 2d 1279 (N.D. Cal. 2000), both of which involved the exercise of general powers of appointments under facts very like those in *Gerson*. The Eighth and Ninth Circuits had held that the plain language of the statute rendered the entire pre-September 25, 1985 trust exempt from the GST tax, including the exercise of powers of appointment created under that trust. The majority noted that these contrary holdings predated the final regulations, which, though only interpretative regulations, have the force of law and are valid reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). The court rejected the views of the Eighth and Ninth Circuits in *Simpson* and *Bachler*, and sustained the regulations as harmonious with the statutory effective date rules.

There were three concurring opinions and two dissenting opinions. Judge Swift wrote a three-judge concurring opinion that stated that the decisions of the Eighth and Ninth circuits in *Simpson* and *Bachler* had confused which transfers were protected by the effective date rules and had improperly distinguished the opinions in *Peterson Marital Trust*. Judge Swift stated that the pre-September 25, 1985 creation of the trusts in each case that included powers of appointment made the later exercise of those powers possible, but the “possibility” of a later transfer that was created before the effective date was different from the actual transfer that occurred after that date. The relevant transfer of property that occurred “under” the trust was the one made to the surviving spouse, and not the one that she made when she exercised or permitted to lapse her general power of appointment.

Judge Thornton wrote a separate concur rence with which seven judges agreed (including four judges who signed the majority opinion). Judge Thornton stressed the need to “give effect, if possible, to every clause and word of” the statute, and criticized the Eighth and Ninth Circuits for failing to give ef-
fect to the phrase “generation-skipping” that immediately precedes “transfer under a trust.” The Simpson analysis rendered the phrase “generation-skipping” irrelevant, because neither the GST tax nor the effective date rule apply to any type of transfer other than a generation-skipping transfer. Judge Thornton stated that the only way that the phrase “generation-skipping” used before the phrase “transfer under a trust” can have purpose and effect, is by limiting the effective date protection to a generation-skipping transfer that occurs pursuant to the terms of the trust instrument. A generation-skipping transfer resulting from the exercise of a general power of appointment is not, therefore, a “generation-skipping transfer under a trust.”

Judge Holmes wrote a third concurring opinion (in which Judge Swift joined), focusing on whether the effective date regulations are a reasonable interpretation of the statute. Judge Holmes noted that the intent of Congress on this issue is not clear, leaving the Treasury to construe it. The variation in views in this case alone, Judge Holmes stated, shows that the statute is ambiguous. The only thing required of the regulations is reasonableness, and the regulations are reasonable because they merely extend the long-standing rule that a general power of appointment is taxed as the equivalent of ownership.

Judge Laro and Judge Vasquez both wrote separate dissenting opinions, though Judge Vasquez also joined on Judge Laro’s dissent (together with three other judges.) Judge Laro deemed the regulation not to be “a reasonable and valid interpretation of the plain language” of the effective date rules. The Sixth Circuit, Judge Laro noted, stated that “[w]here the statute is clear, the agency has nothing to interpret and the court has no agency interpretation to which it may be required to defer.” Dixie Fuel Co. v. Comm’r of Soc. Sec., 171 F.3d 1052, 1064 (6th Cir. 1999), abrogated on other grounds by Barnhart v. Peabody Coal Co., 537 U.S. 149 (2003). Judge Laro noted that Peterson Marital Trust was concerned only with the portion of the statute that follows the comma--the exception that provides “only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985.” The instant case, as well as the opinions of the Eighth and Ninth Circuits concerned the part of TRA 1986 section 1433(b)(2)(A) preceding the comma; i.e., the general rule that provides “any generation-skipping transfer under a trust which was irrevocable on September 25, 1985.”

Judge Vasquez wrote a separate dissent to address the issue of the proper deference the Court should give to interpretive regulations. Judge Vasquez did not believe that interpretive regulations are subject to the deference described by the Supreme Court in Natl. Muffler Dealers Association, in light of the opinion of the Court in U.S. v. Mead Corp., 533 U.S. 218 (2001). In Mead, the Supreme Court clarified the limits of Chevron deference owed to an agency’s interpretation of a statute it administers. The Court held
that an agency’s interpretation of a particular statutory provision qualifies for *Chevron* deference when Congress delegated authority to the agency to make rules or regulations carrying the force of law and the agency interpretation claiming deference was promulgated in the exercise of that authority. An agency’s interpretation that does not qualify for *Chevron* deference is “accorded respect proportional to its ‘power to persuade’” *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). Judge Vasquez stated that regulations promulgated under Section 7805 do not have the force of law, because to hold otherwise would recognize no distinction between such regulations and those issued pursuant to an express grant of quasi-legislative authority. Interpretative regulations are owed less deference than legislative regulations. Under *Mead*, the first question is whether Congress delegated authority to the agency to make rules or regulations carrying the force and effect of law. The second question is whether the agency invoked that authority. By promulgating a regulation pursuant to section 7805, the regulation was not issued pursuant to a delegation of authority by Congress to make rules or regulations carrying the force and effect of law. Therefore, Judge Vasquez stated that, under *Mead*, the regulations under the grantor trust effective date rules would not need merely to be a reasonable interpretation; they would need to be persuasive.

The Sixth Circuit affirmed the decision of the Tax Court, giving the regulations special deference under *Chevron*, rejecting the argument that interpretative regulations were not entitled to such great deference. The court held that any regulation promulgated after notice and comment is issued with the force of law, and that it must be sustained unless its position is clearly unreasonable, unless Congress has directly spoken to the precise question at issue. The GST tax effective date provisions do not apply, the court emphasized, to transfers made out of corpus added, directly or constructively, after September 25, 1985. The court reviewed the split among the circuits, and sided with the Second Circuit that either a lapse or an exercise of a general power of appointment should be treated as a constructive addition to an effective date-protected trust. The court stated that when a general power of appointment is exercised, two transfers occur; the holder of the power becomes the owner of the trust assets for tax purposes, and then transfers them to the appointee. When a power of appointment lapses, the holder of the power becomes the owner of the trust assets for tax purposes, and then they are retransferred to the original transferor, who then transfers them to the ultimate takers. In either case, if the last transfer occurs after the effective date of the GST tax, there is no effective date protection available.

**Note.** See also Nenno, “*Gerson v. Comr.: Donees of General Powers of Appointment Over Grandfathered Trusts Unite!*” 32 Estates, Gifts & Tr. J. 131 (March-April, 2007).
B  Code § 2642. Inclusion Ratio


The IRS and the Treasury Department published final regulations detailing how one can effect a qualified severance of a trust for GST tax purposes, and proposed regulations regarding both certain qualified severances and non-qualified severances that are effective for GST tax purposes. The following are the key provisions of these regulations.

_ The Effects of a Qualified Severance. _ A qualified severance of a trust into two or more separate trusts will be treated as creating two independent GST trusts from the date of the severance. Most actions taken with respect to each result trust will have no effect on the other resulting trust or trusts. The qualified severance rules apply for GST tax purposes, and do not determine other income and transfer tax results from the trust. A qualified severance is effective as of the date of the severance, and the resulting trusts are treated as separate trusts for GST tax purposes as of that date. The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding (if the severance is effected pursuant to an order of the local court.) Treas. Regs. §§ 26.2642-6(a), 26.2642-6(c), 26.2642-6(d)(3).

_ Qualified Severance and the Seven-Part Test. _ A qualified severance means a trust division that creates two or more separate trusts, that satisfies seven specific requirements.

First, the severance must occur pursuant to the terms of the governing instrument, or pursuant to applicable local law. Treas. Regs. § 26.2642-6(d)(1).

Second, the severance must be effective under local law. Treas. Regs. § 26.2642-6(d)(2). It is noteworthy that these first two requirements refer to the application of “applicable local law,” rather than to state statutory law. Thus, a judicial order of severance can create a qualified severance even if there is no
authority for the severance under state statutory law or the governing instrument.

Third, the funding of the trust must commence immediately upon, and must occur within a reasonable time (never more than 90 days) after, the selected valuation date. The actual selection of the particular assets to be distributed to each resulting trust, may either consist of the appropriate fraction or percentage (pro rata portion) of each asset held by the original trust, or the assets may be divided among the resulting trusts on a non pro rata basis, based on the fair market value of the assets on the date of severance. Resulting trusts that are funded on a non-pro rata basis must apply the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance. Treas. Regs. § 26.2642-6(d)(3). The new proposed regulations would prohibit in a non-pro rata funding any discount or other reduction in the value of the assets held by the original trust in determining the relative shares of the two resulting trusts. Each resulting trust’s interest in stock, partnership interests, LLC interests, or other assets, would be valued as a pro rata share of the value of the interest held by the original trust before severance. This proposed rule would be effective for qualified severances occurring on or after the date that the final regulations are published in the Federal Register. Prop. Treas. Regs. §§ 26.2642-6(d)(4), 26.2642-6(k)(1).

Fourth, the original trust must be severed on a fractional basis, such that each resulting trust is funded with a fraction or percentage of the original trust. The total of all fractions or percentages must be one or one hundred percent. The regulations permit the use of a formula to determine the respective fractions or percentages. For example, one resulting trust could be a fraction of the original trust, “the numerator of which is equal to the transferor’s unused GST tax exemption, and the denominator of which is the fair market value of the original trust’s assets on the date of severance.” Such a severance would create one trust with a GST inclusion ratio of zero and another trust with a GST inclusion ratio of 1. The original trust may not be severed based on a pecuniary amount. Thus, for example, a resulting trust could not be created in the amount of $2 million, and the rest of the trust assets allocated
to the other resulting trust. Presumably, a trust could not be created in an amount equal to the transferor’s unused GST tax exemption, either. Treas. Regs. § 26.2642-6(d)(4).

Fifth, the terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement is met if the beneficiaries of and interests in the separate resulting trusts, viewed collectively, are the same as the beneficiaries and interests with respect to the original trust. This succession-of-interests test is satisfied with respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-pro rata basis, if: (i) the terms of each resulting trust are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts); and (ii) each beneficiary’s interest in the resulting trusts (collectively) equals the beneficiary’s interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis. The succession-of-interests test also requires that the severance not shift a beneficial interest in the trust to any beneficiary assigned to a lower generation than the person or persons who held the beneficial interest in the original trust, and that it not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust. Treas. Regs. § 26.2642-6(d)(5).

Sixth, a qualified severance of a trust with an inclusion ratio of either one or zero must create resulting trusts with the same inclusion ratio as the original trust. Treas. Regs. § 26.2642-6(d)(6).

Seventh, a qualified severance of a trust with an inclusion ratio of neither one nor zero, that occurs after GST exemption has been allocated to the trust, must initially create two trusts, one of which will have an inclusion ratio of zero and the other of which will have an inclusion ratio of one. This means that one resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the sever-
 ance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction will have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal resulting trusts, the trustee has the option of designating which resulting trust will have an inclusion ratio of zero and which will have an inclusion ratio of one. The division of the trust based on the inclusion ratios will often not be the only required division; additional divisions may be desirable to segregate the assets being held for component groups of family members. The final regulations state that each separate resulting trust may be further divided “in accordance with the rules of this section.” Treas. Regs. §26.2642-6(d)(7). The new proposed regulations would permit the qualified severance of a trust into more than two separate trusts, in order to expedite the multi-step process contemplated by the final regulations. Under the proposed regulations, a trust could be initially severed into more than two resulting trusts, as long as one or more of the resulting trusts, in the aggregate, have a GST inclusion ratio of zero and the other resulting trust or trusts have a GST inclusion ratio of one. Prop. Treas. Regs. § 26.2642-6(d)(7)(ii).

Reporting a Qualified Severance. One reports a qualified severance on Form 706-GS(T), “Generation-Skipping Transfer Tax Return for Terminations,” writing at the top of the form the words “Qualified Severance.” One attaches a Notice of Qualified Severance (Notice) to the return, and files it by April 15th of the year immediately following the year during which the severance occurred, or by the last day of the period covered by an extension of time, if an extension of time is granted, to file such form. Treas. Regs. § 26.2642-6(e)(1). The final regulations deleted the requirement that the words “Qualified Severance” appear in red ink.

The Notice should provide the following information regarding the original trust: (i) the name of the transferor; (ii) the name and date of creation of the original trust; (iii) the tax identifica-
tion number of the original trust; and (iv) the inclusion ratio before the severance. Treas. Regs. § 26.2642-6(e)(2).

The Notice should also provide the following information regarding each resulting: (i) the name and tax identification number of the trust; (ii) the date of severance; (iii) the fraction of the total assets of the original trust received by the resulting trust; (iv) other details explaining the basis for the funding of the resulting trust (a fraction of the total fair market value of the assets on the date of severance, or a fraction of each asset); and (v) the inclusion ratio. Treas. Regs. § 26.2642-6(e)(3).

Timing and Prospective Operation of a Qualified Severance. A qualified severance may occur at any time before the trust terminates, either before or after the allocation of GST exemption to the trust, the occurrence of a taxable event with respect to the trust, or an addition to the trust fund. Treas. Regs. §26.2642-6(f)(1). A qualified severance is effective as of the date of severance, and thus has no effect on a taxable termination or a taxable distribution that occurred before the date of severance. A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. Treas. Regs. §26.2642-6(f)(2), 26.2642-6(j), Ex. 8.

Severance of an Effective Date-Protected Trust. Severing a trust that was created before September 25, 1985, and that is thus protected from the GST tax by the effective date rules, need not be done in accordance with the qualified severance rules but must instead comply with the separate rules of Treas. Regs. § 26.2601-1(b)(1)(iv)(A). An effective date-protected trust to which a post-September 25, 1985 addition has been made, however, is treated for this purpose as two separate trusts, one of which is entirely protected from the GST tax by the effective date rules and that is treated as having an inclusion ratio of zero, and one of which is not effective date-protected and that has an inclusion ratio of one. Treas. Regs. § 26.2642-6(g). Such a trust may be severed into two trusts in accordance with the rules for nonqualified severances, into one trust with an inclusion ratio of one and another with an inclusion ratio of zero. See Treas. Regs. § 26.2654-1(a)(3), and discussion of proposed amendments to those regulations, below.
**Income Taxation of Qualified Severances.** The exchange of a beneficiary’s interest in one trust for an interest in one or more new trusts created by a qualified severance could be deemed a taxable exchange of assets by a broad reading of Section 1001. The income tax treatment of a trust severance is not determined by whether or not it is a qualified severance. Nonetheless, the same regulations project amends the regulations under Section 1001, to explain when a trust severance will result in a realization of gain. Treas. Regs. §§ 1.1001-1(h), 26.2642-6(a). New Treas. Regs. § 1.1001-1(h) states that no severance of a trust is a taxable exchange of property for other property differing materially either in kind or in extent if--(i) state statutes or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) mandatory or discretionary non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding permitted under the GST regulations), is authorized by an applicable state statute or the governing instrument. Treas. Regs. § 1.1001-1(h)(1). This new rule applies to severances occurring on or after August 2, 2007. Taxpayers may apply this new rule to prior severances that occurred after August 24, 2004, at their own option.

**Non-Qualified Severances.** The 2004 proposed regulations substituted the qualified severance rules for the severance rules already contained in the regulations, but many commentators noted that the qualified severance rules addressed situations quite distinct from those affected by the existing severance rules and were intended to be supplementary. The commentators noted that qualified severances are effective prospectively from the date of severance, while the existing severance rules for trusts includible in the grantor’s gross estate are effective retroactively from the date of death. Therefore, the final regulations are supplementary to the existing regulations regarding severances of trusts that are effective under state law. See Treas. Regs. § 26.2654-1(b). The IRS and Treasury did, however, propose a set of amendments to the pre-existing regulations, to amend the rules for mandatory and discretionary severances of trusts includible in the transferor’s gross estate, effective retroactively to the transferor’s date of death. The new proposed regulations also state that trusts resulting from a non-qualified severance will still be treated as separate trusts for GST tax purposes, if the resulting trusts are recognized as separate trusts under applicable state law. Each such resulting trust will have the same inclusion ratio immediately after the severance as the original trust immediately before the severance. Nevertheless, the GST exemption allocated after the severance may
be allocated separately to one or more of the resulting trusts, taxable events with respect to one or more of the resulting trusts will not affect the other resulting trusts, and the resulting trusts will otherwise be treated as separate trusts for GST tax purposes. Prop. Treas. Regs. §§ 26.2642-6(h); 26.2654-1(a)(1)(i), 26.2654-1(a)(1)(iii), 26.2654-1(a)(5), Ex. 8.

**Note.** The qualified severance rules apply to downstream severances. The existing rules under Section 2654 apply to severances involving trusts includible in a decedent’s gross estate, and severances that are effective on the date of death. The qualified severance rules apply where you discover that you did not allocate enough exemption to an existing trust, and want to sever going forward. These rules creates two or more new resulting trusts that are treated as separate beginning on the designated severance date. This can utilize GST exemption more effectively because the GST-exempt trust can be invested and administered in a manner that minimizes current distributions to non-skip person beneficiaries and that maximizes distributions to skip-persons. The non-exempt trust can be invested and administered to maximize current distributions to non-skip persons. The preservation of the existing rules for non-qualified severances removes a serious question that had been raised by the 2004 proposed regulations regarding the use of a revocable trust, rather than a testamentary trust, to create generation-skipping transfers. The final regulations make it clear that a revocable trust may be severed in the same manner as a testamentary trust for GST purposes. Practitioners should carefully study these regulations, as they will quickly become a fundamental element in planning and administering generation-skipping trusts.

See also Zaritsky, “Final and Proposed Regs on Division of Trusts Facilitate GST Tax Planning,” 19 Prob. Pract. Rptr. 1 (Sept. 2007).

IV  CHAPTER 14. SPECIAL VALUATION RULES

**Code § 2702. Trusts with Reserved Interests**

1 Proposed Regulations on How Much Is Included in Grantor’s Gross Estate for Retained Annuity or Unitrust Interest. 72 Fed. Reg. 31487 (June 7, 2007)

The Treasury, however, has now proposed regulations that would cause the principal of a GRAT, QPRT, or other retained annuity, income or unitrust interest to be included in the gross estate of a grantor who died during the term of the reserved income, annuity or unitrust interest, under Section

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2036(a), rather than under Section 2039, in most cases. The regulations generally follow the rules first established for charitable remainder trusts, and concluded that where Sections 2039 and 2036(a) both apply to a trust, other than certain employment-related trusts, Section 2036(a) should be applied.

The proposed regulations provide that, if a decedent transfers property during life to a trust and retains the right to an annuity, unitrust, or other income payment from, or retains the use of an asset in, the trust for the decedent’s life, for a period that does not in fact end before the decedent’s death, or for a period not ascertainable without reference to the decedent’s death, the decedent has retained the right to income from all or a specific portion of the property transferred as described in section 2036. The decedent’s gross estate in such cases will include that portion of the trust corpus, valued as of the decedent’s death (or the alternate valuation date, if applicable) required to yield that annual payment (or use) using the appropriate section 7520 interest rate. For example, a 6-year $10 million GRAT created in July, 2007 (six percent Section 7520 rate) would create a zero gift if the annuity (payable annually) were 20.33636% of the initial value of the trust fund. If the grantor dies after five years and the interest rate under Section 7520 is then nine percent, the grantor’s gross estate will include the lesser of the trust fund at that time or $25,595,729.59 (the principal that would pay a nine percent income interest equal to $2,033,636 per year). The proposed regulations illustrate these principles with several examples, involving a charitable remainder annuity trust, a grantor retained annuity trust, a charitable remainder unitrust, a grantor retained income trust, and a qualified personal residence trust. Prop. Treas. Regs. §20.2036-1(c)(2)(ii). The substantive proposed regulations will apply to the estates of decedents for which the valuation date of the gross estate is on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. Prop. Treas. Regs. §20.2036-1(c)(3).

Note. The IRS rejected the application of Section 2039 in such cases for several reasons. First, Section 2039 appears to have been intended to address annuities purchased by or on behalf of the decedent and annuities provided by the decedent’s employer. Second, the interests retained by grantors in the types of trusts described in this guidance are more similar in most relevant respects to the interests addressed under Section 2036 than those most clearly addressed under Section 2039.

This resolves one of the few uncertainties in using GRATs has been the estate tax treatment of the trust if the grantor dies during the reserved annuity term. It is important because the section under which the inclusion in the grantor’s gross estate is determined may directly affect the basis of the trust assets in the grantor’s gross estate. Section 2036 requires inclusion of the underlying trust assets, giving a basis step-up directly to the assets that
require them. Section 2039 may only provide a basis increase for the annuity itself, rather than the underlying assets, and it is unclear whether a basis step-up is available for annuity interests at all, as they are arguably items of income in respect of a decedent. See Int. Rev. Code §1014(c).

Many practitioners believed that the GRAT should be treated like a charitable remainder annuity trust, which include in the grantor’s gross estate that a portion of the trust assets (up to 100 percent) that would be required to produce an income interest equal to the annuity interest, determined under the Section 7520 actuarial tables. Rev. Rul. 82-105, 1982-1 C.B. 133; see also Rev. Rul. 76-273, 1976-2 C.B. 268. The IRS, however, had issued several private letter rulings that included the value of the entire trust fund in the grantor’s gross estate, under Section 2039(a). See, e.g., PLR 9345035, 9451056, 9448018, and Field Serv. Adv. 200036012 and 200210009. These proposed regulations demonstrate, once again, that private rulings are not necessarily the best evidence of serious IRS positions.

Also, the proposed regulations fail to address at least two important issues. First, is the analysis different for a Walton-GRAT, in which the annuity is continued to the grantor’s estate, if the grantor dies during the annuity term? Could the remaining payments be included separately under Section 2033, while the value of the trust corpus is included under Section 2036(a)(1). This produces an unreasonable result, but the IRS does occasionally take unreasonable positions.

Second, how does one value a GRAT with increasing payments? Do you calculate the amount includible based on the annuity due on the date of death, or do you use the greater payments that would have been made had the grantor lived the entire annuity period?


2 IRS Applies QPRT Rules to Sale of Remainder Interest. PLR 200728018 (July 13, 2007)

The grantors were a married couple, Husband and Wife, who held certain real estate as tenants by the entireties. The property was subdivided into two parcels, one of which constituted a second residence of the couple. No structures on the property were used for commercial purposes. The couple proposed to execute Trust, which was a qualified personal residence trust under the regulations, which would hold the property for their lifetime use of the residence. The QPRT provided that, upon the death of the survivor of Husband and Wife, the trustees will distribute the property to the trustees of Zaritsky, The Year in Review – Page 73
A Purchasing Trust, which was previously established by Husband and Wife for the benefit of their descendants and certain charities. After executing the QPRT, Husband and Wife will transfer the property to the QPRT in exchange for the transfer by Purchasing Trust to Husband and Wife of cash and marketable securities that have an aggregate fair market value on the date of transfer equal to the value of the remainder interest in the QPRT based on the fair market value of the property on the date of transfer (as determined by an expert appraiser) and the actuarial principles of Section 7520.

The IRS stated that the trust was a QPRT and that the valuation rules for such trusts applied to the sale of the remainder interest to Purchasing Trust. Therefore, the transfer of the remainder interest in the QPRT to Purchasing Trust in exchange for cash and marketable securities would not constitute a taxable gift by Husband and Wife to Purchasing Trust.

Note. This ruling is interesting, but not very useful, because the IRS expressly expressed no opinion on whether the trust funds would be included in the gross estate of Husband or Wife under Section 2036, or whether the appraiser correctly determined the fair market value of the parcel of property. The IRS views on those issues are the real open issue in a sale of a remainder interest.

V INCOME TAXES

A Code § 1. Income Tax Rates


The kiddie tax applies to all unearned income of a person who is under the age of 19 (24, in the case of a student), and whose earned income does not exceed one-half of the amount of his or her support. This provision applies to taxable years beginning after May 25, 2007.


The 2008 income tax rates for trusts and estates are:

<table>
<thead>
<tr>
<th>Income</th>
<th>Rate</th>
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</thead>
<tbody>
<tr>
<td>Not over $2,200</td>
<td>15%</td>
</tr>
<tr>
<td>Over $2,200 but not over $5,150</td>
<td>$330 + 25% on excess over $2,200</td>
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</tbody>
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Over $5,150 but not over $7,850  $1,067.50 + 28% on excess over $5,150
Over $7,850 but not over $10,700  $1,823.50 + 33% on excess over $7,850
Over $10,700  $2,765 plus 35% on excess over $10,700

Int. Rev. Code § 1(e). Also, the kiddie tax applies to income over $900 (standard deduction for a dependent under Int. Rev. Code § 63(c)(5)), and a parent may elect to include in gross income up to $9,000 of a child’s income. Int. Rev. Code § 1(g)(4)(A).
B  Code § 67. Miscellaneous Itemized Deductions


Proposed Regulations. The Treasury has proposed regulations dealing with what expenses of a trust or estate are subject to the two percent floor on miscellaneous itemized deductions. The regulations exempt from the two percent floor those costs that could not have been incurred by an individual in connection with property not held in a trust or estate, based on the type of product or service in question, rather than how it is characterized.  Prop. Treas. Regs. § 1.67-4(b). For example, the two percent floor does not apply to costs in connection with fiduciary accountings, judicial or quasi-judicial filings required as part of the trust or estate administration, fiduciary income tax returns, the division or distribution of income or principal among beneficiaries, trust or will contests or constructions, fiduciary bond premiums, and communications with beneficiaries regarding trust or estate matters. The expenses that are subject to the two percent floor include such items as costs associated with the 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.  Id. A single fee that covers both costs that are and are not unique to a trust or estate must be allocated between the two categories, using some reasonable method.  Prop. Treas. Regs. § 1.67-4(c). The regulations will apply to payments made after the date the final regulations are published in the Federal Register.  Prop. Treas. Regs. § 1.67-4(d).

Note. The general rule of the proposed regulations comes as no surprise, as it is consistent with the position espoused by the IRS in a long line of cases. It is, however, incorrect, under the Supreme Court’s decision in Knight v. Comm’r, discussed below, and likely will be changed in the final regulations to the “not commonly incurred by individuals” test preferred by the Court. Also, note that the requirement that a bundled fee be allocated, however, is new and will...
require fiduciaries to keep detailed records of the types of activities on which time is expended.

_Knight v. Comm’r._ William Rudkin created an irrevocable trust for the benefit of his family and funded it with the proceeds of the sale of his interest in Pepperidge Farm Corporation to Campbell Soup Company. Michael J. Knight, the trustee, was expressly authorized by the trust instrument to invest in any type of investment that was suitable for fiduciary investment, and to employ such advisors as the trustee deemed appropriate. Applicable state (Connecticut) law imposed the prudent investor standard on the trustees who were not themselves skilled investors. The trustee then hired an investment advisor to manage the trust assets. The trustee paid the advisor more than $28,000, and deducted the payments as miscellaneous itemized deductions. The IRS stated that the deductions were subject to the two percent floor.

The Tax Court (Judge Wherry), in a reviewed opinion, held for the government. The court stated that the investment expenses paid by the trust were clearly paid or incurred in connection with the administration of a trust or estate, but that they were not incurred because the taxpayer was a trust. The court stated that Section 67(e) is designed to permit the trust to deduct without regard to the two-percent floor, only “those costs which are _unique_ to the administration of an estate or trust” and that individual investors routinely incur costs for investment advice as an part of their investment activities. Therefore, the court stated, such expenses could never be deemed unique to the administration of an estate or trust, even if the fiduciary feels compelled to incur such expenses in order to meet the prudent person standards imposed by state law.

The Second Circuit affirmed, stating that Congress could clearly have created a “but for” causal test, but that the language of the Code does not do so. The court stated that “the plain meaning of § 67(e)(1)’s second clause” applies the two-percent floor to any expenses of at type that could be incurred if the property were held individually. The statute, the court stated, demands an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are “incapable of incurring.” The court expressly rejected the focus by the Federal and Fourth Circuits on whether the costs were “not customarily incurred outside of trusts.” The Second Circuit refused a request for rehearing.

A unanimous Supreme Court (C.J. Roberts) affirmed the decision of the Second Circuit, though it rejected the test applied by that
court and adopted, instead, the test applied by the Federal and Fourth Circuits. The Court stated that the question raised is whether a particular type of cost incurred by a trust (in this case, investment advice) “would not have been incurred” but for the fact that the taxpayer is a trust or estate. This determination amounts to predicting what would happen if the trust’s property were held by an individual. In making a prediction, the word “would” is best read to express concepts such as custom, habit, natural disposition or probability. This is the direct import of the statutory language, even if it is not clearly stated. The Court rejected the Second Circuit’s approach, which asked whether the cost at issue could have been incurred by an individual, because the words “would” and “could” do not mean the same thing. Further, the Second Circuit’s approach would render meaningless the requirement of Section 67(e) that the expense be incurred in connection with the administration of the trust or estate. The Court rejected the trustee’s argument that the proper inquiry is whether a particular expense of a particular trust was caused by the fact that the property was held in trust, because the statute does not adopt a causation test, but rather looks to the whether an individual would have incurred such costs in the absence of a trust. Also, the trustee’s approach would render virtually all trust-related expenses fully deductible, which is inconsistent with the purpose of the 2% floor. The Court then stated that the trustee had failed to establish that it is uncommon or unusual for individuals to hire an investment adviser. The trustee tried to distinguish trust investment advisory fees from those incurred by individuals, because the trustee hired an investment adviser in effectuation of his state law fiduciary duty to manage trust investments “as a prudent investor would.” The Court noted that the prudent investor rule looks to what an individual investor would do, rather to what a prudent trustee would do. Further, the Court noted, nearly all of a trust’s expenses are incurred because the trustee has a fiduciary duty to incur them; otherwise, there would be no reason for the trust to incur the expense in the first place. The Court ultimately agreed with the view adopted by the Fourth and Federal Circuits, that costs incurred by trusts escape the 2% floor if they would not “commonly” or “customarily” be incurred by individuals. Scott v. U.S., 328 F.3d 132 (4th Cir. 2003); Mellon Bank, N.A. v. U.S., 265 F.3d 1275 (Fed. Cir. 2001).

Notice 2008-32. The IRS provided guidance on the treatment of bundled investment advisory costs and other expenses subject to the two percent floor under Section 67, effective until final regulations are re-
leased. The notice states that, for tax years beginning before January 1, 2008, taxpayers need not separate bundled fiduciary fees between those that are and those that are not subject to the two percent floor under Section 67; bundled fiduciary fees can be deducted in full without regard to the Section 67 floor. The notice extends the comment period on the proposed regulations until May 27, after which the IRS stated that it would publish final regulations “without delay.” The IRS stated that the final regulations will include safe harbors for allocating some portion of bundled fees to investment advice, and asked for specific comments on what would be a reasonable percentage. The notice also stated that, while bundled fees are fully deductible for taxable year 2007, it adds that two percent floor expenses that are "readily identifiable" must be treated separately from the otherwise bundled fee.

C Code § 101. Taxation of Life Insurance Proceeds


The ruling posed two situations. In Situation 1, the grantor created two trusts, TR1 and TR2, each of which was a wholly-owned grantor trust under Section 671. (The IRS did not state the reason for grantor trust status, nor was the basis of this status relevant in the ruling.) The trustee of TR2 transferred a life insurance policy on the life of the grantor’s to the trustee of TR1, in exchange for a payment of cash held by TR1. In Situation 2, the facts were the same as those in Situation 1, except that only TR1 was a grantor trust; TR2 was not a grantor trust.

The IRS ruled that in neither case was the transfer of the life insurance policy by the trustee of TR1 to the trustee of TR2 a transfer-for-value, under Section 101, and the proceeds of the transferred policy remained excludible from the beneficiary’s gross income. The IRS explained that life insurance proceeds are usually excludible from the beneficiary’s gross income under Section 101(a)(1), but that they are fully taxable if the policy is acquired in a transfer for valuable consideration. Int. Rev. Code § 101(a)(2). The proceeds of a policy acquired in a transfer for value are includible in the beneficiary’s gross income, to the extent that the proceeds exceed the consideration paid for the policy and the premiums and other amounts thereafter paid by the transferee. The transfer for value rule, however, does not apply to a transfer of a life insurance policy to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation

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in which the insured is a shareholder or officer. The IRS reviewed Rev. Rul. 85-13, in which a grantor bought assets from a grantor trust in exchange for the grantor’s unsecured promissory note. Rev. Rul. 85-13, 1985-1 C.B. 184. The IRS in that ruling treated the grantor as the deemed owner of the trust under Section 675(3), because the grantor borrowed the corpus of the trust without adequate security. The IRS then explained that, the grantor was also treated as the owner of the trust assets for federal income tax purposes. The grantor, therefore, would be deemed to own the consideration both before and after the transaction, so that the exchange of a promissory note for the trust assets could not be taxed as a sale for Federal income tax purposes. The IRS then applied this rule to the two situations in the ruling. In Situation 1, the grantor would be treated as the owner of the assets of both trusts before and after the transaction. Therefore, there could be no transfer for income tax purposes, and the transfer for value rule of Section 101(a)(2) would not apply. In Situation 2, there was a transfer, because the grantor was deemed to own only the assets of TR1, and not those of TR2. The grantor was deemed to own deemed to own the cash held by TR1 before the exchange, and to own the insurance policy held by TR1 after the exchange. In this situation, there was a transfer of a life insurance policy for a valuable consideration, but the transfer was deemed made to the insured personally. Therefore, the transfer for value rule did not apply.

Note. Rev. Rul. 2007-13 may make it easier to solve at least two of the annoying tax and nontax problems that are often raised by the use of irrevocable life insurance trusts. First, such trusts must be irrevocable, but the facts and circumstances of the grantor’s family are constantly changing. This lack of flexibility in an irrevocable trust instrument can be addressed at least partially by naming a trusted and trustworthy person to serve as trustee, and then giving the trustee broad authority to determine when distributions should be made, to whom they should be made and how large they should be. Even such flexibility, however, does not necessarily address all types of changes in circumstances. One technique sometimes used to change the terms under which a life insurance policy is held in trust is to create and fund a second trust, and then to have the trustee of the second trust buy the insurance policy from the trustee of the first trust. Thus, the second trust now would hold the policy on those terms and for those persons that the grantor deems most appropriate. The first trust would hold a cash sum equal to the fair market value of the policy purchased by the second trust.

Rev. Rul. 2007-13 helps assure that such a transaction is not likely to constitute a transfer for value, under Section 101(a)(2), as long as the new trust is a grantor trust for Federal income tax purposes. On the other hand, the trustee of the first trust must be careful to assure that the purchase price paid for the policy constitutes full and adequate consideration for the policy.

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being transferred, in order to avoid a fiduciary liability to the beneficiaries for having wasted trust assets. Full and adequate consideration is the fair market value of the policy. This is not necessarily the gift tax value of the policy under the applicable regulations, but rather the amount that the trustee could obtain from an independent third-party upon a sale of the policy. See Treas. Regs. § 25.2512-6(a). A strong secondary market for life insurance policies has grown in the past few years, and trustees should determine the price that can readily be obtained for a policy, before setting the price at which that policy will be sold to another trust. Also, the trustee must act independently and carefully in evaluating, contracting for and effecting this transfer; any suggestion that the grantor actually controlled the trustee’s actions could impute the trustee’s incidents of ownership over the policy to the grantor, creating a risk of estate taxation under Section 2042.

A second problem often raised by irrevocable life insurance trusts is avoiding the estate taxation on the proceeds of a life insurance policy the incidents of ownership over which are transferred within three years of the grantor’s death. Int. Rev. Code § 2035(a)(2). Some practitioners have tried to avoid this limitation by having the grantor sell the policy to the trustee for its fair market value; Section 2035(a)(2) does not apply to a transfer for full and adequate consideration in money or money’s worth. Rev. Rul. 2007-13 helps minimize the risk that such a sale would be a transfer for value for income tax purposes. Practitioners must, however, remember that this sale will remove the proceeds from the grantor’s gross estate only if the selling grantor receives full and adequate consideration in money or money’s worth. This, again, may be more than the gift tax value of the policy, and may require that the trustee make diligent inquiries into the value of the policy if sold in the secondary market for insurance policies. Also, even if the policy is sold for its full and adequate consideration, the IRS has previously claimed that the appropriate measurement of full and adequate consideration is the amount that would be included in the grantor’s gross estate if the transaction did not occur. This would be the full amount of the proceeds, rather than the fair market value of the policy itself. Compare IRS arguments in U.S. v. Allen, 293 F.2d 916 (10th Cir. 1961) and U.S. v. Past, 347 F.2d 7 (9th Cir. 1965); with IRS approval of sales for the policies’ gift tax value in PLRs 9413045 and 200606027. Therefore, practitioners should take comfort in Rev. Rul. 2007-13, as creating a comfortable way to avoid the transfer for value rule when assigning life insurance policies to a life insurance trust, but should not overlook the estate tax issues that can be at least as challenging as the income tax issues, in such transactions.

The Pension Protection Act of 2006 adopted two new sets of income tax rules on employer-owned life insurance. Section 101(j) treats certain death benefits under such arrangements as taxable income, and Section 264(f) requires pro rata allocation of interest expense to policy cash values for purposes of the income tax deduction for interest paid on loans on such policies. Both rules apply to plans made or substantially modified after August 17, 2008. The IRS now stated that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement, will not be treated as a material change in the life insurance contract for purposes of the employer-owned life insurance rules of Section 101(j). Thus, if the parties to a split-dollar life insurance arrangement may modify the terms of the arrangement without modifying the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of Sections 101(j) and 264(f), even if the modification is treated as a material modification of the split-dollar arrangement for purposes of the split-dollar regulations effective date.


Jones was lead counsel in the defense of Timothy McVeigh against charges that he participated in the bombing of the Alfred P. Murrah Federal Building in Oklahoma City. During the course of his defense of McVeigh, Jones accumulated a file that included copies of extensive materials received from the Government and delivered them Jones, including statements of FBI interviews with witnesses, documentary evidence, medical examiner’s reports, color and black and white photographs, audio and video cassettes, a copy of a text of the Declaration of Independence containing notes made by McVeigh, copies of investigative materials compiled by the Government in its prior investigation of David Koresh, and copies of Government expert summary reports. None of the materials were originals, and none were prepared personally by the taxpayer or for him by anyone under his direction. These materials were always provided to the taxpayer by the Government, and copies
were also held by several other parties. Jones always permitted his client to see the materials upon request, but McVeigh never held any part of the files for more than 72 hours. Jones contributed the documents and materials to the University of Texas at Austin, subject to certain restrictions on the disclosure of certain parts of the collection. Jones obtained an independent professional appraisal valuing the documents at $294,877. The appraiser spent one day reviewing some of the documents, and he discounted the preliminary evaluation by 50 percent because none of the materials were originals. The appraiser did not take into consideration that multiple copies of the materials had been distributed to various attorneys during the course of the trial. Jones deducted $294,877, and the IRS disallowed the deduction.

The Tax Court (Judge Cohen) held for the IRS, finding that Jones did not have a property right in the contents of McVeigh’s file, and thus could not deduct the value of that file given to charity. The court noted that this was a case of first impression, and that no prior court had ever directly ruled on the property rights of an attorney in files related to the representation of the attorney’s client, in this context. The court rejected Jones’s contention that he owned the files because he had possession of the files and he had never allowed his client to possess the files for any extended period. The court noted that, while such possession may be prima facie evidence of ownership in general personal property matters, it did not apply to attorney’s files because of the fiduciary relationship between an attorney and his or her client. The IRS argued that Jones had received the materials as an agent of McVeigh during the course the trial bombing and that the materials belonged to McVeigh, rather than Jones. The Tax Court agreed, notwithstanding the argument by taxpayer that a client may possess a right of access to information in a case file, but the attorney is the rightful owner of the case files and, in any event, may keep copies of the materials in the files. Citing Swift, Currie, McGhee & Hiers v. Henry, 581 S.E.2d 37, 39 (Ga. 2003) (citing Resolution Trust Corp. v. H---, P.C., 128 F.R.D. 647 (N.D. Tex. 1989); In re Kaleidoscope, Inc., 15 Bankr. 232, 241 (Bankr. N.D. Ga. 1981); rev’d on other grounds 25 Bankr. 729 (N.D. Ga. 1982); In re Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn L.L.P., 689 N.E.2d 879, 882-883 (N.Y. App. Div. 1997)). The Tax Court did note, however, that some courts have held that ownership of a case file is divided between attorney and client, and that an attorney’s work product, including internal legal memoranda and preliminary drafts of documents, remains the property of the attorney; though McVeigh has superior property rights in the end product of the attorney’s representation, which includes finalized legal documents, pleadings filed, correspondence among parties, and other papers “exposed to public light by the attorney to further [the] client’s interests.” See In re Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn L.L.P., 689 N.E.2d at 881-882 (quoting


The IRS added to its list of areas in which it will not issue private rulings, the income, gift and estate tax treatment of a charitable contribution of a limited partnership interest or interest in a limited liability company.


On August 14, 2007, the IRS released notices identifying two “transactions of interest” the involvement in which trigger disclosure rules, list maintenance requirements and possible penalties under Sections 6011, 6111 and 6112. The first, Notice 2007-72, involves situations in which a taxpayer=s advisor owns all of the membership interests in an LLC that holds real property that may be subject to a long-term lease, and sells the taxpayer a right to become successor member after a number of years. The taxpayer holds the successor rights for more than a year, and then transfers them to a charity, claiming an income tax deduction substantially higher than the amount that the taxpayer paid for the rights, based on an appraisal based on the value of the underlying real property. The IRS explained that its concerns are based on the large discrepancy between the amount paid by the taxpayer and the amount claimed as a charitable deduction, the possible mischaracterization of the different ownership interests in the LLC, the charity=s agreement to retain the membership interests for a specific period of time, and whether the charity later sells the interests to a party selected by the taxpayer or the taxpayer=s advisor. The charitable contribution arrangement was identified as transactions of interest effective August 14, but the IRS stated that disclosures of these deals or substantially similar deals must be made by taxpayers entering into the transactions on or after November 2, 2006.

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The IRS has provided guidance regarding the Pension Protection Act of 2006 rules that accelerates and increases the tax benefits of contributions of qualified conservation contributions in calendar years 2006 and 2007. The amount of charitable contributions that individual taxpayers can deduct in a taxable year was increased from 30 percent of the contribution base (modified adjusted gross income) to 50 percent (100 percent for contributors who are farmers or ranchers). The new law also extends the carryover period for unused deductions for such contributions from five years to 15 years. The 100 percent limitation applies to contributions made after August 17, 2006, only if the property is required to remain available for agriculture or livestock production; the 50 percent limitation applies otherwise. Int. Rev. Code § 170(b)(1)(E); Pub. L. No. 109-280, 109th Cong., 2nd Sess., 120 Stat. 780 (2006). The Notice contains a series of questions and answers, the key points of which include the following:

- Applying the Percentage Limitations if Other Charitable Gifts Made in the Same Year. The notice explains that a qualified conservation contribution may be taken into account under the percentage limitations and the carryover rules in a taxable year in which an individual has made a qualified conservation contribution, only after taking into account contributions subject to the limitations in Section 170(b)(1)(A), (B), (C), and (D). Thus, for example, an individual who has a $100x contribution base and who makes $60x in cash contributions to 50 percent organizations and a qualified conservation contribution of capital gain property worth $80x, may, if not a qualified farmer or rancher, deduct $50x of the cash contributions and none of the conservation easement. That taxpayer could carryforward $10x of cash contributions (for up to five years), and $80x of qualified conservation contribution (for up to 15 years). A taxpayer who was a qualified farmer or rancher could deduct both $50x of cash and $50x of the conservation easement in the year of the gift, carrying forward $30 of the conservation easement.

- Qualified Contribution. The 50 percent and 100 percent special limitations apply only to qualified conservation contributions of a qualified real property interest to a qualified organization, exclusively for conservation purposes. A qualified real property interest is the...
taxpayer’s entire interest subject to a qualified mineral interest, a remainder interest or a perpetual restriction on the use which may be made of the real property. A gift of the taxpayer’s entire interest in the property without a reservation of a qualified mineral interest does not qualify for the special limitations.

Qualified Farmer or Rancher. The 100 percent limitation applies only to gifts by an individual who is a qualified farmer or rancher, which is defined as an individual whose gross income from the trade or business of farming (See Section 2032A(e)(5)) in the taxable year of the contribution is more than 50 percent of his or her total gross income. Income from a sale (including a bargain sale) of a conservation easement is not gross income from the trade or business of farming, because selling easements is not the trade or business of farming. Income from the sale of timber is farming income, however. Income from fees to permit hunting or fishing on the property is not gross income from farming.

Pass-Through Entities. A qualified conservation contribution made by a pass-through entity such as a partnership or S corporation, looks to the partners, shareholders or other members to determine whether it is a gift made by a qualified farmer or rancher.

Qualifying for the 100 Percent Limit. A qualified conservation contribution need not be of property used or available for use in agriculture or livestock production in order for a qualified farmer or rancher to qualify for the 100 percent limitation. Section 170(b)(1)(E)(iv)(I) requires that an individual be a qualified farmer or rancher to qualify for the 100 percent limitation, but it does not require that the qualified conservation contribution be of property used or available for use in agriculture or livestock production. If the property is used or available for use in agriculture or livestock production, the restriction described in § 170(b)(1)(E)(iv)(II) may apply.

Property Used or Available for Agriculture. Property used or available for use in agriculture or livestock production includes the portions of the property upon which are located any of the following: dwellings used for family living by the farmer or rancher, a lessee that operates the property, or their employees; other types of buildings used for agriculture or livestock purposes; and roads throughout the property. A qualified farmer or rancher can comply with the requirement that a qualified conservation contribution of property used
or available for use in agriculture or livestock production be subject to a restriction that the property remain available for such production, by including in the document of conveyance prohibitions against construction or placement of buildings (except those used for agriculture or livestock production purposes, or dwellings used for family living by the qualified farmer or rancher, a lessee that operates the property, or their employees), removal of mineral substances in any manner that adversely affects the property’s agriculture or livestock production potential, and other uses detrimental to retention of the property for use in agriculture or livestock production. See, e.g., Treas. Regs. § 1.170A-14(f), Ex. 5.

Facade Easement Cannot be Valued by Applying a Percentage to the Value of Underlying Property Before Contribution under Section 170(h). CCA 200738013 (Sept. 21, 2007).

Donors attempted to substantiate their deduction under Section 170(h) for charitable contributions of facade easements, by using appraisals that applied a percentage to the value of the property before the contribution. The appraisers relied on a statement that it is “generally recognized” that facade easement contributions result in a loss of value of between 10 percent and 20 percent of the underlying property.

The IRS Office of Chief Counsel stated that Treas. Regs. § 1.170A-14(h)(3)(i) require that the value of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. The fair market value of the easement is based on the sales price of comparable easements, if there is a substantial record of sales of comparable easements. Otherwise, the fair market value of a perpetual conservation restriction is generally equal to the difference between the fair market value of the property before the granting of the restriction and the fair market value of the property after the granting of the restriction. This is generally referred to as the “before and after” approach. See Hilborn v. Comm’r, 85 T.C. 677 (1985); and Rev. Rul. 73-339, 1973-2 C.B. 68, clarified in Rev. Rul. 76-376, 1976-2 C.B. 53. An appraisal of a facade easement that values the easement as a percentage of the value of the underlying fee before grant of the easement, without reference to the actual value of the underlying fee after the grant, cannot be used to substantiate the easement’s fair market value under tax code Section 170(h). The IRS explained that certain tax advisers and charitable organizations are misinforming the public about the valuation of contributed facade easements by indicating that the service allows tax deductions of approximately 10 percent to 15 percent of the fair market value of the underlying property. The IRS added that there does not exist a “gener-
ally recognized” percentage by which an easement reduces the value of property. The value of a donated facade easement must be individually substantiated with a full appraisal of the value of the easement, and this is generally obtained by determining the values of the underlying fee both before and after the contribution. See *Nicoladis v. Comm'r*, T.C. Memo. 1988-163 (adopting a 10% discount proposed by both parties, but adding that there is no general ten-percent discount for facade easements.)

**E** Code § 529. Education Savings Accounts

**IRS Issues Advance Notice of Proposed Regulations on Abuse of Section 529 Education Savings Accounts.** 73 Fed. Reg. 3441 (Jan. 18, 2008)

The IRS issued advance notice of its intention to propose regulations curtailing possible abuses of the special rules for Section 529 education savings accounts. The advance notice states that the IRS will address in these proposed regulations such issues as:

- using the ability to change the beneficiary of a Section 529 account to establish multiple accounts for the same designated beneficiary;
- using a Section 529 account as a retirement savings account;
- contributing to a Section 529 account for the contributor’s benefit and then changing the beneficiary to someone assigned to the same or a higher generation without a taxable gift;
- treating contributions to a Section 529 account as completed gifts even when the contributor retains the power to withdraw the contributed money.

The IRS also stated that it will issue general anti-abuse rules that will apply whenever a taxpayer creates or uses a Section 529 account for transfer tax avoidance.

**F** Code § 664. Charitable Remainder Trusts

1 **Proposed Regulations Detail 100 Percent Excise Tax on UBTI of a Charitable Remainder Trust.** 73 Fed. Reg. 12313 (March 7, 2008)
The proposed regulations provide that charitable remainder trusts with UBTI in taxable years beginning after December 31, 2006, are exempt from Federal income tax, but are subject to a 100-percent excise tax on the UBTI of the charitable remainder trust. Prop. Regs. § 1.664-1(c)(1). The excise tax is reportable on Form 4720, “Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.” The proposed regulations clarify that the excise tax imposed upon a charitable remainder trust with UBTI is treated as paid from corpus and the trust income that is UBTI is income of the trust for purposes of determining the character of the distribution made to the beneficiary. Prop. Regs. § 1.664-1(c)(1). The proposed regulations provide examples illustrating the tax effects of UBTI on a charitable remainder trust for taxable years beginning after December 31, 2006. In one example, a charitable remainder annuity trust has $60,000 of ordinary income, including $10,000 of income from a partnership that constitutes unrelated business taxable income to the trust. The trust has no deductions that are directly connected with that income, but it has $16,000 of deductible administration expenses. The trust’s net ordinary income is $44,000 ($60,000 - $16,000). The trust’s UBTI is $9,000 ($10,000 – the $1,000 deduction under Section 512(b)(12)). Undistributed ordinary income from prior years is $12,000 and undistributed capital gains from prior years are $50,000. The noncharitable annuity is $100,000 for the taxable year. The trust is liable for a $9,000 excise tax on its UBTI, and the $100,000 distribution to the noncharitable beneficiary is deemed to consist of: $56,000 of ordinary income ($44,000 from current year plus $12,000 from prior years), and $44,000 of capital gains. The $9,000 excise tax is allocated to corpus. Prop. Regs. § 1.664-1(c)(1)(Ex. 1). The second example involves a charitable remainder trust that sells real estate generating gain of $40,000. Because the trust had obtained a loan to finance part price of the real estate, some of the income from the sale is treated as debt-financed income under Section 514 and thus is UBTI. The UBTI under Section 514 is $30,000. The trust has UBTI of $29,000 for the taxable year ($30,000 minus the $1,000 deduction under Section 512(b)(12)). The trust is subject to a $29,000 excise tax under Section 664(c), and the $29,000 of UBTI is allocated to corpus, and does not reduce the amount in any of the categories of income. The entire $40,000 is capital gain for purposes of Section 664 and is allocated accordingly. The proposed regulations will be effective for taxable years beginning after December 31, 2006.

The IRS added to its list of areas in which it will not issue private rulings, whether the early termination of a charitable remainder trust by the commutation of the interests of the parties is properly taxed as a sale or exchange and whether it causes the trust to cease to be a qualified charitable remainder trust.

3 Early Termination of CRUT by Commutation is not Self-Dealing. PLR 200739004 (Sept. 28, 2007)

D created a charitable remainder unitrust to pay the unitrust amount to individual beneficiaries for life. Upon the death of a beneficiary, the associated subshare was to be terminated and the remainder transferred to Charity, a public charity. In a private ruling request, the beneficiaries and Charity stated that administrative expenses and reduced investment performance led them to desire that the trust be terminated early. They proposed that, upon approval by a state court, the trust would be commuted, and each of the non-charitable beneficiaries would receive an actuarially-determined share of the trust’s assets, as would Charity. The actuarial shares would be determined based on the IRS actuarial tables for the month in which the commutation occurred, and none of the individual beneficiaries had any known medical condition which would render the tables inapplicable.

The IRS stated that the transaction takes the form of a distribution of present values of respective interests of each beneficiary and the charity, but that it is also in substance a sale of each unitrust interest to the charity. The disposition of each beneficiary’s interest is not part of a transaction in which the entire interest in the trust is transferred to a third party, so the adjusted basis in each interest is disregarded under Section 1001(e)(1) in determining the gain realized by each beneficiary. Therefore, each beneficiary will realize and recognize capital gain equal to the entire amount received for his or her interest. Payments to beneficiaries by a charitable remainder trust are usually an act of self-dealing, but because the distributions in this ruling are really an acceleration of the unitrust interests, the exception for distributions of the unitrust amount applies and the distributions are not an act of self-dealing.

Note. See also, e.g., similar results in PLRs 200441024, 200323035, 200314031 and 200252092.

4 Termination of Charitable Remainder Trust by Sale of Unitrust Interest to Charity is not Self-Dealing, But Gain Recognized. PLR 200733014 (Aug. 17, 2007)
H and W, a married couple created a net income charitable remainder unitrust with a make-up provision. The unitrust amount would be paid to the couple or the survivor, at which time the entire trust fund would be paid to Charity, a public charity. The trustee proposed to terminate the trust by the grantors transfer of their unitrust/income interest to the charity, in exchange for a distribution from the trust equal to the actuarial fair market value of their reserved unitrust/income interest. All computations would be based on the actuarial tables under Sections 664 and 7520, using the interest rate assumptions effective on the date of the commuting distributions. Assets distributed in-kind would be distributed on a pro-rata basis. Neither grantor was aware of any physical condition that would decrease the grantor’s normal life expectancy, confirmed by a statement from their personal physician.

The IRS concluded that the early termination of the trust would not disqualify it under Section 664, and that the distribution to the grantors would not be subject to the excise tax on self-dealing, because the charity is a public charity and the amount of the distributions is equal to the actuarial fair market value of the reserved unitrust/income interest. The IRS stated that the value of the reserved unitrust/income interest could be calculated by (i) finding the special factor indicated in Treas. Regs. § 1.7520-3(b)(1)(ii); and (ii) using the methodology stated in Treas. Reg. § 1.664-4 for computing the factor for a remainder interest in a unitrust, except that where Treas. Regs. § 1.664-4(a)(3) requires an assumption that the trust’s stated payout percentage is to be paid out each year, the grantors should instead assume a payout of a fixed percentage equal to the lesser of the trust’s stated payout percentage or the Section § 7520 rate for the month of termination. The special factor for the non-charitablepayout interest is 1 minus the special remainder factor. The IRS also stated that the transfer of the grantors’ unitrust/income interest to the charity, together with the trust distribution to the grantors, constituted a sale of the grantors’ interest in the trust (rather than a return of the grantor’s extant interest.) Thus, gain would be realized and recognized under Section 1001. Furthermore, the grantors’ basis would be zero, under Section 1015. The grantors had held their interest for more than one year, and the gain would be a long-term capital gain.

Note. The IRS stressed that state law allows for early termination under the facts presented pursuant to the Court order, and that those requirements would be met. Also, it is odd that the IRS required that the value of the unitrust interest take into account the net income limitation, as it is ignored in computing the deduction for the charitable contribution on the funding of the trust.

See also similar conclusions in PLRs 200725044, 200616035, 200614032, 200525014, 200314021.
G  Code § 671-679. Grantor Trusts


On August 14, 2007, the IRS released notices identifying two “transactions of interest” the involvement in which trigger disclosure rules, list maintenance requirements and possible penalties under Sections 6011, 6111 and 6112. The second, Notice 2007-73, involves two tax shelters in which taxpayers “toggle” on and off the grantor trust status of a trust, in order to avoid recognizing gain, or to claim a tax loss greater than actual economic loss. In one variation, the taxpayer buys four options, consisting of two sets of paired options that are expected to change in valuation in direct opposition to each other, such that when two options have gains, the other two will have offsetting losses. The taxpayer funds a grantor trust with the four options and a small amount of cash, giving a unitrust interest to a family member but retaining a remainder interest in the trust after a fixed relatively short term of years. The grantor retains the nonfiduciary right to reacquire trust assets by substituting assets of equivalent value, to become effective at a fixed future date. Shortly before the substitution power is to become effective, the grantor then sells the remainder interest to an unrelated buyer for its fair market value, which is equal to that of the options (the unitrust interest apparently being equal to the value of the cash contributed to the trust). No gain is reported, because the grantor allocates to the remainder interest an amount of the basis in the underlying assets equal to the sales price. The grantor claims that the sale terminates the grantor trust status under Section 673. The substitution power then becomes effective and restarts grantor trust status, and the grantor closes the loss options, recognizing and deducting the losses. The grantor again uses the same portion of the basis in the options that is attributable to the grantor=s interest, ignoring the fact that this basis has been used once already to offset the gain on the sale of that interest. The third-party then buys the unitrust interest from the grantor=s family member for an amount equal to the actuarial value of that interest, which is approximately equal to the remaining cash. The trust is then terminated and the assets distributed to the buyer, who claims a basis in them equal to the amount paid, thereby recognizing little or no gain on the exercise of the gain options. Thus, the grantor has sold the options for approximately what they cost the grantor, and claimed a significant deductible loss. In the second variation, the grantor contributes marketable securities, rather than options, to the trust. The grantor then substitutes appreciated assets for the marketable securities after the sale of the remainder interest but before the effective date of the "transaction of interest."
power of substitution. Both of these trust deals were identified as transactions of interest effective August 14, but the IRS said that disclosures of these deals or substantially similar deals must be made by taxpayers entering into the transactions on or after November 2, 2006.

H  Code § 685. Funeral Trusts


A qualified funeral trust can accept no more than $9,000 in contributions by or for the benefit of an individual, if the contract is entered into during 2008.

I  Code § 691. Income in Respect of a Decedent

Gain From Sale of Property Is Not Income in Respect of Decedent. PLR 200744001 (Nov. 2, 2007)

The decedent’s revocable trust entered into a contract to sell a plot of real property during the decedent’s life, with an intended closing date of X. Before X, however, a gas pipeline was discovered underneath the property, causing the parties to delay the sale until the parties could resolve a number of issues, such as providing for an easement for the pipeline company to enter onto the property and for the pipeline company to provide restitution for any damage to the property. Before the parties could resolve these issues, the decedent died. The sale actually closed after the date of death.

The IRS explained that the gain was taxable to the trustee, rather than to the decedent’s estate as IRD. IRD is generally defined as those amounts to which a decedent was entitled as gross income but which were not properly includible in computing the decedent’s taxable income for the taxable year ending with the date of the decedent’s death under the method of accounting employed by the decedent. Treas. Regs. § 1.691-1(b). The IRS explained that entering into a binding contract to sell real estate prior to the date of death typically converts the gain into IRD, even if the sale closes after the date of death, because all of the substantive prerequisites to the realization of the gain have been completed before death. Rev. Rul. 78-32, 1978-1 C.B. 198. In the ruling, there remained several important issues that had to be addressed before the sale of the property could be closed. Therefore, the gain was not IRD.

Rev. Rul. 2007-24. A, an individual, wished to do a tax-free exchange of a non-qualified annuity contract issued by Insurer X for a desired annuity contract issued by Insurer Y. In 2007, A requested that Insurer X issue directly to Insurer Y a check as consideration for a new annuity contract, but Insurer X refused to do so and, instead, issued a check to A. A endorsed the check directly to Insurer Y as consideration for a new annuity contract.

The IRS stated that the transaction did not constitute an exchange and was not, therefore, a tax-free transaction. In this case, there was no actual exchange of annuity contracts, no assignment of the Insurer X contract to Insurer Y, and no direct transfer from Insurer X to Insurer Y of the cash value of the old contract. Section 1035 does not apply to “roll-overs” of nonqualified annuities; it applies to exchanges in which cash is not made available to the taxpayer.

Thus, the amount that A received from Insurer X under the first annuity contract is taxable in the year in which it is distributed, under the rules of Section 72(e). See exchange treatment allowed in Rev. Rul. 72-358, 1972-2 C.B. 473 (taxpayer assigned unmatured life insurance contract issued by one insurance company to a second insurance company in exchange for a variable annuity contract issued by the second company); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned contract into a pre-existing annuity contract owned by the same taxpayer). See also legislative history of Section 1035, explaining that it applies to taxpayers who have “merely exchanged an [annuity contract] for another better suited to their needs and who have not actually realized gain.” H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954).

Rev. Proc. 2008-24. The IRS issued further guidance on the treatment of partial exchanges of annuity contracts under Sections 1035 and 72(e), modifying and superseding the interim guidance issued in 2003. The procedure states that a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity...
contract, regardless of whether the two annuity contracts are issued by the same or different companies, will be treated as a tax-free exchange under '1035 if either--

(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or

(b) the taxpayer demonstrates that, between the date of the transfer and the date of the withdrawal or surrender, one of the following conditions occurred:

- the taxpayer attains the age 59 2/3;
- the taxpayer died;
- the transfer occurred from a qualified plan, contract, account, trust or annuity (described in Section 72(e)(5)(D));
- the transfer is allocable to investment in the contract before August 14, 1982;
- the transfer is under a qualified funding asset (described in Section 130(d), but without regard to whether there is a qualified assignment);
- the transfer is one on which the ten percent excise on early distributions from qualified retirement plans would not be imposed (Section 72(t));
- the annuity is purchased by an employer on the termination of a qualified retirement plan (under Sections 401(a) or 403(a)) and held by the employer until such time as the employee separates from service;
- or any similar life event (such as divorce or loss of employment).

A direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies, that does not meet these requirements will be treated as an annuity distribution (taxable under Section 72(e)), followed by a payment for the second contract. The IRS states that it will not require aggregation under Section 72(e)(12), or otherwise, of two annuity contracts that are the subject of a tax-free exchange under Section 1035 and the tax-free rules of this revenue procedure, even if both contracts are issued by the same insurance company. Both contracts will be treated as separate annuity contracts. This revenue procedure
is effective for transfers described in section 3 of this revenue procedure that are completed on or after June 30, 2008.

K  Code §§ 1361-1367.  S Corporations and S Corporation Trusts


The act enables an ESBT to deduct interest expense it incurs when it borrows to buy S corporation stock. This change treats ESBTs the same as the law already treats other taxpayers and qualified S corporation trusts. This provision applies to taxable years beginning after December 31, 2006.


$ Six Generation Test.  The regulations adopt a “six-generation test” for determining whether individuals who share a common ancestor are members of a family for S corporation purposes. Section 1361(c)(1)(B)(ii) treats as members of a family persons with a common ancestor, as long as the common ancestor is not more than six generations removed from the youngest generation of the people being included in the family. The applicable date in Section 1361(c)(1)(B)(iii)on which a person will be tested for qualification as a “common ancestor” shall be the latest of (1) the date the S election is made, (2) the earliest date an individual who is a “member of the family” holds stock in the S corporation, or (3) October 22, 2004. The regulation would clarify that the “six generation” test is applied only at the date specified in Section 1361(c)(1)(B)(iii)for determining
whether an individual meets the definition of “common ancestor,” and has no continuing significance in limiting the number of generations of a family that may hold stock and be treated as a single shareholder. There is no adverse consequence to a person being a member of two families.

§ Defining “Powers of Appointment” and “Potential Current Beneficiaries.” The regulations define “powers of appointment” and “potential current beneficiaries” (PCBs) with regard to ESBTs. Potential current beneficiaries (PCBs) are treated as shareholders of an S corporation for purposes of the number of and identity of permitted shareholders. The new laws state that in determining the PCB’s of an ESBT, powers of appointment will be disregarded to the extent not exercised by the end of the relevant period. The amended section also increases the period from 60 days to one year during which an ESBT may safely dispose of S corporation stock after an ineligible shareholder becomes a PCB. These amendments apply to taxable years beginning after December 31, 2004. The amendment overrides a current regulation and example, under which a broad power of appointment commonly included in many trusts would preclude those trusts from qualifying as ESBTs, because that power would cause the S corporation to have an excessive number of deemed shareholders or to have as deemed shareholders persons ineligible to hold S corporation stock. The proposed regulations remove and replace the sections of the regulation inconsistent with current law. The preamble to the proposed regulations states that the powers to add persons to the class of current beneficiaries or to select from an unlimited class of charitable beneficiaries will, regardless of the identity of the holder, not result in the termination of the S corporation election even if the class of charities that could currently receive distributions or the class of persons who could be added as beneficiaries is sufficiently large to cause the corporation to have more than the number of shareholders allowed by Section 1361(b)(1)(A). Generally, the regulations state that powers held by fiduciaries who are not also beneficiaries of the trust are not “powers of appointment.” The proposed regulations also amend the definition of “potential current beneficiary” to provide that all members of a class of unnamed charities permitted to receive distributions under a discretionary distribution power held by a fiduciary that is not a power of appointment, will be considered, collectively, to be a single PCB for purposes of determining the number of permissible shareholders under Section 1361(b)(1)(A) unless the power is actually exercised, in which case...
each charity that actually receives distributions will also be a PCB. The ESBT election requirements under Treas. Regs. § 1.1361-
1(m)(2)(ii)(A) would be amended to require a trust containing such a power to indicate the presence of the power in the election statement. This amended PCB definition applies only to powers to distribute to one or more members of a class of unnamed charities which is unlimited in number. The amended PCB definition would not apply to a power to make distributions to or among particular named charities. Furthermore, the power to add beneficiaries, whether or not charitable, to a class of current permissible beneficiaries is generally a power of appointment and thus will be disregarded to the extent it is not exercised. If the power is exercised and an unlimited class of charitable beneficiaries is added to the class of current permissible beneficiaries, however, that class will count as a single PCB under the amended definition of PCB, and, to the extent distributions are actually made to one or more charities, those charities will each count as PCBs.

§  Suspended Losses. The regulations explain the allowance of suspended losses to the spouse or former spouse of an S corporation shareholder. Section 235 of the 2004 Act amended Section 1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under Section 1041(a), any loss or deduction with respect to the transferred stock which cannot be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in Section 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Before this amendment, any losses or deductions disallowed under Section 1366(d) were personal to the shareholder and did not transfer upon the transfer of the S corporation stock to another person. Section 1366(d)(2) is effective for transfers after December 31, 2004. The proposed regulations also amend Treas. Regs. §1.1366-2(a)(5) to include this exception to the general rule of nontransferability of losses and deductions. Losses and deductions carried over to the year of transfer that are not used by the transferor spouse in such year will be prorated between the transferor spouse and the transferee spouse based on their stock ownership at the beginning of the succeeding taxable year. The proposed regulations include examples illustrating these rules. The Treasury Department and IRS request comments on the best methods to ensure that losses are properly allocated between the transferor and transferee spouses, including whether a notification requirement should be imposed on the transferor spouse.
§ **At Risk Limitations.** The regulations detail the application of Sections 465 and 469 (at risk limitations) to beneficiaries of a qualified subchapter S trust (QSST). The 2004 Act amends Section 1361(d)(1) to provide that, for purposes of applying Sections 465 and 469 to the beneficiary of a qualified QSST with respect to which the beneficiary has made an election under Section 1361(d)(2), the disposition of S corporation stock by the QSST shall be treated as a disposition by the beneficiary. This creates an exception to the general rule that the trust, rather than the beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of a disposition of the stock. The proposed regulations add conforming language to the regulations.

§ **Conforming to S Corporation Rules.** The regulations conform the regulations (a) to the increase in the number of permissible S corporation shareholders from 75 to 100 (for taxable years beginning after December 31, 2004), (b) the treatment of spouses and their estates and all members of a family and their estates as a single shareholder for the 100 shareholder limitation (also for taxable years beginning after December 31, 2004), and (c) the elimination of the election to treat family members as a single shareholder (effective for taxable years beginning after December 31, 2004).


Individual A is the sole shareholder of S Corporation, X, which makes a 2007 charitable gift of unencumbered property in which the corporation has a basis of $100x. The property has a fair market value of $190x. A’s adjusted basis in the X stock is $50x. In 2007, X has ordinary taxable income of $30x and a long-term capital loss of $25x.

The IRS explained that the Pension Protection Act of 2006, §1203(a), Pub. Law 109-280, 109th Cong., 2nd Sess., 120 Stat. 780 (2006), amended Section 1367(a)(2) to provide that the decrease in an S corporation shareholder basis by reason of a corporate charitable contribution of property is equal to the shareholder’s pro rata share of the corporation’s adjusted basis of the property. The Tax Technical Corrections Act of 2007, § 3(b), Pub. Law 172, 110th Cong., 1st Sess., 121 Stat. 2473 (2007), added Section 1366(d)(4), which does not apply the general loss limitation to the extent of the excess (if any) of (A) the shareholder’s pro rata share of such contribution, over (B) the shareholder’s pro rata share of the adjusted basis of such property. Thus,
in this ruling, X’s charitable contribution is treated as a separately stated item of deduction that passes through to A and is deductible in computing A’s individual tax liability. A’s $50x basis in the X stock is first increased by $30x to reflect A’s share of X’s taxable income. Treas. Regs. § 1.1367-1(f). A’s basis in the X stock is then decreased (but not below zero) by A’s pro rata share of the $100 adjusted basis of the contributed property ($100x). Int. Rev. Code § 1367(a)(2). A’s basis is also reduced by A’s pro rata share of X’s long-term capital loss ($25x). Int. Rev. Code § 1367(a)(2)(B). A’s pro rata share of the aggregate amount of losses and deductions ($100x + $25x) exceeds A’s basis in the X stock of $80x ($50x + $30x). The basis limitation rule does not apply to A’s pro rata share of the amount of deductible appreciation in the contributed property ($90x). The amount of the limitation allocable to a charitable contribution deduction is an amount that bears the same ratio to the Section 1366(d) limitation as the shareholder’s pro rata share of the contributed property’s adjusted basis bears to the total of the shareholder’s pro rata share of the corporation’s losses and deductions (excluding the charitable contribution deduction attributable to the shareholder’s pro rata share of the fair market value of the contributed property over the contributed property’s tax basis). Treas. Regs. § 1.1366-2(a)(4). Accordingly, the amount of the limitation allocable to A’s share of X’s charitable contribution deduction is determined by multiplying A’s basis in the X stock ($80x) by a fraction, the numerator of which is $100x (the contributed property’s adjusted basis) and the denominator of which is $125x (the total of the capital loss and the contributed property’s adjusted basis). $64x is allocated to the charitable contribution deduction. The remaining $16x is allocated to the capital loss. Accordingly, in 2007, the amount of the charitable contribution deduction that A may claim is $154x. This amount is comprised of A’s pro rata share of the property’s appreciation ($90x) plus the amount of the loss limitation allocated to A’s pro rata share of the contributed property’s adjusted basis ($64x). A’s basis in the X stock is reduced to 0 to reflect the $16x reduction in basis attributable to the capital loss and the $64x reduction in basis attributable to the charitable contribution deduction. Treas. Regs. § 1367(a)(2)(B). The disallowed portion of the charitable contribution deduction ($36x) and the capital loss ($9x) shall be treated as incurred by X in the succeeding taxable year with respect to A. Int. Rev. Code § 1367(a)(2)(B).

4 Trust Cannot Deduct Net Operating Loss Carryover from S Portion of ESBT. CCM 200734019 (Aug. 24, 2007)

A residuary testamentary trust held assets that included S corporation stock, and it succeeded to a net operating loss that the testator’s estate could not use
at its termination. Int. Rev. Code § 642(h)(1). The trustee elected ESBT status during the two years following the testator’s death.

The IRS discussed the bifurcated nature of ESBT taxation, in which the S corporation portion of the trust is taxed on those items of income, loss, deduction, or credit required to be taken into account by the trust under Section 1366, any gain or loss from the disposition of the S corporation shares, and any State or local income taxes or administration expenses allocable to the aforementioned items of income. The non-S corporation portion of the trust is taxed on the other items. Treas. Regs. § 1.641(c)-1(a). The IRS stated that Section 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit allocable to the S corporation portion of the ESBT, and that the NOL carryover cannot be used by that portion of the trust.

L Income Tax Procedures


The Mortgage Forgiveness Debt Relief Act of 2007 reduces the ability of trust and estate beneficiaries to obtain copies of tax returns filed by the entity. Section 6103(e) already states that a fiduciary, heir at law, next of kin, or beneficiary under a will can obtain information from a tax return filed by a decedent’s estate, upon showing that the individual has a material interest that will be affected by the return information, and the trustee or trustees and any beneficiary of a trust can obtain information from a trust tax return upon a similar showing. Under the new rules, a beneficiary who is otherwise entitled to examine the tax return of a trust or estate cannot obtain any supporting schedule, attachment or list that includes the taxpayer identity information of a person other than the trust or estate or the beneficiary seeking such disclosure.
VI SELECTED ATTACHMENTS

PLEASE NOTE

THESE ARE NOT THE ACTUAL DOCUMENTS ON WHICH THE IRS OR COURT OPINED. THEY ARE AN INTERPRETATION BY THE AUTHOR OF THE RULINGS OR CASES CITED, OR OF TECHNIQUES THAT MAY ADDRESS PROBLEMS RAISED BY THESE CASES OR RULINGS.

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USE YOUR INDEPENDENT JUDGMENT -- NEITHER THE AUTHOR NOR THE CONFERENCE SPONSOR CAN TAKE ANY RESPONSIBILITY WHATSOEVER FOR THE INDIVIDUAL USE OF THESE SAMPLE DOCUMENTS.
A Family Limited Partnership Agreement and Certificate Two Class General Partnership Interests (Managing and Administrative) to Avoid Issues Under Section 2036(a)(2) -- Corporate Managing General Partner Limits Lapse of Liquidation Rights under Section 2704 – Formed Under the (2001) Revised Uniform Limited Partnership Act – Requires Substantial Non-tax Business Purpose to Avoid Section 2036(a)(1)

Limited Partnership Agreement

On [date], *ManagingGeneralPartner*, of [locality, state] (the managing general partner, defined below), *AdministrativeGeneralPartner*, of [locality, state] (the administrative general partner, defined below), *LimitedPartner1*, of [locality, state], and *LimitedPartner2*, of [locality, state] (together the limited partners and individually a limited partner, defined below), agreed to form this limited partnership (the partnership, defined below).

RECITALS

A. The partners (defined below) desire to enter into this partnership agreement (the agreement, defined below) to establish a limited partnership to own certain property and transact certain business;

B. The partners desire to share in the risks, benefits, profits and losses of the partnership’s activities;

C. The partners desire that *ManagingGeneralPartner* be the sole managing general partner, that *AdministrativeGeneralPartner* be the sole administrative general partner, and that all the other partners be limited partners.

AGREEMENTS

Section 1. Name

1 KEY:

*ManagingGeneralPartner* - Full name of the managing general partner
*AdministrativeGeneralPartner* - Full name of the administrative general partner
*LimitedPartner1* - Full name of the first limited partner
*LimitedPartner2* - Full name of the second limited partner
*Name* - Full name of the partnership
*Agent* - Full name of the registered agent
*State* - State in which the partnership is formed

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The partnership’s name is *Name*.

**Section 2. Place of Business and Agent**

2.1 **Place of Business.** The partnership’s principal place of business is at [full street address], but the administrative general partner may change the partnership’s principal place of business to another location and add additional places of business.

2.2 **Agent.** The partnership’s agent for service of process shall be *Agent*, of [address]. All records that the partnership is required to keep at a specified office shall be kept at its principal place of business.

**Section 3. Business**

The partnership is formed to own and manage certain real and personal property as the administrative general partner may buy for the partnership, and to conduct any other legal business.

**Section 4. Term**

4.1 **Initial Term.** The partnership begins on the date of the agreement and ends on December 31, 2050, unless terminated earlier.

4.2 **Extension.** The partnership may be continued beyond its scheduled termination date by an affirmative vote of all of the then remaining partners.

**Section 5. Capital and Partnership Interests**

5.1 **Partnership Interests.** Each partner’s partnership interest (defined below) and each partner’s percentage of the total partnership capital accounts (defined below) shall be set forth in a schedule to the agreement. A partner’s percentage of partnership interest shall always be the same as his, her or its percentage of the total partnership capital accounts, and a change in a partner’s percentage of the total partnership capital accounts shall automatically be reflected in the partner’s percentage of partnership interest.

5.2 **Additions.** A partner shall not be compelled to make any additional capital contributions.

5.3 **Adjustments.** Each partner’s capital account shall be adjusted as necessary to reflect the economic conditions of the partners and their partnership interests. These adjustments shall include, but are not limited to, the following:
5.3.1 Distributive Share. Adjustments to reflect each partner’s distributive share of partnership profits and losses, including capital gains and losses, and tax-exempt income;

5.3.2 Additional Contributions. Adjustments to reflect each partner’s additional contributions to the partnership;

5.3.3 Distributions. Adjustments to reflect distributions made by the partnership to each partner;

5.3.4 Tax-Sensitive Adjustments. Tax-sensitive adjustments (defined below).

5.4 Loans. A partner’s loans to the partnership shall not be added to that partner’s capital account.

5.5 Amount of Contributions. The amount of a partner’s contributions of property to the partnership and of the partnership’s distributions of property to a partner shall be reflected in the partner’s capital account at the fair market value of the property on the date of the contribution or distribution, reduced by any liabilities secured by that property, if those liabilities are treated under applicable federal income tax laws as being assumed by or taken subject to by the transferee.

5.6 No Interest Paid. A partner shall receive no interest on his, her or its capital contributions or partnership interest.

5.7 Withdrawals. A partner may not withdraw any of his, her or its capital account, without the express written consent of the managing general partner.

Section 6. Profits, Losses and Cash Flow

6.1 Profits and Losses. The partnership’s net profits and losses (and each item of income, deduction, gain, loss, and credit that makes up net profits and losses) shall be computed in accordance with generally accepted accounting principles, consistently applied, and shall be allocated among the partners in proportion to their respective capital accounts.

6.1.1 Gain, etc. On Contributed Property. Notwithstanding the general rule stated in Section 6.1, any income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of any variation between the basis and the fair market value of the contributed property at the time of the contribution, in accordance with any applicable U.S. Treasury regulations.

6.1.2 Income Offset. There shall be an income offset (defined below), under which net losses that would otherwise be allocated to a limited partner and that would cause the limited partner’s capital account to be in deficit shall instead be allocated to the general partners. After such
an allocation of net losses, net profits shall be allocated to the general partners, until the general partners shall have received an allocation of net profits equal to the aggregate allocation of net losses allocated under this paragraph.

6.1.3 *Disassociated Partners.* Profits and losses shall, whenever a partner is disassociated (defined below) from the partnership, be allocated among the partners based on the number of days (defined below) in that year during which each partner owned a partnership interest, or on any other reasonable basis selected by the managing general partner, consistent with applicable U.S. tax laws and regulations.

6.2 *Cash Flow.* The managing general partner shall cause the partnership to distribute its net cash flow (defined below) to the partners annually, in proportion to their partnership capital accounts.

**Section 7. Management**

7.1 *Administrative General Partner.* The administrative general partner shall have the full and exclusive power, on the partnership’s behalf, to manage its business and affairs and to do or cause to be done anything deemed necessary or appropriate for the partnership’s business, apart from determining the amount and timing of distributions of partnership income and capital or otherwise doing anything that would constitute control over the beneficial enjoyment by the other partners of their interests in the partnership and its assets. This authority includes, but is not limited to, the following:

7.1.1 *Selling Assets.* The administrative general partner may sell real or personal property to any person, giving any warranties or assurances deemed appropriate;

7.1.2 *Acquiring Assets.* The administrative general partner may buy, lease or otherwise acquire real or personal property to carry on and conduct the partnership’s business;

7.1.3 *Borrowing.* The administrative general partner may borrow money for the partnership’s business;

7.1.4 *Lending.* The administrative general partner may issue promissory notes and other debt instruments (negotiable or nonnegotiable), in any amounts and secured by any encumbrance on all or any part of the partnership’s assets;

7.1.5 *Assigning Debts.* The administrative general partner may assign any debts owing to the partnership;

7.1.6 *Financing.* The administrative general partner may engage in any other means of financing;
7.1.7 Profit-Sharing Agreements. The administrative general partner may enter into any agreement for sharing of profits and any joint venture agreement with any person or entity engaging in any business or venture in which this partnership may engage;

7.1.8 Operating and Improving Assets, Etc. The administrative general partner may manage, administer, conserve, improve, develop, operate, lease, utilize and defend the partnership’s assets, directly or through third parties;

7.1.9 Executing Agreements. The administrative general partner may execute any type of agreement or instrument in connection with any other partnership power;

7.1.10 Employing Agents. The administrative general partner may employ all types of agents and employees (including lawyers and accountants), even if they are related by blood, marriage, or business relationship to the administrative general partner, and pay them reasonable compensation;

7.1.11 Acquiring Equipment. The administrative general partner may buy or otherwise obtain the use of any type of equipment or other property that may be convenient or advisable in connection with any partnership business;

7.1.12 Incurring Certain Expenses. The administrative general partner may incur any reasonable expense for travel, telephone, telegraph, insurance, taxes and such other things, in carrying on the partnership’s business;

7.1.13 Litigating. The administrative general partner may sue and be sued, complain and defend in the partnership’s name and on its behalf; and

7.1.14 Surrendering Assets. The administrative general partner may quitclaim, release or abandon any partnership assets with or without consideration.

7.2 Managing General Partner. The managing general partner shall have the full and exclusive power to determine the amount and timing of all distributions of partnership income and capital, to participate as a general partner in any decision to terminate the partnership or cause its assets to be distributed, and to do all other things specifically provided in the agreement.

7.3 Multiple Managing General Partners or Administrative General Partners. Multiple managing general partners shall act by unanimous agreement. Multiple administrative general partners shall also act by unanimous agreement.

7.4 Compensation and Expenses. Each general partner shall receive reasonable compensation for services provided to the partnership, and all reasonable expenses incurred by the a general
partner in conducting the partnership’s business, including (but not limited to) overhead, administrative and travel expenses, and such professional, technical, and other services, shall be reimbursed by the partnership.

**7.5 Limited Partners.** A limited partner (other than one who is also a general partner) shall take no part in the management of the partnership, except to the extent expressly provided by applicable state law.

**7.6 Tax Matters Partner.** The administrative general partner shall be the tax matters partner and, as such, shall be solely responsible for representing the partnership in all dealings with the U.S. Internal Revenue Service and any state, local, and foreign tax authorities. The tax matters partner shall keep the other partners reasonably informed of any partnership dealings with any tax agency.

**Section 8. Financial Statements**

Within a reasonable period after the close of each fiscal year, the administrative general partner shall, at the partnership’s expense, give a written report to each partner who requests it, indicating that partner’s share of the partnership income or loss and any changes in that partner’s capital account. This requirement may be satisfied by giving each partner a copy of any tax form that includes such information.

**Section 9. Banking**

All partnership funds shall be deposited in the partnership’s name in such accounts as the administrative general partner may designate. The administrative general partner may authorize other persons to draw checks on partnership bank accounts, but such authority must be in writing. Each bank in which a partnership account is maintained is relieved of any responsibility to inquire into a partner’s authority to deal with such funds, and is absolved of all liability with respect to withdrawals from such partnership accounts by any person duly authorized by the administrative general partner.

**Section 10. Admission, Expulsion and Transferees**

**10.1 Admission.** Except as provided elsewhere in this paragraph 10.1, a person may be admitted as a partner only upon the unanimous vote of the other partners, and only after agreeing in writing to assume all of the obligations and undertakings of the offering partner under the agreement, and paying the partnership a fee (not to exceed one thousand dollars ($1,000)), covering the costs of preparing, executing, and recording all pertinent documents. A person to whom an interest in this partnership is transferred shall become a partner without the unanimous vote of the other partners, if such person is: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the
transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity (defined below); provided, however, that such person shall be admitted as a partner only after agreeing in writing to assume all of the obligations and undertakings of the offering partner under the agreement, and paying the partnership a fee (not to exceed one thousand dollars ($1,000)), covering the costs of preparing, executing, and recording all pertinent documents.

10.2 Expulsion. Any partner may be expelled from the partnership on the unanimous decision of the other partners, excluding the administrative general partner. The partnership must pay an expelled partner an amount equal to the fair market value of his, her or its partnership interest. The fair market value of an expelled partner’s partnership interest shall be determined by an independent appraisal performed by a professional appraiser selected by the partnership, whose decision in this matter shall be conclusive.

10.3 Transferable Interest. Generally, a partner’s only transferable interest in the partnership is his, her or its share of the profits and losses of the partnership and his, her, or its right to receive distributions; provided, however, that a partner’s transferable interest shall be his or her full partnership interest with respect to a transfer to: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity (defined below).

10.3.1 Transfer Does Not Disassociate. A partner’s transfer (defined below) of his, her or its transferable interest in the partnership shall not, by itself, cause the partner’s dissociation or the dissolution of the partnership.

10.3.2 Assignee Not Automatically a Partner. A person to whom a partner attempts to transfer his, her or its partnership interest, and to whom a partner does transfer his, her or its transferable interest in the partnership, shall not become a partner unless admitted into the partnership pursuant to Section 10.1. A transferee of a partner’s transferable interest in the partnership shall not be entitled to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records, unless admitted into the partnership pursuant to Section 10.1.

Section 11. Right of First Refusal

A partner shall not transfer any of his, her or its transferable interest in the partnership except in accordance with the terms of this Section 11. An attempted transfer of any transferable interest in the partnership not in accordance with the terms of this Section 11 shall not be valid and shall not be reflected on the partnership’s books.

11.1 Right of First Refusal. A partner who wishes to transfer any transferable interest in the partnership, or who has reason to believe that an involuntary transfer (defined below) or a

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transfer by operation of law is reasonably foreseeable (an offering partner), shall first give each other partner written notice of the intent to transfer such transferable interest in the partnership (the offered interest) (or of the knowledge that an involuntary transfer or transfer by operation of law is reasonably foreseeable. This notice must contain a description of the portion of interest in the partnership to be transferred, the consideration (if any) to be paid, the terms of transfer and of the payment of consideration (including, but not limited to, the relative percentages of cash and debt, and the terms of any debt instruments), and the name, address (both home and office), and business or occupation of the person to whom the transferable interest in the partnership would be transferred, and any other facts that are or would reasonably be deemed material to the proposed transfer.

11.1 Cross-Purchase Right. Upon the receipt of such notice, each other partner shall have a right to buy that share of the offered interest having the same proportion to all of the offering partner’s partnership interest as the buying partner’s partnership interest bears to the partnership interests of all partners (except the offering partner).

11.2 Written Notice. Each partner may exercise this purchase option by giving the offering partner written notice within thirty (30) days after receipt of the latter’s notice.

11.3 Completing Transfer. If the partners do not agree to buy all of the offered interest, the offering partner may complete the intended transfer. If this transfer is not completed within thirty (30) days after expiration of the option period, any attempted transfer shall be deemed pursuant to a new offer and this Section 11 shall again apply.

11.4 Purchase Price. The purchase price that the partners must pay for the offered interest under this Section 11 shall be the same as those of any proposed transfer if the proposed transfer for which notice was given is to be made for any valuable consideration in money or money’s worth of property. Otherwise, the purchase price that the partners must pay for the offered interest under this Section 11 shall be the fair market value of the offered interest. The fair market value of a partnership interest shall be determined by an independent appraisal performed by a professional appraiser, selected by the managing general partner, whose decision in this matter shall be conclusive.

11.5 Purchase Terms. One quarter (1/4) of the purchase price shall be paid in cash or by good personal check at the closing for the sale of such partnership interest, and the balance shall be paid in twenty (20) equal quarterly principal payments beginning three (3) months after the date of such closing. Simple interest shall be added to each installment, computed against the outstanding principal balance at the applicable federal rate determined for federal income tax purposes on the date of the closing. The buyer shall give the offering partner a promissory note as evidence of this debt, and the buyer may prepay all or any part of the principal balance of the note at any time without penalty or premium.

11.4 The Closing. The purchase of a transferable interest in the partnership under this Section 11 shall take place at a closing to be held not later than the tenth (10th) day after the earlier of
the date on which the partners’ purchase options have all expired, or the earliest date on which the partners in the aggregate exercise their purchase options, if any, to buy all of the offered interest. The closing shall be held during normal business hours at the partnership’s principal business office, or at any other place to which the parties agree. If the offering partner is not present at the closing, then the buyer shall deposit the purchase price by check, note, or both, as this Section 11 requires, with any state or federally chartered bank with which the partnership has an account, as escrow agent, to be paid to the offering partner as soon as is reasonably practicable, less an appropriate fee to the partnership (not to exceed one thousand dollars ($1,000)) to cover additional administrative costs, and the partnership shall adjust its books to reflect the transfer of these transferable interest in the partnership.

11.5 Admission. A transferee under this Section 11 must also comply with the requirements of Section 10.1, in order to become a partner.

Section 12. Dissociation

12.1 Dissociation as Limited Partner. A limited partner who dissociates from the partnership shall have no further rights as a limited partner, and shall own his, her or its interest as a transferee, and not as a partner.

12.2 Dissociation Events. A general or limited partner shall be dissociated from the partnership if any of the following events shall occur.

12.2.1 Withdrawing. The partner notifies the partnership of his, her or its intention to withdraw as a partner.

12.2.2 Expelling. The partner is expelled from the partnership.

12.2.3 Ending a Trust. The partner, if a trust or if acting as a partner by virtue of being a trustee of a trust, distributes the trust’s entire transferable interest in the partnership.

12.2.4 Ending an Estate. The partner, if an estate or if acting as a partner by virtue of being a personal representative of an estate, distributes the estate’s entire transferable interest in the partnership.

12.2.5 Ending Certain Other Partners. The partner’s termination, if the partner is not an individual, partnership, corporation, trust or estate.

12.3 Dissociation by a General Partner. A general partner may dissociate as a general partner at any time, rightfully or wrongfully.
12.3.1 Not Participating in Management. A general partner who dissociates from the partnership shall have no right to participate as a general partner in the management and conduct of the partnership’s activities and shall own his, her or its interest as a transferee, and not as a partner.

12.3.2 Other General Partner Disassociation. In addition to the provisions of Section 12.2, a general partner also dissociates from the partnership if:

(A) Death or Incompetency. The last then-serving general partner dies without leaving his or her general partnership interest to: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity.

(B) Bankruptcy. The partner becomes a debtor in bankruptcy, executes an assignment for the benefit of creditors, seeks, consents to or acquiesces in the appointment of a trustee, receiver or liquidator of that partner or of all or substantially all of that partner’s property.

(C) Receivership, Etc. The partner fails, within ninety (90) days after the appointment, to have vacated or stayed the appointment of a trustee, receiver or liquidator of the partner or of all or substantially all of the partner’s property obtained without the partner’s consent or acquiescence, or fails within ninety (90) days after the expiration of a stay to have the appointment vacated.

12.3 Wrongful Dissociation.

12.3.1 Wrongful Disassociation of Limited Partner. A limited partner’s dissociation from the partnership before December 31, 2050, or such earlier date as the partnership shall otherwise terminate, shall be a wrongful dissociation.

12.3.2 Wrongful Disassociation of General Partner. A general partner’s dissociation is wrongful if it occurs before December 31, 2050, or such earlier date as the partners shall elect to terminate the partnership and the general partner dissociates by voluntary withdrawal, by expulsion by judicial order, or pursuant to Section 12.3.2, Section 12.3.3, or Section 12.2.5.

12.3.2 Liability of Wrongfully Dissociating Partner. A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation. The liability is in addition to any other obligation of the partner to the partnership or to the other partners.
Section 13. Dissolution

13.1 Dissolution. The partnership shall be dissolved upon the expiration of its stated term, the written vote of all of the partners (other than the administrative general partner), or the happening of any of the following:

13.1.1 Dissolution by Consent. The written consent of the managing general partner and of limited partners owning a majority of the rights to receive distributions as limited partners;

13.1.2 Disassociation of Managing General Partner. After the dissociation of a managing general partner, except that if the partnership then has no remaining managing general partners, the partnership shall be dissolved unless, within ninety (90) days after the dissociation, the limited partners holding a majority of the rights to receive distributions at the time the consent is to be effective vote to continue the partnership and to elect a new managing general partner, and a new managing general partner is, in fact, admitted;

13.1.3 Disassociation of Last Limited Partner. Ninety (90) days after the dissociation of the limited partnership’s last limited partner, unless before the end of this period the partnership admits at least one limited partner; or

13.1.3 Declaration of Dissolution. The Secretary of State signs a declaration of dissolution.

13.2 Upon Dissolution. Upon its dissolution, the partnership shall end and commence to wind up its affairs. The partners shall continue to share in profits and losses during liquidation as they did before dissolution. The partnership’s assets may be sold, if a price deemed reasonable by the managing general partner can be obtained. The proceeds from liquidation of partnership assets shall be applied as follows:

13.2.1 Third-Party Debts and Liabilities. First, all of the partnership’s debts and liabilities to persons other than partners shall be paid and discharged in the order of priority as provided by law;

13.2.2 Partners’ Debts and Liabilities. Second, all debts and liabilities to partners shall be paid and discharged in the order of priority as provided by law;

13.2.3 Remaining Assets. Third, all remaining assets shall be distributed proportionately among the partners based on their respective positive capital accounts.

13.3 Gain or Loss. Any gain or loss on the disposition of partnership properties in the process of liquidation shall be credited or charged to the partners in proportion to their positive capital accounts, except that gain or loss with respect to property contributed to the partnership by Zaritsky.
a partner shall be shared among the partners so as to take account of any variation between the basis of the property so contributed and its fair market value at the time of contribution, in accordance with any applicable U.S. Treasury regulations. Any property distributed in kind in the liquidation shall be valued and treated as though it was sold and the cash proceeds distributed. The difference between the value of property distributed in kind and its book value shall be treated as a gain or loss on the sale of property, and shall be credited or charged to the partners accordingly.

13.4 Partnership Assets Sole Source. The partners shall look solely to the partnership’s assets for the payment of any debts or liabilities owed by the partnership to the partners and for the return of their capital contributions and liquidation amounts. If the partnership property remaining after the payment or discharge of all of its debts and liabilities to persons other than partners is insufficient to return the partners’ capital contributions, they shall have no recourse therefore against the partnership or any other partners, except to the extent that such other partners may have outstanding debts or obligations owing to the partnership.

Section 14. Amendments

The agreement shall be amended automatically to reflect any valid transfers of partnership interests. Otherwise, the agreement shall be amended only with the unanimous consent of the partners, except that the administrative general partner shall be excluded from any vote to amend the partnership agreement in a manner that would alter the beneficial enjoyment of the partnership assets.

Section 15. Power of Attorney

15.1 General. Each limited partner names the administrative general partner as the limited partner’s attorney-in-fact, and gives the administrative general partner the full power and authority, in the place of the limited partner, to file and record any written instruments that are necessary or appropriate to (a) amend the certificate of partnership; (b) satisfy requirements of the laws of any state in which the partnership is doing business; (c) continue the partnership, admit additional or substituted partners, dissolve or terminate the partnership or any interest in it; (d) obtain or settle any loan; and (e) transfer any partnership assets.

15.2 Power With an Interest. The power of attorney granted under this Section 15 is coupled with an interest, is irrevocable and survives the limited partner’s incompetency. The administrative general partner may exercise this power of attorney by a facsimile signature or by listing all of the limited partners with the signature of the administrative general partner as the attorney-in-fact for all of them. This power of attorney survives the assignment of a limited partner’s interest, and empowers each administrative general partner to act to the same extent for any successor limited partner.

Section 16. Miscellaneous

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16.1 Notices. Any notice under the agreement shall be given and served either by personal delivery to the party to whom it is directed, or by registered or certified mail, postage and charges prepaid, and if it is sent to a partner, it shall be addressed with his, her, or its address as it appears on the records of the partnership.

16.1.1 How Delivered. Any notice shall be deemed given when it is personally delivered, or, if mailed, on the date it is postmarked by the U.S. Postal Service, if it was addressed as required in this Section 16.

16.1.2 Change of Address. Any partner may change his, her or its address for purposes of the agreement by written notice to an administrative general partner, stating his, her or its new address. A change of address shall be effective fifteen (15) days after the notice is received by an administrative general partner.

16.2 Non-waiver. Any party’s failure to seek redress for violation of or to insist upon the strict performance of any provision of the agreement shall not prevent a subsequent act, which would have originally constituted a violation, from having the effect of an original violation.

16.3 Severability. Every provision of the agreement is intended to be severable. If any term or provision hereof is invalid for any reason whatsoever, its invalidity shall not affect the validity of the remainder of the agreement.

16.4 Good Faith. The performance of any act, or the failure to perform any act, by a partner or the partnership, the effect of which causes any loss or damage to the partnership, shall not subject such partner or the partnership to any liability, if the decision to perform or not to perform the act was made pursuant to advice of the partnership’s legal counsel or in good faith to promote the partnership’s best interests.

16.5 Governing Law. The agreement is to be construed according to the laws of the state of *State*. The administrative general partner may not participate in any decision to change the law according to which the agreement is to be construed.

16.6 Cumulative Rights. The rights and remedies provided in the agreement are cumulative and the use of any right or remedy does not limit a party’s right to use any or all other remedies. All rights and remedies in the agreement are in addition to any other legal rights the parties may have.

16.7 Other Activities. A partner may engage in whatever activities he or she chooses without any obligation to offer any interest in such activities to any party hereof.

16.8 Confidentiality. No partner may, without the administrative general partner’s express written consent, divulge to others any information not already known to the public pertinent
to the services, clients, customers, or operations of the partnership, whether before or after the partnership’s dissolution.

16.9 Counterparts. The agreement may be executed in any number of counterparts with the same effect as if all parties hereto had all signed the same document. All counterparts shall be construed together and shall constitute one (1) agreement.

16.10 Waiver of Partition. Each partner waives any right to maintain any action for partition with respect to the partnership’s property or assets during the partnership’s term.

16.11 Binding Terms. The terms of the agreement are binding upon and inure to the benefit of the parties and, to the extent permitted by the agreement, their heirs, executors, administrators, legal representatives, successors and assigns.

16.12 Personal Property. The interests of each partner in the partnership are personal property.

16.13 Gender and Number. Unless the context requires otherwise, the use of a masculine pronoun includes the feminine and the neuter, and vice versa, and the use of the singular includes the plural, and vice versa.

Section 17. Definitions

17.1 Administrative General Partner. “Administrative general partner” means *AdministrativeGeneralPartner* and any additional or successor administrative general partner.

17.2 Agreement. “Agreement” means the agreement of *Name*, as amended from time to time, including all schedules, as they may be amended from time to time.

17.3 Capital Accounts. “Capital accounts” or “partnership capital” means the total of the partners’ capital contributions, adjusted as provided in the agreement.

17.4 Certificate. “Certificate” means the certificate of limited partnership filed on behalf of the partnership, as amended from time to time.

17.5 Charity. “Charity” means an organization contributions to which are deductible for Federal income, estate and gift tax purposes.

17.6 Days. “Day” or “days” means a calendarday, including any days that fall on legal holidays or weekends.
17.7 General Partner. “General partner” means both the administrative general partner and the managing general partner.

17.8 Income Offset. “Income offset” is synonymous with and interpreted consistently with the “qualified income offset” defined in U.S. Treasury Regulations Section 1.704-1(b)(2)(ii)(d), as amended.

17.9 Limited Partner. “Limited partners” means *LimitedPartner1*, *LimitedPartner2*, and any persons who later become limited partners, each of whom is a limited partner.

17.10 Managing General Partner. “Managing general partner” means *ManagingGeneralPartner*, and any additional or successor managing general partner.

17.11 Net Cash Flow. “Net cash flow” means the partnership’s total net income, computed for federal income tax purposes, increased by any depreciation or depletion deductions taken into account in computing taxable income and any nontaxable income or receipts (other than capital contributions and the proceeds of any partnership borrowing); and reduced by any principal payments on any partnership debts, expenditures to acquire or improve partnership assets, any proceeds from the sale or exchange of partnership assets, and such reasonable reserves and additions thereto as the managing general partner shall determine to be advisable and in the best interests of the partnership, having due regard to the interests of the limited partners.

17.12 Partners. “Partners” or a “partner,” when used without the words “general” or “limited,” means both the general partners and the limited partners.

17.13 Partnership. “Partnership” means *Name*.

17.14 Partnership Capital. “Partnership capital” means the total of the partners’ capital contributions, as adjusted pursuant to the agreement.

17.15 Partnership Interests. “Partnership interests” means the interests of the partners in the partnership, as listed on a schedule to the agreement.

17.16 Tax-Sensitive Adjustments. “Tax-sensitive adjustments” means all adjustments to a partner’s capital account that are not specifically required under the terms of the agreement, but that are required by U.S. Treasury Regulations Section 1.704-1(b)(2)(iv) (“Maintenance of Capital Accounts”), as amended. Such adjustments shall be made annually, unless these regulations require a more frequent adjustment.

17.17 Transfer. “Transfer” of a partnership interest means any sale, pledge, encumbrance, gift, bequest, or other transfer or disposition of the partnership interest or permitting it to be sold, encumbered, attached, or otherwise disposed of, or changing its ownership in any manner, whether
voluntarily, involuntarily, or by operation of law. “Transfer” shall not include any assignment of any partnership interest to another partner or to any trust that is entirely revocable by the assignor, but such trust shall be treated as the agent of the assignor, and any subsequent disposition of such partnership interest by such trust shall be deemed to have been made by the trust’s settlor or grantor.

AGREEED on the date first noted above.

[Signatures, notarial clauses and schedule]

Certificate of Limited Partnership

THIS CERTIFICATE is executed on [date], with respect to the agreement of *Name* (the “partnership”).

1. **Name.** The partnership’s name is *Name*.

2. **Initial Designated Office.** The street and mailing address of the initial designated office is [address].

3. **Registered Agent.** The name and street and mailing address of the partnership’s initial agent for service of process is *GeneralPartner*, [address].

4. **General Partners.** There are two (2) general partners. The name and street and mailing address of the general partners is: *ManagingGeneralPartner*, [address] and *AdministrativeGeneralPartner*, [address].

5. **Date for Dissolution.** The latest date on which the limited partnership is to be dissolved and its affairs wound up is December 31, 2050.

IN WITNESS WHEREOF, the undersigned general partners have signed and sealed this certificate, on the day and year first above written.

[Signatures and notarial clauses]
Grantor Charitable Lead Annuity Trust

On [date], I, *Grantor* (hereinafter “the donor”), desiring to establish a charitable lead annuity trust within the meaning of Rev. Proc. 2007-45, hereby enter into this trust agreement with *FirstTrustee* as the initial trustee (hereinafter “the trustee”). This trust shall be known as the *Grantor* Grantor Charitable Lead Annuity Trust. All references to “section” or “§” in this instrument shall refer to the Internal Revenue Code of 1986, 26 U.S.C. § 1, et seq.

Article 1. Funding of Trust

The donor hereby transfers and irrevocably assigns to the trustee on the above date the property described in Schedule A, and the trustee accepts the property and agrees to hold, manage and distribute the property under the terms set forth in this trust instrument.

Article 2. Payment of the Annuity Amount

A. Annuity Amount Defined. In each taxable year of the trust during the annuity period, the trustee shall pay to *Charity* an annuity amount equal to that percentage of the initial fair market value of the assets of the trust as shall produce a charitable annuity interest equal in value to fifty percent (50%) of the initial value of the entire trust fund, valued as of the date of the transfer.

B. If *Charity* Not Qualified. If *Charity* is not an organization described in §§ 170(c), 2055(a), and 2522(a) at the time any payment is to be made to it, the trustee shall instead distribute such payments to one or more organizations described in §§ 170(c), 2055(a), and 2522(a) as the trustee shall select, and in such proportions as the trustee shall decide, from time to time, in the

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KEY:
*Grantor* -- Full name of the grantor
*FirstTrustee* -- Full name of the initial trustee
*duration* -- Number of years of trust duration
*Charity* -- Full name of the primary charitable beneficiary
*SecondTrustee* -- Full name of the alternate trustee
*First671Person* -- Related person who holds grantor trust power
*Second671Person* -- Alternate related person who holds grantor trust power

2KEY:
trustee’s sole discretion. The term “the charitable organization” shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient.

C. Annuity Period. The annuity period is a term of *duration* years.

Article 3. Distribution upon Termination of Annuity Period.

At the termination of the annuity period, the trustee shall distribute all of the then principal and income of the trust (other than any amount due to the charitable organization under the provisions above) in equal shares, with one (1) share for each of my then-living children and one (1) share for the estate of each of my children who are not then living.

Article 4. Trustees

A. Named Trustees. *FirstTrustee* is the initial trustee of this trust. No trustee named in this instrument or by the trustee shall be required to provide surety or other security on a bond.

B. Successor Trustees. *SecondTrustee*, of [locality, state], shall be the successor trustee, to serve if *FirstTrustee* is unable or unwilling to serve or to continue serving.

C. Bond. No trustee named in this instrument or by another trustee shall be required to provide surety or other security on a bond.

D. Additional Trustee. The trustee may appoint any person as an additional trustee, to serve at the pleasure of the appointing trustee.

E. Delegation. The trustee may delegate to another trustee any power or authority granted by me to the trustee, to continue at the pleasure of the delegating trustee, unless otherwise agreed. Any person dealing in good faith with a trustee may rely on that trustee’s representation that a delegation has been made and remains in effect under this paragraph.

F. Resignation.

1. A trustee may resign by giving written notice specifying the effective date of the resignation to the designated successor.

2. If no successor is designated, the resigning trustee shall give notice to *Charity*, if during the lead term, or otherwise to my then-living adult children.
G. **Vacancies.** A corporation no substantial portion of the stock of which is owned by me, may be named as successor trustee to fill any vacancy, by the affirmative vote of *Charity*, if during the lead term, or otherwise by the majority vote of my then-living adult children.

H. **Responsibility of Successors.** No trustee shall be responsible for or need inquire into any acts or omissions of a prior trustee.

I. **Compensation.** In addition to reimbursement for expenses, each individual trustee is entitled to reasonable compensation for services. Each corporate trustee is entitled to compensation based on its written fee schedule in effect at the time its services are rendered or as otherwise agreed, and its compensation may vary from time to time based on that schedule.

J. **Management Powers.** The trustee may exercise the powers described below, in a fiduciary capacity. Except as provided expressly in Article 6, paragraph I, nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Otherwise, the trustee shall have the following powers.

1. The trustee shall invest and reinvest the trust assets (or leave them temporarily uninvested) in any type of property and every kind of investment (including, but not limited to, insurance contracts, including commercial annuity contracts), in the same manner as a prudent investor would invest his or her own assets.

2. The trustee may sell or exchange any real or personal property contained in the trust, for cash or credit, at public or private sale, and with such warranties or indemnifications as the trustee may deem advisable.

3. The trustee may borrow money (even from the trustee and from any beneficiary of the trust), for the benefit of the trust and secure these debts with assets of the trust.

4. The trustee may grant security interests and execute all instruments creating such interests upon such terms as the trustee may deem appropriate.

5. The trustee may compromise and adjust claims against or on behalf of the trust on such terms as the trustee may deem appropriate.

6. The trustee may take title to any securities in the name of any custodian or nominee, without disclosing this relationship.

7. The trustee may determine whether receipts are income or principal and whether disbursements are to be charged against income or principal, to the extent not established clearly by state law. Determinations made by the trustee in good faith shall not require equitable adjustments.

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8. The trustee may make all tax elections and allocations the trustee may consider appropriate; however, this authority is to be exercised only in a fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties. All tax elections and allocations made by the trustee in good faith shall not require equitable adjustments.

9. The trustee may employ such lawyers, accountants, and other advisers as the trustee may deem useful and appropriate for the administration of the trust. The trustee may employ a professional investment adviser in managing the investments of the trust (including any investments in mutual funds, investment trusts or managed accounts), delegate to this adviser any discretionary investment authorities and rely on the adviser’s investment recommendations without liability to any beneficiary.

10. The trustee may divide and distribute the trust in kind or in cash, or partly in each, without regard to the income tax basis of any asset and without the consent of any beneficiary. The decision of the trustee in dividing any portion of the trust between or among two or more beneficiaries shall be binding on all persons.

11. The trustee shall distribute any of the trust assets to a minor by distributing them to any appropriate person (who may be a trustee) chosen by the trustee as custodian under any appropriate Uniform Transfers (or Gifts) to Minors Act, to be held for the maximum period allowed by law. The trustee may also sell any asset that cannot legally be held under this custodianship and invest the sales proceeds in assets that can be held under this custodianship.

Article 5. Mandatory Lead Trust Provisions

A. Overriding Tax Purpose. This trust is established as and shall operate as a charitable lead trust the charitable interest in which is a guaranteed annuity under Section 170(f)(2)(B) of the Code and all provisions of this instrument shall be construed in a manner consistent with this purpose. The trustee shall not exercise any discretion under this instrument in a manner inconsistent with this purpose.

B. Payment of the Annuity Amount. The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal.

C. Excess Income. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

D. Incorrect Valuation. If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax
purposes, the trustee shall pay to the charitable organization (in the case of an undervaluation) or receive from the charitable organization (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

E. Proration of Annuity Amount. The trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year in which the annuity period ends, the trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

F. Commencement of Annuity Period. The first day of the annuity period shall be the date the property is transferred to the trust, and the last day of the annuity period shall be the day preceding the date *duration* years thereafter.

G. Additional Contributions. No additional contributions shall be made to the trust after the initial contribution.

H. No Noncharitable Payments During Annuity Term. During the trust term, no payment shall be made to any person other than the charitable organization.

I. Prohibited Transactions. The trustee shall not engage in any act of self-dealing within the meaning of § 4941(d), as modified by § 4947(a)(2), and shall not make any taxable expenditures within the meaning of § 4945(d), as modified by § 4947(a)(2). The trustee shall not retain any excess business holdings that would subject the trust to tax under § 4943, as modified by §§ 4947(a)(2) and 4947(b)(3). In addition, the trustee shall not acquire any assets that would subject the trust to tax under § 4944, as modified by §§ 4947(a)(2) and 4947(b)(3), or retain assets which, if acquired by the trustee, would subject the trustee to tax under § 4944, as modified by §§ 4947(a)(2) and 4947(b)(3).

J. Taxable Year. The taxable year of the trust shall be the calendar year.

K. Limited Power of Amendment. This trust is irrevocable. However, the trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the annuity interest passing to the charitable organization is a guaranteed annuity interest under §§ 170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B) and the regulations thereunder.

L. Grantor Trust Power. During the donor’s life, *First671Person* shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. If *First671Person* is unable to exercise this power because of death or disability, it shall be exercisable by *Second671Person*.
Article 6. Trust Administration

A. Disabled Beneficiaries. The trustee may distribute income or principal, or both, for the benefit of a minor or disabled beneficiary to the beneficiary’s parent, guardian or personal representative, or to the person with whom the beneficiary resides, without looking to the proper application of those payments.

B. Accountings. The trustee shall not be required to file annual accounts with any court or court official in any jurisdiction.

C. Change of Situs. The trustee may change the situs of this trust (and to the extent necessary or appropriate, move the trust assets) to a state or country other than the one in which the trust is then administered, if the trustees believe it to be in the best interests of the trust or the beneficiaries. The trustee may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances.

Article 7. Definitions and Miscellaneous

A. Applicable Law. The operation of the trust shall be governed by the laws of the State of [state]. However, the trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the requirements for the charitable deductions available for contributions to a charitable lead annuity trust.

B. Copies. There is only one signed original of this trust instrument. Anyone may rely on a copy of this trust instrument certified by a notary public or similar official to be a true copy of the signed original (and of any amendments) as if that copy were the signed original. Anyone may rely on any statement of fact certified by the person who appears from the original document or a certified copy to be a trustee.

C. Disabled. An individual is “disabled” or “under a disability” if the trustee (or, if the person whose disability is in question is a trustee, the next successor trustee) receives written certification from two (2) physicians, both of whom have personally examined the individual and at least one (1) of whom is board certified in the specialty most closely associated with the alleged disability. The certification must state that the individual is incapable of managing his or her own finances, regardless of cause and regardless of whether there is an adjudication of incompetence, mental illness, or need for a committee, conservator, guardian or other personal representative. No person is liable to anyone for actions taken in reliance on these certifications or for dealing with a Trustee other than the one removed for disability based on these certifications.

D. Number. Whenever the context requires, the singular number includes the plural and the plural the singular.
E. Tax-Related Terms. All tax-related terms shall have the same meaning that they have in the Internal Revenue Code of 1986, as amended.

F. Trust. “Trust,” without further qualification or specification, shall refer to all trusts under this instrument.

G. Trustee. “Trustee” shall include each trustee individually, multiple trustees, and any successor trustee.

DECLARED AND AGREED on the date indicated above.

[signature] (Seal)
*Grantor*, Grantor

[signature] (Seal)
*FirstTrustee*, Trustee

*Charity*

By: [signature] (Seal)

[Notarial clause and schedule]
WAIVER OF CERTAIN RIGHTS

I, *Spouse*, waive all of my right, title, and interest in any property transferred to the attached trust, dated [date] (the “trust”), by *Grantor*. This waiver shall apply both to current and inchoate interests that I may have, including, but not limited to, rights to an intestate share of *Grantor*’s estate, to a statutory share of *Grantor*’s estate, to a share as an omitted spouse, and to a share in the nature of dower or curtesy. This waiver shall constitute a third-party beneficiary contract for the benefit of all the beneficiaries of the trust, and these beneficiaries or the trustee of this said trust may enforce this waiver by appropriate legal action.

Dated: ..........., 20....

[signature]
*Spouse*

Accepted: ............................................
[signature]
*Grantor*
Transfer Fees - How to Make Money in Real Estate
(and Render Your Purchaser’s Title Unmarketable)
Without Really Trying\(^1\)

By
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A. The Basics of the Program

Several companies, particularly in Texas and Florida, have recently developed and copyrighted innovative new programs whereby developers, individual homeowners and Realtors\(^{\circ}\) ("Seller") can derive future income from residential properties that they sell today. These programs provide the Seller with proprietary documentation that enables the Seller to impose a covenant on the title at the time of conveyance to a third party purchaser. The covenant requires the payment of a “transfer fee” to the Seller each time the property is thereafter sold, and imposes a lien in favor of the Seller to secure the obligation to pay that fee. The covenant is then recorded in the land records, where it will be picked up in later title searches. By purporting to impose a lien on the property, the covenant forces the title company to either take exception to the lien, or require payment of the fee at closing. The companies selling these programs ("Program Company") then collect the fees and forward the payments, less a commission, to the Seller.

B. A “No-Lose” Situation for the Seller (?)

The program appears very attractive to Sellers. When a property owned by a Seller participating in the program is sold, the Seller does not collect any transfer fee at the time the covenant is created/imposed. The Seller has no upfront costs, and no costs of administration, but does have the promise of a potentially huge profit in the future. Because of the promise of future profit, the Seller can reduce its sales price, making the sale more attractive to purchasers, and yet still have the prospect to make more money from (an indeterminate) future transfer fee income stream. All of this adds up to provide the Seller with a sales advantage.

The Program Company also markets the product to Realtors\(^{\circ}\), who are allowed to share in the payment of the future transfer fees, as both an incentive to sell the product, and as stated in the marketing materials, a way to derive larger commissions.

According to marketing information of the first known company to market this scheme, the Program Company gets 30%, the Seller gets 60%, and the Realtor gets 10% of each future transfer fee payment.

At least one of the Program Companies has sought to patent its “unique business method” to protect its program from being copied and its prices undercut by competitors.

\(^1\) This paper was presented at the American College of Real Estate Lawyers 2007 Fall Meeting and is now available as part of the ACREL Papers produced by ALI-ABA.
C. Effect of the Covenant on the Title

Most of the transfer fee programs have a 99 year term, with a suggested transfer fee of 1% to 3% per transfer. Because, statistically, the typical residential property is resold every seven years, the transfer fee collection opportunity is quite attractive. If a Seller (not a future owner of the encumbered real estate) is pressured to release the covenant because of a potential lost sale, it is free to do so. However, according to the marketing materials, a 1% additional fee on the purchase price generally is not enough to cause a purchaser to “back down” or, on the other side of the deal, to cause a future title-holder to sue to release the covenant.

In some cases, the covenant provides for a one-time “buy-out” of the transfer fee, for a payment of 5% of the current sales price. Because for this seller and buyer it is cheaper to pay the one-time fee of 1%, there is little incentive to pay 5% to buy-out the covenant, and it remains in place to generate future income.

One of the first of these programs was created by Freehold Licensing. Their program is based on a type of “note” given by Freehold to the Seller, whereby Freehold agrees to pay to the Seller a sum certain, but with no payment schedule. Instead, payments are made as future transfer fees are collected. The only party coming away from the original closing table with extra money is the Realtor©, who generally receives an immediate payment of approximately $1,000, supposedly for getting the Seller to participate in the program.

D. What is the Potential Income to the Seller?

For a residential developer, theoretically, the potential income is significant. Quoting from the Freehold Licensing marketing materials:

“Developer buys 250 acres, plats it into 1,000 lots, and files the Covenant with a 2% Transfer Fee. Homebuilder buys the lots and builds $200,000.00 homes on each lot. Sales through 2010 are exempt.

“After 2010, when the subdivision turns over once (meaning each home sells just one time), Developer earns an estimated $3.5 million dollars (avg. $500,000/year). The next time the homes turn over they have presumably increased in value again, earning Developer an estimated $4.5 million dollars (avg. $650,000/year). This trend continues for 99 years.”

E. The Title Industry’s Response

When title companies first encountered these covenants, they were unsure how to handle them. For example, several years ago title companies encountered another type of scheme where homeowners were filing “Common Law” liens against their own properties. Title companies felt it was safe to ignore these liens, on the basis that they were based on faulty law, and lacked consideration. However, on their face, these new “future transfer” liens appear to be supported by some sort of consideration (reduced purchase price), and could be valid under state law. They also are not so large as to be voided as an unreasonable restraint on alienation. In fact, informal industry assessment suggests that several large developers report no resistance to the imposition of the fee on their properties. Therefore, title companies are unable to simply ignore them.

In Texas, where it appears that these schemes started, the title companies are prohibited from insuring over recorded liens against the property without some kind of surety bond or funded escrow. Because it appears that the Program Company occasionally tracks the records of

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properties subject to their covenants, the risk of having an action filed to foreclose the lien arising from the non-payment of the transfer fee is real. Therefore, for the time being, title companies cannot ignore these liens, and must require that these transfer fees be paid, or an exception will be taken in the title policy.

F. Summary

It’s hard to know what challenges, legislative or otherwise, might be mounted against the Program, but practitioners should be aware of the subject. And it is probably a good idea to ask yourself if you’d be willing to help a client who wanted to implement one.3

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3 Since this paper was originally presented, legislative action aimed at limiting transfer fees has been passed in Florida and Missouri.
STATES MOVE TO LIMIT ENFORCEABILITY OF TRANSFER FEES

Florida and Missouri recently took steps to prohibit the enforceability of transfer fees against subsequent grantees of realty. Counsel, particularly, those representing buyers of residential property, should be aware that these types of restrictions may be present in grant deeds, covenants or other documents and verify whether there is law in their jurisdictions addressing their enforceability.

Florida

The Florida legislature recently moved to prevent a transfer scheme originating in Texas from taking root in Florida. The scheme causing Florida consternation provided for a property owner to reserve in a recorded instrument the right to receipt of a percentage of the purchase price or value of real property on transfer of that property in all future transfers and sales of the property. The percentage is generally a small one, one to two percent (1-2%) of the transfer price or value, but buyers are generally unaware of the fee until they have entered into a contract for the property and review title documents or prepare for closing on the purchase. The scheme unjustly enriches the former owner, adversely impacts the marketability of the real property, impedes the purchase and sale process and places an unreasonable restraint on the transfer of real property subject to these reservations. It further erodes property values in the existing difficult real estate market.

The prohibition against transfer fee covenants enacted by the Florida legislature is set out in newly created Section 689.28, Florida Statutes. The statute is the result of work on Senate Bill 464 by Senator Dave Aronberg (D-Greenacres) and on House Bill 391 by Representative Charles McBurney (R-Jacksonville). The bill was signed by Governor Crist on May 28, 2008, as Laws of Florida 2008-35 and is effective on July 1, 2008. The text of the Florida bill may be accessed at http://www.flsenate.gov/.

Missouri

In Senate Bill No. 907, the Missouri Legislature added Section 442.558 to Missouri’s statutory provisions on Titles and Conveyances of Real Estate. The new Section 442.558 creates a prohibition on transfer fees by declaring that transfer fees, declarations and covenants requiring the payment of a fee to a specified person upon a transfer of a interest in real property are not enforceable against subsequent owners, purchasers, or mortgagees of the real property, and that liens purporting to secure the payment of a transfer fee under a transfer fee covenant are void and unenforceable.

Section 442.558.2 provides that a “transfer fee covenant” recorded in Missouri on or after September 1, 2008, “shall not run with the title to real property and is not binding on or enforceable at law or in equity against any subsequent owner, purchaser, or mortgagee of any interest in real property as an equitable servitude or otherwise.” S.B. 907, 94th Gen. Assem., 2d Reg. Sess. (Mo. 2008). Further, it states that “[a]ny lien purporting to secure the payment of a transfer fee under a transfer fee covenant recorded in [Missouri] on or after September 1, 2008, is void and unenforceable.” Id. The new section defines “transfer fee covenants” as declarations or covenants that require or purport to require the “payment of a transfer fee to the declarant or other person specified in the declaration or covenant or to their successors or assigns upon a subsequent transfer of an interest in the real property.” Id. It defines “transfer fees” as fees or charges “payable upon the transfer of an interest in real property, or payable for the right to make or accept such transfer, regardless of whether the fee or charge is a fixed amount or is determined as a percentage of the value of the property, the purchase price, or other consideration given for the transfer.” Id. Transfer fees do not include (a) a grantee’s consideration payable to the grantor for the transfer, (b) a commission payable to a licensed real estate broker pursuant to an agreement between the broker and the grantor or grantee, (c) any amounts payable to a lender by a borrower under a loan secured by a mortgage against real property, (d) rent or other amounts payable by a lessee to a lessor under a lease, (e) “any
consideration payable to the holder of an option to purchase an interest in real property or the holder of a right of first refusal or first offer to purchase an interest in real property for waiving, releasing, or not exercising the option or right upon the transfer of the property to another person,” and (f) taxes, fees, charges, assessment, fines or other amounts payable or imposed by a governmental authority. Id.

Senate Bill No. 907 was delivered to the Missouri Governor on May 29, 2008. The statutory changes and additions in the bill will take effect on August 28, 2008.

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The Treatment of Mortgage Loan Repurchase Agreements
in Chapter 11 Bankruptcy*

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March 2008

In a recent case of first impression, a bankruptcy court held that a contract for, among other things, the sale and repurchase of mortgage loans was a “repurchase agreement” as defined in Section 101(47) of the Bankruptcy Code and the amended “safe harbor” provisions of Sections 555 and 559 of the Bankruptcy Code were applicable; however, the safe harbor provisions did not apply to the servicing rights for the mortgage loans.

In Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.),² the United States Bankruptcy Court for the District of Delaware recently held that a contract providing for, among other things, the sale and repurchase of mortgage loans was a “repurchase agreement” as defined in Section 101(47) of the Bankruptcy Code and, as such, these provisions of the contract were entitled to the protections afforded by the amended “safe harbor” provisions of Sections 555 and 559 of the Bankruptcy Code. The court also held, however, that the provisions of the contract relating to the servicing rights of such loans were not protected by the safe harbor provisions.

A DISCUSSION OF MORTGAGE LOAN REPURCHASE AGREEMENTS

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A common mortgage loan repurchase agreement provides a means by which a finance provider (a “repo buyer”) can supply a loan originator (a “repo seller”) with the funds necessary to originate mortgage loans. In exchange for providing these funds, the repo seller agrees to sell the loans to the repo buyer for an interim period during which the repo seller may seek to arrange for a final disposition of the mortgage loans by way of a securitization or other means. The repo seller will then re-purchase such loans from the repo buyer in exchange for the transfer of funds from the repo seller to the repo buyer. The repo buyer’s re-transfer of the mortgage loans or the interests in mortgage loans to the repo seller should occur no later than one year after the initial transfer in exchange for the transfer of funds from the repo seller. The re-purchase price paid by the repo seller would consist of the original purchase price paid to the repo seller, plus a premium to compensate the repo buyer for both the time value of its money and the risk associated with the transaction. The repo seller may then sell these mortgage loans to a securitization trust or other ultimate purchaser. The following diagram illustrates an example of such a structure:

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Step 1

Repo Seller

- Originates mortgage loans

Repo Buyer

- Transfer of mortgage loans

Payment of the funds with respect to the transferred loans

Step 2

(to occur less than one year after Part 1, or on demand)

Repo Seller

- Transfer of mortgage loans

Securitization Trust or Other Ultimate Purchaser

- Payment for mortgage loans

Repo Buyer

- Re-transfer of mortgage loans

Payment equal to original "purchase price" paid plus a pricing differential
A repurchase agreement can be contrasted with a secured debt warehouse financing. While these transactions may appear similar, the treatment a secured debt warehouse financing receives in a bankruptcy proceeding is vastly different. In a secured financing, a loan originator (the “Originating Lender”) will seek financing by which to originate loans. The Originating Lender will pledge, rather than sell, assets (typically the loans it originates) to a lender (the “Warehouse Lender”) in exchange for loan funds under a revolving line of credit or other similar facility. The Originating Lender may then sell these mortgage loans to a securitization trust or other ultimate purchaser. The Originating Lender likely would use the proceeds from any such sale to repay the warehouse facility and, in return, the Warehouse Lender will release its lien on such loans. The following diagram illustrates this structure:
Originates mortgage loans

Pledges Assets (typically loans originated by Borrower)

Originating Lender

Loans funds under a revolving line of credit (or similar facility)

Warehouse Lender

Repays all or a portion of the warehouse loan

Originating Lender

Releases its lien on the mortgage loans

Payment for mortgage loans

Transfer mortgage loans

Securitization Trust or Other Ultimate Purchaser
Although a repurchase agreement and a secured debt financing have similar economic benefits, a creditor in a secured debt financing is not entitled to any of the “safe harbor” provisions discussed in greater detail below. Thus, creditors in a secured debtor financing are subject to, among other things, the automatic stay under Section 362(a) of the Bankruptcy Code.

A DISCUSSION OF SAFE HARBOR AND RELATED BANKRUPTCY CODE PROVISIONS

In 2005, Congress enacted amendments to the Bankruptcy Code. These amendments expanded the definition of both a “repurchase agreement” and a “securities contract,” and exempted repurchase agreements from the obligations and restrictions imposed by the following provisions of the Bankruptcy Code: (i) the automatic stay under Section 362(a), which stays the post-petition exercise of the right to terminate the agreement, accelerate obligations of the parties, sell or recover the underlying securities, and set off the remaining mutual debts and claims under the agreement; (ii) the opportunity for the debtor to assume or reject repurchase agreements under Section 365; (iii) the avoidance of pre-petition payments or transfers by the debtor as “preferences” under Sections 547 and 550; and (iv) the prohibition against ipso facto clauses under Section 365(e)(1).

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5 Section 101(47) of the Bankruptcy Code now defines “repurchase agreement” to include mortgage-related securities, mortgage loans, and interests in mortgage-related securities or mortgage loans.

6 Section 741(7) of the Bankruptcy Code now defines “securities contract” to include mortgage loans and any interests in mortgage loans, including repurchase transactions.
Under Section 362(a) of the Bankruptcy Code, when a debtor files for protection under any chapter of the Bankruptcy Code, it triggers an injunction or “automatic stay” against, *inter alia*, the continuance of any action by any creditor against the debtor or the debtor’s property. Section 559 of the Bankruptcy Code, however, exempts “repurchase agreements” from the automatic stay. Section 559 provides, in pertinent part, that the “exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination or acceleration of a repurchase agreement” under an *ipso facto* clause “shall not be stayed, avoided or otherwise limited by operation of any provision of [the Bankruptcy Code].” In essence, Section 559 allows a party protected by a repurchase agreement to enforce the termination provisions of the agreement as a result of a bankruptcy filing by the other party. Section 555 of the Bankruptcy Code provides the same exemption for “securities contracts.” Moreover, Section 362(b)(7) of the Bankruptcy Code exempts setoffs under repurchase agreements from the automatic stay, and enables a repo buyer to recoup its losses by selling the mortgage loans serving as collateral.

Pursuant to Section 365 of the Bankruptcy Code, a bankrupt debtor may assume or reject any executory contract or unexpired lease. As executory contracts and unexpired leases are regarded as property of the bankruptcy estate, a non-debtor party is prohibited from unilaterally terminating a contract or lease with the debtor, absent relief from the automatic stay. This is significant for a repo participant as it would prevent the non-bankrupt party from terminating the repurchase agreement and selling the mortgage loans under Section 365 of the Bankruptcy Code.

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7 The Bankruptcy Code contains no definition of “executory contract.” The majority view, however, is that an executory contract is a contract between a debtor and another party under which both parties have significant performance commitments, such that if either side failed to complete its performance obligations under the contract, it would excuse performance by the other party.
Bankruptcy Code Section 559, however, exempts repurchase agreements from this obligation and allows repo participants to exercise their contractual rights to cause the acceleration, termination or liquidation of a repurchase agreement. As such, a repo participant may terminate the repo agreement and sell the collateral mortgage loans in the event of a repo seller bankruptcy without fear of violating the requirements of Section 365.

Section 547 of the Bankruptcy Code provides that a bankrupt debtor may avoid or recover (for the estate) certain pre-petition transfers as a “preference” payment. Bankruptcy Code Section 548 permits the recovery of certain pre-petition transfers for which the debtors received less than “fair value.” The policy rationale underlying these requirements is that it ensures the fair treatment of all unsecured creditors. The requirements of Sections 547 and 548 of the Bankruptcy Code are of concern for repo participants as a bankruptcy court could seek to undo certain transfers required under a repurchase agreement as “preference” payments or “fraudulent transfers” if such transfers occurred prior to repo seller’s bankruptcy petition. Section 559 of the Bankruptcy Code, however, exempts repurchase agreements from this obligation and allows repo participants to exercise their contractual rights without risk of having them “unwound.”

**Factual Background of the Case**

On November 21, 2006, American Home Mortgage, Inc. (“American Home”) and a group of financial institutions, for whom Calyon New York Branch (“Calyon”) served as administrative agent, entered into an agreement (the “Agreement”). American Home was in the business of originating, selling and servicing mortgage loans. Calyon financed American
Home’s operations via the Agreement pursuant to which Calyon would provide American Home with the funds necessary to originate the mortgage loans. In return, American Home would sell the loans to Calyon for an interim period during which American Home would seek to arrange for a final disposition of the mortgage loans by way of a securitization or other means. Once American Home was able to sell the mortgage loans, it would repurchase the same from the Calyon in exchange for the transfer of funds from American Home to the Calyon. Calyon would then to return the mortgage loans or the interests in mortgage loans to American Home no later than 180 days after the initial transfer in exchange for the transfer of funds from American Home. The repurchase price paid by American Home would consist of the original purchase price paid to American Home plus the “pricing differential,” a per diem “pricing rate” multiplied by the number of days the mortgage loans were in the possession of Calyon.

Additionally, the Agreement provided for the servicing of the mortgage loans. Specifically, the Agreement provided that the underlying mortgage loans were to be transferred to Calyon (as administrative agent) on a “servicing retained” basis. In a servicing retained sale of a mortgage loan, the repo seller retains the right to designate the mortgage loan servicer. Conversely, in a “servicing released” sale of a mortgage loan, the repo buyer purchases both the mortgage loan and the right to designate the mortgage loan servicer. Typically, a buyer will pay a greater price in a servicing released transaction because it is purchasing both the mortgage loan and the right to receive the payments for servicing the loan. In this case, American Home Mortgage Servicing, Inc. (an affiliate of American Home) had the right to service the mortgages, and was entitled to a servicing fee during the term of the Agreement. Pursuant to other
provisions of the Agreement, however, Calyon could designate a new servicer upon the occurrence of an event of default by the incumbent servicer.

Finally, the Agreement contained an *ipso facto* clause, which allowed either party to the Agreement to terminate and/or liquidate for cause if the other party became insolvent, failed to follow the conditions articulated in the Agreement or declared bankruptcy.

**THE BANKRUPTCY COURT’S ANALYSIS AND HOLDING**

In reaching a decision in the case, the court was called upon to decide four issues. The first issue was whether the Agreement was a repurchase agreement as defined in Section 101(47) of the Bankruptcy Code. The second issue was whether such a repurchase agreement was entitled to the protections afforded by the amended “safe harbor” provisions of Sections 555 and 559 of the Bankruptcy Code. The third issue was whether the provisions of the Agreement addressing the servicing of the mortgage loans were afforded the protection of the aforementioned “safe harbor” provisions, or whether these provisions were severable from the rest of the Agreement. The final issue was whether the court should order specific performance of American Home’s obligation to transfer servicing rights to Calyon upon an event of default by American Home Mortgage Servicing.

**A. Is the Agreement a Repurchase Agreement?**

The court began its analysis by describing the nature of a repurchase agreement. The court looked to the Third Circuit, which in *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer S&L Ass’n*[^8] characterized a repurchase agreement as a two-step transaction. The first

[^8]: 878 F.2d 742 (3d Cir. 1989).
step entails a transfer of specified securities by one party (the “repo seller”) to another party (the “repo buyer”) in exchange for cash. The second step is a contemporaneous agreement by the repo seller to repurchase the securities from the repo buyer at the original price, plus an agreed upon additional amount on a specified future date.

The bankruptcy court went on to articulate the specific factors that identify and distinguish a repurchase agreement from a secured financing transaction. The court looked to the plain meaning of Section 101(47) of the Bankruptcy Code, and stated that an agreement will be considered a repurchase agreement if it: (i) provides for the transfer of one or more mortgage loans or interests in mortgage related securities or mortgage loans; (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage related securities or mortgage loans; (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests in mortgage related securities or mortgage loans; (iv) at a date certain not later than one year after such transfer or on demand; and (v) against the transfer of funds. The court then analyzed whether the Agreement fulfilled each of these factors.

The court found the first factor fulfilled as the Agreement provided for the transfer of multiple mortgage loans or interests in mortgage loans. The court noted that even if the Agreement provided for the creation of a lien on the mortgage loans, it would still constitute a “transfer” under 11 U.S.C. §101(54). With respect to the second factor, the court determined the transfer of the mortgage loans from American Home to Calyon to be against the transfer of funds from Calyon to American Home. Additionally, the Agreement contained a concurrent agreement by Calyon to transfer the mortgage loans to American Home and, according to the court, this fulfilled the third factor. With respect to the fourth factor, the court concluded that this factor
was satisfied as the transfer of the mortgage loans from Calyon to American Home was to occur within 180 days of the original transfer, well before the one-year deadline. Finally, as the transfer of the mortgage loans from Calyon to American Home was against the transfer of funds by American Home to the Calyon, the final factor was fulfilled. Thus, the court held that the sale and repurchase of the mortgage loans under the Agreement was a repurchase agreement.

B. Are the Amended “Safe Harbor” Provisions of Sections 555 and 559 of the Bankruptcy Code Applicable?

As the sale and repurchase of the loans under the Agreement was a repurchase agreement, the court held that the “safe harbor” provisions of Sections 559 and 555 of the Bankruptcy Code were applicable. As noted above, these sections protect the exercise of certain contractual rights to liquidate, terminate and accelerate repurchase agreements from the automatic stay, and other bankruptcy limitations.

In reaching this conclusion, the court determined that it need only apply the “plain meaning” of the Section 101(47) definition of “repurchase agreement.” As the Agreement was a repurchase agreement, and as both Calyon and American Home were “repo participants,” Section 559 of the Bankruptcy Code was applicable. The court rejected American Home’s argument that additional criteria were required to find an agreement to be a repurchase agreement. Thus, the court held that the rights of Calyon (as the non-debtor party) relating to the sale and repurchase of mortgage loans were not stayed, avoided or otherwise limited by the operation of any provision of the Bankruptcy Code.

C. Are the Servicing Rights also Protected by the “Safe Harbor” Provisions?

With respect to the servicing of the mortgage loans under the Agreement, however, the court found that the safe harbor provisions were inapplicable. Applying New York law, the
court reached this conclusion for two reasons: (i) the portion of the Agreement that provided for the servicing of the mortgage loans was severable from the portion of the Agreement providing for the sale and repurchase of the mortgage loans; and (ii) the portion of the Agreement providing for the servicing of the mortgage loans was neither a “repurchase agreement” (under 11 U.S.C. §101(47)), nor a “securities contract” (under 11 U.S.C. §741(7)(a)(i)). Based on this finding, the court held that the provisions of the repurchase agreement relating to servicing the mortgage loans were severable from the rest of the Agreement, and were thus not entitled to the protections of the “safe harbor” provisions of the Bankruptcy Code.

D. Is Specific Performance of American Home’s Obligation to Transfer Servicing Rights to Calyon Appropriate?

The court refused to grant specific performance, reasoning that absent an applicable “safe harbor” for the servicing portion of the Agreement, Calyon was not entitled to specific performance.

SIGNIFICANCE OF THE DECISION

The American Home decision is significant in that it is a case of first impression regarding the applicability of the amended “safe harbor” provisions of Sections 555 and 559 of the Bankruptcy Code to a repurchase agreement involving mortgage loans. Participants in a repurchase agreement should take some comfort from the court’s holding that the portion of the agreement providing for the sale and repurchase of mortgage loans fell within the plain meaning of the Bankruptcy Code’s definitions of a “repurchase agreement” and a “securities contract.” This enables repo participants to receive the protections for which they bargained through the application of the amended “safe harbor” provisions.
Of note, however, is the court’s finding that the portion of the agreement providing for the servicing of the mortgage loans was not protected under the amended “safe harbor” provisions of the Bankruptcy Code because that portion of the agreement was neither a repurchase agreement nor a securities contract. As a bankrupt repo seller is unlikely to have the funds necessary to buy back its loans, a repo buyer may have to liquidate collateral loans by sales to third-party buyers. The price a repo buyer could realize from such a sale, however, may be reduced if the repo buyer must sell the mortgage loans subject to the bankrupt repo seller’s servicing rights.
By Stephen R. Buchenroth and Gretchen D. Jeffries

In our previous article, two foreclosure cases from the United Stated District Court for the Northern District of Ohio were discussed because of the stir they created among some real estate lawyers: *In re Foreclosure Cases*, 2007 WL 3232430 (N.D.Ohio, Oct. 31, 2007) and *In re Foreclosure Actions*, 2007 WL 4034554 (N.D.Ohio, Nov. 14, 2007) (collectively, the “Northern District Foreclosure Cases”). The court in both cases dismissed complaints to foreclose on mortgages because the plaintiff lender failed to submit to the court a copy of the assignment of the note and mortgage evidencing the plaintiff’s status as holder of the note and mortgagee under the mortgage.

One Ohio case that was decided contemporaneously with the Northern District Foreclosure Cases but not discussed in the previous comment was *In re Foreclosure Cases*, 521 F.Supp.2d 650 (S.D. Ohio, 2007). This decision from Judge Thomas M. Rose of United Stated District Court for the Southern District further bolstered the decisions issued by Judge Christopher A. Boyko and Judge Kathleen McDonald O’Malley.

*In re Foreclosure Cases* involved 27 foreclosure actions filed in the Southern District of Ohio, in which the court questioned whether the plaintiff lenders had standing when the foreclosure complaint was filed and whether the court had subject matter jurisdiction to hear the cases at the time the foreclosure complaint was filed. 521 F.Supp.2d at 652. In a sentiment that would be echoed through subsequent decisions in the Southern District of Ohio, Judge Rose stated:

…this Court has the responsibility to assure itself that the foreclosure plaintiffs have standing and that subject-matter-jurisdiction requirements are met at the time the complaint is filed. Even without the concerns raised by the documents the plaintiffs have filed, there is reason to question the existence of standing and the jurisdictional amount. See Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims* 3-4 (November 6, 2007), University of Iowa College of Law Legal Studies Research Paper Series Available at SSRN: http://ssrn.com/abstract=1027961 (“[H]ome mortgage lenders often disobey the law and overreach in calculating the mortgage obligations of consumers.... Many of the overcharges and unreliable calculations ... raise the specter of poor recordkeeping, failure to comply with consumer protection laws, and massive, consistent overcharging.”) Id at 654.

Judge Rose provided plaintiff lenders thirty days to submit evidence showing that they had standing when the complaint was filed and that the court had diversity jurisdiction when the complaint was filed. Id at 654. Citing Judge Boyko’s decision, Judge Rose held that failure of plaintiff to proffer such evidence would result in dismissal without prejudice for re-filing if and when the plaintiff acquires standing and the diversity jurisdiction requirements are met. Id.
Judge Rose went on to acknowledge:

This Court is well aware that entities who hold valid notes are entitled to receive timely payments in accordance with the notes. And, if they do not receive timely payments, the entities have the right to seek foreclosure on the accompanying mortgages. However, with regard the enforcement of standing and other jurisdictional requirements pertaining to foreclosure actions, this Court is in full agreement with Judge Christopher A. Boyko of the United States District Court for the Northern District of Ohio who recently stressed that the judicial integrity of the United States District Court is “Priceless.” Id at 655.

Judge Rose decided four more cases in the month of November 2007, all of which echoed the same holding from the above referenced case and provided the plaintiff lenders thirty days to set forth that the plaintiff lender had standing and the court had jurisdiction at the time the foreclosure complaint was filed. 

\[HBC\text{ Bank USA v. Rayford, 2007 WL 4190805 (S.D.Ohio, November 21, 2007)}\]
\[\text{(To show standing in a foreclosure action, the plaintiff must show that it is the holder of the note and the mortgage at the time the complaint was filed.)} \]


Since the Northern District Foreclosure Cases and Judge Rose’s decisions in the Southern District of Ohio, little in the foreclosure arena has changed in the federal district courts in Ohio. However, in the aftermath, some pundits have questioned whether these cases would have been dismissed had the complaints been filed in state court. Of course, whether in federal or state court, standing of the plaintiff to file suit is paramount. In order to satisfy standing requirements in Ohio state court, a party must establish that it is the real party in interest. 

\[\text{State ex rel. Tubbs Jones v. Suster (1998), 84 Ohio St.3d 70, 77}\]
\[\text{(If a party is not the real party in interest, the party lacks standing to prosecute the action).}\]

Several Ohio appellate court decisions decided prior to the federal court decision discussed above appear to give the foreclosing lender some latitude in not attaching the assignment documents to the complaint. Nevertheless, it seems relatively clear that before it is entitled to judgment the plaintiff lender must be able to prove holder status of the note and mortgage.

A 2007 case from an Ohio appellate court addresses the question as to whether ownership of the note and mortgage at the time of the filing of the complaint is essential to establish the plaintiff lender as the real party in interest. 

\[\text{Washington Mut. Bank, F.A. v. Green, 156 Ohio App.3d 461 (Ohio App. 7 Dist.,2004.}.\]
\[\text{In this action, the trial court granted summary judgment to the plaintiff lender in a foreclosure action and the defendant property owner appealed alleging a lack of evidence that the plaintiff lender was the real party in interest. In the trial court, defendant property owner had filed a motion to dismiss the complaint, alleging a lack of evidence that plaintiff lender was the real party in interest given the exhibits to the complaint showed Check ‘n Go as the}\]

-2-
mortgage holder, not plaintiff lender. Id at 462. Plaintiff lender responded that Civ.R. 8 requires only a short and plain statement of the relief sought and so its statement that it is the current owner of the note and mortgage must be taken as true. Id. In response, plaintiff lender filed a motion for summary judgment declaring that because defendant property owner defaulted on the loan, plaintiff lender was entitled to acceleration of the loan and foreclosure. Id at 463. Lender plaintiff attached the affidavit of its vice-president stating that the affiant had personal knowledge of the account, which was under her supervision, that the account was in default and that the copies of the note and mortgage were true and accurate copies. Id. Defendant property owner argued that the exhibits show Check 'n Go as the mortgage holder and that the affidavit does not state how or when plaintiff lender obtained the note and mortgage. Id. Defendant property owner attached exhibits from the county recorder's office showing an assignment of the note and mortgage to The Provident Bank (assignment in March 2001, recorded in April 2001) and to Long Beach Mortgage Company (recorded in July 2001), and stating that the recorder's office had no evidence of the assignment to plaintiff lender. Id.

The appellate court reversed the trial court’s granting of a summary judgment for the plaintiff lender; however, the reason for the reversal was not because the plaintiff lender failed to establish that it was the real party in interest. The Court explained:

Appellant cites cases that require a lawsuit to be brought in the name of the real party in interest. Appellant argues that the record does not show [plaintiff lender]'s interest in the note and mortgage…As long as a set of facts consistent with the complaint would allow plaintiff recovery, the court shall not grant a motion to dismiss. Beretta at ¶ 5. Here, [plaintiff lender]'s complaint states that it is the owner and holder of the promissory note and mortgage. It is well established that the real party in interest in such a case is the current noteholder/mortgage holder, which, due to the possibility of assignment, could be different from the original holder. See Conrad v. Rarey (1931), 125 Ohio St. 326, 331-332, 181 N.E. 444. See, also, 1970 Staff Note to Civ.R. 17(A). Under the aforesaid premises behind motions to dismiss, we must thus presume that plaintiff lender's statement is true. If this statement is presumed true, then plaintiff lender is considered to be the real party in interest for purposes of the pretrial motion to dismiss stage of the proceedings. As such, the trial court correctly refused to grant the motion to dismiss at a time before the allegations of the complaint were required to be proven. Accordingly, this assignment of error is overruled. Id at 463-64.

However, the court did find that defendant property owner’s evidence that she received correspondence from a third party lender claiming to be the current holder of the note and mortgage pertinent to the determination of the real party in interest. The Court said:

Specifically, [defendant property owner] maintained throughout the proceedings that she did not believe that [plaintiff lender] was the real party in interest. She submitted documents from the recorder's office showing assignment of the
mortgage to two different companies in 2001 and noted that she found no entries showing assignment to [plaintiff lender]. She began receiving notices from an entirely different entity seeking to collect on the mortgage during the course of the proceedings, further confusing the issue of the real party in interest. [Plaintiff lender] submitted an affidavit...merely stating that the account is under the supervision of the affiant and the account is in default. The affidavit did not mention how, when, or whether [plaintiff lender] was assigned the mortgage and note. The trial court's grant of summary judgment and denial of the right to file a third-party complaint defeated the purpose of Civ.R. 17(A). That is, [defendant property owner] is not protected from multiple judgments on the same subject matter, and she may be precluded from asserting various counterclaims due to the judgment. Id at 467.

Another Ohio decision did permit an assignment post-filing of the complaint to be determinate in establishing that the lender plaintiff was the real person in interest. Bank of New York v. Stuart, 2007 WL 936706 (Ohio App. 9 Dist., March 30, 2007). Defendant property owners appealed the trial court’s award of summary judgment to plaintiff lender averring that plaintiff lender was not a party in interest at the time the complaint was filed and that the assignment from America's Wholesale Lender to plaintiff lender, which was reduced to writing and filed in the trial court after plaintiff lender filed its complaint for foreclosure, was an insufficient means of advising the court and the parties that [plaintiff lender] was a party in interest. Id at *1. The appellate court disagreed, affirming the trial court’s summary judgment on behalf of plaintiff lender. Id. The court stated that “an action will not be dismissed [for lack of standing to prosecute the action] until a reasonable time has been allowed for the real party in interest to ratify the commencement of the action or to be either joined or substituted as a party.” Id at *2. The court further explained:

In their memorandum opposing [defendant property owners’s] motion for summary judgment, [defendant property owners] argued that [plaintiff lender] did not have a valid assignment of their mortgage when [plaintiff lender] filed its complaint. [Defendant property owners] also pointed out the fact that the assignment from America's Wholesale Lender to [plaintiff lender] had an effective date of more than five months after [plaintiff lender] filed its complaint for foreclosure...this Court has found case law to support appellee's claim that filing the assignment with the trial court before judgment was entered was sufficient to alert the court and appellants that [plaintiff lender] was the real party in interest. (citations omitted)...In the present matter, [defendant property owners] have failed to show that they were prejudiced by the assignment. In addition, the assignment did preclude America's Wholesale Lender from bringing an action against [defendant property owners]. Therefore, this Court finds that [plaintiff lender] was a real party in interest for purposes of filing the foreclosure action. Consequently, the trial court correctly awarded summary judgment in favor of [plaintiff lender]. Id at *2-3.
Ohio appellate cases clearly reject that assignments made after the trial court hearing will suffice to establish the plaintiff lender as the real property in interest. *DLJ Mtge. Capital, Inc. v. Parsons*, 2008 WL 697400 (Ohio App. 7 Dist., Mar 13, 2008). The appellate court in *DLJ Mtge. Capital* compared the case at hand to *Washington Mutual* (discussed earlier) and said:

There is no document, on the record, showing an assignment to [plaintiff lender]. The only evidence on the record of an assignment to [plaintiff lender] is the affidavit of Jon Menz. However, the affidavit fails to mention how, when, or whether [plaintiff lender] was assigned the mortgage and note. As in *Washington Mutual* and *First Union*, the evidence in this case likewise did not establish that [plaintiff lender] is the owner of the note and mortgage. Attached to appellee's appellate brief is a copy of an assignment of the note and mortgage from Olympus Servicing LP to [plaintiff lender]. The file stamp on the assignment shows that it was recorded on February 22, 2007. But the trial court granted summary judgment on November 22, 2006. Although this assignment appears to establish [plaintiff lender] as the party in interest, there is no evidence of this assignment on the record. In fact, evidence of this assignment could not have existed at the time the court granted summary judgment because it had not yet occurred. Hence, it follows that the issue of whether [plaintiff lender] held a valid and secured lien after Olympus assigned the mortgage could not have been determined. *Id* at *3-4.*

The appellate court found that the trial court should have denied summary judgment because a genuine issue of material fact existed as to whether or not plaintiff lender was the real party in interest since there was no evidence on the record of the assignment. See also *Everhome Mtge. Co. v. Rowland*, 2008 WL 747698 (Ohio App. 10 Dist., Mar. 20, 2008) (Court found that it could not consider a lender plaintiff’s evidence introduced on appeal of an assignment post-filing of the foreclosure complaint in order to establish that lender plaintiff was the holder of the note and mortgage because a reviewing court cannot add matter to the record before it which was not part of the trial court’s proceedings.)

While not yet the subject of reported appellate decisions, numerous Ohio trial courts, forced with a growing docket of foreclosure cases and organized efforts by numerous public officials to deal with what is being referred to as “Ohio’s foreclosure crisis,” including the Governor, the Attorney General, the Chief Justice and the Ohio State Bar Association, are dismissing or refusing to proceed with foreclosure action when the plaintiff does not attach a copy of the documents showing holder status of the note and mortgage.

One Ohio court has promulgated additional rules for foreclosure actions within its jurisdiction. The court of common pleas for Summit County, Ohio issued an order on May 1, 2008 (effective June 1, 2008) incorporating new procedures for foreclosure cases. Order Misc. No. 325, issued by the judges of the court stated:
Due to the dramatic increase of foreclosure actions filed and the number of claims filed by parties other than the original mortgagee and note holder, the judges of the common pleas court – general division have determined that when a foreclosure case is filed the use of a Certificate of Readiness is necessary to allow that substantial justice be done and to ensure judicial efficiency. Current circumstances also require a modification of the time in which to file the Preliminary Judicial Report, shortening the time to file such preliminary judicial report from sixty days after filing the complaint to contemporaneous with the filing of plaintiff’s complaint.

The Order amended the rules of practice and procedure of the court to incorporate the new timing of the filing of the Preliminary Judicial Report, which serves as evidence of the state of the record title of the real property, and the requirement of a Certificate of Readiness, which serves to demonstrate that the plaintiff is the real party in interest and the matter is ready to proceed against all necessary parties.

The Certificate of Readiness requires counsel for the plaintiff to certify, among other things, that: (i) should the plaintiff be different from the designated owner of the original note and mortgage due to an assignment, copies of that assignment, and intervening assignments of such note and mortgage are attached to the complaint, and are similarly reflected within the preliminary judicial report; (ii) should the plaintiff be different from the designated owner of the original note and mortgage due to a name change or corporate merger, copies of said name change or merger are attached to the complaint, or an affidavit attesting to the name change or merger along with the dates of the name change or merger is also attached to the complaint; and (iii) all such assignments, name changes, or corporate mergers referred to above, and which are shown on the preliminary judicial report, bear a date prior to the filing date of the complaint in this matter. The form of certificate of readiness can be seen here.

The Northern District Foreclosure Cases and subsequent cases have caused waves not just in Ohio. We are beginning to see the ripple effects in other jurisdictions. Such effects are evident in In re Nosek, 2008 WL 1899845 (Bkrtcy.D.Mass., Apr. 25, 2008), in which the Bankruptcy Court awarded Rule 9011 sanctions against the lender for falsely representing that it was the holder of the note and mortgage, when the lender had sold the note and mortgage five days after closing. The court found:

Throughout most of these proceedings, Ameriquest and its attorneys represented that Ameriquest was the "holder" of the note of the note and mortgage…Unfortunately the parties' confusion and lack of knowledge, or perhaps sloppiness, as to their roles is not unique in the residential mortgage industry. (citations omitted)…Nor are "mistakes" and misrepresentations limited to the identification of roles played by various entities in this industry. In re Schuessler, 2008 WL 1747935, *3 (Bankr.S.D.N.Y. 2008) (movant's motion misrepresented debtor's equity); Porter, Katherine M., "Misbehavior and Mistake in Bankruptcy Mortgage Claims" (citation omitted). As this Court has noted on more than one occasion, those parties who do not hold the note or mortgage and
who do not service the mortgage do not have standing to pursue motions for relief or other actions arising from the mortgage obligation. Schwartz, 366 B.R. at 270. The Court has had to expend time and resources, as have debtors already burdened in their attempts to pay their mortgages, because of the carelessness of those in the residential mortgage industry and the bombast this Court and others have encountered when calling them on their shortcomings. In re Foreclosure Cases, 2007 WL 3232430 at *3, n. 1. Id at *3-4.

The court went on to find the lender’s actions sanctionable despite the lender’s lack of intent to mislead the property owner and the court:

Virtually all of parties argue that there was no intent to mislead the Court. Because the standard to be applied is an objective one, the Court may quickly dispatch this argument. Intent is irrelevant. The argument that the assignment of the note and mortgage was a matter of public record and therefore the Debtor knew or should have known of Norwest's identity is relevant but disingenuous, indeed even arrogant, since many of these same parties asserting this position allege they had no way of knowing about the assignment. They seek to bind the Debtor to one standard and themselves to a much lower one… [This Court] will not tolerate a lender's or servicer's disregard for the rules that govern litigation, including contested matters, in the federal courts. It is the creditor's responsibility to keep a borrower and the Court informed as to who owns the note and mortgage and is servicing the loan, not the borrower's or the Court's responsibility to ferret out the truth. Id at *5.

The judicial admonishment of lenders with sloppy housekeeping persists. We are likely to see more and more ripples outside of Ohio as the number of foreclosures continues to increase.

***************

Stephen R. Buchenroth is a partner in the Columbus office of Vorys, Sater, Seymour and Pease LLP and a former head of the firm’s real estate and commercial practice group. He is a former Chairman of the Real Property Section of the Ohio State Bar Association and a member of the American College of Real Estate Lawyers. Gretchen Jeffries is an associate in the Columbus office of Vorys, Sater, Seymour and Pease LLP and a member of its commercial and real estate group. Ms. Jeffries is a graduate of The Ohio State University and The University of Texas School of Law.
DUE TO THE DRAMATIC INCREASE OF FORECLOSURE ACTIONS
FILED AND THE NUMBER OF CLAIMS FILED BY PARTIES OTHER THAN THE
ORIGINAL MORTGAGEE AND NOTE HOLDER, THE JUDGES OF THE COMMON
PLEAS COURT – GENERAL DIVISION HAVE DETERMINED THAT WHEN A
FORECLOSURE CASE IS FILED THE USE OF A CERTIFICATE OF READINESS IS
NECESSARY TO ALLOW THAT SUBSTANTIAL JUSTICE BE DONE AND TO ENSURE
JUDICIAL EFFICIENCY. CURRENT CIRCUMSTANCES ALSO REQUIRE A
MODIFICATION OF THE TIME IN WHICH TO FILE THE PRELIMINARY JUDICIAL
REPORT, SHORTENING THE TIME TO FILE SUCH PRELIMINARY JUDICIAL REPORT
FROM SIXTY DAYS AFTER FILING THE COMPLAINT TO CONTEMPORANEOUS
WITH THE FILING OF PLAINTIFF’S COMPLAINT.

THE COURT HEREBY INCORPORATES, BY REFERENCE, THE
ATTACHED CERTIFICATE OF READINESS, WHICH IS REQUIRED TO BE FILED
WITH THE CLERK OF COURTS AT THE TIME THE PLAINTIFF’S COMPLAINT IN FORECLOSURE IS FILED. THE COMPLAINT IN FORECLOSURE, THE PRELIMINARY JUDICIAL REPORT AND THE CERTIFICATE OF READINESS SHALL ALL BE FILED CONTEMPORANEOUSLY.

TO ADOPT THESE PROCEDURES, THE RULES OF PRACTICE AND PROCEDURE OF THE COURT OF COMMON PLEAS – GENERAL DIVISION, RULES 11.01 AND 11.02 SHALL BE AMENDED TO READ IN THEIR ENTIRETY AS FOLLOWS (ADDED OR ALTERED LANGUAGE IN BOLD):

11.01 – TITLE EVIDENCE; PRELIMINARY JUDICIAL REPORT AND CERTIFICATE OF READINESS

In actions for the marshaling and foreclosure of liens on real property or partition of real estate, a Preliminary Judicial Report shall be filed with the Clerk by the attorney for the plaintiff at the time of the filing of the complaint. This shall serve as evidence of the state of the record title of the real property in question. Said report may be prepared by an attorney or a competent: abstractor or title company. A copy, certified by the attorney or a photographic copy of the original evidence of title, may be filed with the Clerk in lieu of the original, and shall become and remain a part of the case file. Along with the filing of the Preliminary Judicial Report, the attorney shall file a Certificate of Readiness and any required supporting documentation, demonstrating that plaintiff is the real party in interest and the matter is ready to proceed against all necessary parties. This shall be signed by the attorney. The complaint, the Preliminary Judicial Report and the Certificate of Readiness shall be filed as separate documents at the same time and shall be separately time-stamped with the complaint being filed first.

11.02 – FAILURE TO PROVIDE EVIDENCE

If a Preliminary Judicial Report and the Certificate of Readiness, along with all supporting documentation, are not presented to be filed at the time of the filing of the complaint, the Clerk of Courts shall not accept such complaint for filing.
THIS ORDER SHALL BE EFFECTIVE JUNE 1, 2008 AND ALL
FORECLOSURE FILINGS SHALL BE BOUND BY THE AMENDED LOCAL RULES
AFTER THIS DATE.

IT IS SO ORDERED.

ELINORE MARSH STORMER
ADMINISTRATIVE JUDGE

PAUL J. GALLAGHER
PRESIDING JUDGE

PATRICIA A. COSGROVE, JUDGE

MARY F. SPICER, JUDGE

ROBERT M. GIPPIN, JUDGE

THOMAS A. TEODOSIO, JUDGE

JUDY HUNTER, JUDGE

BRENDA BURNHAM UNRUH, JUDGE

Andrew J. Bauer, Court Executive Officer
In the Court of Common Pleas
County of Summit

Certificate of Readiness

Case Caption

I, ____________________________, counsel for the Plaintiff, certify to the Court that I have reviewed the case file and my own records, and that all of the below statements are correct to the best of my knowledge and belief:

1. The complaint, the mortgage attached to the complaint, and the preliminary judicial report all contain the correct legal description(s) and permanent parcel number(s) relating to the subject property located in Summit County, Ohio.

2. The complaint and the preliminary judicial report both indicate the correct owners of the subject real estate (as shown on the mortgage, tax lien, mechanic's lien, or judgment lien) and signators (as shown on the note and mortgage), and that said owners and signators have been named as Defendants within the complaint.

3. The Plaintiff is the owner of the note and mortgage upon which the complaint is founded and as verified within the preliminary judicial report.

4. Should the Plaintiff be different from the designated owner of the original note and mortgage due to an assignment, copies of that assignment, and intervening assignments of such note and mortgage are attached to the complaint, and are similarly reflected within the preliminary judicial report.

5. Should the Plaintiff be different from the designated owner of the original note and mortgage due to a name change or corporate merger, copies of said name change or merger are attached to the complaint, or an affidavit attesting to the name change or merger along with the dates of the name change or merger is attached to the complaint.
6. Should there be more than one Plaintiff asserting a separate right of ownership in the mortgage and note, all necessary supporting documents establishing the separate chains of ownership are attached to the complaint.

7. The Plaintiff has in its custody and control the original note and mortgage, and said documents are available for inspection upon order of the Court.

8. All such assignments, name changes, or corporate mergers referred to above, and which are shown on the preliminary judicial report, bear a date prior to the filing date of the complaint in this matter.

9. None of the individual Defendants named in this complaint has been adjudicated as incompetent or otherwise under guardianship and/or is a minor.

10. Any person named in their representative capacity (such as a guardian, an estate representative, statutory agent, trustee, or in any other representative capacity) has been correctly designated by name and duly appointed by court order or other government designation, and copies of such appointment documents can be produced upon order of the Court.

11. None of the designated Defendants are currently under the protection of the Federal Bankruptcy Court; if relief from stay has been granted, then a copy of such relief from stay is attached to the complaint.

12. Should the complaint be based upon a judgment lien, mechanic's lien, or a tax certificate, the preliminary judicial report reflects said claim, and a copy of the lien or certificate, together with an affidavit stating the current balance due, is attached to the complaint.

13. Should the complaint be based upon a tax certificate, an affidavit is attached to the complaint describing the tax certificate numbers, the current amount due, and the real estate subject to the within foreclosure.

14. Should the complaint be based upon a mortgage and note, I have available for inspection upon order of the Court a statement showing the total amount due, with a separate itemized part showing the pay-off balance, interest, the interest rate, and any penalties or other charges, with specific reference identifying what the additional penalties and charges are based upon. A person responsible for maintaining such records for the Plaintiff shall certify this statement.
As counsel for the Plaintiff, I acknowledge and otherwise understand that if any of the above requirements are not met or if the provided documents and information are inaccurate, the Court may cause this case to be dismissed without prejudice at the Plaintiff’s cost.

Counsel for Plaintiff

Printed Name and Bar Number

Date

Pursuant to Local Rule 11.09, this Preliminary Certificate of Readiness shall be filed with the Clerk of Courts with the complaint and preliminary judicial report.
She’s a Spreadsheet Wizard: Wining Ways with Spreadsheets

Presenters:
Laura Calloway
Dan Pinnington

Expo: March 13-14, 2008
Hilton Chicago, Chicago, IL

www.techshow.com
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Introduction

If your eyes glazed over the first time you took a look at the opening screen of Microsoft Excel, you’re not alone. The work space is an enormous grid of tiny rectangles and the tool bars contain even more menu choices than Word. As you move the mouse across this grid the pointer assumes numerous strange and incomprehensible shapes. What do all these options do? And how will I ever keep them all straight?

For most of us, our first attempts to obtain something useful from Excel were partially or completely disappointing. It was difficult to figure out how to put information into those little rectangles. They weren’t the right size for what we were trying to type into them, and things would flow over into the next block. And as most of us gave up math after high school, getting a calculation to actually work was impossible. How was this supposed to bring about greater organization or a better analysis of information? Even cutting and pasting didn’t work exactly the same way that it does in Word. And those error messages – they appear to be written in a rare Martian dialect. In short, on the first try Excel was a frustrating experience and it seemed to be way too much trouble and effort for a busy lawyer to attempt to learn how to use. One certainly can’t master it on the fly. Many lawyers who have tried it have never even given it a second look.

Excel and other spreadsheet programs may not be extremely intuitive for lawyers, or anyone else, for that matter, especially those who are not familiar with working with accounting spreadsheets in general. Although, lawyers who are already familiar, and comfortable, with other applications in the Microsoft Office Suite, such as Word and PowerPoint, may have a bit of a leg up at first.

The key point – with just a little time and patience, almost any lawyer will find that a spreadsheet program such as Excel can be mastered, (your authors are living proof!) and that its use can contribute substantially to the lawyer’s ability to compile, organize, analyze and manage information in a law practice, both for clients and for the lawyer’s own benefit, too. Spreadsheets are one of the most helpful and powerful software tools on your computer. It is well worth your time to learn how to use them.

What’s Available In The Spreadsheet World?

As the description of this session indicates, it’s about the use of spreadsheets in the law office – not just how to use Microsoft Excel in a law practice. For that reason, before we launch off into the “why and how you should be using them” part of this presentation, we want to take a moment to make you aware of what else is available
for you to choose from in selecting a spreadsheet program. Although Excel is probably the best known and most frequently used spreadsheet application, there are several other options to choose from.

Of course, for those die-hard WordPerfect fans, and those of you who may be considering a return to WP, the Corel WordPerfect Office 3X suite contains a spreadsheet program called Quattro Pro X3. Like Microsoft Excel, it is an application which resides on the user’s PC and can be used to create spreadsheets or to work with spreadsheets created by other people.

According to the information contained on the Corel website (www.corel.com), Quattro Pro users can open, modify, and re-save Excel spreadsheets in Quattro Pro, allowing transmission and sharing of spreadsheet files with others who do not have Quattro Pro. Features and functionality are claimed to be the same as for Excel, with the addition of the Perfect Expert and Workspace Manager, both of which are claimed to make spreadsheet creation easier.

Quattro Pro X3 comes with all versions of Corel WordPerfect Office X3 and, as of the time this is being written, prices for the Standard edition begin at $134.99 if you are eligible for the upgrade. In order to purchase the Corel WordPerfect Office X3 - Standard Edition upgrade, you must be a licensed owner of one of the following products: WordPerfect Office 8 or higher, CorelDRAW Graphics Suite X3 or higher, Corel Paint Shop Pro X or higher, Corel Painter IX or higher, Corel DESIGNER 12 or higher, Microsoft Office 97 or higher or Microsoft Works Suite 2000 or higher.

There are also lots of new and innovative ways to use the Internet for creating, storing and sharing spreadsheets. If you’d like to know everything that’s out there, who makes it, and how it works, you can take a look at the Wikipedia article covering online spreadsheets at http://en.wikipedia.org/wiki/List_of_online_spreadsheets. Many of these products are free, and some offer free personal versions and more secure, business-level versions for a fee.

Some of these offerings are a little obscure, but there will be a couple that many of you may have heard of and might consider for certain uses in your practice. Some of you may have already tried one, or both, of them. They are Google Spreadsheets, a feature of Google Docs, and Zoho Sheet, a part of Zoho, an online office suite which includes the usual array of desktop applications, plus offerings for customer resource management, project management, online chat, email and wiki creation.
Both Google Docs and Zoho allow the user to create a free account. The user can then log in to the service to create spreadsheets, among other things, which are stored online and can be published to (read only) or shared with (changes and additions allowed) others through a link contained in a notification email. The recipient of the email can then log in and access the spreadsheet to view or modify the information contained in it, and the spreadsheet can even be edited simultaneously by many users, allowing for real-time collaboration. See Figure 1 for a screenshot of a Google Docs spreadsheet, and Figure 2 for a screenshot of a Zoho sheet.

![Figure 1: Screenshot of a Google Docs spreadsheet](image-url)

Although we would not recommend storing or collaborating on extremely sensitive confidential client information through an online spreadsheet at this point in time, there are still lots of things that such an application could help practicing lawyers with. For example, collaborating lawyers might use an online spreadsheet to compile a
witness list, helping each other fill in missing addresses, telephone numbers, work information, etc. They might also use such a spreadsheet to share information and comments about the members of a list of prospective jurors.

![Screenshot of a Zoho sheet](image)

**Figure 2: Screenshot of a Zoho sheet**

Because they reside on Google and Zoho’s web servers and are opened in your web browser, just like any other web page, spreadsheets created in this way can be accessed and worked on, and then stored again, from anywhere you have Internet access. You don’t even have to have your own computer in hand – just any Internet connected computer with a browser. Of course, as with any web surfing you do from a public computer, you want to be sure to clear the browser’s history and cache files when you’re done.

The complete features of Google Docs and Zoho are beyond the scope of this presentation. For additional information on Google Docs see [www.google.com](http://www.google.com) and click on More. For information about Zoho go to [www.zoho.com](http://www.zoho.com).
For more information on how you can use these and other online applications for collaboration within your office or with clients, witnesses and other lawyers see Dennis Kennedy and Tom Mighell’s paper for the Techshow Session Working Together from Wherever You are: The Lawyer’s Guide to Collaborating on the Internet found under the Internet Track on this CD. For even more information, see their just published book, "The Lawyer’s Guide to Collaboration Tools and Technologies: Smart Ways to Work Together." (ABA Law Practice Management Section, published 2008).

**Why Lawyers Need Spreadsheets**

Almost any information (other than a narrative) which can be organized and presented in a word processing document can be better organized and presented in an spreadsheet, if you know how to properly use it. This includes both textual and numerical information.

Spreadsheets can be used to easily and instantly sort and filter text, allowing you to view the information in many different ways. This can let your zero in on specific information, or from a larger point of view, let you bring together related or similar information in a way that will allow patterns to emerge.

You can use a spreadsheet as a brainstorming tool. You can enter ideas and questions in groups spread out across dozens or rows and columns, and more one or more entries nearer to related entries as things come together. Once you have all the ideas in one place, you can easily put them into a single column, then cut and paste that information to your Word processor.

When it comes to numbers, spreadsheets can perform calculations on values which are static or are constantly changing, using everything from very simple to complex formulas and chained calculations. Most importantly - assuming the formulas are all correct - they will come up with the correct answer every single time, unlike using a paper and desktop calculator. And the real power – if you decide you need to change one or a few numbers, all the formulas are recalculated faster than you can blink your eyes. When it comes to looking at different damage scenarios, lease expenses or other circumstances where many different values need to be calculated, they are truly an amazing tool.

And don’t stop there: spreadsheets can be used to convert numerical data into charts and graphs, which can then be sent to word processing or presentation documents. Remember, a picture (AKA a graph or chart) is worth a thousand words.
Spreadsheets will also allow you to funnel information into mail and other merges as if the spreadsheet were a database. Spreadsheets can even be used to create timelines or chains of events based on an initial date, which can then be changed to create a whole new set of chaining deadlines.

If you’re now convinced that spreadsheets would be a powerful tool in your practice, then welcome aboard. What follows will, hopefully, give you some ideas about how you can adapt automated spreadsheets to your practice and how you can customize them for your use.

Excel ‘Excentricities’

From here on out, we’re going to be talking about using Excel in the law office, because it’s what we both use, however, if you are already familiar with another application, you should still be able to adapt most of this information for use with your favorite spreadsheet program. Many of the features, steps and keyboard shortcuts we will review are the same or very similar in many of the desktop and online spreadsheet applications.

An Entry Is An Entry Is An Entry?

First, Excel recognizes an entry as either text, a value or a formula. And, depending on how Excel recognizes an entry it handles it differently. For example, text is aligned to left by default while values are aligned to right. This will help you to know what Excel thinks about what you’ve entered, and if it’s on the same page you are.

Second, for Excel a value will be one of two things, either a quantity or a time. We all know what a quantity is: a numerical representation of how many things there are in a certain group of things. For Excel, times are either dates or times of day, represented in mathematical terms, so that they can be added to or subtracted from one another. This is what allows you to use Excel for computing and chaining dates. Which brings us to Excel and Y2K.

Who would have thought we could find something about Y2K to talk about way on up into 2008? But you need to remember the lessons of Y2K to understand how Excel processes date information, and how to keep yourself out of trouble.

The big lesson of the Y2K debacle was that, once the century turned, a date like 01/01/00 might mean one thing to the person entering it and another thing to the computer receiving it. Is this January 1, 1900 or January 1, 2000? Most of us now use four places for the year when we create documents using this type of format, but if
you’re going to use a two place format to enter the year, at least in Excel 2003, you need to know how it splits the centuries. And it’s not at the year 2000, as you would expect.

Excel 2003 recognizes 01/01/00 through 12/31/29 as being January 1, 2000 through December 31, 2029, however it recognizes 1/01/30 up to 12/31/99 as January 1, 1930 up to December 31, 1999. So, as you can see, at least for documents created using Excel 2003, a Y2030 calamity is in the works if someone is still using and relying on historical information entered in a two digit date format. Save yourself the trouble and use four digits for the year in all spreadsheets you create if they are to be used to measure trends over any substantial period of time, as one would want to do in spreadsheets used in the management of an ongoing law firm or other business.

**What Was That Number?**

It’s also helpful to understand how many different ways Excel can format a value. The default “general” format will treat a value as an unspecified type of number and drop leading zeros (012373 will become 12373), and sometimes trailing zeros, too. (You may be thinking $127.20 but Excel will give you 127.2 if it isn’t specifically told it’s dealing with dollars.)

The easiest way to solve the leading and trailing zero problem is to select another number format for your entries. There are pre-set formats which can be applied to values for currency, accounting, percentages, fractions, and scientific notation, and you can create your own custom formats if needed. If you want or need to use the general format, you can place an apostrophe in front of numbers beginning with zero, but they will be formatted as text rather than as numbers.

Finally, you also need to know that if a value is wider than the cell in which you, or a formula you’ve created, place it, Excel will do a couple of things to cope. If the number is large enough (like billions or trillions) Excel will convert it to scientific notation in order to make it fit. Or it may just give up and show you #######. In either case, widen the cell to eliminate “nonsense” within it.

**Doing the Math**

Probably the best single thing about Excel is that it will let you set up a mathematical “scenario” and then play out “what if” by changing one or more of the numbers in that scenario. For example, let’s suppose you’ve gathered all the information on bills which must be paid from the proceeds of a particular settlement
before the remainder can be divided between yourself and your client. The deal is not firm, but the defense attorney has told you he thinks he can get $X. Then he comes back to you and says that, because of this, that or the other, he can only induce the defendant to offer $Y. Rather than having to re-add, re-subtract, and re-divide out your and your client’s percentages, all you have to do is substitute $Y for $X in your spreadsheet, and you can see immediately, and without error, what this new offer means.

Spreadsheet applications can perform everything from simple addition and subtraction through math based on complex formulas with multiple variables based on the outcome of the previous calculation. For this reason they can be especially useful in cases which involve financial data and drug dosages based on patient size, weight and other physical factors.

**Turning Numbers into Pictures**

The old saying is that a picture is worth a thousand words, and sometimes that is especially true when you are trying to tell a story with numbers. This is when Excel’s ability to convert numeric data into graphs and charts comes in especially handy.

For example, suppose you are handling a fraud case in which the defendant represented that it’s company had a certain cash position on a series of dates, but the cash position during those time periods was really a great deal more bleak. A spreadsheet can help you set out the representations and the reality, and the difference between them, but you probably wouldn’t want to use interminable column and rows of numbers to illustrate the magnitude of the misrepresentation to the jury.

Instead, you can turn those columns and rows of numbers into a graphic representation of what the defendant was saying about its cash position – and the reality, as shown in Figure 3 on the next page. This graphic representation was created from the data contained in the spreadsheet entitled Daily Cash Positions, which appears on the CD with this paper.
Using Excel as a Database

If you’re planning on entering hundreds or thousands of records with a high number of fields in each record, a true database application, especially one developed for your particular use, if available, would probably be of greater utility to you; however, for managing smaller data sets, Excel can be a great substitute for a database application because it has some built-in database features and you won’t need to learn how to use yet another program.

Creating a database within an Excel spreadsheet is simple. First, you determine each item of information you’d like for the database to record. If you’d like to organize and use information about a list of potential jurors, you would probably want a field for each of the following: Name, address, employer, and any other types of information you might be able to gather ahead of time, such as education and any professional, social or political affiliations. Next, you set up the first row of your spreadsheet with each of these items in a cell, and then enter the necessary information for your first entry. Your spreadsheet will look something like the one below.
Figure 4. Sheet with headers and one row of information.

Then, choose Data | Form... from the menu, and Excel will study the information you've already entered and create a data form that you can use to enter the rest of your names, etc.

Figure 5. Data entry dialog box.
Once you’ve completed your entries, you can sort them based on any of the fields, such as name or employer. In fact, you can sort based on up to three fields at a time. This would allow you to sort by employer, and then put the names in alphabetical order based first on last name and then on first name. To do this first select the cell with the name of the field you want to sort by first, then click Data from the menu and then Sort. Excel will open a sort box with your selected field, and provide you with two additional fields to customize your sort.

Figure 6. Sort Dialog box.

Select the appropriate fields, click OK, and your spreadsheet will be sorted as desired.

Figure 7. Entries sorted by Employer.
You can use the Data | Filter | Auto Filter commands on the menu to turn each field into a drop down box, which will then allow you to select just the records with a particular entry in that field. Auto filtering drops out all records which don’t meet your criteria. When you’re done, just click Data | Filter again, and select Show All.

![Figure 8. Sheet showing auto filtering.](image)

**Now, Show Me Some Spreadsheets I Can Use!**

We’ve gathered some spreadsheets from practicing lawyers, and worked up a few ourselves, which are also loaded onto the CD with this paper. We hope some of these will be of use to you in your day to day practice.

**How Do I Become a Spreadsheet Wizard, Too?**

Becoming a spreadsheet wizard is much like becoming a good lawyer – practice makes perfect, or at least it makes you better. We recommend that you take a weekend to read through one of the many “how to” books that have been written for Excel, such as the “Dummies” or “Just the Steps for Dummies” series and work through each of the examples to get familiar with all the menu items and commands. Start out slowly, using a spreadsheet any time you need to perform calculations or sort more than a few items of data. Before you know it, you’ll be building in formulas, doing complex sorting, and wowing the competition with your ability to analyze and find the information you need – right when you need it.

Dan Pinnington’s Excel cheat sheet, also loaded on the CD with this paper, will help you learn some of the most common commands quickly and easily. It lists common things that you would want to do in Excel, and provides the instructions on how to complete those tasks.
If you like self-paced learning, check out Keystone Learning Systems (www.keystonelearning.com). A set of Basic, Intermediate and Advanced DVD’s with 490 minutes video tutorials for Excel costs $160. You can watch these on your computer, stopping or pausing the video as you try things being taught your self. The topics covered are as follows:

Microsoft Excel 2007: Beginner
- Getting Started
- Entering Data
- Changing Worksheet Layout
- Entering Formulas
- Formatting
- Using Themes and Styles
- Printing
- Charts

Microsoft Excel 2007: Intermediate
- Managing Workbooks
- Tables and Data Management
- Using Cell References
- Auditing
- Creating Web Pages from Workbooks
- Using Excel with Other Applications
- Customizing Excel
- Using Scenarios and Watching Cells
- PivotTables and PivotCharts

Microsoft Excel 2007: Advanced
- Collaborating
- Advanced Formulas and Functions
- Data Consolidation
- SmartArt
- Track Revisions
- Data Validation and Conditional Formatting
- Creating Templates
- Macros

Make and take the time to become a spreadsheet wizard. You will use this powerful tool on a daily basis, and you won’t know how you lived without it.
A Special Report to Members of the News & Trade Media
Release Date: January 15, 2008

A Look Inside the Estate Planning Industry

Results of the 2007 WealthCounsel® Industry Trends Survey

A survey of estate planning attorneys throughout the country conducted by WealthCounsel, LLC in November 2007.

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Marlene Frith
Director of Marketing & Business Development
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www.wealthcounsel.com
We are pleased to announce the results of the 2007 WealthCounsel® Industry Trends Survey – a groundbreaking initiative designed to gauge the pulse of estate planning activities throughout the country. Approximately 5,000 estate planning practitioners throughout the nation were invited to participate in this innovative web-based survey conducted during the three-week period from Nov. 12-30, 2007. Nearly 500 respondents – most of whom are members of WealthCounsel – participated in the survey.

As the nation’s premier community of estate planning attorneys, WealthCounsel developed the assessment to identify the challenges facing today’s practitioners and to obtain a sense for the estate planning needs of American consumers. Respondents were asked to share information on seven major topics:

- Challenges of starting an estate planning practice
- Industry trends that attorneys anticipate
- Client demographics and consumer concerns relating to estate planning
- A profile of their specific areas of expertise
- Sources to which they turn for professional development and continuing legal education
- Marketing practices / client generation strategies
- Staffing and employment issues

It is important to note that survey respondents were seasoned practitioners with substantial estate planning and legal expertise. Seventy-five percent (75%) indicated they have practiced law for more than 11 years, and fifty-five percent (55%) indicated that they have specialized in an estate planning practice for more than 11 years.

Who Should Care About This Survey?

Estate planning practitioners, consumers, businesses, and members of the media will find the results of this assessment insightful and useful for a variety of purposes.

- Financial professionals involved in estate planning, or attorneys seeking to establish an estate planning practice or transition from another area of law into estate planning, will find that the survey provides “actionable intelligence” as they develop their business strategies or expand their practices.
- Consumers will learn what factors motivated others to engage in estate planning, and will gain a clearer understanding of why estate planning is important to consumers of all ages and income brackets.
- Businesses that provide products and services to law firms, such as marketing organizations, website developers, professional employer organizations, and numerous others will enjoy the inside look at the needs of estate planning practitioners and law firms.
- Members of the news media and publishers of industry trade magazines will benefit from the quantitative and qualitative survey results for use as background in feature articles. Advertisers will gain practical insight relating to targeting messages in trade publications that are most often read by estate planning attorneys.

Next Survey To Be Released in 2009

As thought leaders in the industry, WealthCounsel and its more than 1,000 member law firms are on the forefront of estate planning issues on a daily basis. We were pleased to share our insight through the fascinating results of this survey – the first of its kind to be conducted in the industry.

We will continue to tap the intellectual capital of the hundreds of WealthCounsel members throughout the country who are committed to excellence in estate planning. In November 2008, we will once again launch a similar survey to an even broader marketplace, and we look forward to releasing the results of the 2008 WealthCounsel® Industry Trends Survey during the 43rd Annual Heckerling Institute on Estate Planning in January 2009.
SECTION ONE:  
Profile of Respondents

Of those who contributed to this survey, 99% have earned their JD, 17% have an LL.M., and 10% were CPAs. Others held a variety of credentials, including the following: MBA, CFP, PhD, CLU, ChFC, CELA, life and health licenses, Series 6, 7, 52, and 63 securities licenses.

The charts below show longevity of practicing law, the amount of time spent in estate planning, and the primary states in which the respondents practice law.

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<th># YEARS PRACTICING LAW</th>
<th># YEARS IN ESTATE PLANNING</th>
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<tr>
<td>10% Less than 5 years</td>
<td>19% Less than 5 years</td>
</tr>
<tr>
<td>16% 5-10 years</td>
<td>25% 5-10 years</td>
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<tr>
<td>16% 11-15 years</td>
<td>21% 11-15 years</td>
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<td>39% 16-30 years</td>
<td>28% 16-30 years</td>
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<tr>
<td>20% Greater than 30 years</td>
<td>6% Greater than 30 years</td>
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<table>
<thead>
<tr>
<th>State</th>
<th>Percentage</th>
<th>State</th>
<th>Percentage</th>
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<tbody>
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<td>Missouri</td>
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<tr>
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<td>0.62%</td>
<td>Montana</td>
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<td>Nevada</td>
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<td>19.96%</td>
<td>New Hampshire</td>
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<tr>
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<td>New Mexico</td>
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<td>Wyoming</td>
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SECTION ONE: Profile of Respondents

Survey respondents (whom as the preceding charts demonstrate included both seasoned practitioners and newcomers to the profession) were asked to reflect on a variety of challenges they faced when establishing their practices.

Fifty-one percent (51%) of the respondents indicated that acquiring the necessary educational and technical skills to competently recommend solutions to their clients was one of the greatest challenges. Sixteen percent (16%) struggled with finding the start-up capital, and ten (10%) percent were challenged with selecting the best drafting system for their practice. Finding a community of colleagues for the purpose of collaboration was a challenge for only five percent (5%).

Inasmuch as the majority of those who participated in the survey were members of WealthCounsel and thus engaged in using the company’s WealthDocs™ document drafting system as well as participating in the collaborative exchange of ideas through WealthCounsel’s listservs and other resources in conjunction with the company’s Five-Star Practice Solution™, it is not a surprise that only ten percent (10%) indicated that a drafting system was a challenge, and that only five percent (5%) lacked a collaborative community of colleagues.

Q: What was the most significant challenge you faced during the first year of starting your practice?

Q: Did you begin your practice on your own or with a firm?
In our experience and interaction with WealthCounsel members and other estate planning professionals over the years, we have found that estate planning attorneys often hold leadership roles in their communities and donate time to meaningful causes by serving on non-profit boards or volunteering with civic organizations. The results of the 2007 WealthCounsel Industry Trends Survey supports this assumption, where 73% of respondents indicated that they participate in their communities in this fashion.

**Q: Do you currently serve on a board of a non-profit association or volunteer your time to civic organizations within your community?**

**Yes 73%**

**No 27%**

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**SECTION TWO: The Industry**

WealthCounsel subscribes to the philosophy that estate planning is an interdisciplinary function requiring the collaborative efforts of a variety of professionals – i.e. attorneys, CPAs, financial planners, financial advisors, trust officers, and insurance professionals. Membership in WealthCounsel represents a commitment to a client-centric approach to estate planning founded on the principles of competence, collaboration, and a meaningful sense of professional community. We encourage financial and insurance professionals to assume their rightful place at the strategy table with estate planning attorneys and the entire team of interdisciplinary professionals.

In taking the pulse of the estate planning attorneys who participated, we were pleased to learn that most affirmed this interdisciplinary philosophy.

**Q: Do you believe estate planning is an interdisciplinary function requiring a collaborative approach among the attorney, CPA financial planner, and insurance professional?**

Ninety-four percent (94%) of respondents indicated that they felt estate planning is an interdisciplinary function requiring a collaborative approach among the attorney, CPA, financial planner and insurance professional.

Sixty-nine percent (69%) of all participants operate a “client-centric” practice where they typically engage a team of professionals during the estate planning process.

**94% of respondents believe that estate planning is an interdisciplinary function requiring a collaborative approach among the attorney, CPA, financial planner, and insurance professional.**
As legal practitioners on the frontlines of the estate planning process, the respondents truly have unique insight into the industry. WealthCounsel wanted to tap this source of intellectual capital to determine what they viewed as the primary shift in the industry in terms of expected growth in specialized areas of estate planning during the next five years.

**Q: What is the primary estate planning industry shift you see over the next five (5) years?**

Below is what they told us.

- Shift toward elder law planning (38%)
- Shift toward lifetime planning rather than post mortem planning (21%)
- Shift toward beneficiary inheritance asset protection planning (21%)
- Shift toward business succession planning (6%)
- Shift toward business entity planning (6%)
- Other (8%)

**Q: Do you believe the aging baby boomer population will create a greater demand for estate planning services?**

93% of estate planning attorneys believe that baby boomers will create a greater demand for estate planning services.
In terms of which trade publications estate planning attorneys most often read, survey respondents told us that state bar publications are a popular source for staying abreast of current estate planning topics, but not necessarily to the exclusion of other magazines.

Q: Which trade publications do you read or subscribe to?
SECTION THREE:  
Client Demographics & Concerns

Participants were asked to consider their “typical dominant market clientele” in terms of marital status, net worth, and age.

It is significant to note that more than 39% of clients had a net worth exceeding $2 million, and that 90% of clients are age 50 or older.

**Marital Status**
- Married (94%)
- Divorced/Remarried (17%)
- Single (11%)

**Net Worth**
- $2 – 5 Million (31%)
- $1 – 2 Million (29%)
- $500,000 – 1 Million (25%)
- Greater than $5 Million (8%)
- Less than $500,000 (7%)

**Client Age**
- 60s (43%)
- 50s (34%)
- 70s (13%)
- 40s (9%)
- 30s (1%)
In order for estate planning attorneys to make decisions about practice areas in which they wish to specialize, or methods to generate clients, they must first have an understanding of client psychographics, or the typical reasons that motivate clients to seek the services of an estate planning practitioner.

Q: What would you consider to be the top three pressing concerns or reasons that clients seek your services?

- 60% of clients want to avoid probate
- 57% of clients want to avoid loss of estate value due to estate taxes
- 44% of clients have a friend or relative who passed away with no estate plan in place, and they want to avoid creating a similar chaotic experience for their own family.

Other leading drivers for clients to seek estate planning included:

- 40% of clients want to protect children from mismanaging their inheritance
- 31% of clients want asset protection for his/her beneficiaries
- 22% of clients are concerned with financing healthcare or long term care
- 20% of clients want asset protection for themselves

As noted above, one of the greatest motivators for consumers to engage in estate planning is the desire to have their assets distributed to their children or heirs with a certain degree of control. Sometimes referred to as “parenting from the grave,” a living trust, for example, enables the grantor to distribute the assets in ways that will prevent their children from mismanaging their inheritance. Still others want to make sure their adult children’s assets are protected from creditors and predators, or even from divorcing spouses.
SECTION FOUR: Practice Profile

Estate planning attorneys often make decisions about areas of specialization based upon their own interests, experiences of colleagues or mentors, or based upon a sense that there is sufficient market demand for those areas of expertise.

Q: Which practice area is the primary revenue generator in your business?

Of the various practice areas within the estate planning field, the survey discovered the following primary revenue generators.

- Estate Planning (foundation and advanced planning) (69%)
- Elder Law / Medicaid Planning (10%)
- Trust Administration/Probate (10%)
- Planning for Business Owners (6%)
- Other (5%)

Q: Which practice area is the secondary revenue generator in your practice?

Secondary revenue generator within these same business models:

- Trust Administration/Probate (39%)
- Estate Planning (foundation and advanced planning) (23%)
- Planning for business owners (20%)
- Elder Law/Medicaid Planning (11%)
- Other (5%)
- Client Maintenance Program (2%)
Q: Which practice area do you want to add to your business model?

Many practitioners add practice areas on to their business model as they gain experience or set revenue goals. This survey determined that of the varying practice areas, those that the respondents wished to add to their model included:

1. A client maintenance program (27%)
2. Planning for business owners (25%)
3. Trust administration (17%)
4. Elder law (14%)
5. Medicaid planning (10%)
6. Other practice area other than those listed (7%).
Q: What is the single greatest challenge you face in your practice today?

Operating a practice and owning one’s own business is an admirable goal that holds both risks and rewards, success and failure. The single greatest challenges being faced in individual practices nationwide are:

1. Finding clients (19%)
2. Staffing (14%)
3. Improving personal lifestyle (11%)
4. Effectively managing office finances (9%)
5. Generating referral business (9%)
6. Marketing (7%)
7. Legal/technical education (6%)
8. Sustaining business (5%)
9. Drafting legal documents (5%)
10. Closing prospective clients (4%)
11. Communication with client (2%)
12. Other (8%)

Q: What changes have you observed in your practice over the past five years?

Respondents were asked to check all categories that apply:

- Sixty-two percent (62%) have become more selective in accepting clients
- Fifty-seven percent (57%) have obtained more professional referrals
- Forty-four percent (54%) have increased their marketing efforts
- Forty-four percent (44%) have narrowed the scope of their practice
- Twenty-five percent (25%) have broadened or shifted their practice
- Eleven percent (11%) have decreased marketing efforts
- Three percent (3%) have received fewer professional referrals
- Two percent (2%) have become less selective in accepting clients
Q: Rate the following in their importance in developing and sustaining your business.

Participants of the 2007 WealthCounsel Industry Trends Survey gave us insight on what they felt was important to them in building and sustaining their businesses.

It is interesting to note that 63% chose an efficient document drafting system as one of the most critical elements in developing and sustaining their business. Recognizing, once again, that the majority of respondents were WealthCounsel members, this statistic confirms the value of our own business model inasmuch as the WealthDocs™ document drafting system is the cornerstone product in the company’s Five-Star Practice Solution™. The second most essential factor indicated that 60% needed the strong support from family and friends.

<table>
<thead>
<tr>
<th>Respondents were asked to rate the following in their importance in developing and sustaining their business.</th>
<th>Not Important</th>
<th>Important</th>
<th>Essential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substantive tax- or strategy-based education</td>
<td>6%</td>
<td>42%</td>
<td>52%</td>
</tr>
<tr>
<td>Practice development/ profitability oriented education</td>
<td>11%</td>
<td>51%</td>
<td>38%</td>
</tr>
<tr>
<td>Efficient, cutting-edge document drafting system</td>
<td>6%</td>
<td>31%</td>
<td>63%</td>
</tr>
<tr>
<td>Strong core of colleagues to brainstorm with &amp; obtain assistance from</td>
<td>10%</td>
<td>53%</td>
<td>37%</td>
</tr>
<tr>
<td>Generating more referrals from financial professionals</td>
<td>11%</td>
<td>41%</td>
<td>48%</td>
</tr>
<tr>
<td>Obtaining or having a mentor</td>
<td>45%</td>
<td>38%</td>
<td>17%</td>
</tr>
<tr>
<td>Becoming or being a mentor</td>
<td>44%</td>
<td>50%</td>
<td>6%</td>
</tr>
<tr>
<td>Having strong support of family &amp; friends</td>
<td>9%</td>
<td>31%</td>
<td>60%</td>
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SECTION FIVE: Professional Development & Continuing Education

Q: What is your annual budget for professional development?

Professional development is defined as monetary resources applied to the purchase of continuing education, coaching services, and literature.

- 35% budget between $1,000-$3,500
- 28% budget between $3,501-$7,500
- 17% budget more than $10,000
- 13% budget $7,501-$10,000
- 7% budget less than $1,000
- 7% budget between $1,000-$3,500
- 28% budget between $3,501-$7,500
- 17% budget more than $10,000
- 13% budget $7,501-$10,000
- 7% budget less than $1,000
Q: How do you obtain the majority of your continuing legal education credits?

Survey respondents were asked to provide the sources to which they turn to obtain their continuing legal education. Many practitioners use a combination of sources to satisfy their CLE credits, and the chart below reflects that the two most popular sources were state bars and WealthCounsel.

Inasmuch as WealthCounsel prides itself in the course offerings it provides to its members (and non-members in some instances), we were pleased to see that a significant number of the respondents were taking advantage of this key element of our Five-Star Practice Solution™.

Q: What one thing could you add to your professional life that would create a significant impact on your overall professional satisfaction?

Professional satisfaction is an important component in operating a successful practice. Survey participants indicated that developing more collegial relationships was the most important factor for 40% of respondents. Obtaining positive publicity or being quoted in industry trade journals or other media was the second most important factor.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Develop more collegial relationships</td>
<td>40%</td>
</tr>
<tr>
<td>Become published or quoted in a trade journal or other media</td>
<td>24%</td>
</tr>
<tr>
<td>Serve on a board or become more involved in community</td>
<td>14%</td>
</tr>
<tr>
<td>Have a mentor</td>
<td>14%</td>
</tr>
<tr>
<td>Be a mentor or serve others</td>
<td>8%</td>
</tr>
</tbody>
</table>

**SECTION SIX: Marketing & Client Generation**

Q: What is your annual budget for marketing and advertising?

- 30% budget less than 2%
- 16% budget between 6% and 10%
- 16% budget 15%
- 15% budget more than 10%
- 10% budget 2%
- 9% budget 3%
- 4% budget 4%
Q: Do you have a website? If you do not have a website, do you plan to launch a website within the next year?

74% of survey participants indicated they have a website, while the remainder did not. Of those who did not have websites, fifty-seven (57%) percent plan to create and launch one within the next year.

Q: What is the primary resource in obtaining new clients?

1. Professional referrals (57%)
2. Client referrals (30%)
3. Retail seminars (6%)
4. Advertising (5%)
5. Yellow Pages (1%)
6. Website (1%)

SECTION SEVEN: Staffing – Employment Issues

Sourcing and hiring top performing employees is a challenge in any industry, and keeping outstanding employees is often a matter of offering competitive salaries and benefits. The survey discovered that the greatest challenge in keeping high-quality team members relate to compensation.

Q: What is the primary challenge in retaining excellent staff?

Qualitative feedback on this question (obtained in conjunction with checking “other”) indicated that attorneys cite a variety of factors as it relates to keeping excellent staff. Among those are: (1) finding employees with a good work ethic; (2) not being satisfied with the quality of their work product; (3) lack of trust in employees who do not demonstrate a responsible attitude; (4) insufficient time to train the employee; (5) a poor local labor pool; (6) lack of someone in the office to manage the staff; and (5) competition from other employers in the area.
SUMMARY:

WealthCounsel is pleased to share the results of its 2007 Industry Trends Survey with members of the news media, estate planning practitioners, consumers, businesses, and other interested parties. We trust the information from our survey provided valuable insight into the estate planning industry, and we invite any questions you may have.

Members of the media and others may utilize the statistics and other information in this survey, but as a courtesy, we would ask to be notified in advance of stories that may be developed citing this information. The project manager and media contact for this survey is Marlene Frith, Director of Marketing & Business Development. She may be reached at marlene.frith@wealthcounsel.com, or by calling 888-659-4069, Ext. 817.

About WealthCounsel

For more than ten years, WealthCounsel has been helping estate planning attorneys build and sustain successful practices. As a membership-based organization featuring a collaborative network of more than 1,600 practitioners throughout all 50 states, WealthCounsel commands a unique position in the marketplace. We offer attorneys a powerful combination of resources and tools, known as our Five-Star Practice Solution™. Specifically, we provide our members with (1) WealthDocs™, one of the nation’s leading document drafting systems; (2) relevant continuing legal education and team training; (3) a community of attorneys throughout the country; (4) professional resources and practice-building tools, including listservs and a resource center; (5) and quality customer service and technical support.

Membership in WealthCounsel represents a commitment to a client-centric approach to estate planning founded on the principles of competence, collaboration, and a meaningful sense of professional community.