Financial & Estate Planning Seminar
May 19, 2016

8:15 a.m.	Registration & Continental Breakfast
8:45 – 9:00	**Welcome from WV Bankers Association, WV Society of CPAs, WV State Bar**
9:00 – 10:00	**Pernicious Problems and Promising Possibilities for Estate Planners in 2016** *Charles A. "Clary" Redd, Esq., Stinson Leonard Street LLP, St. Louis MO*
10:00 – 10:10	Break
10:10 – 11:00	**Pernicious Problems and Promising Possibilities for Estate Planners in 2016**
11:00 – 11:10	Break
11:10 – 12:00	**Pernicious Problems and Promising Possibilities for Estate Planners in 2016**
12:00 – 12:30	Lunch
12:30 – 1:00	**Legislative Update** *Tom Heywood, Esq., Bowles Rice LLP*
1:00 – 1:15	**Philanthropy WV Initiative – Keep5Local** *Paul Daugherty, EVP of Philanthropy WV*
1:15 – 2:15	**The New West Virginia Self-Settled Domestic Asset Protection Trust Legislation** *John Allevato, Esq., Spilman Thomas & Battle PLLC* *Chris Winton, Esq., Ray, Winton & Kelly PLLC*
2:15 – 3:00	**Fiduciary Income Tax Issues** *Marlin Witt, CPA, CFP, CGMA, Arnett Carbis Toothman PLLC*
3:00 – 3:15	Break
3:15 – 4:00	**Basic Generation-Skipping Tax** *Marcia Broughton, Esq., Jackson Kelly PLLC*
4:00 – 5:00	**Panel – Hot Topics and Discussion of Items of Interest to Estate Planners** *John Allevato, Esq., Spilman Thomas & Battle PLLC* *David Croft, Esq., Spilman Thomas & Battle PLLC* *Laura Ellis, Vice President, BB&T Wealth* *John Hussell, Esq., Wooton Wooton & Davis PLLC* *J. E. White, Esq., Anspach Meeks Ellenberger LLP*
5:15 – 5:45	**Reception**
5:45 – 6:30	**Dinner and Wine Tasting/Paring with John Brown**
6:30 – 7:00	**Wine Auctions and Other Resources - John Brown**

Pernicious Problems and Promising Possibilities for Estate Planners in 2016

Financial & Estate Planning Seminar

Sponsored by the West Virginia Bankers Association, the West Virginia Society of CPAs and the West Virginia State Bar Probate Law Committee

May 19, 2016

Edgewood Country Club
1600 Edgewood Drive
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CHARLES A. REDD

CHARLES A. REDD is a partner in the St. Louis, Missouri, office of the law firm of STINSON LEONARD STREET LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now U.S. Trust, Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar (Probate and Trust Committee), the Illinois State Bar Association (Section on Trusts and Estates), The Bar Association of Metropolitan St. Louis (Probate and Trust Section, member and past chairman) and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award.

Mr. Redd is an elected member of The American Law Institute, a Fellow of The American College of Trust and Estate Counsel (Missouri State Chair; Past Regent; Communications Committee (Chair); Estate and Gift Tax Committee; and Fiduciary Litigation Committee) and an Adjunct Professor of Law (Estate Planning) at Northwestern University School of Law. He also serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. Mr. Redd is listed in The Best Lawyers in America and is nationally ranked by Chambers USA in its "Wealth Management" category. He frequently writes and lectures nationally on topics in the trusts and estates field.

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Pernicious Problems and Promising Possibilities for Estate Planners in 2016

By:
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I. LEGISLATIVE AND REGULATORY DEVELOPMENTS

A. Obama Administration Releases Green Book for Fiscal Year 2017 With Many Proposals That Impact Trusts and Estates Practitioners

General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, Department of the Treasury (February 9, 2016)

1. **Modification of Estate, Gift and Generation-Skipping Transfer Tax Rates and Exemptions**. For decedents dying and transfers after 2016, the Obama Administration (the "Administration") proposed to restore the estate, gift and generation-skipping transfer ("GST") tax rates and applicable exclusion amounts that were in effect in 2009. Therefore, the top tax rate would be 45% and the applicable exclusion amount would be $3.5 million for estate and GST tax purposes, and $1 million for gift taxes. These applicable exclusion amounts would not adjust due to inflation. The Administration stated that provisions would be added to avoid "clawback," in which gift or estate tax would be incurred by reason of the decrease in the applicable exclusion amount with respect to a prior gift that was excluded from tax at the time of the transfer. In addition, portability would be allowed to continue, but a surviving spouse would only be able to apply the predeceased spouse's remaining gift tax exclusion amount to gifts made by the surviving spouse and not the predeceased spouse's remaining estate tax exclusion amount.

2. **Increase in Capital Gains Rate and Taxation of Appreciated Assets Transferred by Gift or Bequest**. Treasury stated that "[p]referential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers" and that "preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets."

The Administration proposed to increase the highest long-term capital gains and qualified dividend tax rates from 20% to 24.2%. The 3.8% net investment income tax would remain unchanged.

In addition, a transfer by gift or a transfer of property upon death would be considered a sale of the transferred property, giving rise to tax on the appreciation in the value of the property, if any. The tax would be payable by the donor in the case of a gift and by the decedent's estate in the case of a bequest.

Gifts or bequests to a spouse or charity would not be taxable events. The spouse or charity would receive a carryover basis in the property. In addition, gifts or bequests of tangible personal property (other than collectibles) would not be subject to taxation.

The Administration would allow a $100,000 exclusion for capital gains arising due to death. Any unused exclusion would be portable to the decedent's surviving spouse, if any. The current exclusion for capital gains on the sale of a principal residence would apply to capital gains on bequests on any residence and would also be portable to the surviving spouse. Exclusions would also apply for certain small business stock and family-owned and family-operated businesses.

Capital gains tax arising upon death would be payable over a 15-year period, except for any capital gains tax on liquid assets or business for which the deferral election is made.

The tax imposed on gains realized at death would be deductible on the decedent's estate tax return. In addition, ordinary income reported on the decedent's final income tax return may be offset by the unlimited use of capital losses and carry-forwards.

The proposal includes additional features, such as allowing a deduction for appraisals of appreciated assets and requiring consistency in valuation for transfer and income tax purposes.

3. Expansion of the Requirement of Consistency in Value for Transfer and Income Tax Purposes. As discussed below, President Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) (the "Act") into law on July 31, 2015. New IRC § 1014(f) requires that the basis of IRC § 1014(a) property (*i.e.,* certain property acquired from a decedent) not exceed the final value of such property as determined for estate tax purposes, or if the final value has not been determined, the value of that property as reported on a statement to the decedent's recipients under new IRC § 6035.

The Administration would apply the basis consistency rules imposed by the Act on (1) donees of gifts made during the donor's life, provided that the gift was required to be reported on a gift tax return; and (2) recipients of property received from a decedent and that qualified for the estate tax marital deduction, if an estate tax return was required to be filed.

4. Coordination of Income and Transfer Tax Treatment for Sales to Grantor Trusts and GRATs. Treasury explained that grantor retained annuity trusts ("GRATs") and sales to grantor trusts "are used for transferring wealth while minimizing the gift and income tax cost of transfers." In addition, with both transactions, Treasury pointed out that the grantor can purchase assets from the trust and obtain a step-up in basis for the asset when it is included in the grantor's gross estate, while at the same time avoiding estate tax through the use of the grantor's applicable exclusion amount. Treasury also noted that taxpayers often minimize the risk of GRATs by using a very short term and "zeroing-out" the taxable gift upon funding the GRAT by using a very large annuity. The Administration proposed that, if a person who is a deemed owner of a trust under the grantor trust rules engages in a sale, exchange or similar transaction with the trust that is disregarded for income tax purposes, then the portion of the trust attributable to property received by the trust in such transaction (including income and appreciation on such property) will be subject to: (a) estate tax upon the owner's death, (b) gift tax at any time during the grantor's life that grantor trust status is terminated and (c) gift tax to the extent any distribution is made to another person (except in discharge of the grantor's obligation to the distributee) during the life of the deemed owner. The amount subject to transfer tax would be reduced by any portion of such amount that was previously treated as a taxable gift. The trust at issue would be liable for the gift and estate taxes arising from such transfers.

The Administration would exclude from this rule certain trusts that are already potentially includable in the grantor's gross estate, including a grantor-retained income trust, a grantor-retained annuity trust ("GRATs") and a qualified personal residence trust. The rule would also not apply to typical irrevocable life insurance trusts, whether such trust holds life insurance policies on the life of the grantor or the grantor's spouse.

To require some "downside risk" for GRATs, the Administration would require that a GRAT have a minimum term of 10 years and have a maximum term of the life expectancy of the annuitant plus ten years. The Administration would also require that the GRAT have a remainder interest with a value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000. In addition, the governing document of the GRAT could not provide for a decreasing annuity. The Administration would also prohibit the grantor from engaging in any tax-free exchange of any asset held in the trust.

5. Limit on the Duration of the GST Exemption. Due to many states' repealing the rule against perpetuities or otherwise significantly deferring the date by which non-charitable trusts must terminate, and due to the expanding GST exemption (which is $5,450,000 for 2016), the Administration indicated that the GST tax is currently not accomplishing the objective for which it was enacted: preventing the avoidance of estate tax through the use of dynasty trusts.

The proposal would require that, on the 90th anniversary of the creation of a trust, the inclusion ratio of the trust would be increased to one, effectively eliminating any GST exemption allocated to the trust. Trusts that are decanted and trusts transferred under the rule for pour-over trusts under IRC § 2653(b)(2) will be deemed to have the same date of creation as the initial trust, with an exception for certain distributee trusts established under IRC § 2642(c)(2).

The Administration would grant authority to the IRS to issue guidance regarding this rule. The Administration would apply this rule to trusts created after enactment and to the portion of any pre-existing trust attributable to additions to such a trust made after that date (subject to rules similar to the grandfather rules applicable to additions to trusts created prior to the effective date of the GST tax).

6. Minimum Required Distributions Modified for Certain IRAs and Qualified Plans. Treasury explained that the minimum required distribution ("MRD") rules "are designed to prevent taxpayers from leaving [amounts held in retirement plans] to accumulate in tax-exempt arrangements for the benefit of the taxpayers' heirs." Many retirees with only modest retirement benefits, however, are subject to the MRD rules as well, even though they are unlikely to use these accounts for estate planning purposes. To give these retirees more control over when and how rapidly they withdraw funds from these accounts, the Administration proposed to exempt a taxpayer from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed \$100,000. This amount would be indexed for inflation. Benefits under a defined benefit pension plan for which payments have begun would not be included in determining the aggregate value of such assets.

The Administration also proposed that Roth IRAs should be subject to the same MRD and contribution rules that are imposed on retirement plans. The Administration reasoned that Roth IRA account holders benefit from tax-free earnings in the same manner as individuals holding other retirement plans. Further, since Roth IRAs are not subject to the MRD rules, but designated Roth accounts in employer-sponsored plans are subject to the MRD rules, there is an incentive to not invest in employer-sponsored plans, even though non-tax reasons may exist for investing in such plans. Thus, the Administration would require distributions from Roth IRAs shortly after age 70½ and would prohibit additional contributions to Roth IRAs after reaching age 70½.

These proposals would be effective only for taxpayers attaining age 70½ on or after December 31, 2016 and for taxpayers who die on or after that date before attaining age 70½.

7. Expansion of Inherited IRA Rollovers for Non-Spouse Beneficiaries. The Administration explained that not all the methods for rolling over a qualified retirement plan or IRA are available to a non-spouse beneficiary of such accounts. Specifically, non-spouse beneficiaries of such accounts, unlike surviving spouse beneficiaries, cannot take a distribution from an inherited account and transfer it within 60 days to an IRA owned by such beneficiary (a "60-day rollover"). For non-spouse beneficiaries, such rollovers have to be accomplished through a direct Trustee-to-Trustee transfer.

Asserting that these exceptions for non-spouse beneficiaries "create traps for the unwary," the Administration proposed allowing a non-spouse beneficiary of a retirement plan or IRA to move the assets from such accounts to a non-spousal inherited IRA through a 60-day rollover of such assets. The beneficiary must inform the new IRA provider that the new IRA is being established as an inherited IRA.

8. Acceleration of Required Distributions for Certain Non-Spouse Beneficiaries of Inherited IRAs and Retirement Plans. If a retirement plan participant or IRA owner dies on or after the owner's "required beginning date" for receiving minimum required distributions ("MRD") from such account and there is a non-spouse individual designated as beneficiary, the distribution period is the beneficiary's life expectancy, calculated in the year after the year of death. If a participant or an IRA owner dies before the required beginning date and any portion of the benefit is payable to a non-spouse designated beneficiary, distributions must begin within one year of the participant or IRA owner's death and be paid over the life or life expectancy of the designated beneficiary or be paid entirely by the end of the fifth year after the year of death.

Treasury stated that these rules are a tax-preference for non-spouse heirs of a plan participant or owner: "[b]ecause the beneficiary of an inherited account can be much younger than a plan participant or IRA owner, the current rules allowing such a beneficiary to stretch the receipt of distributions over many years permit the beneficiary to enjoy tax-favored accumulation of earnings over long periods of time." The proposal generally would require non-spouse beneficiaries of retirement plans and IRAs to take distributions over five years or less, regardless of when the participant or owner dies. This rule would not apply to any beneficiary who, as of the date of death, is not more than 10 years younger than the participant or IRA owner. The rule also would not apply to beneficiaries who are disabled, chronically ill or minor children.

The proposal would also require that any balance remaining after the death of a beneficiary (including those excepted from the five-year rule proposed above or in the case of a surviving spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death. The proposed rule would not apply to benefits determined under a binding annuity contract.

9. <u>Limiting the Total Accrual of Retirement Benefits</u>. The Administration proposed that a taxpayer who, in the aggregate, has accumulated amounts in retirement plans and/or IRAs in excess of the amount necessary to provide the maximum annuity permitted for a defined benefit plan under current law (generally $210,000) would be prohibited from making additional contributions to or receiving additional accruals under those accounts. However, the taxpayer's account balance could continue to grow with investment earnings and gains. Currently, the maximum permitted accumulation in a defined benefit plan for an individual age 62 is approximately $3.4 million.

If a taxpayer reached the maximum permitted accumulation, there would be two instances in which further contributions or accruals would be permitted: (a) if the taxpayer's investment return for a year was less than the rate of return assumed in the calculation of the maximum permitted accumulation; or (b) if the maximum defined benefit level increases due to inflation adjustments.

Contributions or accruals in excess of the maximum permitted amount would be treated in a manner similar to excess deferrals under current law for IRC § 401(k) plans.

10. <u>Modification of Roth Conversions</u>. The Administration would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includable in income if such amounts were not rolled over. Thus, amounts representing the taxpayer's basis in a traditional IRA could not be converted to a Roth IRA. Treasury explained that this rule would prohibit taxpayers from contributing to Roth IRAs even though their modified adjusted gross income exceeds the limit for such contributions by making a non-deductible contribution to a traditional IRA and then converting the entire traditional IRA to a Roth IRA. A similar rule would apply to amounts in eligible retirement plans that are rolled over to a Roth IRA.

11. Simplifying Contribution Limitations for Charitable Deductions and Expanding the Carryforward Period for Excess Contributions. Current law limits the income tax charitable deduction to a percentage of the donor's contribution base (*i.e.*, adjusted gross income less net operating loss carryback). The percentage is either 30% or 50%, depending on the type of property contributed, the type of charitable organization that received the donation and whether the contribution was made to or for the use of the charitable organization. Contributions to a charitable organization (but not for the use of a charitable organization) that exceed these limitations may be carried forward to be deducted over the subsequent five years.

To ease the burden on taxpayers and potentially increase compliance, the Administration proposed to simplify these rules so that the general contribution base limit would remain at 50% for contributions of cash to public charities. All other contributions (except for qualified conservation contributions, which are subject to separate contribution and carryforward limitations) would be limited to 30% of the taxpayer's contribution base. The 30% limitation would no longer depend on the type of property contributed, the type of charitable organization receiving the contribution or whether the contribution was to or for the use of the charitable organization.

The Administration would also extend the carryforward period for excess contributions from 5 to 15 years.

12. Modification of the GST Tax Treatment of Health and Education Exclusion Trusts ("HEET"). A HEET is designed to enable the making of distributions for educational and medical expenses that would qualify for the exclusions from gift and GST taxes under IRC §§ 2503(e) and 2611(b)(1). Treasury stated that grantors often take the position that a HEET avoids GST tax over multiple generations. However, IRC § 2611(b)(1) is designed only to exclude from GST tax those payments made by a living donor directly to a health care provider or an educational institution. Thus, the Administration proposed to amend IRC § 2611(b)(1) to specify that the exclusion applies only to these types of payments, *i.e.*, gifts, and not trust distributions, even if such payments are made to health care providers and educational institutions.

13. Annual Exclusion Gift Changes. Treasury discussed a new proposal arising from the IRS' often unsuccessful attempts to enforce the present interest requirement for annual exclusion gifts, particularly relating to the use of *Crummey* withdrawal rights to meet this requirement. Treasury stated that "the cost to taxpayers of complying with the *Crummey* rules is significant, as is the cost to IRS of enforcing the rules." Treasury also stated that "the IRS is concerned about the lack of a limit on the number of beneficiaries to whom *Crummey* powers are given."

The Administration proposed creating another category of gifts that are future interests but that would be excluded from gift tax. Such transfers would be limited to $50,000 per year (adjusted for inflation) for each donor. This new category would include "transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee." Thus, transfers that fall into this category, which traditionally only qualified for the annual exclusion through the use of *Crummey* withdrawal rights or similar rights, will qualify for the annual exclusion regardless of whether the donee holds such rights, provided that the value of such transfers does not exceed $50,000 per donor.

The proposed rule would be an additional limitation on annual exclusion gifts. If the value of the gifts in this category exceed $50,000 by a donor for any year, such excess would be treated as a taxable gift, regardless of whether the value of all present interest gifts by the donor to the donee for such year is less than the maximum amount allowed per donee (currently $14,000).

14. Expanding the Powers of the Executor. The current definition of "executor" under IRC § 2203 applies only for purposes of the estate tax. The Administration would expand the scope of this definition so that it applies to all federal taxes. The executor would then have the authority to handle any tax issues that arose before a decedent's death and were still unresolved after the decedent's death.

The definition of executor states that if "there is no executor or administrator appointed, qualified, and acting within the United States," the executor is "any person in actual or constructive possession of any property of the decedent." Under this definition, multiple individuals could qualify as the executor and each could file the same tax return or take other conflicting actions. The Administration stated that rulemaking authority would be granted to resolve conflicts among multiple executors.

15. Extension of Liens on Deferrals Under IRC § 6166. Treasury stated that the IRS has had difficulty collecting deferred estate tax under IRC § 6166, which allows the deferral of estate tax on certain closely held business interests for up to 14 years from the original due date for the estate tax payment. Under IRC § 6324(a)(1), a lien is imposed on estate assets, to secure full payment of estate tax, generally for the ten-year period immediately following the decedent's death. The Administration would amend IRC § 6324(a)(1) to extend the estate tax lien throughout the 14-year IRC § 6166 deferral period. This proposed legislation would apply not only to decedents dying after enactment, but would also apply to estates for which a lien under IRC § 6324(a)(1) was in place and had not expired upon the date of enactment.

16. Increase in Tax Rates for Carried Interests. The Administration proposed to change the tax consequences arising from holding "carried" or "profits" interests, which, typically, are interests in a partnership in which the partner receives an interest in the future profits of the partnership in exchange for services. Such partners are taxed at long-term capital gain rates in the same manner as partners who do not hold a carried interest, even though partners who hold a carried interest perform services. Furthermore, income attributable to a carried interest is subject to self-employment tax, but such income may be reduced for purposes of calculating self-employment taxes by capital gains, certain interest and dividends.

The Treasury stated that "[a] service provider's share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service providers to receive capital gains treatment on labor income without limit, the current system creates an unfair and inefficient tax preference."

The Administration proposed to treat as ordinary income, rather than as capital gain, a partner's share of income on an "investment services partnership interest" ("ISPI") in an investment partnership, regardless of the character of the income at the partnership level. This proposal would also require the taxpayer to pay self-employment taxes on such income.

"ISPI" would be defined as a carried interest in an investment partnership that is held by a person who provides services to the partnership. An "investment partnership" would be defined as a partnership substantially all of the assets of which are "investment-type" assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents or derivative contracts with respect to those interests). In addition, over half of the partnership's contributed capital must come from partners in whose hands the interests constitute property not held in connection with a trade or business.

These rules would not apply to income attributable to certain invested capital, which generally would be defined as contributed property that is allocated in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and such allocations are significant. In addition, gain recognized on the sale of an ISPI generally would be treated as ordinary income other than gain attributed to invested capital.

The Administration would also include an anti-abuse rule designed to prevent the avoidance of the proposed treatment through the use of compensatory arrangements other than partnership interests (a "disqualified interest"), such as convertible or contingent debt. Interests that fall into this anti-abuse rule would be taxed at ordinary income tax rates.

The proposal is not intended to affect adversely real estate investment trusts which own carried interests.

B. Trusts and Estates Related Provisions of Protecting Americans From Tax Hikes Act (PATH Act)

2016 Consolidated Appropriations Act, Division Q, P.L. 114-113 (December 18, 2015)

1. <u>IRA Charitable Rollover Made Permanent</u>. The PATH Act makes permanent IRC § 408(d)(8), which allows individuals age 70½ and older to distribute up to

$100,000 in a given taxable year from their IRAs to charities and have the amount so distributed excluded from gross income.

IRC § 408(d)(8) applies only to "qualified charitable distributions," which are any distributions out of an IRA directly to an organization described in IRC § 170(b)(1)(A) (other than an organization described in IRC § 509(a)(3) or a donor advised fund (as defined in IRC § 4966(d)(2)). Qualified charitable distributions do not include distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. IRC § 408(d)(8)(C). The Technical Explanation of House Amendment #2 to the Senate Amendment to H.R. 2029, the "Protecting Americans from Tax Hikes Act of 2015," Prepared by the Staff of the Joint Committee on Taxation, JCX-144-15 (the "JCT Report"), elaborates by stating that, "for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution." JCT Report, p. 19.

Under IRC § 408(d)(8)(D), a qualified charitable distribution is treated as consisting, first, of what otherwise would have been taxable distributions up to the aggregate amount that would have been includible in gross income if the aggregate balance of all IRAs having the same owner were distributed during the same year. The apparent purpose of this ordering rule is to ensure that qualified charitable distributions will contain all of the distributions that would have been taxable without this new provision, leaving as much as possible of the nontaxable distributions to be distributed to noncharitable recipients. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution. IRC § 408(d)(8)(D).

Distributions that are excluded from gross income by reason of the new provisions are not taken into account in determining the deduction for charitable contributions under IRC § 170. IRC § 408(d)(8)(E). The provisions do not effect distributions that are not qualified charitable distributions, the determination of whether an IRA qualifies as an IRA or the treatment of any noncharitable distribution for minimum distribution purposes.

2. <u>Valuation of Remainder Interests Upon Early Termination of Certain CRUTs</u>. For purposes of determining the settlor's charitable income tax deduction for the gift of the remainder interest in a "net income" charitable remainder unitrust (a "NICRUT"), or in a "net income with make-up" charitable remainder unitrust (a "NIMCRUT"), the value of the remainder interest is determined assuming that the full unitrust amount will be paid each year. Under pre-PATH law, it was unclear whether the same approach to value such a remainder interest would be used upon early termination of a NICRUT or a NIMCRUT. Section 344(a)(1) of the PATH Act amended IRC § 664(e) to make clear that the same approach is to be so used.

3. Modification of Savings Accounts for People With Disabilities. The PATH Act removed the residency requirement for beneficiaries of an account established under the Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014 (the "ABLE Act"), P.L. 113-295 (December 19, 2014), better known as "ABLE accounts." The PATH Act also authorized roll overs from qualified tuition program accounts (more commonly referred to as "529 plans") into ABLE accounts so long as the other ABLE account requirements are met.

The ABLE Act permits a state to establish and maintain a savings program called a "qualified ABLE program," under which contributions may be made to an account that is established to meet the qualified disability expenses of the beneficiary of the account. Previously, such beneficiary had to be a resident of the state in which the account was established in order to receive benefits. The PATH Act has removed this requirement for tax years beginning January 1, 2015. The beneficiary may deposit funds into an ABLE account without affecting the beneficiary's eligibility for Social Security or other government benefits. To maintain Social Security Income ("SSI") eligibility, however, the ABLE account balance may not exceed $100,000. Medicaid coverage may be maintained no matter the amount that has accrued in the ABLE account. Section 103 of Pub. L. 113-295, Div. B.

The beneficiary must be the owner of the ABLE account. IRC § 529A(e)(6). If the beneficiary is unable to establish the account, a guardian, parent or agent under a durable power of attorney may establish the account. In addition, another person besides the beneficiary may have signature authority over the account and manage it for the sole benefit of the beneficiary. Prop. Reg. § 1.529A-1(b)(4); -2(c).

Generally, all assets held in an ABLE account are exempt from taxation. IRC § 529A(a). Contributions to an ABLE account by anyone other than the beneficiary are treated as completed gifts and are not excluded from gift tax by reason of being a gift for medical expenses under IRC § 2503(e). The contributions are treated as present interest gifts and therefore will qualify for the annual exclusion. All contributions must be in cash, and the aggregate contributions in any one year from all contributors cannot exceed the annual exclusion amount under IRC § 2503(b). IRC § 529A(b)(2); (c)(2). This includes roll over contributions from IRC § 529 plans in excess of the annual exclusion amount.

Money deposited into an ABLE account may be distributed tax-free for "qualified disability expenses." IRC § 529A(c)(1). Funds in the account can be used to pay for health care, education, transportation and other expenses. IRC § 529A(e)(5). Distributions may also be made for housing expenses, but such distributions may adversely affect a beneficiary's eligibility for SSI. Section 103 of Pub. L. 113-295, Div. B; *see also* Notice 2015-81, 2015-49 I.R.B. 784 (December 7, 2015).

Earnings that are distributed and not used for qualified disability expenses are treated as taxable income to the beneficiary and are assessed an additional tax of 10% of the amount treated as taxable income, unless certain exceptions are met. IRC § 529A(c)(3). Distributions are not treated as taxable gifts. IRC § 529A(c)(2).

4. <u>Exclusion from Gross Income of Recontributed Refunds for Qualified Expenses under IRC § 529</u>. Qualified tuition programs under IRC § 529 of the IRC (better known as "529 accounts" or "529 plans") are programs maintained by individual states under which a person may use such assets for qualified tuition expenses. All contributions must be made in cash, and such contributions are treated as completed gifts by the contributor (even if someone other than the account owner) for gift tax purposes at the time the contribution is made. IRC § 529(b)(2); Treas. Reg. § 1.529-5(b)(1). However, contributions may be made to the IRC § 529 plan in excess of the annual exclusion amount under IRC § 2503(b) and the donor may elect to treat such excess portion as a ratable distribution to the IRC § 529 plan over a five-year period. IRC § 529(c)(2); Treas. Reg. § 1.529-5(b)(2). At death, the value of the assets in an IRC § 529 account is not included in the gross estate of a decedent who was an IRC § 529 plan account owner on behalf of a designated beneficiary. Treas. Reg. § 1.529-5(d)(1). The value of the assets is includible in the gross estate of the designated beneficiary. Treas. Reg. § 1.529-5(d)(3).

The PATH Act struck the previous IRC § 529(c)(3)(D), which required that distributions be aggregated for income tax purposes if the beneficiary received multiple distributions in a taxable year, and added a new paragraph (D), which states that if a beneficiary receives a refund of a qualified expense, the refunded amount will not be included in the beneficiary's gross income under IRC § 529(c)(3)(A) so long as the amount is recontributed to the 529 account within 60 days of the refund and does not exceed the refunded amount.

5. <u>Gift Tax Does Not Apply to Transfers Made to Certain Charitable Organizations</u>. IRC § 2501 imposes a tax on "the transfer of property by gift during such calendar year by any individual resident or nonresident." Transfers of certain property or to certain types of organizations are exempt from application of the gift tax. See IRC § 2501(a)(2)-(5). For example, gifts to political organizations within the meaning of IRC § 527(e) and gifts of intangible property transferred by nonresident aliens are exempt from tax. The PATH Act extended the list of exceptions by adding new paragraph (a)(6) for gifts made after December 18, 2015, which reads:

> (6) Transfers to certain exempt organizations.
>
> Paragraph (1) shall not apply to the transfer of money or other property to an organization described in paragraph (4), (5), or (6) of section 501(c) and exempt from tax under section 501(a), for the use of such organization.

Thus, any assets transferred to a civic league (IRC § 501(c)(4)); to a labor, agricultural, or horticulture organization (IRC § 501(c)(5)); or to a business league or board of trade (IRC § 501(c)(6)) are now expressly exempt from gift tax under IRC § 2501.

C. Trust and Estate Related Items Contained in the Joint Treasury, IRS 2015-2016 Priority Guidance Plan

July 31, 2015; First Quarter Update (October 23, 2015); Second Quarter Update (February 5, 2016)

1. Income Taxation. Guidance on the basis of grantor trust assets at death under IRC § 1014. See the summary of Rev. Proc. 2015-37, below.

Guidance regarding material participation of trusts and estates for purposes of IRC § 469.

Finalizing regulations proposed on December 2, 2013 under IRC § 1411 (REG-130843-13), primarily dealing with the application of IRC § 1411 to charitable remainder trusts and qualified subchapter S trusts.

2. Portability. A revenue procedure under IRC § 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability. *See* Rev. Proc. 2001-38, 2001-1 C.B. 1335.

3. Valuation. Regulations under IRC § 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.

Guidance on the gift tax effect of defined value formula clauses under IRC §§ 2511 and 2512.

Guidance on the valuation of promissory notes for transfer tax purposes under IRC §§ 2031, 2033, 2512 and 7872. Finalizing regulations proposed on November 18, 2011 (REG 112196-07) under IRC § 2032(a) regarding the imposition of restrictions on estate assets during the six-month alternate valuation period. The proposed regulations expanded the description of intervening events that would be regarded as dispositions that trigger alternate valuation as of that date.

4. Estate Tax Deductions. Guidance under IRC § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate. The guidance is likely to be focused on leveraged tax benefits such as deductions arising from *Graegin* loans. *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477.

5. Generation-Skipping Transfer Tax. Regulations under IRC § 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an estate tax inclusion period.

Finalizing regulations published on April 17, 2008 (REG-147775-06) under IRC § 2642(g) regarding extensions of time to make allocations of generation-skipping transfer tax exemption.

6. Procedure. Regulations under IRC § 6166 regarding the furnishing of security in connection with an election to pay estate tax installments.

7. Employee Benefits. Regulations on the exceptions to additional tax under IRC § 72(t) on early distributions from retirement plans and IRAs.

Regulations under IRC §§ 219, 408, 408A and 4973 regarding IRAs.

Finalize regulations issued on December 8, 2008 (REG-148326-05) on income inclusion under IRC § 409A.

8. **Charitable Giving**. Guidance on qualified contingencies of charitable remainder annuity trusts under IRC § 664.

Guidance under IRC § 4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.

9. **Ethics**. Regulations revising Circular 230 regarding proceedings before the IRS.

II. INCOME TAXATION

A. New Basis Consistency and Reporting Rules for Property Acquired from a Decedent

Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41 (July 31, 2015); Notice 2015-57, 2015-36 I.R.B. 294 (August 21, 2015); Notice 2016-19, 2016-9 I.R.B. (February 11, 2016); Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent (January 29, 2016); T.D. 9757 (March 4, 2016); Notice 2016-27 (March 23, 2016)

President Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) (the "Act") into law on July 31, 2015. The Act is effective immediately and affects all United States Estate (and Generation-Skipping Transfer) Tax Returns (Form 706) filed after July 31, 2015. Section 2004 of the Act adds new IRC § 1014(f), new IRC § 6035 and amends IRC §§ 6662 and 6724.

1. **Basis Consistency**. IRC § 1014(f) provides rules requiring that the basis of IRC § 1014(a) property (*i.e.*, certain property acquired from a decedent) not exceed the final value of such property as determined for estate tax purposes, or if the final value has not been determined, the value of that property as reported on a statement to the decedent's recipients under new IRC § 6035.

2. **New Reporting Requirements**. IRC § 6035 imposes new reporting requirements for individuals who are required to file a Form 706 under IRC § 6018(a) (*i.e.*, the executor) or under IRC § 6018(b) (*i.e.*, the decedent's recipients). If a Form 706 must be filed under IRC § 6018, the reporting party is now also required to report valuation information to the IRS and to each person acquiring any interest in property included in the decedent's gross estate. IRC § 6035 provides that such statements must be furnished at the time prescribed in regulations, but no later than the earlier of: (a) 30 days after the return's due date, including extensions; or (b) 30 days after the return is filed. If valuation or other adjustments are made after the

statements are furnished, a supplemental statement shall be filed within 30 days of the date of the adjustment.

3. New Penalties. IRC § 6662 is amended by adding subsections (e) and (k), which provide that accuracy-related penalties apply to a taxpayer who reports a higher basis than the estate tax value that applies under IRC § 1014(f). Furthermore, IRC § 6724 is amended to treat Form 8971 as an "informational return" and as a "payee statement." Thus, failure to provide Forms 8971 will result in penalties as provided in IRC §§ 6721 and 6722.

4. Temporary and Proposed Regulations. On March 4, 2016, the Department of Treasury published temporary and proposed regulations providing guidance regarding the basis consistency and information reporting rules of IRC §§ 1014(f) and 6035. The proposed regulations apply to property acquired from a decedent or by reason of the death of a decedent whose Federal estate tax return is filed after July 31, 2015.

The proposed regulations clarify various definitions contained in IRC §§ 1014(f) and 6035. "Information Return" means Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," and the "Statement" required to be furnished to each beneficiary. Prop. Reg. § 1.6035-1(g)(2). "Statement" means the payee statement described as Schedule A of the Information Return. Prop. Reg. § 1.6035-1(g)(2).

The proposed regulations also provide guidance on the following topics: (1) property subject to the basis consistency rules; (2) reporting requirements; (3) property subject to the reporting requirements; (4) reporting due dates; (5) the effect of post-death adjustments to basis; (6) identity of the beneficiaries who must receive a Statement; (7) supplemental information and treatment of subsequently-discovered property; (8) reporting subsequent transfers; and (9) beneficiaries' inability to contest estate tax value.

a. Property Subject to the Basis Consistency Rules. Generally, all property included in the decedent's gross estate (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) that generates a Federal estate tax in excess of allowable credits (other than a credit for a prepayment of tax) is subject to the basis consistency rules. Prop. Reg. § 1.1014-10(b)(1). If the estate pays no Federal estate tax, then none of the estate property is subject to the basis consistency rules. Prop. Reg. § 1.1014-10(b)(3).

Property that qualifies for an estate tax charitable or marital deduction under IRC §§ 2055, 2056 or 2056A are excluded from the property subject to the basis consistency rules because such property does not generate estate tax liability. Prop. Reg. § 1.1014-10(b)(2).

In addition, tangible personal property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b) is not subject to the basis consistency rules. The proposed regulations are not clear whether this exception applies if the aggregate value of all tangible personal property is under the $3,000.00 threshold provided in Treas. Reg. § 20.2031-6(b) or whether the exception applies to each item of tangible personal property the value of which is under the $3,000.00 threshold. However, an example in the proposed regulations indicates that this exception applies for any individual item the value of which is under $3,000.00. Prop. Reg. § 1.6035-1(b)(2), Ex.1. A further indication that the exception applies to each item the value of which is under $3,000.00 is found in the Instructions to Form 706, which requires an appraisal only for those items valued at more than $3,000.00.

b. **Reporting Requirements**. An "executor" who is required to file a Federal estate tax return pursuant to IRC § 6018(a) is required to provide an Information Return (i.e., Form 8971 and Schedule A) to the IRS and a Statement (i.e., Schedule A) to all beneficiaries who will receive property that was included in the decedent's gross estate. Prop. Reg. § 1.6035-1(a)(1). This reporting requirement does not apply if the executor is not required by IRC § 6018(a) to file a Federal estate tax return, but files a Federal estate tax return for other reasons (*e.g.,* to make a portability election, a GST exemption allocation or a protective filing to avoid any penalty if an asset value is later determined to require the filing of a return). Prop. Reg. § 1.6035-1(a)(2).

c. **Property Subject to the Reporting Requirements**. Generally, all property required to be reported on a Federal estate tax return (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) is subject to the reporting requirement. Prop. Reg. § 1.6035-1(b)(1). This includes property included in the gross estate but not held by the estate, such as property held in a revocable trust established by the decedent. Regarding property owned by a deceased nonresident alien, only the property that is subject to the U.S. estate tax is reportable. Prop. Reg. § 1.6035-(b)(1). For a decedent holding community property, the reporting requirement only applies to the decedent's one-half of community property. Prop. Reg. § 1.6035-(b)(1).

Four classes of property are exempt from the reporting requirement: (a) cash (other than a coin collection or other coins or bills with numismatic value); (b) income in respect of a decedent (as defined in IRC § 691); (c) tangible personal property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b); and (d) property sold, exchanged or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized. Prop. Reg. § 1.6035-(b)(1) (i)-(iv).

d. **Reporting Due Dates**. The due date for providing an Information Return and Statement to the IRS and the Statements to the beneficiaries is the earlier of 30 days after the due date of the Federal estate tax return or 30 days after the date the Federal estate tax return is actually filed. Prop. Reg. § 1.6035-1(d)(1). Transitional relief regarding the initial time for filing is provided so that if the due date is before June 30, 2016, the executor need not submit the Information Return and Statements until June 30, 2016. Prop. Reg. § 1.6035-1(d)(2); Notice 2016-27.

e. **Effect of Post Death Adjustments**. The proposed regulations recognize that post-death adjustments to a property's basis may still occur after the valuation date for estate tax purposes. A beneficiary's initial basis in property acquired from the decedent or as a result of the decedent's death will be the value of such property as reported on the Federal estate tax return. However, the beneficiary's initial basis may be adjusted due to the operation of other provisions of the IRC governing basis. Prop. Reg. § 1.1014-10(a)(2). Such adjustments could include gain recognized by the decedent's estate upon distribution of the property, post-death capital improvements and depreciation and post-death adjustments to the basis of an interest in a partnership or S corporation. Prop. Reg. § 1.1014-10(a)(2). The basis of property subject to debt (whether recourse or non-recourse) is the gross up value of the property and thus, post-death payments on such debt will not result in an adjustment to the property's basis. Prop. Reg. § 1.1014-10(a)(2).

f. Identity of the Beneficiaries Who Must Receive a Statement. Statements must be provided to any person receiving reportable property (referred to as a "beneficiary"). Prop. Reg. § 1.6035-1(c)(1). There is no exception to exclude reporting to a beneficiary who receives property which is not subject to the basis consistency rules (*i.e.*, bequests that qualify for the marital or charitable deduction). If a beneficiary is a trust or another estate, the Statement is provided to the trustee or the executor not the beneficiaries of that trust or estate. Prop. Reg. § 1.6035-1(c)(2).

If the executor has not identified the property that will be distributed to each beneficiary by the due date for submitting the Information Return and Statements, the executor must report on the Statement for each such beneficiary all of the reportable property that could be used to satisfy that beneficiary's interest. Prop. Reg. § 1.6035-1(c)(3); Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 2. "Once an exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement." Prop. Reg. § 1.6035-1(c)(3).

If a beneficiary cannot be located by the reporting due date, the executor must still file the Information Report and must explain the efforts made to located the beneficiary. Prop. Reg. § 1.6035-1(c)(4). A supplemental report must be filed within 30 days of locating the beneficiary. Prop. Reg. § 1.6035-1(c)(4).

For life estates, a beneficiary includes "the life tenant, the beneficiary of a remainder interest is remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971. If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting…to report the change of beneficiary." Prop. Reg. § 1.6035-1(c)(1). The inclusion of a contingent beneficiary as a beneficiary who must receive a Statement may be a drafting error, but until such time as the proposed regulations are finalized or amended, executors must report the basis of life estate property to contingent beneficiaries.

g. Supplemental Information and Subsequently-Discovered Property. An executor must file supplemental Information Returns and Statements if any change occurs that causes the reported information to be incorrect. Prop. Reg. § 1.6035-1(e)(2). No supplement is required to: (i) correct an inconsequential error or omission within the meaning of Treas. Reg. § 301.6772-1(b); or (2) specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries. Prop. Reg. § 1.6035-1(e)(3). The due date of the supplement is 30 days after: (1) the final value is determined, (2) incorrect or incomplete information is discovered or (3) a supplemental Federal estate tax return is filed reporting additional assets. Prop. Reg. § 1.6035-1(e)(4)(i).

If property is later discovered and reported on a supplemental Federal estate tax return before the period of limitation on assessment of tax expires, such property's basis for basis consistency purposes will be the final value as shown on the supplement to the Federal estate tax return. Prop. Reg. § 1.1014-10(C)(3)(i)(A). However, if the discovered property is not reported on a supplemental Federal estate tax return before the limitation period expires, the basis of such property is zero. Prop. Reg. § 1.1014-10(c)(3)(i)(B).

h. Reporting Subsequent Transfers. If property that previously was reported or is required to be reported is distributed or transferred (by gift or otherwise) by the beneficiary to a related transferee in a transaction in which the related transferee determines its basis, in whole or in part, by reference to the beneficiary/transferor's basis, the beneficiary/transferor must, within 30 days of the transfer, file with the IRS a supplemental Statement and furnish a copy to the transferee. Prop. Reg. § 1.6035-1(f). If the subsequent transfer occurs before the final value is determined for estate tax purposes then the transferor must also give the executor a copy of the Statement. Prop. Reg. § 1.6035-1(f). "A related transferee means any member of the transferor's family as defined in IRC § 2704(c)(2), any controlled entity…and any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. §1.6035-1(f).

i. Beneficiaries' Inability to Contest Estate Tax Value. The proposed regulations do not provide a process by which a beneficiary could challenge a value reported on a Federal estate tax return, rather, the IRS believes that a beneficiary can use state law avenues (*i.e.,* a breach of fiduciary duty claim) to pursue remedies against the executor.

B. State Statute That Taxed Trust Income Solely Based on Residence of Beneficiary Found Unconstitutional Under Due Process and Commerce Clauses

Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue, 2015 N.C. LEXIS 976 (N.C. Super. Ct. April 23, 2015)

Joseph Lee Rice, III (the "Settlor"), a resident of New York, created the Joseph Lee Rice, III Family 1992 Trust (the "Family Trust") for the benefit of his children. William B. Matteson, also a resident of New York, served as the initial Trustee. The trust agreement provided that the Family Trust was to be governed by the laws of the State of New York. In 1997, Kimberley Rice Kaestner ("Kaestner"), one of the Settlor's children, moved to North Carolina. William B. Matteson resigned as Trustee in 2005, and David Bernstein ("Bernstein"), a Connecticut resident, became Trustee.

In 2006, pursuant to the terms of the Family Trust Agreement, Bernstein divided the Family Trust into three separate trusts for each child. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). The Kaestner Trust benefited Kaestner as well as her three children, each of whom resided in North Carolina from 2005 to 2008, the tax years at issue. The contingent beneficiaries of Kaestner Trust were Kaestner's siblings, none of whom resided in North Carolina.

From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008. However, two loans were made from the Kaestner Trust during the same period: a $250,000 loan was made to Kaestner for an investment and another loan was made to a separate trust "to enable [the trust] to make a capital call on a limited partnership interest" held in that trust. Both loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets.

Each year, from 2005 to 2008, the North Carolina Department of Revenue (the "State") taxed the Kaestner Trust on its income. The Kaestner Trust paid the taxes and sought a refund for the taxes paid, which the State denied in 2011. Section 105-160.2 of the North Carolina statutes provides, in relevant part, that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." The Kaestner Trust sued, alleging that this statute was unconstitutional under the Due Process and Commerce Clauses of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution.

1. <u>Due Process Clause</u>. Tax assessment is a deprivation of property under the Due Process Clause and, therefore, there must be a link between "a state and a person, property or transaction [the government] seeks to tax." Quoting *Quill v. North Dakota*, 504 U.S. 298 (1992). In addition, the income attributed to the State for tax purposes [must be] rationally related to values connected with the taxing state.

The court first analyzed the contacts the Kaestner Trust had with North Carolina, finding that no physical presence existed. The Kaestner Trust did not hold real property, personal property, investments or records in North Carolina. In addition, Bernstein's "usual place of business" was outside of North Carolina. The State argued that the location of intangible property cannot be determined. The court, however, found that intangible property is traditionally treated as sitused in the location in which the physical certificates are held. In this case, that was outside of North Carolina. *See Safe Deposit Trust Co. v. Virginia*, 280 U.S. 82 (1929); *Hanson v. Denckla*, 357 U.S. 235 (1958). Accordingly, the tax on the Kaestner Trust would only withstand the Due Process Clause requirements if the Kaestner Trust "purposely availed" itself of the benefits and laws of the State.

The State argued that because the beneficiaries resided in the State and availed themselves of the laws and benefits of North Carolina, the tax on the Kaestner Trust was justified. The court noted, however, that the trust is a separate entity. Therefore, it was the trust that was required to avail itself of the benefits and laws, not the beneficiaries. In North Carolina, beneficiaries do not have legal interest in income until distributed and neither Kaestner nor her children could compel distributions from the trust. In addition, the court found that meetings between Kaestner and Bernstein were not communication initiated by the Kaestner Trust and was, consequently, not sufficient to "purposefully avail" the trust of the State's benefits for purposes of the tax. Accordingly, the court found that there were insignificant contacts with the state other than the residence of the beneficiaries to justify taxation under the United States and state Constitutions.

2. <u>Commerce Clause</u>. A tax does not violate the Commerce Clause so long as it: (a) is applied to an activity with a substantial nexus with the taxing state; (b) is fairly apportioned; (c) does not discriminate against interstate commerce; and (d) is fairly related to the services provided by the state. *Quill*, *supra*. The *Quill* court differentiated the "minimum contacts" test from the "substantial nexus" test by stating that the due process requirements address whether an individual's connections are substantial enough to legitimize the exercise of state power but that the Commerce Clause addresses structural concerns about the effects of state regulation on the national economy. The presence in the state can be one that is not related to the activity being taxed.

As stated in its Due Process analysis, the court reiterated that the Kaestner Trust kept no records in the State nor did it hold real or personal property in the State that may support a connection to North Carolina outside of the residency of the beneficiaries. Furthermore, the tax must be "fairly related to services provided by the State" to withstand the Commerce Clause analysis. The court found, however, that the Kaestner Trust did not engage in any activity in North Carolina so it did not use any of the State's services that would justify a tax based on the domicile of beneficiaries alone. *See McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. Ct. 2013). Thus, the State statute violated both the Due Process and Commerce Clauses to the extent the only basis for taxation was the residence of the beneficiaries.

C. New Jersey Division of Taxation Barred from Taxing Undistributed Income of a Non-New Jersey Trust

Residuary Trust A Under Will of Kassner v. Director, Division of Taxation, 28 N.J.Tax 541, 2015 N.J. Tax LEXIS 11 (N.J. Super. Ct. May 28, 2015), *affirming* 27 N.J. Tax 68 (N.J. Tax Ct. 2013)

The Superior Court of New Jersey affirmed a ruling that a non-New Jersey trust does not owe New Jersey income tax on undistributed out-of-state income because the trust owned no assets in New Jersey, its sole trustee resided outside of New Jersey and the trust was administered exclusively outside of New Jersey.

In 2006, Residuary Trust A (the "Trust") owned shares in four New Jersey S Corporations. The Trust paid New Jersey tax on its net pro rata share of the S Corporations' income that was allocated to New Jersey. It did not pay New Jersey tax on income allocated to states other than New Jersey. In 2009, the New Jersey Division of Taxation issued a Notice of Deficiency asserting that the S Corporation stock was located in New Jersey and thus the Division had power to tax all of the undistributed income of the Trust, including that income generated from property outside New Jersey. The Division also asserted that guidance issued by the Division in 2011, which provided that the Trust is subject to taxation on its retained income if it has any New Jersey income, applied retroactively.

The court rejected the contention that the S Corporation stock was a New Jersey asset and concluded that the owner of New Jersey S Corporation stock does not own or hold title to the underlying assets of the corporations. The court also concluded that imposing the tax on the Trust's 2006 income, based on Division guidance released in 2011, would violate the "square corners doctrine," which requirements the government to deal fairly with its citizens and promotes a policy whereby taxpayers may reliably engage in tax planning without fear that the taxing authority will retroactively change the rules.

D. Distributions Made by Committee Subject to Grantor Consent Creates Incomplete, Non-Grantor Trust for Gift Tax Purposes

PLRs 201510001-201510008 (March 6, 2015); PLR 201550005 (December 11, 2015).

The IRS issued nine rulings in 2015 affirming the structure of incomplete nongrantor trusts, commonly referred to as "ING trusts." In each ruling, a grantor created an irrevocable trust for the benefit of himself, his spouse, his issue and other individuals. The trust instrument provided that the Trustees were to distribute income and principal from the trust as directed by a power of appointment committee ("Committee"), acting in a non-fiduciary capacity. Specifically, the Trustees were required to distribute trust assets to (1) the Grantor or other trust beneficiaries at the direction of a majority of the Committee members with the Grantor's consent or (2) the Grantor or other trust beneficiaries by unanimous consent of the Committee members other than the Grantor. The Committee members were beneficiaries of the trust. The Committee ceased to exist at such time as the Grantor was the sole member or upon the Grantor's death.

In addition, the Grantor reserved to himself the power, exercisable in a non-fiduciary capacity, to appoint trust principal to any one or more beneficiaries for their respective health, education, support and maintenance. Upon the Grantor's death, the Grantor had the power to direct the trust assets to any person or entity other than himself, his estate, his creditors or the creditors of his estate. Absent this direction, the balance passed to the remaining trust beneficiaries pursuant to the trust terms.

Each Grantor sought the following rulings:

(1) So long as the Committee serves, the trust's income would not be included in the gross income of the Grantor or any member of the Committee.

(2) The Grantor's contributions to the trust would not be completed gifts for federal gift tax purposes and distributions by the Committee to the Grantor would not be completed gifts by any Committee member.

(3) Distributions by the Committee to any beneficiary other than the Grantor would not be completed gifts by any Committee member and Committee members did not possess a general power of appointment over the trust assets and therefore no portion of the trust would be included the gross estate of any Committee member under IRC § 2041.

(4) For PLR 201550005 only, that one-half of the community property contributed to the trust would receive a step-up in basis upon the first to die of two Grantor spouses.

1. <u>Trust not a Grantor Trust for Income Tax Purposes</u>. IRC §§ 673-678 provide the circumstances under which a grantor or another individual will be treated as owner of the trust for income tax purposes. As to the grantor, IRC §§ 673 through 677 provide that the grantor will be treated as owner of any portion of the trust:

- To the extent the grantor retains a reversionary interest in the trust that exceeds 5% of the value of the trust assets at creation of the trust,
- For which the grantor or a nonadverse party may exercise a power over trust assets without the consent of an adverse party
- For which administrative control is primarily for the benefit of the grantor rather than a beneficiary
- To the extent the grantor and/or a nonadverse party retains the power to revise the title of any portion of the trust assets in the grantor
- For which the income can be distributed to the grantor or the grantor's spouse without the consent of an adverse party.

Finally, IRC § 678 provides that persons other than the grantor will be treated as owner if such person alone has the power to vest the corpus or income in himself or herself.

The IRS held that neither the Grantor nor any beneficiary would be owners of the trust under IRC §§ 673-678 because there were no circumstances that would trigger their application. However, the IRS declined to issue a definitive determination as to IRC § 675 because the income tax returns filed by the Grantor and the trust beneficiaries would be the best evidence of whether administrative controls were exercised primarily for the benefit of the Grantor.

2. <u>Grantor's Contributions Are Incomplete Gifts and Distributions by Committee to Grantor Are Not Completed Gifts by Committee Members</u>. A gift is complete under Treas. Reg. § 25.2511-2(b) when the Grantor departs with dominion and control over an asset such that no power remains to change the disposition of trust assets. Here, the Grantor retained a consent power over actions taken by a majority of the Committee. The Grantor will be deemed to have a power of appointment over trust assets if such power is exercisable in conjunction with any person who does not have a substantial adverse interest in the disposition of the property. Treas. Reg. § 25.2511-2(e). In the case of the Grantor's consent power, the Committee members were co-holders of the power, but their interests were not adverse to the Grantor's because they did not possess the power after the Grantor's death to exercise the power in favor of themselves, their estate, their creditors or creditors of their estate. Accordingly, the Grantor alone had the power to distribute income and principal to trust beneficiaries, making the contribution to the trust an incomplete gift.

The Grantor's power to direct distribution of principal caused contributions to be an incomplete gift because the power allowed him to name new beneficiaries or change the interests of the existing beneficiaries. Treas. Reg. § 25.2511-2(c). In addition, the Grantor's ability to direct trust assets through a testamentary special power of appointment constituted the retention of dominion and control over the remainder of the trust, also making the Grantor's contribution an incomplete gift.

Any distribution authorized by the Committee to Grantor was merely a return of the Grantor's property, so there would be no completed gift by Committee members to the Grantor. The fair market value of the trust assets would be included in the Grantor's gross estate at death.

3. **Distributions by Committee to Other Trust Beneficiaries Not Completed Gifts by Committee Members under IRC § 2514 and Committee Powers Not General Power of Appointment under IRC § 2041**. IRC § 2514 provides that the exercise or release of a general power of appointment is considered a transfer of property for gift tax purposes. Pursuant to IRC § 2514(c)(3)(A), if the power is exercisable only in conjunction with the creator, the power is not a general power of appointment. Alternatively, if the power is only exercisable in conjunction with a person having a substantial adverse interest in the property that is adverse to the exercise of the power in favor of the possessor, such power shall not be deemed a general power of appointment. IRC § 2514(c)(3)(B). If such power is not exercised or released during life, IRC § 2041 provides that any assets over which a decedent holds a general power of appointment is includible in decedent's gross estate for estate tax purposes.

The Committee's unanimous power to distribute trust assets was not a condition precedent to the exercise of Grantor's consent power. Therefore, the Grantor retained dominion and control over the trust assets until the Committee exercised their unanimous power. This restraint meant that the distribution of trust assets to the Grantor or other trust beneficiaries were not completed gifts by Committee members. Distributions to the Grantor were considered a mere return of property to the Grantor. Distributions to the other trust beneficiaries, though not completed gifts by the Committee members, were completed gifts by Grantor for gift tax purposes.

The Committee's powers under the Grantor's consent power were only exercisable in conjunction with the creator of the power (the Grantor). Therefore, no general power of appointment was created in Committee members for purposes of IRC §§ 2514(b) and 2041(a)(2). Committee members had substantial adverse interests in property subject to the power because the co-holders of the power could exercise the power in favor of themselves following the death of another co-holder. Therefore, any distribution to a beneficiary would be a gift by the Grantor, not by other Committee members.

4. **<u>One-Half of Community Property Will Receive Basis Step-up at Grantor's Death Provided Committee Still Exists</u>**. PLR 201550005 varied slightly from the other rulings in that two spouses were the Grantors of the trust and they resided in a community property state. The property contributed to the trust was stipulated as community property and the Grantors sought confirmation that one-half of the trust property would receive a step-up in basis following the first death so long as the Committee remained inexistence. The IRS confirmed that one-half of the trust property would be entitled to a basis adjustment as provided in IRC § 1014 because the trust property will be included in decedent's gross estate for federal estate tax purposes under IRC §§ 2036 and 2038 assuming that the Committee is still in existence.

E. Potential for Using Grantor Trust Not Includable in Grantor's Gross Estate to Achieve Basis Step-Up

Rev Proc. 2015-37, 2015-26 I.R.B. 1196 (June 29, 2015)

In Rev. Proc. 2015-37, the IRS stated that it will no longer issue letter rulings addressing whether assets in a grantor trust receive an IRC § 1014 basis adjustment when the assets are not included in the deemed owner's gross estate at death. The Rev. Proc. is effective for all letter ruling requests received after June 15, 2015. This Rev. Proc. may be an effort to discourage taxpayers from emulating what PLR 201245006 seems to suggest is possible.

In PLR 201245006, Taxpayer was a citizen and resident of a foreign country and proposed establishing an irrevocable trust governed by the laws of the foreign country. Taxpayer and an unrelated party were to be Trustees. The trust instrument provided that no adverse party, as defined in IRC § 672(a), could act as a Trustee. The trust instrument directed the Trustees to distribute income to Taxpayer. The Trustees also were given the power to distribute principal to Taxpayer in the Trustees' discretion. Upon Taxpayer's death, the property was to be distributed among Taxpayer's descendants pursuant to Taxpayer's exercise of a power of appointment. Any unappointed property was to remain in the trust for the benefit of Taxpayer's descendants. The trust property consisted of cash and stock that was traded on the exchange of the foreign country and on the New York Stock Exchange.

The IRS concluded that the property distributed from the trust would qualify as property acquired from a decedent under IRC § 1014(b)(1) and would, therefore, receive a basis step-up. The IRS stated that the rule of IRC § 1014(b)(1) "applies to property located outside the United States, as well as to property located inside the United States." The IRS then concluded that Taxpayer could be treated as the owner of the trust for income tax purposes, despite not being a citizen or resident of the United States, because Taxpayer was the sole beneficiary of the trust during his lifetime. See IRC § 672(f); Treas. Reg. § 1.672(f)-1, -3(b)(1).

Prior to this ruling, the only relevant guidance was CCA 200937028, which seemed to lead to the conclusion that property transferred before death, even to a grantor trust, would not qualify under IRC § 1014 unless the property was included in decedent's gross estate pursuant to IRC § 1014(b)(9). *See* Kess, *Basis Step-Up For Grantor Trust Assets Not Included in Grantor's Taxable Estate*, CCH JOURNAL OF PASSTHROUGH ENTITIES 33,761 (2013). The taxpayers in CCA 200937028 assumed that the trust was a grantor trust because the grantor held the right to substitute assets. However, the IRS never ruled on the income tax status of the trust in CCA 200937028. Revenue Procedure 2015-37 may be a signal that the IRS will return to the reasoning of CCA 200937028. *See* Velarde, *Trust No-Rule May Be Precursor to Stronger Guidance*, Tax Notes, http://www.taxnotes.com/imp/14673916.

In addition, in its latest Priority Guidance Plan, discussed above, the IRS announced that it plans to issue guidance regarding the "basis of grantor trust assets at death under §1014," perhaps to deal to with the issue raised in Rev. Proc. 2015-37.

F. Assets of Separate Accounts for Variable Life Insurance Policies Held in Trust Includible in Gross Income Under Investor Control Doctrine

Webber v. Commissioner, 144 T.C. No. 17 (June 30, 2015)

1. <u>Background</u>. Jeffrey Webber was a successful businessman who owned his own consulting firm and managed several private equity partnerships for which he managed the investments. Webber hired Susan Chang as his accountant to assist Webber with his investment responsibilities. Webber sought the assistance of lawyer William Lipkind for his personal estate planning. Lipkind suggested that Webber create a grantor trust to purchase private placement life insurance policies from Lighthouse, a Cayman Islands insurance company. Webber established a grantor trust, the Jeffrey T. Webber 1999 Alaska Trust, on March 24, 1999 (the "Alaska Trust"). Webber contributed $700,000 to the Alaska Trust, which the Trustees used to purchase two variable insurance policies from Lighthouse. Webber filed a United States Gift Tax Return (Form 709) reporting the $700,000 contribution to the Alaska Trust as a gift.

In 2003, Webber became concerned about his creditor issues and requested that Lipkind move his assets offshore. Lipkind initially advised against doing so due to tax consequences but eventually agreed to move forward. Webber signed the instrument establishing the Chalk Hill Trust on October 9, 2003, a foreign grantor trust under the laws of the Commonwealth of the Bahamas. The Alaska Trust simultaneously assigned the Lighthouse insurance policies to the Chalk Hill Trust. Webber filed an Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520) that reported the transfer and signed the return as "owner-beneficiary" of the Chalk Hill Trust. Eventually, on March 6, 2008, Webber moved the Chalk Hill Trust assets back to a domestic grantor trust sitused in Delaware (the "Delaware Trust") after believing that the creditor risk had passed.

The policies Webber obtained from Lighthouse insured two of his relatives. Each policy had a minimum death benefit of $2,720,000. Pursuant to Cayman Islands insurance law, each policy required that a separate account be established to fund benefits under the policy. The beneficiary was entitled to receive the greater of the minimum death benefit or the account balance.

Under the terms of the Lighthouse policies, the policyholder was permitted to assign the policy, use it as collateral for a loan, borrow against it and surrender it. Lighthouse retained the power to reject any request to assign or to pledge the policy as security. The amount the policyholder could extract by surrender or loan was limited to the policy's cash surrender value. The cash surrender value of each policy could never exceed the amount of premiums paid. "Premiums paid" did not necessarily include all assets in a policy's separate account available to cover premiums. Therefore, if a separate account appreciated in value and additional premium payments to Lighthouse did not have to be made, only the actual premium payment(s) would be allocated to the cash surrender value. The Alaska Trust submitted an additional premium payment of $35,046 to Lighthouse after the initial $700,000 transfer to the Alaska Trust (which was used in full to make the initial premium payment to Lighthouse). Therefore, the premiums paid by the Alaska Trust totaled $735,046.

Each separate account on the Lighthouse policies held by the Chalk Hill Trust had an investment manager that was responsible for directing investments. The policyholder could provide general objectives to the investment manager for building the portfolio. A majority of the investments for the Chalk Hill Trust's Lighthouse policies were nonpublicly-traded securities held by separate special purpose companies. Boiler Riffle Investments, Ltd. ("Boiler Riffle"), an entity owned by Lighthouse, was the special purpose company that held the separate account investments during the tax years at issue, 2006 and 2007. Neither Boiler Riffle nor the investment manager kept records to show that any due diligence was ever conducted.

Webber gave investment recommendations to the investment manager. In so doing, he followed the "Lipkind Protocol." The Lipkind Protocol required Webber to communicate all of his investment recommendations through Lipkind or Chang. Lipkind or Chang would then communicate with the appropriate party. This resulted in over 70,000 email messages between or among Lipkind, Chang, the investment manager and/or Lighthouse regarding Webber's investment preferences. Lipkind also communicated frequently via telephone.

From 2006 to 2007, Boiler Riffle made only those investments recommended by Webber via Lipkind and Chang. As a result, nearly all of the investments were issued by startup companies for which Webber was either a board member or in which he personally invested via direct ownership of securities, ownership of securities held in an IRA, or ownership of securities held in a venture capital fund he managed. The investment manager did no research regarding the investments that would have uncovered these facts.

During Lipkind's initial 1998 meeting with Webber, Lipkind discussed the investor control doctrine and highlighted the doctrine as an open legal issue having significant tax consequences. However, Lipkind was confident—based on his review of IRS rulings, judicial precedent, and opinion letters from United States law firms—that the Lighthouse products complied with United States tax laws.

The IRS examined Webber's 2006 and 2007 income tax returns and advanced several arguments as to why Webber was taxable on the income Boiler Riffle derived from the investments held in the separate accounts. Primarily, the IRS argued that Webber should be deemed to own the separate account assets under the investor control doctrine. The IRS issued a notice of deficiency in March 2011, and Webber initiated this action in the U.S. Tax Court.

2. Rulings.

a. Investor Control Doctrine. If a policyholder retains sufficient incidents of ownership over the assets held in the separate accounts, the policyholder will be deemed the true owner of the assets for income tax purposes under the investor control doctrine. After a review of the history of incidents of ownership cases, the Tax Court noted that its primary incident of ownership concern for purposes of the investor control doctrine is whether the policyholder had the power to decide what specific investments would be held in the account. Other considerations—such as the power to vote securities in the separate account, to exercise other rights or options related to the investments, to extract money from the account and to derive an "effective benefit" from the assets—are also relevant.

Here, Lighthouse owned the special purpose entities holding the separate account investments, including Boiler Riffle. However, the policies permitted only general objectives and guidelines to be submitted to the investment manager for building the separate account investment portfolio. The Tax Court found that Webber had the "unfettered ability" to select investments for the accounts despite the policies' restrictions. In operation, the investment manager invested almost entirely in those items selected by Webber as communicated through Lipkind and Chang. Furthermore, Webber stated that the only way the investment manager had access to the securities it held was through him. The investment manager also failed to maintain records regarding due diligence or complete a full "know your customer" review. There was no hard evidence that the investment manager ever refused Webber's suggestions regarding the purchase or sale of securities.

The Tax Court also found that Webber maintained the power, through Lipkind and Chang, to direct what to do with the ongoing investments, including routine shareholder matters. For example, Webber instructed Boiler Riffle regarding how to vote on an amendment for a company in which Webber had a personal interest. He also instructed Boiler Riffle on how to respond to capital calls for the investments. Webber could also extract cash in excess of the cash surrender value by using a method other than a policy loan. Webber frequently sold assets to the separate accounts or requested that loans be made to entities owned by him, permitting Webber to access needed capital without violating the cash surrender value limitation. Webber derived other benefits from the separate accounts by investing in assets that were likely for personal enjoyment such as a winery and a Canadian hunting lodge.

Based on the foregoing, the Tax Court held that Webber retained control over the separate accounts and was able to derive several personal benefits from them during the tax years in question. Therefore, Webber should have been treated as owner of the accounts for federal income tax purposes. Consequently, the dividends, interest and capital gains received by Boiler Riffle were includible in Webber's gross income for 2006 and 2007.

b. <u>Webber's Counterarguments</u>. Webber contended that he was not in constructive receipt of the income and therefore could not be taxed on the income in the separate accounts. A taxpayer is not in constructive receipt if control over receipt is subject to substantial limitations or restrictions. Treas. Reg. § 1.451-2(a). Webber said he could only access the income by surrendering the policies for their cash surrender value. The Tax Court dismissed the application of the constructive receipt doctrine by stating that the constructive receipt doctrine applies to situations in which a taxpayer selects a different reporting year for income than the year it was actually earned for cash basis taxpayers. A finding of constructive receipt was not a prerequisite to application of the investor control doctrine.

Webber also asserted that the investor control doctrine should not apply to life insurance contracts because prior cases addressing its application discussed variable annuity contracts. The Tax Court also dismissed this argument, citing Rev. Rul. 2003-91, 2003-33 I.R.B. 347, which addressed the doctrine's applicability to variable life insurance contracts. The Tax Court also found significant support in the statutory text and treasury regulations stating that variable annuity contracts and variable life insurance should be treated the same.

c. <u>Accuracy-Related Penalty</u>. The IRS requested imposition of a 20% accuracy-related penalty under IRC § 6662 on the underpayment of tax for years 2006 and 2007 for substantial understatement of income tax. The Tax Court refused to impose the penalty because it found that Webber reasonably relied on the advice of Lipkind in good faith in pursuing the life insurance investment strategy. Furthermore, Webber did not attempt to hide his estate plan from the IRS based on previous filings including the previously filed Form 709 and Form 3520.

III. ESTATE AND GIFT TAX

A. Tax Court Rules in Favor of Taxpayers Regarding Estate and Gift Tax Consequences of Transfers to Family Limited Liability Company

Purdue v. Commissioner, T.C. Memo. 2015-249 (December 28, 2015)

The Tax Court made three significant holdings. First, a Family Limited Liability Company ("FLLC") was found to have a legitimate non-tax reason for formation and thus property transferred to the FLLC by the family matriarch was not subject to IRC § 2036 estate tax inclusion. Second, gifts by the family matriarch of FLLC interests to an irrevocable trust containing Crummey withdrawal rights were present interest gifts. Finally, the matriarch's estate could deduct interest on loans that were necessary to pay estate tax.

1. <u>Facts</u>. Beginning the late 1990's, Barbara M. Purdue and her husband Robert A. Purdue (collectively, the "Parents") engaged an attorney and financial advisory firm for estate and gift tax planning and advice concerning centralizing management of the Parents' numerous investments. At the commencement of this planning, the Parents held an interest in a commercial building which held a long-term lease generating consistent and reliable cash flow. The Parents also owned various marketable securities worth approximately $24 million, which were held in five different brokerage accounts directed among three management firms. Each management firm operated independent of the others and none of the firms consulted with one another.

The Parents, following the recommendations of their advisors, formed the Purdue Family Limited Liability Company ("PFLLC"). Mrs. Purdue retained the right to income and distributions from all property she transferred to the PFLLC in proportion to her PFLLC ownership percentage. The PFLLC operating agreement and a memorandum from the Parents' advisors provided that the Parents formed PFLLC to (a) consolidate the management and control of the Parents' assets and improve the efficiency of the management by holding the assets in a single, flexible entity; (b) avoid fractionalization of ownership; (c) keep ownership of the assets within the extended family; (d) protect assets from unknown future creditors; (e) provide flexibility in management of assets not available through other business entities; (f) promote education of, and communication among, members of the extended family with respect to financial matters; (g) obtain tax savings through valuation discounts. After the assets were transferred to the PFLLC, a professional investment strategy was implemented and the Parents' children (the "Purdue Children") made the investment decisions jointly on behalf of the PFLLC.

The Parents also established the Purdue Family Trust ("PFT"). The PFT beneficiaries were the Parents' descendants and the spouses of their descendants. The PFT agreement provided the beneficiaries with *Crummey* withdrawal rights with respect to transfers made to the PFT. From 2002 until her death in 2007, Mrs. Purdue made annual exclusion gifts of PFLLC interests to the PFT. The value of the gifts was based upon valuation summaries prepared by the Parents' attorney or an independent appraiser. Each year, the beneficiaries of the PFT were provided with withdrawal right waivers with respect to the prior year's gifts of PFLLC interests to the PFT, reflecting that all the beneficiaries had waived their withdrawal rights. From 2001 until Mrs. Purdue's death, the PFT made cash distributions which included the trust's share of distributions from the PFLLC.

The Purdue Children were well informed of the creation of the PFLLC and the PFT and took an active role in the management of each. Beginning in 2001, the Purdue Children held annual combined meetings of the PFLLC and the PFT in their capacities as co-trustees for the PFT, co-attorneys in fact for the Parents, and members of the PFLLC on behalf of the PFT and the Parents. During these meetings, the Purdue Children discussed the Purdue family's accounts and assets, ratified prior PFLLC distributions, approved annual cash distributions, heard presentations from the Rainier Group investment manager and received estate tax planning updates and advice from the Parents' attorney.

Mrs. Purdue died in 2007 and her estate timely filed its Form 706. The IRS determined an estate tax deficiency and gift tax deficiencies relating to Mrs. Purdue's gifts of PFLLC interests to the PFT. Finally, the IRS challenged the Estate's deduction of interest on loans from the Purdue Children to the Estate to pay the Estate tax liability.

2. **<u>Estate Tax Deficiency</u>**. Section 2036 provides that the full value of transferred property will be included in the value of the decedent's gross estate when the following three conditions are met: (a) the decedent made an *inter vivos* transfer of property; (b) the decedent's transfer was not a bona fide sale for adequate and full consideration; and (c) the decedent retained an interest or right enumerated in IRC § 2036(a)(1) or (2) or (b) in the transferred property that was not relinquished before death. The issue in *Purdue* is whether Mrs. Purdue's transfer was a bona fide sale for adequate and full consideration.

The Tax Court recognized that "[i]n the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership and the transferors received partnership interests proportional to the value of the property transferred." However, mere recitation of nontax reasons in an operating agreement is not necessarily enough to treat the transfer as a bona fide sale for adequate and full consideration. As the Tax Court observed, "[w]e must separate the true nontax reasons for the PFLLC's formation from those that merely clothe transfer tax savings motives."

The Tax Court recognized that transfer tax savings were obviously one reason for the transfer but there were also nontax reasons for the transfer. Specifically, Mrs. Purdue's transfer to the PFLLC allowed for the consolidation of management of the Parents' assets. Prior to the transfer, Mr. Purdue handled all of the financial decisions regarding the assets. After the transfer, a well-coordinated professional investment strategy was implemented and the Purdue Children made the PFLLC investment decisions jointly. The Tax Court found the consolidation of assets was a legitimate non-tax reason for Mrs. Purdue's transfer.

The Tax Court next examined the following six factors to determine whether consolidation of assets was a significant reason as opposed to a theoretical justification that merely clothed the transfer tax savings motive: (a) the taxpayer's standing on both sides of the transaction; (b) the taxpayer's financial dependence on distributions from the partnership; (c) the taxpayer's commingling of partnership funds with the taxpayer's own; (d) the taxpayer's actual failure to transfer the property to the partnership; (e) discounting the value of the partnership interests relative to the value of the property contributed; and (f) the taxpayer's old age or poor health when the partnership was formed.

Examining these factors, the Tax Court concluded that the consolidation of assets was a significant reason as opposed to a theoretical justification and thus the transfer represented a bona-fide sale. First, while Mrs. Purdue stood on both sides of the transfer (*i.e.* she was the transferor and also a member of the transferee), the Tax Court determined that this factor should not weigh against the estate because the transfer represented an arm's-length transaction as a result of the legitimate nontax reason for establishing the PFLLC. Second, Mrs. Purdue was not financially dependent on distributions from the PFLLC because she retained substantial assets outside of the PFLLC to pay her living expenses. Third, there was no commingling of Mrs. Purdue's funds with the PFLLC's funds and the formalities of the PFLLC were respected. Fourth, Mrs. Purdue actually transferred the property to the PFLLC. Fifth, Mrs. Purdue received interests in the PFLLC proportional to the property she contributed. Finally, the evidence established that Mrs. Purdue was in good health at the time the transfer was made.

The Tax Court found that since a legitimate and significant nontax reason existed for the transfer, Mrs. Purdue received full and adequate consideration for the transfer and thus Section 2036 did not apply.

3. Gift Tax Deficiency. The IRS also claimed that the gifts of PFLLC interest to the PFT did not qualify for the annual gift tax exclusion because they did not satisfy the criteria for a present interest under IRC § 2503(b) and *Hackl v. Commissioner*, 189 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

The Tax Court noted that for a gift of an interest in a business to constitute a present interest, the gift must confer on the donee a substantial present economic benefit by reason of use, possession or enjoyment of (1) property or (2) income from the property. Applying this test to the gifts of the PFLLC interests, the Tax Court required the estate to prove that: (i) the PFLLC would generate income, (ii) some portion of that income would flow steadily to the donees and (iii) that the portion of income could be readily ascertained.

The Tax Court concluded that the estate met its burden and the transfers were indeed of present interests. First, the PFLLC held an interest in the commercial building which was expected to generate rent income as well as dividend paying marketable securities. Second, the PFT received annual distributions from the PFLLC and subsequently passed these distributions along to the PFT's beneficiaries. Third, the income generated from the PFLLC (*i.e.* rent and stock dividends) was readily ascertainable from the lease and public information relating to the marketable securities.

4. Deductibility of Interest on Loans. Finally, the IRS argued that the \$20,891 in interest that accrued on the loans from the Purdue Children to the estate were not necessarily incurred by the estate and thus not allowable as an administration expense deduction under IRC § 2053. The Tax Court held the estate met the burden of showing the interest was necessarily incurred because the loan was the only viable option to the estate.

B. IRS Issues Final Portability Regulations
T.D. 9725 (June 12, 2015)

The IRS has finalized portability regulations that were proposed with temporary regulations on June 15, 2012. REG-141832-11, T.D. 9593.

1. Introduction. As enacted by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, P.L. 111-312 (December 17, 2010), and as modified by The American Tax Relief Act of 2012, P.L. 112-240 (January 2, 2013), IRC § 2010(c)(4) defines the deceased spousal unused exclusion ("DSUE") amount as the lesser of:

the basic exclusion amount (which is $5,000,000 as adjusted for inflation, IRC § 2010(c)(3)); or the excess of:

- the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
- the amount with respect to which the tentative tax is determined under IRC § 2001(b)(1) on the estate of such deceased spouse (which is the tentative tax computed on the sum of the amount of the deceased spouse's taxable estate and the amount of the deceased spouse's adjusted taxable gifts).

The following discusses the primary clarifications made by the final regulations, along with some of the issues that remain unresolved.

2. Last Deceased Spouse. Note that the definition of the DSUE amount refers to the applicable exclusion amount of the "last" deceased spouse. The final regulations confirm that this prevents a person who is the surviving spouse of multiple spouses from "stacking" DSUE amounts. For example, W, who has a $5 million applicable exclusion amount (ignoring adjustments for inflation), survives H1 who dies with a $3 million applicable exclusion amount (after taking into consideration the estate tax on H1's estate). W, now with an $8 million applicable exclusion amount, marries H2, who has a $5 million applicable exclusion amount. H2 then predeceases W while still holding a $5 million applicable exclusion amount. Due to the definition of the DSUE amount, after H2's death, W's applicable exclusion amount is $10 million: W's basic exclusion amount of $5 million plus the $5 million of DSUE amount that W received from H2. After W survives H2, the $3 million in DSUE amount that W received from H1 expires. Treas. Reg. §§ 20.2010-1(d); 20.2010-3(a); 25.2505-2(a).

3. Order of Applying the Basic Exclusion Amount and the DSUE Amount. According to the final regulations, when a surviving spouse who holds a DSUE amount makes a taxable gift, the DSUE amount is used first in applying the surviving spouse's applicable exclusion amount to such taxable gift. If, in the above example, W made a $2 million taxable gift after W married H2, W's applicable exclusion amount would be reduced to $6 million, made up of W's $5 million basic exclusion amount and $1 million of DSUE amount remaining from H1 after the taxable gift. Therefore, when W survived H2, she was able to keep her entire $5 million basic exclusion amount. Treas. Reg. § 25.2505-2(b).

4. Prior Taxable Gifts. The final regulations also provide that, when W survives H2 in the previous example, her new applicable exclusion amount is not reduced by any amount of the first DSUE amount consumed by taxable gifts. Thus, when W survives H2, her applicable exclusion amount is actually $12 million (her $5 million basic exclusion amount, plus the $2 million taxable gift, plus the $5 million DSUE amount received from H2). Treas. Reg. § § 20.2010-2(b)(2).

5. Examination of Prior Returns. Under IRC § 2010(c)(5)(B), the IRS may examine the deceased spouse's estate tax return to determine whether the surviving spouse has correctly calculated the DSUE amount. This power exists regardless of whether the statute of limitations for assessment under IRC § 6501 with respect to the deceased spouse's estate tax return has passed. However, the final regulations state that the IRS may assess additional tax on the return of the deceased spouse only if that tax is assessed within the period of limitations on assessment under IRC § 6501 applicable to the tax shown on that return. Treas. Reg. §§ 20.2010-2(d); -3(d); 25.2505-2(e).

6. Availability of Extension of Time to Elect Portability. The final regulations expressly state that a Personal Representative of an estate who did not file a return when the value of the assets reported on the return was under the threshold for filing an estate tax return can request relief to make the portability election if the requirements under Treas. Reg. § 301.9100-3 are met. However, estates that are above such filing threshold (regardless of whether there is a taxable estate) cannot obtain such relief. Treas. Reg. § 20.2010-2(a)(1). The IRS has issued several private letter rulings granting extensions. The IRS's standard extension has been 120 days from the date of the ruling. *See, e.g.*, PLRs 201548004 (November 27, 2015); 201544017 (October 30, 2015); 201537010 (September 11, 2015).

7. Effect of Portability Election Where DSUE Amount is Uncertain. Events arising after the filing of an estate tax return that elects portability may cause a DSUE amount to change or create a DSUE amount when none existed at the time of filing the estate tax return. For example, deductions may later become available that may cause the DSUE amount to appear or to be increased over the amount initially reported. The final regulations state that these adjustments may be taken into account in determining the DSUE amount available to the surviving spouse. A protective election of portability is not required.

The attorney preparing the estate tax return should include a formula or written statement that provides, for example, that the DSUE amount desired is the largest DSUE amount after taking into account all asset values, credits and deductions that affect the computation of the DSUE amount as finally determined for federal estate tax purposes. Schiller, "Estate Planning at the Movies(R): Jeremiah Johnson Marks the Final Portability Regulations," LISI Estate Planning Newsletter #2316 (June 22, 2015) at http://www.leimbergservices.com.

8. Requirement of a "Complete and Properly Prepared" Estate Tax Return. The final regulations state that the portability election and DSUE amount are properly elected as long as the executor has timely filed a complete and properly prepared estate tax return and did not elect out of the portability election. The return must be prepared in accordance with IRS instructions to be considered complete and properly prepared. Treas. Reg. § 20.2010-2(a)(7)(i). The IRS will consider whether a filed return is complete and properly prepared on a case-by-case basis.

An exception applies to the general requirement to file a complete and properly prepared estate tax return that will relieve the Personal Representative from including valuation and appraisals when the estate is not required to file an estate tax return under IRC § 6018. The exception would apply with respect to property passing under an estate tax marital or charitable deduction. Under this exception, the Personal Representative only needs to exercise due diligence in determining the value of the property at issue rather than determining the actual fair market value.

However, the Personal Representative must still report the description, ownership and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the deduction. The exception is not available for certain property when the value of such property is needed to determine an estate or generation-skipping transfer tax benefit (but not to determine basis under IRC § 1014). The exception is also not available when less than the entire value of an interest in property is marital or charitable deduction property, or when a partial disclaimer or a partial qualified terminable interest property election is made and only part of the property affected is marital or charitable deduction property.

The IRS stated that it may issue later rulings to further define this exception. Treas. Reg. § 20.2010-2(a)(7)(ii).

9. Special Rules for Qualified Domestic Trusts. With respect to a surviving spouse who is a beneficiary of a qualified domestic trust ("QDOT"), no part of the DSUE amount from the prior deceased spouse is available until the QDOT terminates and the estate tax under IRC § 2056A is imposed. Under the final regulations, if the surviving spouse becomes a United States citizen and the requirements of IRC § 2056A(b)(12) and applicable regulations are satisfied so that the tax under IRC § 2056A no longer applies, the surviving spouse can then utilize the predeceased spouse's DSUE amount in making taxable gifts. Treas. Reg. §§ 20.2010-2(c)(4); 20.2010-3(c)(3) and 25.2505-2(d)(3).

10. Availability of DSUE Amount by Surviving Spouse Who Becomes a United States Citizen. A noncitizen, non-resident surviving spouse (or his or her estate) cannot use the DSUE amount of a prior deceased spouse except to the extent allowed by treaty. However, if a surviving spouse becomes a United States citizen after the death of the prior deceased spouse, the DSUE amount of the prior deceased spouse may be used by that United States citizen surviving spouse if a portability election is made by the prior deceased spouse's Personal Representative. Treas. Reg. §§ 20.2010-3(c); 25.2505-2(d).

11. Portability Election and Rev. Proc. 2001-38. One way to maximize the benefit of a portability-based estate plan and obtain some of the benefits of using a credit shelter trust-based plan is to mandate distribution of all the predeceased spouse's property to a QTIP trust. Not only are the predeceased spouse's assets included in the surviving spouse's gross estate and would such assets receive a step-up in basis, but also a reverse QTIP election can be made, and GST exemption can be allocated to the trust. IRC § 2652(a)(3).

Rev. Proc. 2001-38, 2001-1 C.B. 1335, provides that the IRS will ignore a QTIP election if such election was not necessary to reduce estate tax liability to zero. If the predeceased spouse's portability-based estate plan provides for the transfer of all property to a QTIP trust, and the predeceased spouse's executor makes a QTIP election, and if the estate has a value below the applicable exclusion amount, the QTIP election would not be necessary to reduce estate tax liability to zero; there would not have been an estate tax anyway. If the QTIP election is ignored, the predeceased spouse's applicable exclusion amount will then have to be utilized, decreasing, if not eliminating, a DSUE amount for the surviving spouse. Thus, it appears that Rev. Proc. 2001-38 could effectively prohibit use of portability in this situation.

The IRS, implicitly acknowledging this issue, has added to its Priority Guidance Plan a project to provide guidance regarding the validity of the QTIP election on an estate tax return filed only to elect portability. Joint Treasury, IRS 2015-2016 Priority Guidance Plan (July 31, 2015).

In the final regulations, however, the IRS left this issue unaddressed. The final regulations also removed an example contained in the temporary regulations that indicated that a QTIP election may be made under the exception to the requirement that the portability election be made on a complete and properly prepared estate tax return. Schiller, *supra.*

12. Effective date. The final regulations apply to estates of decedents dying on or after June 12, 2015.

C. Annual Exclusions Allowed for Gifts in Trust With Withdrawal Rights Despite Arbitration and *In Terrorem* Clauses
Mikel v. Commissioner, T.C. Memo. 2015-64 (April 6, 2015)

1. Facts. Husband and wife, residents of New York, created and funded an irrevocable trust in 2007. The governing instrument contained provisions conferring *Crummey* withdrawal rights on 60 individuals. Under these provisions, the withdrawal rights were triggered as and when contributions were made to the trust, and the Trustees were required to give notices to the withdrawal right holders whenever such contributions were made. Further, whenever contributions were made to the trust, the withdrawal right holders had thirty days thereafter within which to exercise their rights. The withdrawal right holders were each entitled to withdraw an amount equal to the amount of the contribution triggering their rights divided by the number of withdrawal right holders – but in all events limited to the amount of the federal gift tax annual exclusion.

The trust instrument contained a couple of other provisions. First, there was a mandatory arbitration provision. If ever a dispute were to arise regarding the proper interpretation of the instrument, that dispute was not to be litigated in a court but had to be submitted for resolution to a panel consisting of three persons of the Orthodox Jewish faith (a "Beth Din"). The Beth Din was required to give any party the same rights he or she would have under New York law. Second, there was an *in terrorem* clause. A beneficiary would cease to be a beneficiary if he or she were to institute or participate in any proceeding to oppose or challenge a trust distribution or file any action in a court of law. Because of these provisions, the IRS took the position that the husband and wife's contributions to the trust were not gifts of a present interest and so were not gifts qualifying for the annual exclusion.

The Tax Court held for the taxpayers. The contributions to the trust did qualify as annual exclusion gifts. The provisions summarized in the preceding paragraph did not render the contributions gifts of a future interest.

2. Court's Analysis. With regard to the mandatory arbitration provision, the Tax Court said there was no reason to believe the Beth Din, if called upon to do so, would not enforce the beneficiaries' withdrawal rights. In addition, the Tax Court noted that a withdrawal right holder would have the right, under New York law, to have a dispute relating to withdrawal rights resolved in state court. The Tax Court pointed out, in its footnote 4, and the IRS conceded, that a New York court will not enforce an arbitration order against a non-consenting party.

As to the *in terrorem* clause, the Tax Court concluded that it simply didn't apply. The Tax Court explained a refusal by the Trustees to honor the exercise of a withdrawal right would not give rise to a "proceeding to oppose or challenge a trust distribution." Moreover, the *in terrorem* clause language "file any action in a court of law" did not, in the Tax Court's view, expand the scope of the clause. The Tax Court said that phrase had to be construed *in pari materia* with the surrounding language dealing specifically with a proceeding to oppose or challenge a trust distribution.

3. CCA 201208026. It is interesting to compare *Mikel* to CCA 201208026. The facts are strikingly similar. It seems highly probable that *Mikel* was litigation that directly resulted from the taxpayers' refusal to concede to the IRS' reasoning in CCA 201208026.

4. Conclusion. The IRS has had a bad string of losses in cases involving allowance of the gift tax annual exclusion where contributions have been made to irrevocable trusts whose governing instruments contain *Crummey* withdrawal rights:

- *Crummey* 397 F.2d 82 (9th Cir. 1968)
- *Cristofani* 97 T.C. 74 (1991)
- *Kohlsaat* T.C. Memo. 1997-212
- *Turner* T.C. Memo. 2011-209[1]
- *Mikel* T.C. Memo. 2015-64

It's no wonder the Administration, in its last three Green Books, has proposed to give donors a new, separate $50,000 per donor annual exclusion for future interest gifts in exchange (in part) for invalidating the annual exclusion for contributions to *Crummey* withdrawal right trusts.

D. Donees Liable for Unpaid Gift Tax Under Transferee Liability Rules; Fiduciaries Personally Liable Under Federal Priority Statute

[1] "The fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so."[2] Shaw, by this time, had joined Dornbush's law firm.

United States v. Marshall, 798 F.3d 296 (5th Cir. August 19, 2015), *withdrawing* 771 F.3d 854 (5th Cir. November 10, 2014)

The Fifth Circuit imposed transferee liability for unpaid gift taxes on an indirect gift and found the fiduciaries of one donee personally liable for the tax under the federal priority statute for distributing property of the estate and trust before paying the federal government for the unpaid gift tax.

J. Howard Marshall ("Decedent") sold shares of Marshall Petroleum, Inc. ("MPI") back to MPI at less than fair market value in 1995 (the "1995 gift") and died shortly thereafter. This sale was deemed an indirect gift to the other shareholders of MPI by the IRS because the sale increased the value of the stock for the remaining shareholders. Decedent failed to pay any gift tax. At the time of the gift, there were five other shareholders of MPI: (1) Eleanor Pierce Stevens ("Stevens"), as beneficiary of a grantor retained income trust ("GRIT") created upon Stevens' divorce from Decedent; (2) E. Pierce Marshall, Decedent's son; (3) Elaine T. Marshall, wife of E. Pierce Marshall; (4) the Preston Marshall Trust, created for the benefit of Decedent's grandson; and (5) the E. Pierce Marshall, Jr. Trust, created for the benefit of Decedent's other grandson, E. Pierce Marshall, Jr. ("E. Pierce, Jr."). Before this case was resolved, Stevens and E. Pierce Marshall died in 2007 and 2006, respectively.

The IRS and Decedent's estate entered into a stipulation in 2002, which determined the value and recipients of the 1995 gift. The IRS then tried to collect gift tax from the donees pursuant to IRC § 6324(b), which provides that "the *donee* of any gift shall be personally liable for such tax to the extent of the value of such gift." (emphasis added). E. Pierce Marshall's estate paid approximately $45 million toward the unpaid tax on behalf of himself, his wife, and the trusts for his children. Stevens' estate did not pay any tax, arguing that the trust, not Stevens individually, was a donee of the 1995 gift.

In 2010, the IRS sued seeking to recover the unpaid gift tax plus interest from the donees. The IRS also sought to recover from E. Pierce, Jr., as Executor of Stevens' estate, and Finley Hilliard ("Hilliard"), as Trustee of Stevens' revocable trust, to the extent they paid other debts before paying the unpaid tax on the 1995 gift. The District Court held that: (1) a donee's liability under IRC § 6324(b) is separate from a donor's liability under IRC §§ 2501 and 2502, and a donee's liability for the tax includes interest on such tax; (2) Stevens was a donee for purposes of the 1995 gift as the current income beneficiary of the GRIT; and (3) E. Pierce, Jr. and Hilliard were personally liable for the debts paid before payment to the federal government. All parties appealed, and the United States Court of Appeals for the Fifth Circuit affirmed.

1. Donee Liability for Unpaid Gift Tax and Interest. The IRS argued that donee liability under IRC § 6324(b) should be read in conjunction with IRC §§ 6601 (authorizing interest on unpaid taxes) and 6901 (subjecting unpaid tax liabilities to same provisions as the taxes to which liabilities were incurred). The Fifth Circuit agreed with the IRS. Specifically, the Fifth Circuit stated that IRC § 6324(b) does not address interest assessed on unpaid taxes. Therefore, IRC § 6324(b) must be read with IRC § 6901, which the Fifth Circuit found was not limited in application to when the government chose to institute an action under

IRC § 6901 but also applies when the government chooses to institute an action against a donee directly. *See* IRC § 7402 (stating that remedies are "in addition to and not exclusive of any and all other remedies of the United States"). Because IRC § 6901 subjects donee liability to the same provisions as the underlying gift tax, IRC § 6601 interest assessments are also included as part of a donee's liability. Therefore, the donees were liable under IRC §6324(b) for both the unpaid tax and any interest thereon but in the aggregate not to exceed the amounts of the gifts.

2. <u>Stevens as Donee of the 1995 Gift</u>. Stevens argued that *res judicata*, as a result of the 2002 stipulation and previous Tax Court decisions, did not bar her from challenging her status as a donee. The Fifth Circuit found that the application of *res judicata* turned on the question of whether Stevens was, in fact, a donee. Stevens' estate failed to pay the gift tax in part because she claimed that she did not own stock in her own name at the time of the 1995 gift.

Stevens first asserted that the GRIT could not be the donee of the 1995 gift because the GRIT could not access the increased value of MPI stock, and therefore did not receive a present interest in the property. Relying on *Kincaid v. United States*, 682 F.2d 1220 (5th Cir. 1982) and Treas. Reg. § 25.2511-1(h)(1), the Court held that it has been clearly established that a transfer to a corporation for less than fair market value is a gift to individual shareholders. In addition, the GRIT beneficiary was clearly identifiable, which meant that the GRIT received a present interest in the stock.

Stevens also argued that, if the GRIT was the donee, then the Trustee was the donee, or, if the Fifth Circuit disagreed, the remainder beneficiaries were the donees. Relying on *Helvering v. Hutchings*, 312 U.S. 393 (1941), the Fifth Circuit found that a beneficiary holding a beneficial interest in a trust is the donee of a gift for transfers in trust. The issue in *Helvering* was whether the Trustee was the donee of a transfer in trust such that the donor could only claim one exemption or whether each beneficiary of the trust was a donee such that several exemptions could be claimed. The Supreme Court held that the beneficiary "to whose benefit the surrender inures" is the donee for purposes of the gift. The GRIT provided for income distributions to Stevens for ten years and distribution of the remaining trust assets to Stevens' son upon the GRIT's termination. Accordingly, as the current income beneficiary, the Fifth Circuit found Stevens was a donee of the 1995 gift.

Lastly, Stevens urged the Fifth Circuit to apply the ordinary course of business exception under Treas. Reg. § 25.2512-8 and find that Decedent lacked donative intent, qualifying the transaction as a non-gift transaction. The ordinary course of business exception provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Here, the stipulation and previous Tax Court cases indicated that there was donative intent and a gift was made.

3. <u>Fiduciary Liability</u>. As Executor of Stevens' estate, E. Pierce, Jr. distributed various items of tangible personal property and paid one year's rent on Stevens' apartment but never paid any portion of the unpaid gift tax from the 1995 gift. As Trustee of

Stevens' revocable trust, Hilliard paid accounting and legal fees of charitable organizations from the trust assets but also never paid any of the gift tax owed. In addition, E. Pierce, Jr. and Hilliard filed an estate tax return for Stevens and set aside over $1 million for charitable distributions.

The federal priority statute, located at 31 USC § 3713, provides that the government has priority over all other creditors of a decedent. A representative of a person or estate can be liable for unpaid federal claims if any debts are paid ahead of such federal claims. Section 3713 fiduciary liability requires that: (a) a fiduciary (b) distributed assets of the estate before paying a government claim and (c) knew or should have known of the government's claim. Actual knowledge is not required; constructive knowledge is sufficient. E. Pierce, Jr. and Hilliard admitted during their deposition they knew of the potential claim, which the Fifth Circuit found evidence enough to determine they had the requisite level of knowledge.

a. <u>Liability of Charitable Set Aside</u>. Regarding the charitable set aside, E. Pierce, Jr. argued that he should not be liable because the set aside is subject to invasion by the government under Treas. Reg. § 1.642(c)-2(d). The Fifth Circuit disagreed, finding that the federal priority statute does not limit liability even if the set aside can be reached by the government. It only requires that a debt is paid before the federal government. Consequently, E. Pierce Jr. and Hilliard were liable for the charitable set aside.

b. <u>Liability for Personal Property and Rental Payments</u>. E. Pierce Jr. also argued that the government failed to present sufficient evidence to hold him liable for the distribution of personal property and rent payments. E. Pierce Jr. would have incurred fees to store the property, prompting him to sell it. The Fifth Circuit rejected this argument, holding that avoiding costs does not change the fact that he sold the property before paying the government. Therefore, he was liable for the distribution of property.

E. Pierce Jr. stated that the rent payments were required so that a memorial service could be held in Stevens' apartment. The Fifth Circuit found that this was a legitimate use of funds to the extent of the funeral costs. Texas law, however, limits the amount of funeral expenses that are debts of the estate to $15,000. Therefore, E. Pierce Jr. was liable for the amount of rent payments exceeding $15,000.

c. <u>Liability for Charitable Organizations' Accounting and Legal Services</u>. Hilliard admitted that the accounting and legal fees paid were for the benefit of various charitable organizations and not for preserving and managing the estate. Had the expenses been for preservation of the estate, they would have been classified as debts of the estate under Texas law and taken priority over the federal government. Hilliard was, therefore, liable for the accounting and legal fees paid on behalf of the charities.

4. <u>Breach of Fiduciary Duty</u>. The District Court had held that E. Pierce, Jr. had breached his fiduciary duty because he owed a duty to the creditors of Stevens' estate. The Fifth Circuit reversed this holding, finding that Texas case law was in conflict on the issue of duties to creditors. The Fifth Circuit found that none of the cases relied upon by the government applied to whether an independent Executor owed a duty to estate creditors in a case like this one. Therefore, the Fifth Circuit held that independent Executors, such as E. Pierce, Jr., do not owe a duty to creditors of the estate.

E. IRS Assesses Large Estate and Gift Tax Deficiencies Against Estate of Texas Billionaire

Estate of Wyly v. Commissioner, Docket No. 31961-15 (Filed December 28, 2015)

Donald R. Miller, Jr. ("Executor"), on behalf of the Estate of Charles J. Wyly, Jr., filed a petition in the Tax Court for a redetermination of a gift tax deficiency assessed on October 6, 2015 and of an estate tax deficiency assessed September 30, 2015. Decedent died August 11, 2011 in Dallas, Texas. Prior to his death, Decedent filed gift tax returns for tax years 1992, 1996 and 1999.

The IRS asserts that Decedent made several gifts to various family members or to trusts or entities for their benefit between 2001 and 2005 and in 2010 totaling $25,949,703. Decedent did not file gift tax returns for tax years 2001 through 2005 and 2010 because, as the Estate contends, Decedent did not make gifts in those years. The IRS assessed an IRC § 6651(f) penalty for fraudulent failure to file on each of the purported gifts resulting in penalties of $19,462,278. In the alternative, the IRS suggested gifts were made in 1992, 1996 and 1999 totaling $28,182,939 and assessed an IRC § 6663 penalty of $21,137,205 for fraud in the previously filed gift tax returns. The IRS also assessed an estate tax deficiency of $60,238,689 plus an IRC § 6662 accuracy-related penalty of $12,047,737.

1. <u>Gift Tax Deficiencies</u>. The IRS asserted that Decedent made gifts to Stargate Sport Horses LP for the benefit of his daughter, Emily Wyly, each year from 2001 to 2005. In addition, the IRS claimed that Decedent made gifts to Little Woody, LLC from 2001 to 2004 for the benefit of Ms. Wyly and another daughter, Jennifer Wyly Lincoln. In both instances, the Estate denied that Decedent was the donor of the gifts and asserted that the assets received by Stargate Sport Horses LP and Little Woody, LLC came from Isle of Man ("IOM") entities in exchange for interests in each entity. The Estate also denied that Decedent exercised dominion and control over the assets because the assets were not owned by Decedent.

The IRS alleges Decedent gifted $4,500,000 to "sub-funds" created for his daughters through IOM entities. The Estate asserts that the sub-funds are actually trusts established by each daughter, as settlor, and Decedent, as Trustee.

The IRS declared a gift of $2,914,816 to IOM entities for the benefit of the Executor and a gift of a $50,000 ring owned by an IOM entity to Decedent's daughter, Martha Miller. The Estate denied both allegations and claimed that the Executor transferred options owned by him to an IOM grantor trust with Executor as settlor, and said trust then transferred the options to a subsidiary IOM corporation in exchange for a private annuity. Furthermore, the Estate asserted that the ring was purchased by the Executor, Martha's husband, and gifted to Martha by him.

The IRS claimed that a promissory note issued by the Charles J. Wyly, Jr. Irrevocable Trust was forgiven in 2010 with a principal amount of $25,487,656 and $24,165,656 in accrued interest, resulting in gifts to Decedent's children, but the Estate averred that the note was paid in full. Alternatively, the IRS suggested that a gift was made for the principal amount in 1999 and was not properly reported on the 1999 gift tax return. The Estate rebutted this assertion by stating that the Decedent sold his limited partner interest in Stargate, Ltd. to the trust, which was a grantor trust to Decedent.

The IRS' alternative argument was that Decedent made gifts of options and warrants in publicly traded companies to IOM entities in exchange for private annuities on the lives of Decedent and his spouse in 1992 and 1996. The Estate argued that those assets were not gifted but sold to the IOM entities and intended to be of equal value with the private annuities.

2. Estate Tax Deficiencies. The IRS claimed that the unreported gifts increased the amount that should have been reported on Decedent's estate tax return. In addition, the IRS asserted that the gross estate should have included additional assets of $102,534,267 held by certain IOM entities and trusts under IRC §§ 674, 679, 2035, 2036 and 2038. The Estate rebutted the IRS assertion under IRC §§ 674 and 679 because those sections relate to income tax. Furthermore, the Estate contended that the transfers were not under includible under IRC §§ 2035, 2036 and 2038 because they were bona fide sales for full and adequate consideration. According to the Estate, each trust in question had an IOM trust company as Trustee at all times and were not subordinate or related parties to Decedent under IRC § 672(c).

The IRS included in Decedent's gross estate nearly 99% of Stargate, Ltd. with an alleged value of $17,928,664. The Estate argued that the value is only reached by ignoring the sale transaction related to the promissory note the IRS desired to include in Decedent's taxable gifts. Accordingly, if the sale is being ignored for estate tax purposes, the promissory note above should also be ignored. The Estate again asserted that IRC §§ 674 and 679 do not apply because they relate to income tax. The Estate also asserted that the transactions were bona fide sales for which Decedent retained no powers or rights under the law in the assets transferred, and therefore the assets could not be included in the Decedent's gross estate under IRC §§ 2035, 2036 and 2038.

The IRS denied an estate tax deduction for nearly $33,000,000 for debts due to Security Capital Ltd., a Cayman Island corporation, which the Estate claimed were bona fide legal obligations. The Estate also argued it will be entitled to deduct income tax deficiencies, including penalties and interest, that may result from a pending decision in the United States Bankruptcy Court, which will also address many of the gift tax deficiencies assessed by the IRS. *In Re: Samuel Evans Wyly et al.*, Debtors, Case No. 14-35043 (Bankr. N.D. Tex. 2016).

The IRS also denied a deduction for disgorgement amounts due in a Securities and Exchange Commission action against the Estate, which is currently on appeal to the United States Court of Appeals for the Second Circuit. *Securities and Exchange Commission v. Wylie*, 56 F.Supp. 3d 394 (2014). The Estate argues that attorneys' fees will continue to be incurred along with other administrative expenses, including any pending litigation related to the Estate and the Estate is entitled to deduct such expenses and fees.

The Estate seeks a determination that there is no gift or estate tax deficiency, that the Estate is not liable for any penalties and that the Estate overpaid its estate tax liability in an amount yet to be determined. The IRS response is due March 30, 2016.

F. IRS Settles Dispute with Estate Over SCIN Transactions

CCA 201330033 (July 26, 2013); *Estate of Davidson v. Commissioner*, Tax Court Docket No. 013748-13; Stipulated Decision Entered July 6, 2015

1. **Facts**. The following discusses the facts of the CCA as supplemented by the facts stated in the Estate's petition, filed on June 14, 2013, and the IRS' response, filed on August 9, 2013.

Until his death, Mr. Davidson was the President, Chairman and Chief Executive Officer of Guardian Industries Corporation, described in the Tax Court petition as "one of the world's leading manufacturers of glass, automotive, and building products." Before the transactions involved in this case, Mr. Davidson owned 78% of the outstanding common stock of Guardian Industries.

In 2008, as part of revisions to his estate plan, Mr. Davidson established multiple grantor trusts for the benefit of family members (the "Trusts"). Trusts were established for his two children (the "Children's Trusts") and Trusts were established for his grandchildren (the "Grandchildren's Trusts").

On January 2, 2009, Mr. Davidson transferred 9,534 common shares and 1,693 preferred shares of Guardian Industries stock to the Grandchildren's Trusts. In exchange, Mr. Davidson received two SCINs with a 5-year term and an interest rate of 2.4%, the same rate as the IRC § 7520 rate in effect for January 2009. Both SCINs required a balloon payment of principal at the end of the term. The appraised value of the Guardian Industries stock transferred in exchange for each SCIN equaled $27,107,949. The face value of each note equaled $50,993,900. Thus, these SCINs were "principal premium" SCINs. The Estate explained that this premium was determined under IRC § 7520 and Table 90CM (a mortality table under IRC § 7520) and added to the face value of the SCINs "to compensate for the actuarial risk of Mr. Davidson's premature death and the termination of note payments." The five-year term was based on Mr. Davidson's life expectancy as determined by the IRC § 7520 mortality tables.

Each note was secured by the stock transferred to the Trust that was the maker of the note. In addition, each of the Grandchildren's Trusts held additional property, presumably "seed" money, which served as additional security. Mr. Davidson died before any payments under these SCINs were made.

On January 21, 2009, Mr. Davidson made a transfer of Guardian Industries preferred and common stock to the Children's Trusts in exchange for two SCINs. These SCINs were similar to the SCINs utilized in the January 2, 2009 transactions described above, but they were "interest premium" SCINs: instead of an interest rate equal to the IRC § 7520 rate, the SCINs had an interest rate of 15.83%. As with the earlier SCIN transactions, this premium was calculated under IRC § 7520 and Table 90CM. The face value of each SCIN was virtually equal to the value of the stock transferred to the Children's Trust that was the maker of the SCIN.

Like the prior SCIN transactions, each SCIN transferred on January 21, 2009 was secured by the transferred stock and other assets held by the Children's Trust. Both SCINs required a balloon payment of principal at the end of the term. Like the earlier SCIN transactions, Mr. Davidson died before receiving any payments under these SCINs. In its petition, the Estate asserted that "Mr. Davidson fully intended to collect the payments under the SCINs when due."

Shortly after the transactions on January 21, 2009, Mr. Davidson was diagnosed with an unspecified condition and died less than two months later, on March 13, 2009, at the age of 86. He still owned a portion of the Guardian Industries common stock on the date of his death. Mr. Davidson's Estate disclosed the SCIN transactions on his 2009 Form 709, but did not report any gifts arising from these transactions. In addition, the Estate did not report any of the property involved in the SCIN transactions as included in Mr. Davidson's gross estate on the United States Estate (and Generation-Skipping Transfer) Tax Return ("Form 706").

2. **Notice of Deficiency**. The IRS issued a notice of deficiency on May 2, 2013, asserting deficiencies in gift and generation-skipping transfer ("GST") tax for 2008 and 2009. The IRS also asserted deficiencies in estate and GST tax related to the Form 706. For the 2008 and 2009 Forms 709, the IRS asserted over $697.1 million for the gift tax deficiency and nearly $199.5 million for the GST tax deficiency. For the Form 706, the IRS asserted over $1.87 billion for the estate tax deficiency, $15.88 million for the GST tax deficiency and over $200,000 in penalties. It was likely that an IRS victory with regard to the gift tax deficiency would eliminate the estate tax deficiency, so the deficiencies arising from the Form 709 and Form 706 should not be aggregated.

The notice of deficiency showed that the IRS valued the SCINs at a lower value and valued the common and preferred stock at a higher value than reported by Mr. Davidson and his Estate. As discussed in the CCA, the IRS did not utilize IRC § 7520 in valuing the SCINs. Consequently, the IRS asserted that the SCIN transactions resulted in gifts from Mr. Davidson to the Trusts.

3. **Analysis in the CCA**. In CCA 201330033, the IRS addressed whether all or any portion of the transfers of stock from Mr. Davidson to the Trusts in exchange for the SCINs constituted a gift ("Issue 1"). In addition, the IRS raised the issue of how should the fair market value of the SCINs be determined ("Issue #2"). Finally, the IRS considered, if the SCIN transfers do not constitute gifts, what were the estate tax consequences of the cancellation of the SCINs upon Mr. Davidson's death ("Issue 3").

a. **Issues 1 and 2**. The IRS stated that, where property is exchanged for promissory notes, the exchange will not be treated as a gift if the value of the property transferred is substantially equal to the value of the notes. The face value and length of payments of the notes must be reasonable in light of the circumstances.

To determine if the exchanges constituted gifts, the IRS had to determine the value of the Guardian Industries stock that Mr. Davidson transferred to the Trusts shortly before his death and the value of the notes, taking into consideration the self-cancelling nature of the notes. If the fair market value of the notes was less than the fair market value of the property transferred to the Trusts, the difference in value will be deemed a gift. Treas. Reg. § 25.2512-8.

The IRS analyzed Treas. Reg. § 25.2512-4, which states that there is a presumption that the fair market value of notes, secured or unsecured, is the amount of unpaid principal, plus accrued interest to the date of the gift. One way to rebut the presumption is to show by satisfactory evidence that the note is worth less than the unpaid amount. This evidence may exist due to the interest rate, the maturity date or other cause. Another way to rebut the presumption is to show that the note is uncollectible in part, which may be the case if one or more parties is insolvent. In addition, to show that the note is uncollectible in part, it must be shown that the property pledged or mortgaged as security, if any, is insufficient to satisfy the note.

The IRS then discussed *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g* T.C. Memo. 2001-128. In that case, the decedent sold real property to his son in exchange for a SCIN. The decedent died unexpectedly five months after the issuance of the note. The Sixth Circuit stated that, at the time of the transaction, there was a real expectation of repayment and intent to enforce the collection of the indebtedness. Thus, the Sixth Circuit concluded that the transaction was bona fide.

In *Estate of Costanza*, the IRS asserted that, if its argument that the transaction was not bona fide was unsuccessful, it would argue in the alternative that the exchange constituted a bargain sale. The Sixth Circuit did not address the argument but instead remanded the case to the Tax Court. Before the Tax Court could issue a ruling on this issue, the parties settled. In the CCA, the IRS was careful to specify that a bargain sale argument under similar facts was not precluded by *Estate of Costanza*.

In addition to the availability of this argument despite *Estate of Costanza*, the IRS argued that *Estate of Costanza* was distinguishable from the facts of this CCA. The IRS pointed out that the decedent in *Estate of Costanza* needed retirement income. Thus, the decedent had a bona fide reason to enter into a transaction by which he would receive regular distributions of income and principal. In contrast, the notes under the facts of the CCA were balloon notes. Only interest would have been paid, on an annual basis, in the years before maturity. Moreover, the IRS emphasized that Mr. Davidson did not need retirement income because he had substantial assets outside of the Trusts. The IRS declared that "the arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock."

The IRS then added that the SCINs "lack the indicia of genuine debt because there must be a reasonable expectation that the debt will be repaid." However, the IRS conceded that there are insufficient facts at this point to determine whether the Trusts contained enough principal to pay back the SCINs. The IRS then stated that "we do not believe that the § 7520 tables apply to value the notes in this situation."

In its petition, the Estate asserted that the IRS "has identified no evidence to support the contention that": (a) "the SCINs were not bona fide debt"; (b) "Mr. Davidson did not intend to collect or did not expect to collect all payments due"; (c) "the trusts that were the obligors of the SCINs would be unable to make payments on the SCINs when due"; and (d) "the SCINs were not bona fide consideration for the Guardian stock Mr. Davidson exchanged therefor." The IRS denied these allegations and asserted that the burden of proof lies with the Estate regarding all these issues.

The IRS found that the notes should be valued based on a method that takes into account the willing buyer/willing seller standard of Treas. Reg. § 25.2512-8 and should also account for Mr. Davidson's medical history on the date of the gift, citing to GCM 39503 (June 28, 1985).

With regard to the IRS' reliance on Treas. Reg. § 25.2512-8 for the proposition that it should utilize the willing buyer/willing seller standard for determining the value of the SCINs, the IRS seems to be relying specifically on the statement in that regulation that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." In addition, any transaction that does not meet this standard will be considered a gift to the extent that the property transferred by the donor exceeds the value of consideration received.

As explained in the Estate's petition, presumably based on the position stated in the CCA, the IRS used a 5.3% interest rate to value the SCINs, rather than the 2.4% interest rate used by Mr. Davidson's advisors. In addition, instead of the five-year life expectancy used by Mr. Davidson's advisors in calculating the value of the SCINs, the IRS used a 2.5-year life expectancy.

b. **Issue 3**. The IRS then turned its attention to the estate tax consequences of the cancellation of the SCINs upon Mr. Davidson's death. Although the IRS does not state so explicitly, the IRS' position was that the assets transferred in exchange for the SCINs were includible in Mr. Davidson's gross estate under IRC §§ 2035, 2036 and 2038.

The IRS first discussed *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-2 C.B. 1. In that case, the decedent sold stock and other property to the corporation in exchange for SCINs. At the time of the transaction, the decedent had a ten-year life expectancy under the actuarial tables. The decedent, however, died only eighteen months after the transaction. The Tax Court agreed with the taxpayer that the value of the notes should not be included in the decedent's gross estate. The parties stipulated that the transaction was bona fide and for adequate consideration. Also, the Tax Court stated that there was no evidence that the decedent had a shorter life expectancy than that stated in the actuarial tables.

The IRS also discussed *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995), in which the decedent exchanged property for a SCIN less than one month before death. The decedent was in poor health at the time of the transaction. The Court of Federal Claims found that it was unlikely at the time of the transaction that the decedent would ever be repaid. In addition, there were no scheduled payments, no interest rate was stated and the debt was unsecured. Also, primarily because the note was a demand note, the Court of Federal Claims indicated that the decedent retained an interest in the amount transferred.

The IRS only stated that "[t]here are similarities between the decedent in the subject case and the decedent in *Estate of Musgrove*," adding that the decedent in each case "was in very poor health and died shortly after the note was issued." The IRS added that in each case there was a "legitimate question as to whether the note would be repaid."

If a completed gift arose from the SCIN transactions, there should not have been any estate tax consequences. Apparently Issue 3 was an alternative argument that the assets transferred in the SCIN transactions, if they did not constitutes gifts, were includible in Mr. Davidson's gross estate under IRC §§ 2035, 2036 and 2038. In its petition, the estate was likely addressing this issue when it stated, for each SCIN transaction, that the transfers of stock by Mr. Davidson in exchange for one of the SCINs "vested title and beneficial ownership of the stock transferred in the trust to which such transfer was made."

4. Settlement. In the stipulated decision entered on July 6, 2015 settling the case, the total estate and GST tax deficiency was approximately $152 million, a small fraction of the amount asserted in the notice of deficiency. The gift and GST deficiency was approximately $178 million.

Notwithstanding this favorable settlement for the Estate, the *Davidson* case illustrates that the IRS will challenge SCIN transactions, especially those involving a debtor who died before the end of the note term.

G. IRS Attacks Gift to Trust in Exchange for Promissory Note
Estate of Woelbing v. Commissioner, Docket Nos. 30261-13 and 30260-13 (Settled March 2016)

On June 21, 1999, Donald and Marion Woelbing created the 1999 Woelbing Insurance Trust ("Trust"). Mr. Woelbing was the majority shareholder of Carma Laboratories, Inc. ("Carma"). In 2006, he transferred Carma nonvoting stock to the Trust in exchange for a promissory note (the "2006 stock transaction"). The promissory note bore interest at the applicable federal rate ("AFR"). The stock was valued at over $59 million. The promissory note was issued for this amount as well. The agreement regarding the transaction contained a defined value clause, under which the number of shares transferred would change upon a revaluation of the stock so that the aggregate value of the stock transferred would not change, thereby avoiding gift tax upon the revaluation.

Mr. Woelbing reported the 2006 stock transaction on his 2006 gift tax return. Mr. Woelbing then died on July 6, 2009. His estate subsequently filed an estate tax return.

The IRS examined the estate tax return and issued a notice of deficiency asserting $31.8 million in gift taxes and negligence penalties for the 2006 taxable year and $88.4 million in estate taxes and negligence penalties. The IRS asserted that the transfer of the Carma stock in the 2006 stock transaction should be treated as a taxable gift under IRC § 2702. The IRS valued the stock transferred at $116.8 million. Regarding the estate tax deficiency, the IRS asserted that the 2006 stock transaction should be treated as a transfer with a retained interest under IRC §§ 2036 and 2038, such that all of the stock transferred is includable in Mr. Woelbing's gross estate. The IRS asserted that the promissory note issued in exchange for the stock was not bona fide. The IRS has also issued a notice of deficiency to the estate of Mr. Woelbing's surviving spouse, Marion Woelbing, who died on September 29, 2013. Because Mr. and Mrs. Woelbing split gifts on their 2006 gift tax returns, the IRS was able to make substantially similar assertions against Mrs. Woelbing's estate. Neither notice of deficiency mentioned the defined-value clause.

In response, the executors of the Estates (the "Estates") filed petitions in Tax Court. Mr. Woelbing's Estate asserted that the 2006 stock transaction should not be treated as a transfer with a retained interest and therefore includable in Mr. Woelbing's gross estate under IRC §§ 2036 and 2038 because the transfer was a bona fide sale for full and adequate consideration. The Estates also asserted that the principal amount of the note had a fair market value equal to the value of the stock transferred.

To counter the argument that the promissory note was not bona fide, the Estates asserted that the Trust had sufficient funds to make payments on the note, in excess of 10% of the face value of the note. The Trust also held life insurance policies with cash surrender value which could be used as collateral for a loan the proceeds of which could be used to make payments on the note.

In settlement, as reported by counsel for the taxpayer, the IRS accepted the validity of the Wandry-like formula language (more shares were retained but penalties and interest were avoided), and the Service conceded that IRC §§ 2036 and 2702 did not apply because the 10% equity "test" was satisfied.

H. Tax Court Finds Transfers in 1972 to Irrevocable Trusts Not in Furtherance of Settlement Agreement

Redstone v. Commissioner, T.C. Memo. 2015-237 (December 9, 2015)

1. <u>Background Facts</u>. Michael "Mickey" Redstone started a drive-in movie business in 1936, which both of his sons, Sumner and Edward, joined in their later years. For each drive-in theater, Mickey formed three separate entities – one to hold the real estate, one for general operations, and one to manage refreshments. This structure was an impediment to financing, so Mickey incorporated National Amusements, Inc. ("NAI") as a holding company to consolidate Mickey, Sumner and Edward's interests in all of the previous entities. Mickey contributed $3,000 cash and stock with a value of $30,328 to the former companies. Edward contributed stock with a value of $17,845 and Sumner contributed stock with a value of $18,445 of stock. In exchange for their contributions, each received 100 shares of NAI.

In May 1968, Mickey created a trust for the benefit of his grandchildren (the "Grandchildren's Trust"), naming his wife, Edward and Sumner as Trustees. He then transferred 50 shares of NAI common stock to the Grandchildren's Trust.

In June 1971, Edward left NAI due to frustration with his role in the company and demanded possession of the stock certificates representing the 100 shares registered in his name. NAI refused to release the stock certificates. Edward then hired an attorney to gain possession of the certificates and threatened to sell the shares to an individual outside the family if the shares were not redeemed by NAI. Mickey's attorneys asserted that a portion of Edward's shares had been held in an oral trust for the benefit of Edward's children since NAI was formed. Mickey's attorneys reasoned that, because Edward did not contribute 33% of NAI's capital at inception, the shares representing the difference between his contribution and those actually received were held in oral trust for Edward's children, Ruth Ann and Michael.

After settlement negotiations failed, Edward sued NAI. The action against NAI was eventually settled, resulting in 33 1/3 shares being held by Edward as Trustee "for the benefit of his children." The settlement agreement stated that NAI would redeem the 66 2/3 shares belonging to Edward for $5,000,000. NAI was to pay Edward 44 quarterly installments of $125,000 plus a final payment of the balance due. This was evidenced by a promissory note bearing interest at a "floating prime rate." Also pursuant to the settlement agreement, Edward executed two irrevocable trusts, one for each of his children, and transferred 16 2/3 shares of NAI stock to Sumner as Trustee of each trust.

Three weeks later, Sumner executed one irrevocable trust for each of his children, Brent and Shari, and assigned 16 2/3 shares of NAI stock to himself as Trustee of each trust (the "1972 transfers"). Sumner did not file a gift tax return reflecting the transfers. The trust instruments stated that the stock transferred to each trust had been held pursuant to an oral trust as of NAI's date of formation. Before transferring the stock to his children's trusts, Sumner sought the advice of Samuel Rosen, the Redstone family accountant. After consulting with individuals at his former accounting firm, Rosen advised Sumner that he would not be required to file a gift tax return because no taxable gift was made.

In March 1984, NAI redeemed all shares held by the Grandchildren's Trust and the trusts created for Edward's children for approximately $257,143 per share. Edward's son, Michael, sued NAI in 2006 contending that additional shares of NAI should have been transferred to his trust, to his sister's trust, and to the Grandchildren's Trust in 1972 when the transfers first occurred. During litigation, Sumner testified that he transferred the stock to Brent and Shari's trusts voluntarily and that, in contrast to the position Mickey took with Edward, Mickey did not necessarily believe that any of Sumner's shares were held in oral trust for his children.

In May 2011, as a result of Sumner's litigation testimony, the IRS examined Sumner's 1972 transfers. In 1975, the IRS conducted a limited review of Sumner's 1972 political contributions and any related gift tax consequences but determined that no tax was due for such contributions. The agent leading the 2011 investigation was unaware of the previous investigation into Sumner's transfers. IRC § 7605(b) provides that only one inspection of a taxpayer's books may be made each taxable year unless the taxpayer requests otherwise. Sumner filed a "second examination" complaint under IRC § 7605(b) after the IRS assessed a deficiency for the 1972 transfers in 2014.

The IRS asserted a deficiency for the 1972 transfers and Sumner challenged the deficiency. The IRS' business valuation expert, Steven Hastings, concluded that under the mergers and acquisitions approach - one of three different approaches Hastings used, all resulting in similar values - the value of the shares transferred in July 1972 was $75,000 per share, or $2,500,000 total. Hastings relied on the amount paid to Edward as evidence of value because redemption of Edward's shares was reasonably arms-length and contemporaneous with Sumner's transfers to his children's trusts.

Sumner's expert, Gordon Klein found that the value of the shares was $735,981. Klein reached his value by using the engrafting method, which involves relying on the per share redemption price NAI paid to the trusts in 1984 and computing ratios between the 1984 sales price and NAI's average net income for the three preceding years as well as the 1984 sales price and the book value of shareholders' equity in 1984. Klein then applied those ratios to comparable data at the time of the 1972 transfers to obtain the value.

2. <u>Rulings</u>

a. <u>Statute of Limitations</u>. The Tax Court held that the IRS' assessment of deficiency was timely and not barred by the statute of limitations because Sumner failed to file a gift tax return. Therefore, the statute never began to run. Sumner raised a laches defense, which the Tax Court quickly dismissed by noting that the United States is not subject to the defense of laches, especially where enforcement of tax is sought and the government was not aware of the gifts until 2010 following Sumner's litigation testimony.

b. <u>IRC § 7605(b) Second Examination Violation</u>. Sumner argued that the 1975 review of his political campaign contributions constituted the one and only permitted review of his books for the 1972 tax year under IRC § 7605(b). The Tax Court refused to extend this protection to Sumner because it was unclear that the 1975 examination was a full access investigation. Furthermore, "compliance checks" are not examinations for purposes of IRC § 7605(b), and the IRS complied with the mandatory notice requirements for second inspections. During the course of the year-long examination, Sumner responded to all requests and did not raise an IRC § 7605(b) objection. Accordingly, the Tax Court refused to entertain a waiver of the assessed deficiency resulting from any violation of IRC § 7605(b).

c. <u>Gift Tax Application</u>. In *Redstone v. Commissioner*, 145 T.C. No. 11 (October 26, 2015), the Tax Court held that Edward's stock transfer to trusts for Ruth Ann and Michael was not a gift because it was a transfer in the ordinary course of business. *See* Treas. Reg. § 25.2512-8. The transfer resulted from litigation with NAI, in which Edward was forced to transfer 33 1/3 shares to his children to have 66 2/3 shares acknowledged as belonging to Edward. Therefore, the transfers were made for full and adequate consideration.

The Tax Court refused to apply the same exception to Sumner's 1972 transfers. Sumner failed to provide evidence showing that Mickey took issue with Sumner's ownership in NAI stock. In fact, the Tax Court stated, Sumner and Mickey worked in concert to force Edward to shift shares to his children and allow NAI to redeem Edward's remaining shares. Sumner retorted that his transfers facilitated the settlement with Edward. The Tax Court did not find merit in this argument because the agreement did not mention any required transfer by Sumner. The sole rationale for Sumner's transfer was "love and affection."

The Tax Court promptly dismissed the credibility of Sumner's expert who used the 1984 redemption as his primary metric. The Tax Court cited several cases supporting the notion that future sales may be taken into account for previous valuations if they occur within a reasonable period of time of the valuation date. Due to the twelve year difference, too many factors may have impacted the value in 1984, so the Tax Court refused to follow Sumner's expert valuation. The Tax Court upheld the IRS expert's valuation of $75,000 per share because the redemption of Edward's shares occurred within a reasonable time before the valuation date, reflected appropriate market conditions and was generally based on arm's-length settlement negotiations.

d. <u>Additions to Tax</u>. The Tax Court held that Sumner would not be charged any addition to tax for fraud because the "oral trust theory" had real consequences and Sumner acted in accordance with his father's wishes regarding treatment of the stock. The Tax Court also denied the IRS' request to charge a failure to file penalty under IRC § 6651(a)(1) and a negligence penalty under IRC § 6653(a). The Tax Court found that Sumner relied in good faith on the tax advice of his accountant in failing to file a gift tax return for 1972 and should not be penalized for so doing.

I. IRS Concludes that Statute of Limitation on Gift Did Not Apply Because of Inadequate Disclosure

FFA 20152201F (May 29, 2015)

1. <u>Facts</u>. Donor filed a United States Gift Tax Return (Form 709) disclosing two gifts to the Donor's daughter. The gifts were interests in two different partnerships that shared the same general partner. Schedule A of the Form 709 provided the percentage interest in each partnership transferred and the abbreviated names of the partnerships. Schedule A also disclosed the EIN of each partnership, although one EIN was missing a digit. Donor also attached a one-paragraph supplement to the Form 709 stating that the assets of the partnership were primarily farm land, the land was independently appraised, and that discounts were taken for "minority interests, lack of marketability, etc."

The IRS inquired as to the possibility of extending the assessment period for the gift tax return. The Donor's attorney refused to extend the assessment period.

2. **<u>Analysis</u>.** Pursuant to IRC § 6501, a gift that is required to be disclosed is not adequately disclosed on a Form 709, the gift tax may be assessed at any time. A gift is adequately disclosed if it is disclosed in or attached to a return such that it is "adequate to apprise the [Service] of the nature" of the gift. In the FFA, the IRS summarized the requirements for adequate disclosure under Treas. Reg. § 301.6501(c)-1(f)(2) by explaining that a disclosure is adequate if it includes (a) a description of the transferred property; (b) the identities of, and any relationship between, the transferors and transferees; (c) a detailed description of the method used to determine the fair market value of the property transferred; and (d) a statement describing any position taken that is contrary to any Treasury regulation or revenue rulings.

The FFA states that the Donor satisfied requirements (b) and (d) of the above requirements. However, the IRS did not believe that at least one of the gifted partnership interests was adequately described because the complete EIN was not provided and the partnership name was abbreviated for that partnership interest.

The IRS also believed that the Donor did not provide a detailed description of the method used to determine the fair market value of the property transferred. It stated that even though the Donor obtained an appraisal for the land, the gift was composed of the partnership interests, and therefore the partnership interest should have been appraised. Further, even if the appraised land was the primary asset of the partnership, there was not sufficient financial data, an explanation of the discount, including an explanation of the amount of each discount, or a statement regarding the total value of the partnership.

Thus, the IRS concluded that the assessment of the gift at issue would not be subject to any statute of limitation under IRC § 6501.

IV. VALUATION

A. Tax Court Examines the Valuation of Net, Net Gifts
Steinberg v. Commissioner, 145 T.C. No. 7 (September 16, 2015)

1. **<u>Facts</u>**. An 89-year-old donor made a $109 million taxable gift to her four daughters. The gift was made after the donor and the daughters entered into a gifting agreement, which obligated the daughters to pay (1) the donor's gift tax and (2) any additional estate tax resulting from IRC § 2035(b). The gift was a net gift in two respects. First, the daughters were legally obligated to pay their mother's $32.4 million gift tax. Second, the daughters were legally obligated to pay any additional estate tax that would be assessed against their mother's estate pursuant to IRC § 2035(b).

The donor reported the value of the gift by reducing the value of the gift by both the gift tax that the daughters would definitely have to pay and the IRC § 2035(b) estate tax that the daughters would have to pay if the donor didn't survive at least three years following the gift. An expert appraiser determined the amount of that contingent estate tax liability. The expert, using the IRS' actuarial tables and the applicable IRC § 7520 rates, calculated the present value of the contingent estate tax liability, as of the date of the gift, to be $5.84 million. The donor timely filed a gift tax return. The IRS issued a notice of deficiency, which disallowed donor's entire $5.84 million discount for the donee's assumption of the IRC § 2035(b) estate tax liability.

2. **IRC § 2035(b) Estate Tax Gross Up**. IRC § 2035(b) increases a decedent's gross estate by the amount of any gift tax paid by the decedent or the decedent's estate on any gift made by the decedent during the three-year period preceding the decedent's death. This "gross-up" includes gift tax attributable to a net gift the decedent made during that period. *Estate of Sachs v. Commissioner*, 88 T.C. 769, 777-778 (1987), *aff'd in part, rev'd in part on other grounds*, 856 F.2d 1158, 1164 (8th Cir. 1988). IRC § 2035(b) was enacted to eliminate a taxpayer's incentive to make deathbed transfers which would ultimately result in lower tax paid due to the fact that the gift tax regime is tax exclusive while the estate tax regime is tax inclusive. In other words, the amount paid as gift tax is not subject to the gift tax but the amount paid as estate tax is subject to the estate tax. IRC § 2035(b)'s gross up removes the advantage of the gift tax's exclusive system by grossing up the amount of the gift tax back into the taxable estate. Thus, the combined gift tax and estate tax will be equal to what the estate tax would have been if the gift not been made.

3. **Net, Net Gifts**. The donor argued that the value of the gift should not only be reduced by the value of the gift tax obligation the daughters assumed (the net gift) but should also be reduced by the value of the contingent IRC § 2035(b) estate tax liability (the "net, net gift").

The Tax Court agreed, reasoning that the daughters' assumption of the IRC § 2035(b) estate tax liability should be treated similar to a donee's assumption of the gift tax liability. In both cases, the assumption of liability is a detriment to the donee and a benefit to the donor or, in the case of IRC § 2035(b) estate tax, is a benefit to the donor's estate. First, using the willing buyer/willing seller test, the Tax Court reasoned that any hypothetical buyer of the property who assumed liabilities would insist on a reduction of the purchase price to reflect his or her assumption of the liabilities. Since the IRC § 2035(b) estate tax liability did not exist before the gifting agreement, which was the product of lengthy negotiations, the assumption of this liability was a detriment to the daughters because it might result in a reduction in the value of the gifts they received if the donor died within three years of the gifts. Second, the donor benefited because the IRC § 2035(b) estate tax is generally borne by the donor's estate and the daughters' assumption of the tax liability gives the donor's estate recourse against the daughters.

The IRS argued that the daughters' assumption of the IRC § 2035(b) estate tax liability did not create any new burden on the daughters or benefit for the donor because at the time of the gift the donor's will left her residuary estate to the daughters and the law of the donor's domicile required that estate tax be apportioned to the residuary of the donor's estate. However, the Tax Court was not convinced by this argument. First, at the time the gifts were made it was not possible to determine which law would govern the apportionment of estate taxes: the donor was alive and entirely capable of changing her domicile before her death. Thus, there was the possibility that the law of another state would apply to her estate. Second, at the time the gifts were made it was not possible to determine the provisions of the donor's will that would exist at the time of her death. As a matter of law the donor is entitled to change the provisions of her will before her death and there is no certainty that her daughters would remain the beneficiaries of her will. The evidence established that the donor previously changed her will, which at one point excluded one of the daughters as a beneficiary. In other words, there was no guarantee that the estate tax would be paid from the residuary of the donor's estate nor was there a guarantee that the daughters would be beneficiaries of such residue. There was a guarantee, however, that the daughters would be obligated to pay any IRC § 2035(b) estate tax.

Finally, the Tax Court accepted the donor's expert's determination of the gift tax offset. The expert used the government's actuary tables, which "is the most common way to measure the value of a property interest that is dependent on the life expectancy of an individual," to estimate the likelihood that the donor would die in each of the three years after making the gift. While the IRS objected to the expert's use of the IRC § 7520 rate, the IRS did not provide any evidence, such as rebuttal expert testimony, that suggested a more appropriate method should have been used.

4. Planning Note. Advisors should carefully consider whether the "Net, Net Gift" technique validated in *Steinberg* is worth the gamble. A donee's assumption of the contingent IRC § 2035(b) estate tax liability in the case of an older donor may be particularly attractive because it will result in a larger reduction in the gift value than when a younger donor is involved, given that the older donor is less likely to live for three years after having made the gift. If the donor manages to survive the requisite three years, the reduction in value is achieved even though IRC § 2035(b) estate tax is not incurred. However, if the donor survives less than three years following the gift, not only is there IRC § 2035(b) estate tax (payable by the donees), but also the donor's gross estate is increased by a new asset: the donee's obligation to pay that estate tax, the date-of-death value of which would seem to be the dollar amount of the tax, not the present value of the contingent estate tax liability as of the date of the gift.

V. CHARITABLE GIVING

A. Charitable Set Aside Not Too Remote As To Be Negligible for Purposes of IRC § 642(c) Given Ongoing Potential for Will Challenge

Estate of John D. DiMarco v. Commissioner, T.C. Memo 2015-184 (September 21, 2015)

John DiMarco ("Decedent") died testate on December 16, 2008 as a resident of New York. Decedent was single and left no children. The 2010 Form 1041 for Decedent's estate was submitted April 19, 2012 and claimed a deduction of $314,942 as a charitable set aside under IRC § 642(c)(2). In October 2013, the IRS denied the deduction in its entirety and issued a deficiency notice in the amount of $108,588. On appeal, the Tax Court determined that the charitable amount was not permanently set aside in the manner required under IRC § 642(c)(2). Therefore, the Estate was not entitled to the deduction on its 2010 income tax return.

1. Factual Background. Decedent's Will was executed in Connecticut on February 25, 1983 and witnessed by three individuals. Article I directed the Executor to pay expenses, funeral costs, taxes and debts other than real property encumbrances. Article III of

Decedent's Will conveyed his residuary estate to the church Decedent regularly attended at his death but did not specify whether gross income was to be set aside or placed into a separate account. Decedent's father, who was named as Executor, predeceased Decedent, and Decedent's Will designated the "pastor at [Decedent's] church" as successor Executor. At his death, Decedent regularly attended two churches. Accordingly, each pastor assumed duties as co-executors.

In May 2009, Sandra DiMarco Solomon, Decedent's heir-at-law, met with attorney Frederick Killeen ("Killeen") to determine whether she and other heirs had any claims against Decedent's estate. In August 2009, she met with additional heirs to notify them of the possibility. The Executors filed a petition for probate on October 26, 2009 naming seven individuals as "distributees," all of whom were Decedent's paternal cousins, despite no specific devises in the Will to any of them. Killeen entered an appearance on behalf of the paternal heirs in February 2010. Shortly thereafter, the New York State Assistant Attorney General entered an appearance on behalf of the charitable beneficiaries. Preliminary letters testamentary were then issued to the two pastors.

The Executors amended the petition for probate on October 25, 2010, naming Decedent's maternal heirs. The following day, a guardian-ad-litem was appointed to represent any unascertained heirs. In the guardian's December 2010 report, he expressed concern over the Will's ambiguous and vague provisions. Meanwhile, the guardian initiated a genealogical search for additional hears, but the search obtained no results and the guardian-ad-litem was discharged.

Killeen wrote a letter to his clients in April 2011 urging them to settle with the Estate. A settlement conference was held March 22, 2012, at which time Decedent's Executors prepared a proposed distribution accounting for the estates expenses, distributions to beneficiaries and executors' commissions. The parties reached a settlement during the conference, which provided that Decedent's heirs would share equally in 1/3 of the Estate. The remaining 2/3 of the Estate would be equally distributed to each church. The settlement was stipulated on record in late April 2012 and Decedent's Will was admitted to probate on May 1.

A second settlement was reached in December 2012 in which Decedent's heirs agreed to pay their own attorneys' fees from the assets they received, and the Executors would share 1.5 times the statutory commission. Each heir executed a receipt and release which was then filed with the court reflecting the amount received and date of payment. The settlement was approved by the court on or about January 28, 2013.

2. <u>Analysis</u>. IRC § 642 provides that an estate may take an income deduction for income that is "permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes." To receive the deduction, the charitable contribution must be from the estate's gross income, the governing instrument's terms must make the charitable contribution, and the contribution must have been set aside for a charitable purpose. Assets are "permanently set aside" when income is appropriated and dedicated finally such that no changes could impair the character of the action. The IRS contended that Decedent's assets were not permanently set aside under this definition.

The Estate, therefore, had to prove that the likelihood the amount set aside could go to non-charitable beneficiaries was "so remote as to be negligible." This standard has been interpreted to mean, "[a] chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." (Citing *Estate of Belmont v. Commissioner*, 144 T.C. 84, 92 (2015)). The Tax Court found that the numerous, ongoing legal controversies present at the time the Estate's income tax return was filed should have alerted the parties that there was still a possibility assets could go to entities or individuals other than the churches.

Specifically, the Tax Court pointed to Killeen's appearance on behalf of potential heirs in February 2010 and the attorney general's appearance on behalf of charitable beneficiaries, whose interests conflicted with those of the individuals represented by Killeen, as evidence that too many contingencies regarding the Charitable Contributions existed during the tax year in question. Furthermore, the Tax Court found it illuminating that the first settlement regarding distributions was not finally settled until January 28, 2013 when the heirs agreed to pay their own attorneys' fees and filed receipts and releases with the courts. This settlement came nine months after the Estate filed its income tax return.

The Estate argued that the settlement meeting on March 22, 2012 was evidence that prolonged controversy was unlikely. The Tax Court dismissed this argument stating that the first settlement was still not approved until one week after the return was filed. Therefore, until such time, anyone could have brought another challenge. Further still, the first settlement only allocated the beneficial interests, but additional legal fees could have arisen that would have reduce the amount ultimately distributed to charitable beneficiaries.

B. Tax Court Denies Charitable Deduction Because Contribution Not Permanently Set Aside

Estate of Belmont v. Commissioner, 144 T.C. No. 6 (February 19, 2015)

Eileen Belmont ("Eileen") died on April 1, 2007, as a resident of Ohio. Her Will stated that, after specific bequests, the Personal Representative shall transfer the residue of her estate to the Columbus Jewish Foundation (the "Foundation").

Eileen's estate (the "Estate") received a distribution from her pension that constituted income in respect of a decedent under IRC § 691. This distribution was intended to be used to fund the residuary bequest. The Estate filed an income tax return for its taxable period ending March 31, 2008 and claimed a charitable contribution deduction of nearly $220,000 under IRC § 642(c)(2). *See*, *also*, Treas. Reg. § 1.642(c)-2(d).

Eileen also owned a condominium in Santa Monica, California. Her brother, David Belmont ("David"), lived in the condominium at the time of Ms. Belmont's death. The Estate opened an ancillary probate administration in California to administer the condominium. David filed a claim against the Estate asserting that he was entitled to a life estate in the condominium based on services he provided to his and Eileen's mother and funds purportedly due to him from the sale of other family real estate. A California trial court and appellate court found for David.

In order to pay the attorneys' fees and other administrative costs of this litigation, the Estate had to use part of the funds that it intended to set aside for the Foundation and for which it had claimed a deduction. At the time of trial in this matter, the Estate had approximately $185,000 remaining in its checking account.

The IRS denied the entire charitable deduction because the Estate did not meet the requirement under IRC § 642(c)(2) that it must permanently set aside for ultimate distribution to charity the funds with respect to which the deduction is claimed. IRC § 642(c)(2) provides that:

> In the case of an estate . . . there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for [charitable purposes].

With regard to the requirement that the gross income must be permanently set aside, Treas. Reg. § 1.642(c)-2(d) provides that "under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to [a charitable] purpose" must be "so remote as to be negligible."

Although the Tax Court had not considered the phrase "so remote as to be negligible" in prior cases under IRC § 642(c)(2), the Tax Court has analyzed identical language under IRC § 170. For instance, such language under IRC § 170 has been interpreted to mean "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance." *Briggs v. Commissioner*, 72 T.C. 646 (1979), *aff'd without published opinion*, 665 F.2d 1051 (9th Cir. 1981).

The Tax Court found that "[t]he information that was known or reasonably knowable to the Estate when it filed its Form 1041 on July 17, 2008, indicates that David's claim to a life tenancy interest in the Santa Monica condo was a serious claim based on alleged events that predated the end of the taxable year ended March 31, 2008." Consequently, the dissipation of funds set aside for the Foundation was not so remote as to be negligible. As of March 31, 2008, there was only about $65,000 in funds left to pay several administration expenses, including attorneys' fees in both Ohio and California. David's actions before the filing of the income tax return indicated that "he would put up a litigious fight." The Tax Court pointed out that these factors were not disclosed to the CPA who prepared the income tax return.

C. Net Income with Makeup Charitable Remainder Unitrust Fails to Qualify for Charitable Deduction

Estate of Schaefer v. Commissioner, 145 T.C. No. 4 (July 28, 2015)

Arthur Schaefer ("Decedent") created the AES Family Limited Partnership (the "Partnership") in November 2004. Decedent transferred 3.83% of the Partnership to each of his sons, Ronald and Benjamin, and transferred the remaining 92.34% to Schaefer Investment, LLC along with a money market checking account. Decedent also created two charitable remainder trusts (collectively, the "Trusts") and transferred a 49.5% nonvoting interest to each of the two Trusts. Decedent was the income beneficiary of the Trusts during his lifetime, and Ronald and Benjamin would each become income beneficiaries of one of the Trusts following Decedent's death.

Each Trust required that the Trustee distribute the lesser of the annual Trust income or a fixed percentage of the fair market value of the Trust assets, valued annually, to the income beneficiary. In any year the income exceeded the fixed percentage, the Trustee could also distribute the additional income to Decedent's sons to make up for years in which the fixed percentage was greater than the annual income. These provisions qualified the Trusts as net income with makeup charitable remainder unitrusts (commonly known as NIMCRUTs) pursuant to IRC § 664(d)(3). The Trusts were to terminate upon the later of the date of death of the last income beneficiary or twenty years from the date the Trusts were funded.

Upon Decedent's death, the Executor reduced the amounts reported as transferred to the Trusts by the amounts the Executor deemed as charitable. The Executor did not claim a charitable deduction for the Trusts. The IRS argued that the Executor improperly calculated the charitable remainder and asserted that in order to receive the deduction, the remainder must be calculated by using the fixed percentage, which results in a less than 10% remainder interest attributable to each Trust in violation of IRC § 664(d)(2). Decedent's estate claimed that the charitable remainder should have been calculated by using the anticipated net income from the Trusts, determined by using the IRC § 7520 rate, so long as the income distribution was at least 5% of the net fair market value of the assets annually.

Pursuant to IRC § 664(d)(2), the remainder interest of a charitable remainder unitrust must be at least 10% of the net fair market value of the property contributed to receive a charitable deduction. Treas. Reg. § 1.664-4(a) provides that the charitable remainder interest must be computed using the life contingencies of the beneficiaries, the IRC § 7520 rate and the assumption that the fixed percentage is distributed in accordance with the payout sequence of the trust. The parties disagreed regarding whether the regulations address calculation of the remainder interest for a NIMCRUT. In Rev. Rul. 72-395, 1972-2 C.B. 340, and Rev. Proc. 2005-54, 2005-2 C.B. 353, the IRS stated that the remainder interest of a NIMCRUT is valued using the fixed percentage stated in the trust instrument, regardless of the fact that distributions are limited to trust income.

The Tax Court acknowledged that both the IRS approach and the estate's approach were flawed. The IRS' approach typically resulted in an undervaluation, while the estate's approach had no basis in the statutes or regulations. Pursuant to IRC § 664(e):

> For purposes of determining the amount of any charitable contribution, the remainder interest of a charitable remainder annuity trust or charitable remainder unitrust shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year.

The Tax Court found the language of IRC § 664(e) ambiguous because it does not specifically state whether the "5 percent of net fair market value" amount is a "sum certain" as reflected in IRC § 664(d)(1) (addressing charitable remainder annuity trusts) or whether such amount is a "fixed percentage" of the net fair market value as reflected in IRC § 664(d)(2) (addressing charitable remainder unitrusts).

As a result of the ambiguity, the Tax Court looked to the legislative history of IRC § 664(e) to determine the proper computation method. Ultimately, the Tax Court relied heavily on the Senate report that added IRC § 664(e) to the Code for its holding. The Senate report stated that the remainder interest was to be determined by assuming that the beneficiary will receive the greater of either (1) 5% of the net fair market value or (2) the amount provided in the trust instrument. The Tax Court stated that "[t]he Senate report makes clear that where there is a net income provision, the distribution amount or rate set forth in the trust instrument is to be used for valuation purposes even though distributions may be limited by net income."

The Tax Court also found Treas. Reg. § 1.664-4(a)(3) ambiguous. This regulation discusses the value of the remainder interest in a charitable remainder unitrust. However, the Tax Court found that Rev. Rul. 72-395 and Rev. Proc. 2005-54 were consistent with the legislative history of IRC § 664(e). Both rulings found that the NIMCRUT remainder interest should be valued by using the amount provided in the trust instrument, even where distributions are limited by net income. Accordingly, the Tax Court held that the remainder interests for Decedent's Trusts should be valued using the fixed percentage provided in the trust instrument because it represented the higher distribution amount. As a result, the Trusts did not qualify for a charitable deduction because less than 10% of the initial fair market value contributed to the Trusts would pass to charity upon termination.

D. Estate Tax Charitable Deduction Reduced when Trustee Diverts Property from Charity and Alters Testamentary Plan

Estate of Victoria E. Dieringer v. Commissioner, 146 T.C. No. 8 (March 30, 2016)

1. <u>Factual Background</u>. Victoria E. Dieringer ("Decedent") died testate on April 14, 2009, a resident of Oregon. Decedent, a widow, had 12 children. Decedent's trust generally provided for distribution of certain personal effects to her children, specific gifts totaling $600,000 to unrelated charities and the balance of her trust was to be distributed to the Bob and Evelyn Dieringer Family Foundation (the "Foundation"). Her son, Eugene Dieringer ("Eugene") was Executor of her Estate, Trustee of her trust and the director of the Foundation.

The bulk of Decedent's assets consisted of a majority interest in Dieringer Properties, Inc. ("DPI"), a closely-held business that managed commercial and residential real estate. Decedent owned 425 of 525 voting shares and 7,736.5 of 9,220.5 nonvoting shares of DPI at the time of her death. The Estate hired an appraiser to value the DPI stock on a majority basis. The appraiser determined that the voting shares had a value of $1,824 per share and the non-voting shares had a value of $1,733 per share. The non-voting shares received a 5% discount due to the non-voting status. The adjusted value of DPI on Decedent's date of death was $17,777,626.

The United States Estate Tax Return ("Form 706") for Decedent's Estate stated that she owned an interest in DPI with a fair market value of $14,182,471. The Estate also claimed an estate tax charitable deduction on the Form 706 of $18,812,181. The Estate reported no estate tax liability.

In November 2009, DPI elected S corporation status on the advice of Thomas Keepes, who was a director of DPI. DPI became concerned that the Foundation would be required to make annual distributions of income and could be subject to a tax on the value of its excess business holdings under IRC § 4943. DPI decided to redeem the trust's interests in the company. Prior to redemption, the two voting shareholders were the trust and Eugene, and the non-voting shareholders were the trust, Eugene and Patrick Dieringer (Decedent's son). DPI agreed to redeem the trust's interest in DPI in exchange for two notes receivable, a short-term note in the amount of $2,250,000 and a long-term note in the amount of $3,776,558. The redemption price was $779 per voting share and $742 per non-voting share.

Eugene arranged for an appraisal of the DPI shares on a minority interest basis, and the appraiser determined that the per-share price was $916 per voting share and $870 per non-voting share. In April 2010, the redemption agreement was modified so that DPI redeemed all of the trust's voting shares and 5,600.5 of the trust's non-voting shares. The long-term promissory note was amended to reflect a value of $2,968,462. The appraised values included a 15% lack of control discount and a 35% lack of marketability discount. The non-voting share value also included a 5% lack of voting power discount.

Separately, Eugene, Patrick and Timothy Dieringer (Decedent's son) entered into subscription agreements with DPI to infuse the company with cash to pay the short-term promissory note. After modifying the subscription amounts to reflect the appraised value on a minority basis, Eugene purchased 100 voting shares and 2,190 non-voting shares for $1,997,568. Patrick purchased 65 shares of voting stock and 86 shares of non-voting stock for $134,393. Timothy purchased 25 shares of voting stock and 108 non-voting shares for $99,611. After the redemption and subscription, Eugene owned 70% of the voting stock of DPI and 48.6% of the non-voting stock.

For calendar year 2009, the trust reported a capital loss in the amount of $385,934 from the sale of the voting stock and a capital loss of $4,831,439 for the sale of 5,600.5 shares of non-voting stock.

On January 1, 2011, the Foundation received 2,163 non-voting shares of DPI, a short-term note receivable in the amount of $2,250,000 and a long-term note receivable in the amount of $2,921,312 in satisfaction of its interests in the trust.

In September 2013, the IRS reduced the charitable deduction based upon the value of property actually distributed to the Bob and Evelyn Dieringer Family Foundation (the "Foundation"). The IRS issued a deficiency notice in the amount of $4,124,717 and assessed an IRC § 6662(a) accuracy-related penalty of $824,943.

2. Analysis. The Tax Court stated that "[i]f a trustee has the power to divert property to be transferred for charitable purposes 'to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent'. . . the charitable contribution deduction is limited to the portion, if any, of the property that is exempt from the trustee's exercise of the power." (Citing to Treas. Reg. § 20.2055-2(b)(1)).

The Estate argued that the value of the assets in the trust and the corresponding charitable deduction should be based upon the value of the assets as reported on the Form 706. The Estate argued that the decrease in value of the DPI shares occurring between Decedent's date of death and the redemption of shares was the result of several post-death events and should not reduce the value of the charitable deduction permitted under IRC § 2055. The IRS argued that the decrease in value "was primarily due to the specific instruction to value decedent's majority interest as a minority interest with a 50% discount," rather than the post-death events cited by the Estate.

The Tax Court upheld the deficiency, finding that the Foundation did not receive the bequeathed shares of DPI nor the value of those shares as part of the redemption. The Tax Court determined that the charitable amount that could properly be deducted was the amount actually transferred to the Foundation, rather than the amount reported on Decedent's Form 706, because the executor's actions altered Decedent's estate plan by diverting value that should have been transferred to the Foundation in favor of 3 of Decedent's children.

In addition to the estate tax deficiency, the IRS sought an accuracy-related penalty on the basis that the underpayment of estate tax was due to the Estate's negligence or disregard of the rules and regulations. The Tax Court found that the IRS met its burden of proof that the Estate's position was negligent due to Eugene's specific instructions to the appraiser to appraise a minority interest without informing the appraiser that the redemption was for a majority interest in DPI.

VI. MARITAL RIGHTS: IRS Issues Guidance on Implications of the Supreme Court's *Obergefell* Decision on Same Sex Marriage

REG-148998-13, 80 Fed. Reg. 64,378, Prop. Reg. § 301.7701-18 (October 23, 2015)

The IRS, in the wake of *United States v. Windsor*, 133 S.Ct. 2675 (June 26, 2013) and *Obergefell v. Hodges*, 135 S.Ct. 2584 (June 26, 2015), recently issued proposed regulations (REG-148998-13) amending the current regulations under IRC § 7701 to account for the constitutional right of same-sex couples to marry in the United States.

In 2013, the Supreme Court, in *Windsor*, struck down Section 3 of the Defense of Marriage Act (DOMA), which previously limited any marriage benefits under federal law to opposite-sex spouses. Subsequent IRS guidance provided that a same-sex couple that was legally married in a domestic or foreign jurisdiction that recognized their marriage would be treated as married for federal tax purposes, regardless of where they currently live. See Rev. Rul. 2013-17, 2013-38 IRB 201.

In 2015, the Supreme Court, in *Obergefell*, held that the Fourteenth Amendment requires all States license a marriage between two people of the same sex and no State could refuse to recognize a lawful same-sex marriage performed in another State.

The proposed regulations would provide that, for federal tax purposes, the terms *spouse*, *husband* and *wife* mean an individual lawfully married to another individual, and the term *husband and wife* means two individuals lawfully married to each other. These definitions apply regardless of sex of the individuals. In addition, the proposed regulations would provide that a marriage of two individuals will be recognized for federal tax purposes if that marriage would be recognized by any state, possession or territory of the United States. Whether a marriage conducted in a foreign jurisdiction will be recognized for federal tax purposes depends on whether that marriage would be recognized in at least one state, possession or territory of the United States.

The proposed regulations would <u>not</u> treat registered domestic partnerships, civil unions or similar relationships that are not denominated as marriage under state law as marriage for federal tax purposes, as no provision of the IRC indicates that Congress intended to recognize as marriages civil unions, registered domestic partnerships or similar relationships.

The proposed regulations will obsolete Rev. Rul. 2013-17 as of the date the regulations are finalized, and until that date, taxpayers may continue to rely on Rev. Rul. 2013-17.

VII. RETIREMENT ASSETS: Beneficiary Designation Forms Not "Plan Documents" Requiring Compliance By Participant for Benefits to Be Paid

Mays-Williams v. Williams, 777 F.3d 1035 (9th Cir. January 28, 2015)

Decedent, Asa Williams, Sr., was a participant in two ERISA-qualified employee benefit programs at his death—the Xerox Retirement Income Guarantee Plan ("RIGP") and the Xerox Savings Plan (the "Savings Plan") (collectively, the "Xerox Plans"). Decedent named his then-spouse, Carmen Mays-Williams, as beneficiary of the Xerox Plans in 2002. Following their divorce in 2006, Decedent called and told the plan representative that he wished to name his son, Asa Williams, Jr., as beneficiary of the RIGP plan. Decedent did the same, again telephonically, for the RIGP plan in 2008 and for both Xerox Plans in January 2011. Each time Decedent was sent beneficiary forms, which he failed to complete and return to the plan administrator. Decedent died in May 2011. Decedent's former spouse as well as his son submitted claims for the retirement benefits. The plan administrator then interpleaded both parties for a determination as to the proper beneficiary.

The plan administrator must distribute benefits "in accordance with the documents and instruments governing the plan." 29 U.S.C. § 1104(a)(1)(D). The United States District Court for the Western District of Washington granted summary judgment to the former spouse under the theory that the beneficiary designation forms were plan documents that Decedent was required to complete and sign for the beneficiary properly to change from his former spouse to his son. The son appealed.

The United States Court of Appeals for the Ninth Circuit analyzed the RIGP Agreement, the RIGP summary document and the Savings Plan summary document and determined that neither document required use of the beneficiary designation form to change beneficiaries. Instead, the Ninth Circuit found that the RIGP summary document refers to the use of a form only once. The one reference requires that a married participant wishing to designate someone other than a spouse must have written spousal consent "on forms available." The Savings Plan summary document and excerpts from the Savings Plan Agreement described a similar process but without reference to any forms.

Further, the Ninth Circuit relied on an interpretation 29 U.S.C. § 1024(b)(4) from a previous ruling finding that plan documents and "other instruments under which the plan is established or operated" relate only to those documents that provide information about the plan and describe the benefits in more detail. *See Hughes Salaried Retirees Action Comm. v. Adm'r of the Hughes Non-Bargaining Ret. Plan*, 72 F.3d 686 (9th Cir. 1995). The Ninth Circuit cited the Supreme Court decision in *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan*, 555 U.S. 285 (2009), in which it stated that "documents and instruments governing the plan" under 29 U.S.C. § 1104(a)(1)(D) and "other instruments" under 29 U.S.C. § 1024(b)(4) overlap, for the notion that only documents providing "information as to 'where [the participant] stands with respect to the plan'" qualify as documents with which a plan administrator must comply in awarding benefits. Additionally, the plan documents on record did not reference any required forms for *unmarried* persons. (Emphasis added.) Accordingly, the beneficiary designation forms were not plan documents governing benefit awards.

Decedent's former spouse then argued that, even if beneficiary designation forms are not "plan documents," if a plan grants the administrator discretion to determine benefit eligibility, then the exercise of such discretion should be upheld as reasonable. The Ninth Circuit rejected the former spouse's contention that either Xerox or the plan administrator exercised any discretion. On the contrary, the plan administrator failed to exercise any discretion as evidenced by its decision to interplead the former spouse and the son into a court action rather than determine whether Decedent's telephonic designation was valid. The Ninth Circuit concluded that none of the plan documents explicitly required unmarried persons to use the beneficiary designation form but the plan documents did encourage participants to call Xerox to change beneficiaries. Thus, the Ninth Circuit concluded that Decedent substantially complied with the plan documents by calling Xerox about his intentions. The Ninth Circuit therefore reversed the District Court's granting of summary judgment.

VIII. TRUST ADMINISTRATION, FIDUCIARY LITIGATION AND ETHICS

A. New York Court Rejects Attempted Decanting

In re Petition of Johnson, 2015 N.Y. Misc. LEXIS 51
(N.Y. Surr. January 13, 2015)

Phyllis C. Johnson ("Phyllis") created a trust under a trust agreement dated May 8, 1995 (the "1985 Trust"), naming Michael L. Johnson, her husband at the time, as trustee. The petitioner in this case, Katharine A. Johnson, was the primary beneficiary under the 1985 Trust. Katharine was the daughter of Michael and Phyllis.

The relevant provisions of the 1985 Trust were as follows:

- The trustee had discretion to make distributions of principal to Katharine and her descendants pursuant to an ascertainable standard.
- When Katharine reached age 25, the trustee could distribute any or all of the principal in the trustee's discretion for Katharine's best interests.
- When Katharine reached age 35, the trustee was directed to distribute all the Trust property to Katharine.
- If Katharine were to die before the distribution of all Trust property, the remaining property could be distributed pursuant to Katharine's testamentary limited power of appointment in favor of Phyllis's descendants (other than Katharine). If none of Phyllis's descendants were then living, then the power of appointment could be exercised in favor of any person other than Katharine, Katharine's estate, Katharine's creditors or the creditors of Katharine's estate.
- The takers in default were Katharine's descendants. If no such descendants were then living, the property would be distributed to Phyllis's descendants. If none of Phyllis's descendants were then living, the property would be distributed to Phyllis and Michael, or to the survivor of them. If neither Phyllis nor Michael survived, the property would be distributed to the New York City Ballet, Inc.

Katharine was between ages 25 and 35 when she filed the petition in this case.

Katharine and Michael divorced in 1997. In 1998, Robert Lowenfish was appointed as co-trustee of the 1985 Trust to serve with Michael.

On April 21, 1997, Michael created the "Christopher A. Johnson and Katharine A. Johnson Irrevocable Trust of 1997" (the "1997 Trust"). Mr. Lowenfish was sole trustee. A share of the Trust property was administered for Katharine's benefit. The trustee could distribute income and principal to Katharine from this share in the trustee's complete discretion. All trust property held in Katharine's share was to be distributed outright to Katharine when she reached age 35. If Katharine died before reaching age 35, then the property could be distributed pursuant to a testamentary limited power of appointment exercisable in favor of Katharine's spouse and descendants, if any. The takers-in-default were Katharine's descendants or, if no such descendants were then living, Michael's descendants. If none of Michael's descendants were then living, then the property in Katharine's share would be distributed to her estate.

On July 25, 2011, Michael established the "Katharine A. Johnson 2011 Trust" (the "Appointed Trust") and named Mr. Lowenfish as trustee. Mr. Lowenfish, as co-trustee of the 1985 Trust and the 1997 Trust, exercised his authority to decant the assets of both Trusts to the Appointed Trust pursuant to NY EPTL § 10-6.6 (as in effect on the date of the decanting, which was before the latest amendment to the statute became effective on August 17, 2011).

The relevant provisions of the Appointed Trust were as follows:

- The trustee had discretion to distribute income and principal to Katharine for any purpose.
- Katharine held a testamentary limited power of appointment in favor of Michael's descendants other than Katharine.
- The takers-in-default were Katharine's descendants. If none of Katharine's descendants were then living, the trust property would be distributed to Michael's descendants. The trust property distributable to each taker-in-default was to be retained in a separate trust for that person's benefit.
- If the power of appointment was not exercised and none of the takers-in-default were then living, the trust property would be distributed to Michael's heirs under the New York intestacy law.

Therefore, the terms of the Appointed Trust changed the beneficiaries of the 1985 Trust by: (1) replacing the descendants of Phyllis as permissible appointees under the power of appointment with Michael's descendants (the court pointed out that the two classes of descendants were identical, but that this could change); and (2) removing Phyllis, Michael, Phyllis's descendants and the New York Ballet, Inc. as possible takers-in-default and adding Michael's descendants and collateral heirs as possible takers-in-default.

With respect to the 1997 Trust, the Appointed Trust change the beneficiaries of the 1997 by: (1) removing Katharine's spouse and descendants as permissible appointees of the power of appointment and adding Michael's descendants as permissible appointees and (2) replacing Katharine's estate as a taker-in-default with Michael's collateral heirs.

Katharine argued that the decanting did not comply with NY EPTL § 10-6.6, which provided that a trustee may engage in a decanting transaction if the decanting is "in favor of the proper objects of the exercise of the power." The court interpreted this provision to mean the beneficiaries of the Appointed trust must be limited to the beneficiaries named in the 1985 Trust. Therefore, because the Appointed Trust added beneficiaries to the 1985 Trust, the court invalidated the decanting.

B. Failure to Diversify, Alone, Does Not Constitute a Breach of Fiduciary Duty *In re JP Morgan Chase Bank, N.A.*, 133 A.D.3d 1292 (N.Y. App., November 20, 2015)

JP Morgan Chase Bank served as Trustee of three separate trusts, each of which was initially funded with shares of Kodak stock. Two of the trusts were established in 1966 and the third trust was established in 1976. The Trustee had sole investment authority over the trusts and none of the trusts provided for any restrictions regarding investment decisions. In 1968, the Trustee began selling small amounts of Kodak stock. In the 1990s, the Trustee sold larger portions of the stock. The three trusts were entirely divested of the Kodak stock by January 2002. Upon the death of one of the beneficiaries, the Trustee filed petitions seeking judicial settlement of the trust accounts. The remainder beneficiaries of the deceased beneficiary's interest objected alleging, *inter alia*, that the Trustee failed to adequately diversify the trusts' investments. The New York Surrogate Court determined the Trustee was negligent in its management of the three trusts by failing to sell 95% of the Kodak stock held in each trust within 30 days of the receipt of the stock. The Surrogate Court surcharged the Trustee by employing the lost capital method (*i.e.,* determining the value of stock on the date it should have been sold and subtracting from that figure the proceeds from the sale of the stock) and also surcharged the Trustee's commissions. The Supreme Court, Appellate Division, of New York, modified the Surrogate Court's decision and held that the Trustee did not breach its fiduciary duty.

The Appellate Division first determined that the Surrogate Court abused its discretion by directing the Trustee to forfeit its commissions. Trustees are entitled to annual commissions unless there is a finding that the Trustee acted in bad faith, fraudulently or for personal enrichment. The Surrogate Court made no such findings and thus the Trustee was entitled to the commissions earned.

Next, the Appellate Division engaged in an independent analysis to determine whether the Trustee breached a fiduciary duty by not diversifying the investments of the trusts. In so doing, the Appellate Division recognized that the Trustee was subject to three separate standards of care:

- From 1966 until 1970: The common-law rule requiring the trustee to "employ such diligence and such prudence in care and management, as in general, prudent [persons] of discretion and intelligence in such matters, employ in their own like affairs."
- From 1970 until 1995: The statutory prudent person rule requiring the trustee to invest trust funds in the same manner as "prudent [persons] of discretion and intelligence in such matters who are seeking a reasonable income and preservation of their capital."
- From 1995 until present: The Uniform Prudent Investor Act, which adopts the modern portfolio theory, requiring the trustee to "exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes and terms and provisions of the governing instrument."

The Appellate Division recognized that under each standard, a surcharge is warranted only where the objector establishes that a financial loss resulted from the Trustee's negligence or failure to act prudently. This requires "a balanced and perceptive analysis of [the Trustee's] consideration and action in light of the history of each individual investment, viewed at the time of its action or its omission to act." (internal citation omitted). Examining the record on appeal, the appellate court determined that the Trustee did not breach its duties under any of the three standards.

1. Analysis of Trustee's Actions Pursuant to the Common-Law Rule. From 1966 until 1970, the Trustee "was obligated to employ such diligence and such prudence in the care and management, as in general, prudent [persons] of discretion and intelligence in such matters, employ in their own like affairs." The record established that during this time the Kodak stock significantly outperformed the S&P 500 Index and thus it would be unreasonable to hold that Trustee acted imprudently in retaining the stock because the stock had appreciated or was appreciating in value and was providing significant income.

2. <u>Analysis of Trustee's Actions Pursuant to the Statutory Prudent Person Rule</u>. From 1970 until 1995, the Trustee was required to act as a prudent person who is seeking a reasonable income and preservation of capital. The record revealed that during this time: (i) the Kodak stock was considered a top-quality stock; (ii) a single sale of all stock (as opposed to gradual sales) would result in significant capital gains tax liability, which would have reduced income and the principal of the trust; and (iii) the stock was providing significant income. Thus, the Trustee acted prudently because its decision not to diversify preserved the income generated by the stock and the principal increased in value. Specifically, the appellate court recognized that "the very nature of the prudent person standard dictates against any absolute rule that a fiduciary's failure to diversify, in and of itself, constitutes imprudence."

3. <u>Analysis of Trustee's Actions Pursuant to Uniform Prudent Investor Act</u>. Beginning in 1995, the Trustee was required to act as a prudent investor would for the entire portfolio, taking into account the purposes, terms and provisions of the governing instrument. As was the case for prior time periods, during this time period the Kodak stock generated income and retained a high safety rating until the late 1990s. The Trustee divested the holdings from 1998 through 2002 when the value of the stock began to decline and the safety ratings started to fluctuate. The Appellate Division determined that the Trustee complied with the Prudent Investor Act by "diversifying the remaining concentration of Kodak stock, with the exercise of 'reasonable care, skill and caution…in light of facts and circumstances prevailing at the time.'"

C. Court Disallows Grantor's Exercise of Substitution Power

In re Dino Rigoni Intentional Grantor Trust for Benefit of Rajzer, 2015 Mich. App. LEXIS 1369 (July 14, 2015)

In 2001, Dino Rigoni created an estate plan to convey approximately 551 acres of farmland to Christopher Rajzer and Dina L. Rajzer. As part of the plan, Mr. Rigoni created Rigoni Investments, LLC ("Rigoni Investments") and transferred 100% of the ownership interest in Rigoni Investments to a revocable living trust for himself (the "Rigoni Trust"). Mr. Rigoni then conveyed the farmland to Rigoni Investments. Finally, Mr. Rigoni created two identical irrevocable grantor trusts for each of the Rajzers (the "Rajzer Trusts"), each containing a substitution clause permitting Mr. Rigoni to substitute property of "equivalent value" for trust assets without the approval or consent of the Trustee.

The Rigoni Trust then sold a 20% membership interest in Rigoni Investments to each of the Rajzer Trusts in exchange for a promissory note from each Rajzer Trust in the amount of $185,416. After Rigoni Trust's gifting of another 10% interest in Rigoni Investments to each of the Rajzer Trusts, the Rajzer trusts collectively owned 60% of Rigoni Investments (the sole asset of which was the farmland). From 1996 to 2011, the farmland increased substantially in value from $1,088,000 to $3,980,000.

In April 2011, pursuant to the substitution clause, Mr. Rigoni ordered the Trustee of the Rajzer Trusts to substitute the promissory notes of each Rajzer Trust for the 20% membership interest in Rigoni Investments which each trust had purchased. The Trustee refused, arguing that the substitution clauses in the Rajzer Trusts required substitution of property of equivalent value and that the two promissory notes were not equivalent value for substitution. In January 2012, Mr. Rigoni again ordered the Trustee to substitute the promissory notes of each Rajzer Trust, this time for the 30% membership interest in Rigoni Investments owned by each trust. The Trustee again refused on the grounds that Mr. Rigoni had failed to offer property of equivalent value for substitution. Mr. Rigoni then filed a petition to compel the Trustee to allow the substitution.

After extensive expert testimony from both parties, the trial court determined that the substitution clause required that Mr. Rigoni substitute property of equivalent value at the same time he reacquired trust property. The trial court then found that the method of valuing the membership interest should take into account the market value of the farmland as the underlying asset of Rigoni Investments. The trial court further found that no discounts should be given to the value of the interest because the Rajzer Trusts as holders of the interest were not willing sellers. Using this methodology, the trial court determined that the value of the 60% membership interest was $2,388,000, far less than the combined value of the notes. Mr. Rigoni appealed to the Michigan Court of Appeals.

On appeal, the Court of Appeals affirmed the trial court's interpretation of the substitution clause, finding that the language of the substitution clause required Mr. Rigoni to present property of equivalent value before the Trustee was prohibited from denying the requested substitution. As such, the Trustee still possessed the power and duty to determine whether the substitute property was of equivalent value before allowing the substitution. Until Mr. Rigoni presented property of equivalent value, the Trustee could properly refuse the substitution.

Regarding the valuation of the membership interest in Rigoni Investments, the Court of Appeals affirmed the valuation method chosen by the trial court. The Court of Appeals noted that including the value of the underlying asset, the farmland, in determining the value of the membership interest was supported by Rev. Rul. 59-60, 1959-1 C.B. 237, which provides that "the value of the stock of a closely held investment or real estate holding company . . . is closely related to the value of the assets underlying the stock." Moreover, the Court of Appeals noted that the discounts to the value requested by Mr. Rigoni were based on an assumption that a purchaser of the membership interest could not reach the farmland and was thus only purchasing a right to the income stream. The Court of Appeals rejected the assumption, however, noting that members of Rigoni Investments could reach the farmland upon unanimous consent. The Court of Appeals further found that because the Rajzer Trusts were not willing sellers of the membership interest, discounts to the value were improper. Finally, the Court of Appeals noted that, for tax purposes, a substitution of property for "equivalent value" should not increase the net worth of the grantor, citing Rev. Rul. 2008-22, 2008-16 IRB 796. Accordingly, the Court of

Appeals affirmed the trial court's determination that the promissory notes were not equivalent value to the membership interest in Rigoni Investments.

D. Trustee Breached Fiduciary Duty to Trust by Providing False Address and Caused Insurance Policies to Lapse

Rafert v. Meyer, 859 N.W.2d 332 (Neb. February 27, 2015)

Robert Meyer prepared an irrevocable trust (the "Trust") for his client, Jlee Rafert, and designated himself as Trustee. Rafert signed the Trust on March 17, 2009, but Meyer did not discuss the Trust provisions with Rafert or explain the responsibility for trust administration. Meyer, as Trustee, applied for three life insurance policies on Rafert's life with three different insurance companies and provided a false mailing address in South Dakota. Meyer was a resident of Nebraska and had never received mail in South Dakota.

Rafert paid the insurance premiums in 2009. In 2010, two insurers sent premium notices to the South Dakota address. Meyer failed to pay the premiums, and the two companies sent final notices stating that each of the policies had lapsed but could be reinstated. Meyer sent additional premium payments directly to an insurance agent after the policies lapsed, but the agent failed to forward the payments to the insurance companies. Rafert and the beneficiaries, Rafert's four daughters, did not receive notice of the lapses until August 2012. They then sued Meyer alleging that he breached his fiduciary duties to the Trust, resulting in the loss of the initial premiums paid on the life insurance policies.

Meyer moved to dismiss the complaint, arguing that he did not cause the nonpayment and did not receive notice from the insurers that the policies were in danger of lapsing. He also claimed that his failure to submit annual reports to the beneficiaries did not cause the damages because the lapses occurred after the date the last annual report was due. The District Court dismissed the complaint citing the Trust language that the Trustee did not have a duty to pay the premiums or send notification of nonpayment to Rafert or to the beneficiaries. Rafert and her daughters appealed.

Trust terms prevail over Nebraska statutes with some exceptions. The trust instrument may not exculpate the Trustee from his or her duty to act in good faith and the duty "to keep the qualified beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." Neb. Rev. Stat. § 30-3805. Furthermore, an exculpatory provision in the trust instrument is inapplicable to the extent it relieves the Trustee for liability from breaches of trust committed in bad faith. See Neb. Rev. Stat. § 30-3897(a)(1). The contents of an exculpatory clause must be communicated to the settlor for it to be valid. See Neb. Rev. Stat. § 30-3897(b).

Article II of the Trust instrument provided that the Trustee had no obligation to the pay insurance premiums or to notify anyone regarding nonpayment of premiums. It also stated that the Trustee could not be held liable in the event premiums were not paid. Article IV of the Trust instrument provided that the Trustee was required to give an annual report to the beneficiaries regarding the property held by the Trust, including any receipts or disbursements made.

The Nebraska Supreme Court reversed the District Court stating that deference is given to Trust terms but that the Trust terms do not override all of the Trustee's duties, such as those provided in Section 30-3805 of Nebraska statutes. Accordingly, Meyer had a duty to inform the beneficiaries that the premiums had not been paid so that they could protect their interests in the Trust by securing payment. Meyer caused the nonpayment by providing a false address for notices. The Court also noted that the outcome would be the same regardless of whether Article II was an exculpatory clause or a term limiting the Trustee's duties. The false address showed bad faith, and Meyer did not communicate the contents and effect of Article II to Rafert before Rafert signed the trust agreement.

The Supreme Court also held that Meyer's duty to report the danger of the lapses arose as soon as the insurers issued notices of nonpayment irrespective of when the annual report was due to the beneficiaries. The Court reasoned that Meyer's failure to provide a proper address and to inform the beneficiaries that the policies were in danger of lapsing could be reasonably inferred to have caused the policies to lapse. Had the beneficiaries known of the impending lapses, they would have secured payment for the premiums before the lapse date. Therefore, Meyer's motion to dismiss was denied.

E. Trust Protector Not Real Party in Interest

Schwartz v. Wellin, 90 F. Supp. 3d 579 (February 11, 2015); 2014 U.S. Dist. LEXIS 172610 (December 15, 2014); 2014 U.S. Dist. LEXIS 143644 (D.S.C. October 9, 2014); 2014 U.S. Dist. LEXIS 1528 (D.S.C. January 7, 2014).

1. <u>Preliminary Injunction Action</u>. The Wellin 2009 Irrevocable Trust (the "Trust") held a 98.9% limited partner interest in Friendship Partners, LP (the "Partnership"). Friendship Management, LLC ("Friendship Management") held the remaining 1.1% interest as general partner. Friendship Management ordered liquidation of the Partnership in December 2013. The proceeds from the liquidation were to be distributed to the general and limited partners on a pro rata basis.

Keith Wellin's children comprised the Trust's distribution committee and were also the Trustees and the Trust's beneficiaries. The children signed written consents to the plan of distribution, which included a direction that the Trust retain enough assets to satisfy a promissory note held by Keith Wellin and distribute the remaining assets outright to themselves as beneficiaries. The Partnership assets were liquidated shortly thereafter.

The Trustees set aside $52 million to satisfy the promissory note and distributed the remaining $95 million to the beneficiaries. Lester Schwartz ("Schwartz"), as Trust Protector of the Trust, filed a complaint following the distribution of Trust assets against Keith Wellin, the children, Friendship Management and the Partnership. Schwartz alleged that the children "frustrated the intent and purposes of the Trust" by distributing assets which should have remained in the Trust for the benefit of the remainder beneficiaries. The probate court issued a temporary restraining order ("TRO") enjoining the children from disposing of any of the Trust's assets without Schwartz's consent. The children removed the case to the United States District

Court for the District of South Carolina. Schwartz moved to extend the TRO and to obtain a preliminary injunction against the children.

The District Court determined that Schwartz failed to meet his burden of proof for the preliminary injunction, which required him to demonstrate: (a) likelihood of success on the merits; (b) irreparable harm; (c) that the balance of the equities was in his favor; and (d) that the injunction was in the public interest.

a. **Success on the Merits**. The District Court found that Schwartz failed to prove that he would succeed on the merits because his complaint stated several legal conclusions but insufficient factual allegations regarding the children's supposed breach of duty.

b. **Irreparable Harm**. Relying on *Sampson v. Murray*, 415 U.S. 61 (1974), the District Court found that monetary injury is insufficient for a preliminary injunction, which, by Schwartz's own admission, was all he sought in the case.

c. **Balance of the Equities**. Schwartz argued that the balance of the equities was in his favor because defendants had "unclean hands." The District Court disagreed, stating that an injunction would give Schwartz "veto power" over the Trustees, which is not within the scope of a Trust Protector's powers.

d. **Public Interest**. Schwartz asserted that the requested injunction would serve the public interest by "maintain[ing] the integrity of trusts," but the District Court rejected this argument. Specifically, the District Court was concerned about granting the "extraordinary remedy of an injunction" for matters as private as this. In such private matters, likelihood of success may satisfy the public interest prong of the test, but, as noted above, Schwartz failed to show likelihood of success on the merits. Therefore, Schwartz also failed to show that the injunction was in the public interest.

2. **Motion to Substitute a Party in Interest.** Following the District Court's denial of the injunction, the children moved to dismiss the case on the basis that Schwartz was not a real party in interest. To be a real party in interest, South Dakota law (which governed the interpretation of the trust instrument) requires that the person who brings the suit have a "real, actual, material, or substantial interest in the subject matter." Citing Ellingson v. Ammann, 830 N.W.2d 99 (S.D. 2013). Schwartz argued that he qualified as a real party in interest because the Trust expressly authorized him to represent the Trust in litigation. The District Court denied Schwartz' contention on the grounds that he had not personally suffered an injury as a result of the children's conduct. Accordingly, the District Court granted the motion to dismiss but allowed 15 days for the filing of a motion to substitute a party in interest. Schwartz then moved to substitute Larry McDevitt ("McDevitt"), as Co-Trustee of the Trust, as the plaintiff in the action.

On April 29, 2014, the children, as Trustees, purported to remove Schwartz as Trust Protector. On May 2, 2014, Schwartz appointed McDevitt as Trustee and McDevitt accepted. Immediately following McDevitt's appointment, Schwartz and McDevitt filed the motion to substitute. Rule 17 of the Federal Rules of Civil Procedure requires that an action be brought "by a person who possesses the right to enforce the claim and who has a significant interest in the litigation." A Trustee qualifies as such a real party in interest. Therefore, McDevitt could be substituted so long as he was validly appointed.

The governing instrument of the Trust stated, "[t]here shall always be a Trust Protector for each separate trust." Schwartz argued that this provision required a Trust Protector to serve at all times. Accordingly, Schwartz's removal was improper because the children did not appoint, until July of 2014, a successor Trust Protector following their purported removal of Schwartz. The children suggested that the Trust did not require appointment of a successor Trust Protector simultaneously with the removal of the previous Trust Protector and did not require a Trust Protector to serve at all times. In support of their argument, the children pointed to the provision beginning "[t]he Trust Protector acting from time to time, if any…" as evidence that a Trust Protector was not required to serve at all times. The District Court found this provision unclear as to whether "if any" modified the existence of a Trust Protector or the Trust Protector's actions. Regardless, the District Court found that the children's three month delay in appointing a successor Trust Protector violated the plain language of the Trust. Therefore, Schwartz's removal was invalid, Schwartz's appointment of McDevitt as Trustee was valid, and McDevitt was substituted as plaintiff in the action per the court's order on October 9, 2014.

3. <u>Second Motion to Dismiss</u>. On October 14, 2014, the children again attempted to remove Schwartz and simultaneously replace him with Brian Hellman. Six days later, Hellman attempted to remove McDevitt as Trustee and, another eleven days later, appoint one of Wellin's grandchildren, Keith Plum, as Trustee. The Wellin children then filed another motion to dismiss. The determining factor was whether Schwartz was acting within his powers as Trust Protector when he amended the procedure for removing the Trust Protector.

Prior to Schwartz' amendment in November 2013, Wellin reserved the power to remove and replace the Trust Protector. If he could not act, Wellin vested the power to remove and replace the Trust Protector in his children. Schwartz amended the provision to provide that upon the later of Wellin's death or November 20, 2018, a majority of the children could request , no more than once every five years, that a committee be appointed to determine whether a Trust Protector should be removed or replaced. The amendment also set forth very specific eligibility requirements for the committee. Specifically, committee members could not be Trust beneficiaries, could not be related or subordinate to the Trust Protector as defined in IRC § 672(c), had to be Fellows of the American College of Trust and Estate Counsel and had to be members of different law firms. Wellin died on September 14, 2014.

The children argued that Schwartz did not have the authority to increase his power as Trust Protector and, therefore, the children properly removed him under the original removal provision. Consequently, Hellman's subsequent actions as Trust Protector were valid. Taken as true, McDevitt would no longer qualify as a real party in interest, the court would not have subject matter jurisdiction, and the case would require dismissal. McDevitt asserted that the Trust Protector's amendment was valid and, because the children did not comply with the revised removal provision, McDevitt was still a real party in interest.

Article VI, paragraph 3 of the Trust provided that, during Wellin's life, the Trust Protector could amend the Trust "with regard to how the beneficiaries will benefit from the trust, and to amend the trust administrative provisions." In addition, Article VI, paragraph 8 gave the Trust Protector the power to "irrevocably release, renounce, suspend, or modify to a lesser extent any or all powers and discretions conferred under this instrument . . ." The Wellin children argued that paragraph 8 limited the Trust Protector's power to amend the Trust.

The District Court held that the paragraph 8 was not a limit on paragraph 3 because paragraph 8 was permissive and described what a Trust Protector "may" do, not what the Trust Protector could "only" do. Furthermore, the District Court found significant tax implications underlying paragraph 8 because without it the Trust Protector would not be able to limit Trustee powers to avoid adverse tax consequences. Other provisions that intended to limit the Trust Protector's powers were expressly addressed in other areas of the Trust, supporting the District Court's interpretation that paragraph 8 was not meant to limit the Trust Protector's authority to amend. The plain language, according to the District Court, allowed the Trust Protector to modify "any or all powers and discretions," which includes those of a Trustee, beneficiary, or Trust Protector. Under this plain language, Schwartz' amendment was valid.

The District Court also found it telling that even after Schwartz's amendment, Wellin was living and retained the power to remove and replace the Trust Protector on his own. Wellin's lack of action in removing Schwartz after he amended the Trust Protector removal provision supported McDevitt's position that the amendment was valid. As such, the children's purported removal of Schwartz and all actions stemming therefrom were invalid. McDevitt remained Trustee of the Trust and a real party in interest with standing to bring the suit.

F. Court Declines to Extend an Attorney's Duty of Care to Third Party Beneficiaries

Baker v. Wood, Ris & Hames, Prof'l Corp., 364 P.3d 872 (Col. February 8, 2016)

Beneficiaries under a Trust Agreement petitioned court to abandon the "strict privity rule" to allow them to bring a legal malpractice action against attorney who drafted estate planning documents for their father.

1. __Facts__. Grantor retained an attorney to prepare a Will and testamentary trusts. The Will provided that there would be a small cash distribution to his 2 children from a prior marriage and his 2 stepchildren. The residue to be divided between a marital trust and a family trust. Grantor's wife was to be the trustee and beneficiary of both of the trusts, with the right to receive principal and income. The trust assets were to be divided equally among the 4 children upon the death of Grantor's wife.

A substantial portion of the assets were held by Grantor in joint tenancy with his wife. Upon his death, the assets passed directly to his wife as the surviving joint tenant, and therefore, outside of his estate. The petitioners wanted to gather information relating to their father's estate. They contacted the attorney and received a letter in response describing the creation, funding and general operation of the trusts. The letter also stated that the attorney represented

Grantor's wife as the personal representative of Grantor's estate and that they should seek legal counsel if they wanted more information about the estate planning documents. The letter did not mention that a substantial amount of their father's assets passed outside of his estate as a result of the property that was held in joint tenancy.

Grantor's wife then retained the same attorney to prepare her own estate plan. Upon her death and pursuant to her Will, she left a condominium, which she had inherited from Grantor, to her daughter, and split the residue of her estate between her daughter and her two stepchildren, the petitioners.

The petitioners alleged that as a result of the distribution of assets, they each received only fifteen percent of their father and stepmother's estate, while their stepsister received seventy percent. Petitioners sued the attorney, asserting claims primarily for (a) breach of contract third-party beneficiary, (b) professional negligence and (c) fraudulent concealment and negligent misrepresentation. They alleged that the attorney should have made their father aware of the implications that joint tenancy could have on his estate plan, and that the failure to sever the joint tenancy frustrated their father's estate planning intent. They also alleged that by assisting their stepmother in executing her own estate plan, they assisted in controverting the estate plan of their father which the attorney had helped create.

2. <u>Analysis</u>. The Supreme Court of Colorado started by reciting that under Colorado law, an attorney's obligation is generally to his or her client, and that fraud or a malicious or tortious act must be found in order to impose liability on an attorney from a nonclient claim. The Supreme Court laid out four reasons that it believed justified limiting third party claims against attorneys. First, the Supreme Court believed that limiting an attorney's liability protected the duty of loyalty that an attorney owed to his or her client. Second, expanding an attorney's liability would result in an attorney having conflicting duties between his or her client and third parties, including placing an undue burden on the attorney-client relationship by requiring the attorney to reveal confidential information they received from his or her client. Third, imposing this type of liability on attorneys would open up an attorney to liability from "an unforeseeable and unlimited number of people," and that fear of this liability would result in client's needs going unaddressed if an attorney turned down work that was potentially fraught with liability. Fourth, the intent of the testator should be taken from the testator's testamentary documents and not from the testimony of interested beneficiaries.

The Supreme Court then explained the policies that the petitioners had asked the Supreme Court to adopt: the California Test and the Florida-Iowa Rule. The California Test requires a balancing of factors such as how much the testamentary document was to affect the plaintiff, the foreseeability of harm, the degree of harm to the plaintiff, etc., to determine whether the beneficiary of an estate is able to bring a claim against an attorney for malpractice. *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961). The Supreme Court found that the California Test was inconsistent with the policies of Colorado, as evidenced by the holdings of various Colorado courts and legislative statutes.

The Supreme Court believed that the California Rule applied only if the testator's intent was clear on the face of a document, but the document was later found to be invalid due to the negligence of the attorney who drafted and helped the client execute the document. In this case, the documents were properly executed, and the distributions were made in accordance with the document, but the beneficiaries' claim was that the attorney had not properly advised their client as to the how the titling of Grantor's assets could impact his estate plan. Therefore, the malpractice allegation against the attorney did not relate to the testamentary documents, but rather to the underlying assets.

The Supreme Court then discussed the Florida-Iowa Rule. The Florida-Iowa Rule is an extension of the third-party beneficiary rule of contracts. Courts that have allowed for this extension of liability on the belief that the beneficiaries of an estate planning document are essentially third-party beneficiaries of a contract between the testator and the estate planning attorney. For example, the Iowa Supreme Court has held that an estate planning attorney owes a duty to the identifiable beneficiaries of testamentary documents. *Schreiner v. Scoville*, 410 N.W.2d 679, 683 (Iowa 1987). The Supreme Court in this case found that, for the same reasons it rejected the California Test, it would not impose additional duties on the attorneys of Colorado. The Supreme Court also stated that, similar to its analysis under the California Test, even if it had adopted this rule, the petitioners claim in this case would have failed.

Thus, the Supreme Court declined to extend the duty of care of attorneys to third party beneficiaries, effectively affirming the strict privity rule.

G. Court Rejects Third Party Beneficiary Malpractice Claims Against Estate Planning Attorney

Linth v. Gay, 360 P.3d 844 (Wash. Ct. App. September 22, 2015)

1. **Facts**. The primary beneficiary under a trust agreement brought a legal malpractice action against an attorney who drafted a trust and an amendment to the trust. The attorney was retained to create a revocable trust for the primary beneficiary's mother. The original trust provided that upon the death of the grantor, the primary beneficiary would receive a distribution of $100,000, along with a 5-year estate in the grantor's 60-acre residence. After five years, the petitioner would receive a life estate in the northeast corner of the residence.

One month later the grantor signed an amendment which was also prepared by the attorney. The grantor resigned as Trustee at this time, and the attorney remained as counsel to the successor Trustee. The amendment stated that the entire residence, if it was still in grantor's estate at the time of her death, would be conveyed to a charitable foundation ("the Foundation"), and that the plan for the Foundation was attached to the amendment. The primary beneficiary was granted the right to occupy the residence, free of any costs, subject to the Foundation plan.

In fact, the Foundation plan did not exist at the time of the execution of the attachment, and there was no attachment to the amendment. The grantor died before the Foundation was created. After resolution of the matter pursuant to a Nonjudicial Dispute Resolution Agreement, the beneficiary brought a legal malpractice action against the attorney. The petitioner alleged that the attorney owed her a duty before the grantor's death, when he negligently prepared and executed the estate planning documents, and also after the grantor's death, when he negligently represented the Trustee.

2. Analysis. The Washington Court of Appeals recited that Washington law provides that to maintain a legal malpractice claim, a petitioner must show: (1) the existence of an attorney client relationship which gives rise to a duty of care, (2) an act or omission by the attorney that breaches the duty of care, (3) damage to the client and (4) proximate causation between the attorney's breach of the duty and the damage incurred.

The Court of Appeals first looked at whether the attorney owed the petitioner a duty to have the estate plan documents properly executed, specifically relating to the failure of the attorney to attach a copy of the foundation plan to the amendment before the grantor died. To resolve the issue, the Court of Appeals looked to previous cases involving third-party beneficiary claims, specifically *Parks v. Fink*, 293 P.3d 1275 (2013). The court in *Parks* held that an attorney did not owe a duty of care to a prospective beneficiary to promptly execute a will. The *Parks* court feared that to impose such a duty on an attorney would compromise the attorney's duty to the client and would place an "untenable burden" on the attorney-client relationship. The Court of Appeals found that the situation in the present case closely paralleled that of *Parks*. In addition, the Court of Appeals noted that the interest of the client to have sufficient time to examine his or her estate planning options conflicted with the beneficiary's interest in having the estate planning documents executed promptly. Given this conflict, the Court of Appeals believed that the imposition of an additional duty on the attorney would be inappropriate.

The Court of Appeals then took up the primary beneficiary's claim that the attorney, as the legal advisor to the personal representative and trustee, owed a duty to her as a nonclient beneficiary. The court looked to *Trask v. Butler*, 872 P.2d 1080 (1994), to determine this issue. *Trask* involved a plaintiff who brought a legal malpractice claim, as a beneficiary, against the former personal representative's attorney. The Court of Appeals found that there were legal procedures available to the beneficiaries to protect their interests against the personal representative who owes the beneficiaries a duty of care. The Court of Appeals in this case was persuaded by *Trask* and found that the petitioner had the option, which she was currently pursuing, of bringing an action against the personal representative of the estate.

H. Georgia Supreme Court Directs Court of Appeals Regarding Fiduciary Duty Standards to be Applied to the Management of Family Entities Owned by Trust

Rollins v. Rollins, 780 S.E.2d 328 (Ga. November 23, 2015)

In 1968, O. Wayne Rollins established the Rollins Children's Trust (the "RCT") for the benefit of his grandchildren. At the time of trial in this case, Wayne's sons, Gary and Randall, were two of the three Trustees. Wayne created several family entities to hold the RCT assets.

Wayne also established nine Subchapter S Trusts (the "S Trusts") in 1986 for the benefit of his grandchildren. The S Trusts held interests in the family entities. Gary and Randall shared voting control over the family entities, with Randall holding majority interests. Gary and Randall also managed these entities. Gary was sole Trustee of the S Trusts.

In 2010, beneficiaries of the S Trusts and the RCT filed suit for an accounting of the family entities and numerous other breaches of fiduciary duty. The Court of Appeals ruled that the beneficiaries were entitled to accountings and that the Trustees held trustee-level fiduciary duties with regard to the management of the family entities, as opposed to the corporate or partnership-level fiduciary duty, which are lower standards.

The Supreme Court of Georgia reversed the Court of Appeals regarding whether Gary as Trustee was required to provide an accounting of the family entities, stating that the Court of Appeals "failed to give due deference to the discretion of the trial court in this matter."

Regarding whether the Court of Appeals applied the proper fiduciary standard to Gary and Randall, as Trustees, regarding their management of the family entities, the Supreme Court first analyzed Wayne's intent. The Supreme Court believed that Wayne, an experienced businessman, did not want the Trustees to have control over family entities to the same extent the Trustees would have control over other trust property not held in a family entities. These Trusts only held a minority interests in the family entities. The Supreme Court concluded that "the only reasonable conclusion with regard to the settlor's intention is that he did not intend for the trustees to be held to trustee-level fiduciary standards when performing their corporate duties." Thus, the Supreme Court held that in this case, the Trustees should be held to a corporate or partnership-level fiduciary standard.

On remand, the Court of Appeals concluded that a jury must determine the capacity in which Gary and Randall were acting when they committed the alleged breaches of fiduciary duty when managing the family entities.

The Supreme Court again granted certiorari to determine whether a jury must decide which fiduciary duty applies to the various decisions made by Gary and Randall. The Supreme Court explained that "[p]laintiffs seek damages for the manner in which they have allegedly been impacted by certain corporate management decisions Gary and Randall have made in their role as managers of certain family entities." The Supreme Court repeated its determination in its prior opinion that, even though Gary and Randall managed the entities, the S Trusts and the RCT held only minority interests in these family entities. Therefore, a corporate or partnership-level fiduciary standard should be applied. The Supreme Court stated that it is not necessary for a jury to decide this issue.

The Supreme Court noted, however, that the above direction "does not preclude the Court of Appeals . . . from applying a trustee-level fiduciary standard to decisions [Gary and Randall] made as trustees of the trusts." For example, the beneficiaries complained that Gary and Randall breached their fiduciary duties as Trustees when they invested RCT assets in entities controlled by Gary and Randall. The beneficiaries also asserted that Gary and Randall breached their fiduciary duties when they conditioned distributions from RCT upon a code of conduct. The

Supreme Court stated that, in this situation, Gary and Randall were acting as Trustees, and the Court of Appeals should apply a trustee-level fiduciary standard.

Similarly, the beneficiaries also alleged that Gary, as Trustee of the S Trusts, breached his fiduciary duty by placing the trust assets in entities controlled by Gary and Randall. The Supreme Court stated that "[t]hese alleged actions could only have been taken in Gary's capacity as a trustee and must be examined in accordance with the fiduciary and other duties imposed by the trust." The Supreme Court came to a similar conclusion with regard to Gary's vote, as Trustee, to amend a partnership agreement for one of the family entities to allow non-pro rata distributions.

Gary, as Trustee, also executed a shareholder agreement regarding one of the family entities that restricted the shareholders from transferring their shares to anyone other than Wayne's descendants. Gary also executed this agreement in his individual capacity with respect to his personal interest in this entity. Randall also executed the shareholder agreement as president of the entity. The Supreme Court stated that the trustee-level fiduciary standard applies with respect to Gary's execution as Trustee, but that standard does not apply to his actions in his individual capacity. The trustee-level fiduciary standard also would not apply to Randall's execution of the agreement in his capacity as president.

Gary and Randall also applied a code of conduct in determining whether distributions would be made from certain partnership entities to the S Trust beneficiaries. The Supreme Court found that these decisions were made with respect to each S Trust capital account. Consequently, Gary and Randall made these decisions as managing partners. These decisions were not made by Gary in his capacity as Trustee. Therefore, the Court of Appeals must determine whether this decision was a breach of duty by applying a partner-level fiduciary standard.

The Supreme Court remanded the case again the Court of Appeals to apply the appropriate fiduciary standards to Gary and Randall's management of the family entities in accordance with its directions.

I. New York Court of Appeals Absolves Lawyers of Charge They Perpetrated Constructive Fraud

Aoki v. Aoki, 2016 NY Slip Op 02474 (March 31, 2016)

Rocky Aoki was the founder of the Benihana Restaurant chain, comprising approximately 110 restaurants worldwide. The restaurant chain was controlled by Benihana of Tokyo, Inc. ("BOT"), which Rocky controlled in its entirety. In 1998, Rocky was convicted of insider trading and resigned from his positions related to the restaurant chain.

Rocky's personal lawyer of 30 years was Darwin C. Dornbush. In 1998, on Rocky's behalf, Dornbush engaged a trusts and estates lawyer, Norman Shaw, to draft the governing instrument of an asset protection trust, the Benihana Protective Trust (the "BPT"), for Rocky. Rocky transferred his interest in BOT to the BPT. Rocky and his six children were discretionary beneficiaries. Rocky also held a testamentary limited power of appointment exercisable in favor of any person other than himself, his estate, his creditors or the creditors of his estate. Two of the children, Kana and Kevin, along with Dornbush, were the Trustees.

In July 2002, Rocky married his third wife, Keiko Ono Aoki ("Keiko"). Rocky's children became concerned that Keiko might influence Rocky into depriving them of part or all of the inheritance they expected. Their concern was amplified when, in September of 2002, Keiko was asked if she would sign a postnuptial agreement, and she refused. Within a few days thereafter, Kana and Kevin met with Dornbush to voice their concerns. It was proposed that Rocky execute a partial release of his power of appointment so that he could appoint only to his descendants or trusts for his descendants.

On September 23, 2002, Rocky met with Kana, Kevin and Dornbush, and they reviewed a "close to final draft" of a document entitled "Partial Release of a Power of Appointment under New York Estates, Powers & Trusts Law § 10-9.2" (the "September Release"). The next day Rocky, Kana and Kevin met with Dornbush and Shaw,[2] and Rocky then signed the September Release. The relevant language of the September Release provided as follows:

> "I hereby irrevocably partially release the power of appointment [in Article V(a) of the BPT agreement] so that, from now on, I shall have only the following power: I shall have a testamentary power to appoint any of the principal and accumulated net income remaining at my death to or for the benefit of any one or more of my descendants."

In December of 2002, Rocky signed a document titled "Further Partial Release of Power of Appointment Under New York Estates, Powers & Trust Law § 10-9.2" (the "December Release"). The December Release further limited Rocky's power of appointment by eliminating as potential donees those descendants who were non-resident aliens. Shaw later testified that the December Release was executed solely for tax purposes.

In July of 2003, Rocky retained a new lawyer, Joseph Manson. Manson was Keiko's regular counsel. On August 4, 2003, Rocky executed a codicil to his Will, prepared by Manson, by which Rocky exercised the power of appointment by appointing 25% of the BPT principal to Keiko outright and the remaining 75% to a trust for her lifetime benefit. The codicil also conferred on Keiko a testamentary power to appoint the trust property among Rocky's descendants and designated her as the executrix. Manson asked Dornbush to give a legal opinion regarding whether the codicil's provision by which Rocky would exercise his power of appointment (if the codicil remained in place at Rocky's death) would be valid. Upon receiving this request, Dornbush wrote a memorandum to the file stating, in part:

> "Undoubtedly, the fur will fly when Manson and his clients, Keiko and Rocky, discover the existence of the executed Partial Release."

[2] Shaw, by this time, had joined Dornbush's law firm.

On September 8, 2003, Shaw rendered his opinion that Rocky's attempted exercise of his power of appointment would be invalid because of the releases.

On September 22, 2003, Rocky executed an affidavit in which he stated he did not understand that by signing the releases he could not leave his Benihana stock to anyone he chose through his will. The affidavit stated in part: "If I had known that these documents prevented any changes to the disposition of my stock, I never would have signed the documents."

In deposition testimony given in connection with fiduciary misconduct litigation initiated by Rocky in 2006, Rocky stated, regarding his execution of the September Release, that Dornbush, his friend and lawyer for a long time, said "Rocky, sign here," and he signed as instructed. Rocky further testified that he never would have signed the releases had he understood before he signed them that they were irrevocable. At his deposition in the same litigation, Dornbush testified that he explained to Rocky that, upon signing the release, disposition of the Benihana assets would be limited to his children and their descendants. Both Rocky and Shaw testified that Shaw explained that the effect of the September Release was that Rocky could appoint only to his descendants.

On September 7, 2007, Rocky executed a new Will. Similar to the August 4, 2003 codicil, the Will contained language by which Rocky would appoint 25% of the BPT principal outright to Keiko and the remaining 75% to a trust providing her with a lifetime income interest. The Will further provided, however, in an apparent act of retribution against Kana and Kevin, that:

> "In the event that it is finally determined that the [above] exercise of my power of appointment is invalid because, contrary to my wishes, the [releases] are found to be valid, I hereby exercise said power fifty percent in favor of DEVON AOKI, and fifty percent in favor of STEVEN AOKI."

Rocky died in July of 2008 survived by Keiko and his six children. In February of 2009, the Trustees of the BPT commenced litigation in the Surrogate's Court of New York County to determine the validity of the releases. Devon and Steven filed an answer taking the position that the releases were valid. Keiko answered, asserting in one of her five affirmative defenses that the releases were invalid as "the product of fraud" or having been "obtained through fraudulent devices." At the conclusion of discovery, Devon and Steven brought a motion for summary judgment.

At the hearing on the motion, Keiko relied on circumstantial evidence that Rocky did not intend irrevocably to limit his power of appointment over the assets of the BPT and argued that Dornbush and Shaw had a conflict of interest in representing both Rocky and his children and preparing the releases for Rocky's signature. According to Keiko, the fraud arose from Dornbush and Shaw's failure to inform Rocky of the irrevocable nature of the releases.

The Surrogate dismissed four of Keiko's affirmative defenses but allowed the fraud affirmative defense to remain. The court found that Rocky relied on Dornbush and Shaw, and they owed fiduciary duties to him. The court further found that Dornbush and Shaw had entered into an attorney-client relationship with Kana and Kevin and that Dornbush and Shaw had an "impermissible conflict of interest" and had failed to inform Rocky of that conflict.

The court found that, due to the fiduciary duties owed by Dornbush and Shaw to Rocky, it was reasonable for Rocky to have relied on Dornbush and Shaw regarding the execution of the releases, even though Rocky failed to read the releases before signing them. According to the court, under New York law, this was a case of constructive fraud, the remedies for which protect a party who, "by virtue of an unequal relationship, places his trust and confidence in another and thereby 'relax[es] the care and vigilance he would ordinarily exercise in the circumstances'" *quoting Brown v. Lockwood*, 76 A.D.2d 721 (N.Y. App. Div., 2nd Dept. 1980). The court concluded that there existed triable issues of fact on the issue of constructive fraud and whether the proponents of the releases could meet their burden of demonstrating that Rocky's signature on the releases was voluntary and not the result of misrepresentation or omissions by Dornbush and Shaw. Accordingly, the Surrogate denied the summary judgment motion.

Following a bench trial, the Surrogate's Court declared the releases invalid. *In re Aoki*, 243 N.Y.L.J. 93, at 18 (May 17, 2010). The court found that Devon and Steven failed to meet their burden of proving that Rocky signed the releases voluntarily and not as a result of omissions by his counsel. The court stated that there was no evidence that anyone explained the releases to Rocky, that Rocky understood the substance of what he was signing or that the releases were irrevocable.

Devon and Steven appealed, and the Supreme Court, Appellate Division, First Department (the intermediate appellate court in New York), concluded that there was no evidence in the record showing that Rocky was not aware of the irrevocability of the releases. Furthermore, Rocky had the opportunity, as to both the September Release and the December Release, to read them and ask any questions but failed to do so. Accordingly, the Appellate Division reversed, concluding the releases should have been upheld and the summary judgment motion granted. *In re Kevin Aoki*, 117 A.D.3d 499 (N.Y. App. Div., 1st Dept. 2014).

Keiko appealed the Appellate Division's ruling. The Court of Appeals of New York (New York's highest court) affirmed the Appellate Division's order. In so doing, the Court of Appeals stated:

> "Dornbush and Shaw were clearly Rocky's fiduciaries. But…the critical inquiry is whether they were either parties to the Releases or stood to directly benefit from their execution, such that the burden shifted to Devon and Steven to demonstrate that the Releases were not procured by fraud… Neither Dornbush nor Shaw were parties to the Releases or stood to directly benefit from their execution… Therefore, the Appellate Division correctly determined that… the Surrogate had improperly shifted the burden of proof to Devon and Steven to demonstrate that the Releases were not procured by fraud… [I]t is undisputed that Shaw explained the overall effect of the September Release to Rocky, and that Rocky signed it. …Rocky testified that he may have signed the Releases

without actually reading them, but that was not the result of any alleged misrepresentations or omissions by Dornbush and/or Shaw, the latter having explained to Rocky what he was signing and receiving confirmation from Rocky that he wanted to sign the Releases.

IX. PROCEDURAL DEVELOPMENTS:

IRS Announces It Will Issue Closing Letters Only Upon Request
June 16, 2015

The IRS has announced that for United States Estate (and Generation-Skipping Transfer) Tax Returns (Form 706) filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the Executor. Executors who desire a closing letter are instructed to wait at least four months after filing the return to make the closing letter request. A request for a closing letter can be made by calling (866) 699-4083 and providing the following information:

- Name of the decedent;
- Decedent's social security number; and
- The date of the decedent's death.

A closing letter will be prepared and issued to the Executor at the address of record.

For Forms 706 filed before June 1, 2015, the IRS will continue to issue closing letters within four to six months from the date that Form 706 is filed if the return is without errors or special circumstances, but closing letters for returns that are selected for examination or reviewed for statistical purposes will take longer.

Moreover, the IRS has changed its policy of issuing closing letters for Forms 706 filed after January 1, 2015 and before June 1, 2015. For these returns, the IRS will issue closing letters if the filing threshold was met (*i.e.*, the decedent's gross estate exceeds the basic exclusion amount in effect under IRC § 2010(c)). For a return filed to elect portability, a closing letter will be issued only if the portability election is denied due to a late filing. Finally, if a return was filed pursuant to Rev. Proc. 2014-18, 2014-7 I.R.B. 513 (providing a simplified method to obtain an extension of time to make a portability election; applies to returns filed prior to December 31, 2014 that elect portability for a decedent who died between December 31, 2010 and December 31, 2013) a closing letter will be issued only if the portability election was denied due to a failure to meet the requirements of Rev. Proc. 2014-18.

X. ASSET PROTECTION

A. U.S. District Court Reverses Bankruptcy Court Decision to Avoid Transfer to Spendthrift Trust

Safanda v. Castellano, 2015 U.S. Dist. LEXIS 54458 (N.D. Ill. April 27, 2015), *rev'g In re Castellano*, 514 B.R. 555 (Bankr. N.D. Ill. 2014)

1. Facts. On February 18, 1997, Faith Campbell, mother of Linda Castellano (the "Debtor"), established a revocable trust (the Campbell Trust"). The Campbell Trust was to be divided into equal shares among the settlor's four children upon the settlor's death and distributed outright to each beneficiary. The Campbell Trust contained a spendthrift provision for the protection of the trust beneficiaries, which stated:

> [I]f by reason of bankruptcy or insolvency or any attempted execution, levy, attachment, or seizure of any assets remaining [in this trust] . . . under claims of creditors or otherwise, all or any part of the income or principal might fail to be enjoyed by any beneficiary or might vest in or be enjoyed by some other person, then the interest of that beneficiary shall immediately terminate. *Thereafter, the [] Trustee shall pay to or for the benefit of that beneficiary only those amounts that the [] Trustee, in its sole and absolute discretion, deems advisable for the education and support of that beneficiary* . . . (emphasis in original).

The settlor died in February 2011, and J.T. Del Alcazar was appointed Trustee of the Campbell Trust. Del Alcazar was related by marriage to the trust beneficiaries. Del Alcazar had not made the required distributions to the settlor's children as of October 2011.

On October 5, 2011, the Debtor's lawyer sent a letter (the "Letter") to Del Alcazar stating that the Debtor and the Debtor's husband were insolvent and would be filing for bankruptcy. Accordingly, the Debtor believed it Del Alcazar's duty to exercise his authority under the spendthrift provision regarding distributions to the Debtor. Following receipt of the Letter, Del Alcazar then transferred the Debtor's share of the Campbell Trust into an account with Merrill Lynch "named the Faith F. Campbell *Spendthrift Trust* f/b/o Linda Castellano" (the "Spendthrift Trust") (emphasis in original).

The Debtor filed for Chapter 7 bankruptcy on November 18, 2011. Subsequently, on November 21, 2011, the Debtor executed a receipt of trust assets and release of Trustee (the "Receipt") acknowledging, *inter alia*, that she was no longer a "named beneficiary" of the Campbell Trust as of October 5, 2011 pursuant to the Letter and that she was now classified as a "life-time, limited beneficiary" of the Spendthrift Trust.

The Bankruptcy Trustee filed a complaint against the Debtor seeking to avoid the transfer from the Campbell Trust to the Spendthrift Trust under the United States Bankruptcy Code, 11 U.S.C. § 548(e), and seeking turnover of the assets pursuant to Sections 543 and 550.

2. Bankruptcy Court Analysis. Section 548(e) states that a Bankruptcy Trustee may avoid transfers made within ten years of a debtor's filing for bankruptcy if: (1) a debtor transfers an interest in property; (2) into a "self-settled trust or similar device"; (3) of which the debtor is a beneficiary; (4) with actual intent to defraud creditors. The Bankruptcy Trustee must prove each element by a preponderance of the evidence.

First, the court found that the Debtor "recruited" Del Alcazar to transfer the assets on her behalf through the Letter, which was effectively the same as receiving the funds outright and transferring them on her own accord. The Debtor confirmed this indirect transfer by executing the Receipt. Accordingly, the court said, the Debtor indirectly transferred her interest in the Campbell Trust.

Second, the court held that "similar device" requires broad interpretation, leaving discretion to the court to "effectuate its terms." Under the court's broad interpretation, the court said the Spendthrift Trust was created indirectly by the Debtor to protect the Debtor's inheritance from her creditors and to preserve the Debtor's ability to receive distributions during her lifetime, which were sufficient to constitute a "similar device" for purposes of Section 548(e).

Third, the Debtor was found to be the beneficiary of the Spendthrift Trust because the Spendthrift Trust account was titled, in part, "f/b/o Linda Castellano," and the Debtor consistently referred to herself as a "beneficiary" in the Receipt she signed in November 2011.

Lastly, the court looked negatively upon the timing of the Letter, asset transfer and Receipt in relation to the Debtor's bankruptcy petition. The court found the Letter to be the trigger for all subsequent events, including distributions to the other beneficiaries of the Campbell Trust. Furthermore, the Debtor testified that the purpose of the transfer was to protect those assets from creditors.

Consequently, the Bankruptcy Court permitted the Bankruptcy Trustee to avoid the transfer to the Spendthrift Trust. The Debtor appealed.

3. <u>District Court Analysis</u>. The United States District Court for the Northern District of Illinois found that Section 548(e) did not apply to the facts of the case because the transfer of trust property to the Merrill Lynch account was merely a division of the Campbell Trust property. Accordingly, there could not be a transfer of an interest of the debtor as required by Section 548(e).

Instead, the District Court found that Section 541(c)(2) of the Bankruptcy Code should have been considered by the Bankruptcy Court in reaching its decision. Section 541(c)(2) provides that the bankruptcy estate does not include (1) a beneficial interest in a trust whereby "(2) the trust agreement contains language restricting the transfer of the interest and (3) the transfer restriction is enforceable under 'applicable nonbankruptcy law.'" Therefore, if the Campbell Trust and the Debtor's interest met the requirements of Section 541(c)(2), the Bankruptcy Trustee should not have been permitted to avoid the transfer because the Debtor's interest in the trust would have been excluded from the bankruptcy estate.

a. <u>Beneficial Interest In A Trust</u>. The Campbell Trust was to terminate upon the settlor's death following the settlement of her "estate." The Debtor and the Bankruptcy Trustee debated about whether "estate" meant "probate estate" or "trust estate." The District Court found that, while the meaning was unclear, when read in conjunction with Section 9.01 of the trust agreement, the Campbell Trust contemplated a period of time following the settlor's death in which the Trustee would divide the trust assets among the trust beneficiaries and make distributions accordingly. Because Del Alcazar had not yet made distributions from the trust on the day the Debtor filed for bankruptcy, the Campbell Trust still owned the assets and the Debtor had an interest in it.

b. Language Restricting the Transfer of the Interest. The District Court viewed the spendthrift clause as a two part clause. The first part was a more "traditional" spendthrift clause, preventing creditors from having access to the trust assets and preventing beneficiaries from "alienating their interest" in the trust. The second part converted the beneficiary's interest to a discretionary interest. The District Court found that each part independently restricted the transfer of the beneficiary's interest in the trust.

c. Transfer Restriction Enforceability Under State Law. The District Court analyzed this factor under the laws of South Carolina, Illinois and Wisconsin, due to debate between the Debtor and the Bankruptcy Trustee as to which state law applied. The District Court found that the transfer restrictions were enforceable under each state's law.

South Carolina and Wisconsin permit spendthrift clauses by statute, while Illinois has done so through its case law. The Bankruptcy Trustee contended that the spendthrift provisions no longer protected the Debtor's interest in the trust once Del Alcazar was permitted to make distributions to the Debtor from the trust estate. The District Court found, however, that each state extended spendthrift protection to a beneficiary's interest up until the point at which a distribution was required or declared by the trustee. South Carolina statutes provide that a spendthrift provision protects against involuntary transfers from a trust until a distribution is actually made. Relying on *In re Marriage of Sharp*, 860 N.E.2d 539 (Ill. App. 2006) and *Community Bank of Elmhurst v. Klein*, 6 N.E.3d 841 (Ill. App. 2014), in which both courts held that spendthrift protection ends when a beneficiary has "access to the trust assets," the District Court found that spendthrift clauses also protected the Debtor's interest in the Campbell Trust. Finally, Wisconsin statutes provided that trust principal was protected from involuntary transfers until "due and payable." *In re McCoy*, 464 B.R. 832 (Bankr. W.D. Wis. 2011), analyzed Wisconsin's statutes regarding the meaning of "due and payable," ultimately finding that the legislature intended to protect involuntary transfers only when mandatory under the trust agreement. Del Alcazar ultimately controlled if and when the Debtor would receive distributions from the Campbell Trust, and therefore, the distributions were not mandatory nor had they been declared payable to the Debtor.

In addition, the District Court found that discretionary trusts were valid under each state's laws. Discretionary trusts were valid by statute in South Carolina. The District Court noted that although not addressed by statute in Illinois and Wisconsin, both states permitted child support creditors to reach discretionary trust assets. Wisconsin also permitted invasion of discretionary trust assets to repay public support of the beneficiary. The District Court viewed these limited exceptions as evidence that both states intended to protect discretionary trust assets from other creditors. Therefore, the Debtor's interest in the Campbell Trust met the requirements of Section 541(c)(2) and should have been excluded from the bankruptcy estate.

B. Assets of Flawed QPRT Included in Bankruptcy Estate

In re Ferrante, No. AP 8:12-01330-TA, 2015 WL 5064087, at *1 (B.A.P. 9th Cir. August 26, 2015)

In 1994, Robert Ferrante ("Ferrante") transferred his personal residence to a QPRT known as the 518 Trust. Treasury Regulations impose a number of technical requirements that must be met in order for a trust to qualify as a QPRT. *See,* Treas. Regs. § 25.2702-5(c). At the time the 518 Trust was created it was in compliance with these regulations; however, it contained a provision granting Ferrante the option to acquire all or part of the residence from the 518 Trust immediately prior to the expiration of the trust's term.

In 1997, the Department of Treasury promulgated regulations prohibiting QPRT documents from allowing the sale of the residence to the grantor during the QPRT Term or at any time after the QPRT Term. Treas. Reg. § 25.2702-5(c)(9). These regulations provided a grace period for then existing QPRTs that did not comply with the 1997 regulations to engage in a reformation action to modify the trust so it would be in compliance with the new regulations. Treas. Reg. § 25.2702-5(a)(2). The 518 Trust was not reformed nor was a reformation action initiated to modify the terms of the 518 Trust to comply with the 1997 regulations.

In 2004, Ferrante was sued for default on a loan and the lender obtained a sizable judgment against the Ferrante. Subsequently, Ferrante filed a Chapter 7 bankruptcy case in which the bankruptcy trustee initiated an adversary proceeding seeking an order revoking the 518 Trust to bring the residence into the bankruptcy estate. The bankruptcy court made two significant rulings. First, it ruled that all QPRTs are revocable trusts because they will terminate if the grantor chooses not to use the residence held in the trust as a personal residence. Second, it ruled that the 518 Trust terminated in 1998 after it failed to take action to modify its terms to comply with the new regulations prohibiting sales to the grantor. The Ninth Circuit's Bankruptcy Appellate Panel "(BAP)" affirmed the second ruling and, since that ruling was dispositive of the issues in front of the BAP, did not address the bankruptcy court's first ruling.

The BAP affirmation of the bankruptcy court's ruling was based on three facts. First, since the 518 Trust did not take action to modify its terms to comply with the 1997 Treasury Regulations, it ceased to be a QPRT in 1998. Second, the trust instrument provided that the 518 Trust shall terminate when it ceases to be a [QPRT] and on such termination the Trustee shall distribute all of the assets to Ferrante or within 30 days of the termination date, the Trustee may elect to convert the trust to a GRAT. Third, the Trustee did not convert the 518 Trust to a GRAT and thus the 518 Trust terminated and its terms required distribution of the assets to Ferrante.

C. Utah Supreme Court Applies Strong Public Policy and Includes Trust Assets In Divorce Action

Dahl v. Dahl, 2015 UT 79, 794 Utah Adv. Rep. 5, 2015 WL 5098279 (Utah August 27, 2015)

After nearly eighteen years of marriage, Dr. Charles Dahl filed for divorce from Ms. Kim Dahl on October 24, 2006 in Utah. In July 2009, Ms. Dahl brought a separate action against the

Dahl Family Irrevocable Trust (the "Trust"), claiming that assets within the trust were marital property subject to equitable division between the spouses. The Trust contained a choice of law provision, which provided that Nevada law should govern the validity, construction and effect of the provisions of the Trust.

In the divorce action, the district court refused to consider the assets within the Trust in making its equitable distribution because Ms. Dahl failed to join the Trust as a party to the divorce action. In the trust action, the district court applied both Nevada and Utah law and held that the Trust was irrevocable and that Ms. Dahl had no enforceable interest in the Trust assets. Ms. Dahl appealed, arguing that the Trust was revocable under Utah law and that the district court erred in construing the Trust under Nevada law given Utah's public policy regarding the equitable distribution of the marital estate. The court of appeals certified the two appeals to the Utah Supreme Court, and the Utah Supreme Court consolidated the cases.

Applying Utah choice-of-law rules, the Utah Supreme Court refused to enforce the choice of law provision contained in the Trust, finding that doing so would undermine a strong public policy of the State of Utah regarding the equitable division of marital assets. In finding a strong public interest, the Supreme Court cited the Utah statute governing equitable division of marital assets in divorce cases, Utah Code § 30–3–5(1). The Supreme Court also cited to legal precedent interpreting the statute as empowering Utah courts to enforce the duty of support between divorcing spouses and determined that Utah had a strong public interest in ensuring that marital assets were equitably distributed during divorce and that each spouse retained sufficient assets to avoid becoming a public charge. The Supreme Court further noted that at least some of the Trust assets originated as marital property, and, therefore, Utah had a strong interest in ensuring that those assets were equitably divided in the Dahls' divorce action.

Under Nevada law, however, the Trust would be deemed irrevocable and Ms. Dahl would have no enforceable interest in the Trust. Without an enforceable interest in the Trust, Ms. Dahl could not seek a share of the Trust assets and the court would be unable to achieve an equitable division of the Dahls' marital assets. Thus, although the Supreme Court recognized that the determination of the revocability of a trust was an issue of trust construction to which it would ordinarily apply the stated choice of law, in this case Nevada law, the Supreme Court found that the application of Nevada law would preclude the equitable division of the Dahl's marital assets and undermine Utah's strong public policy regarding equitable distribution. As a result, the Supreme Court construed the Trust according to Utah law.

The Supreme Court then found that the Trust was revocable under Utah law and remanded the case to the district court to either credit Ms. Dahl with an offset equal to the value of the marital property in the Trust or allow Ms. Dahl to withdraw her share of that property.

XI. **LIFE INSURANCE: Securing Financing Arrangement for a Buy/Sell Agreement, Alone, is Not Enough to Create an Insurable Interest in the Context of Life Insurance**

Johnson v. Estate of Minnick, 861 NW2d 705 (Neb. April 17, 2015):

Tenant Farmer ("Tenant") and landowner ("Landlord") entered into a written buyout agreement whereby, after Landlord's death, Tenant would purchase farmland he had been renting for a specified price. The buyout agreement specifically provided that Tenant will purchase life insurance on Landlord and that on Landlord's death Tenant will pay the proceeds of the policy to the personal representative of Landlord's Estate. After Landlord's death, Tenant received the proceeds from the life insurance policy and attempted to use those proceeds to purchase the farmland from Landlord's Estate. The Estate refused to sell arguing, *inter alia*, that the buyout agreement was void because it required Tenant to purchase life insurance on Landlord and the life insurance policy was void because Tenant did not have an insurable interest on the property. The Supreme Court of Nebraska held that, under the facts of this case, Tenant did not have an insurable interest on the life of the landlord.

Under common law, "life insurance policies issued to a party not having an insurable interest in the life of an insured are considered a wager on the life of another and therefore void as being against public policy." Citing *Warnock v. Davis*, 104 U.S. 775 (1881). Nebraska, like many other states, has enacted a statute which specifically identifies when an insurable interest in life or health insurance exists. *See* Neb. Rev. Stat. § 44-103(13)(b). Nebraska's statute recognizes an insurable interest where "the beneficiary because of relationship, either pecuniary or from ties of blood or marriage, has reason to expect some benefit from the continuance of the life of the insured."

The Tenant was not related to the Landlord by blood or marriage and thus the determination of whether Tenant had an insurable interest on Landlord's life turns on whether a pecuniary relationship existed. The court found that no such relationship existed. A pecuniary interest exists where the beneficiary of a policy has reason to expect some benefit from the continuation of the life of the insured. For example, a pecuniary interest may exist where: (i) one business partner has an expectation of a benefit from the continued life of another business partner;[3] (ii) a business entity employs a key employee whose death would adversely affect the business;[4] or (3) a creditor has an expectation to be paid during the life of a debtor.[5]

Here the court determined that Tenant did not have a pecuniary interest in the life of the Landlord because, it reasoned, Tenant's pecuniary interest - saved premium payments - is realized only if Landlord died sooner rather than later. Specifically, the court reasoned:

> [Tenant] had no reason to expect any pecuniary benefit from the continuance of [Landlord's] life. As long as [Landlord] lived and was willing to rent the land to

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[3] *See, e.g., Graves v. Norred*, 510 So.2d 816 (Ala. 1987); *Ridley v. VanderBoegh*, 511 P.2d 273 (ID 1973).
[4] *See, e.g., U.S. v. Supplee-Biddle Co.*, 265 U.S. 189 (1924).
[5] *See, e.g., Costentino v. William Penn Life Ins. Co. of New York*, 224 A.D.2d 777 (N.Y. Sup. Ct. 1996).

[Tenant], [Tenant] would remain a tenant on the land. The only difference in the relationship after the execution of the buyout agreement was that [Tenant] had the financial obligation to pay premiums on the life insurance policy. The longer [Landlord] lived, the more premiums [Tenant] would have to pay to keep the policy in force. Under this arrangement, [Tenant's] pecuniary interest would not benefit from the continuation of [Landlord's] life; to the contrary, it would benefit from [Landlord's] death before additional premiums came due. In effect, [Tenant] was gambling that [Landlord] would die sooner rather than later. This is precisely the reason why an insurance policy on the life of one in whom the owner and beneficiary of the policy lacks an insurable interest is void as against public policy.

Financial & Estate Planning Seminar

2016 Legislative Update

Tom Heywood

May 19, 2016

Bowles Rice LLP
ATTORNEYS AT LAW

2016 Regular Session

- Senate vacancy – constitutional crisis averted
- Tough budget (just passed!)
- An election year
- Confluence of business agenda and social issues agenda

Significant Legislation in 2016

- SB 1 – Workplace Freedom Act
- HB 4005 – Prevailing Wage Act

Significant Legislation in 2016

- HB 2615 – Crowdfunding bill
- HB 4228 – Uber bill
- SB 298 – Brunch bill

Social Issues Bills

- HB 4012 – Religious Freedom Restoration Act **[Died]**
- HB 4145 – Conceal Carry bill

Bills of Interest to Estate Planners

- SB 493 — Domestic Asset Protection Trusts
- SB 599 — Uniform Unclaimed Property Act amendments **[VETOED]**
- SB 702 — Relating to real estate title

Bills of Interest to Estate Planners

- HB 4235 — Publication requirements for administration of estates

- HB 4378 — Information regarding protected persons **[VETOED]**

Questions?

Bowles Rice LLP
ATTORNEYS AT LAW

Keep 5 Local

GIVE TODAY
TO GROW TOMORROW

News ALERT!!!

West Virginia is sitting
on billions of dollars in
personal wealth – BILLIONS!

But keeping that wealth in
West Virginia isn't guaranteed.

Transfer of Wealth

West Virginia is experiencing the largest transfer of wealth in history.

Transfer of Wealth or “TOW” = The transfer of financial and other assets from one generation to another.

So far, 36 West Virginia counties have completed TOW studies, and the results are AMAZING.

Transfer of Wealth

The combined net worth of those 36 counties was more than **$93.6 billion in 2010**.

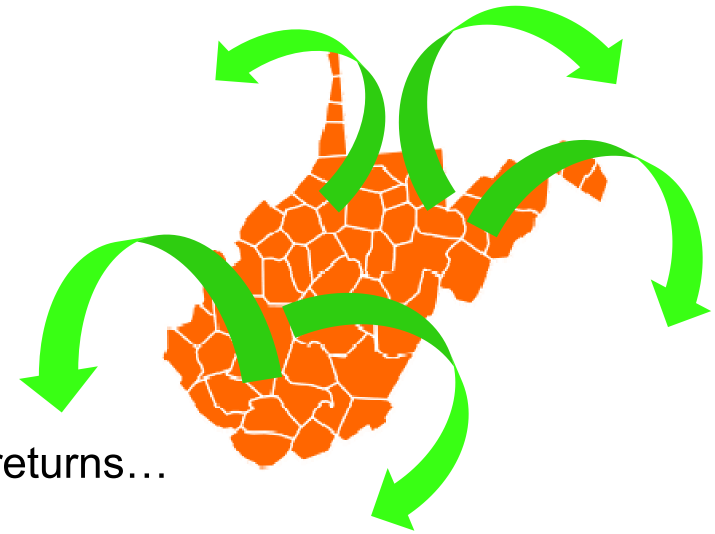
Over 10 years, more than **$29.8 billion** will be handed down.

It's happening right now!

Where will that money go?

To taxes, heirs and any number of destinations other than West Virginia communities.

Studies show that when wealth leaves a state, it rarely returns…



The Solution: Keep 5 Local

If at least **5%** of that wealth ($1.49 Billion) is kept in West Virginia and endowments are created at community foundations, it will yield an estimated **$74.5 million annually** for community investments.

Over **50** years, those 36 counties will see more than **$257 billion** in wealth transfers.

Keeping 5 percent of that in West Virginia means the funds available for grant-making in those communities in 50 years could exceed ***$641million***.

Keep 5 Local: Create a Legacy

West Virginia's future is in your hands. Create a legacy for your community.
Your at least 5% giving now and 5% in your estate matters.

Philanthropic estate planning gives you the power to have a lasting effect on your family, your community and your state.

By leveraging the expertise and experience at local **community foundations**, West Virginians can harness the power of 5% of wealth transfers and create a better, brighter future for tomorrow.

Community Foundations

Community Foundations are nonprofit, tax-exempt, publicly-supported grant-making organizations serving specific regions. These foundations are public charities that develop broad support from many unrelated donors with a wide range of charitable interests in a specific community.

The long-term goal of a community foundation is to build permanent funds supported by many donors, which makes them the ideal vehicle for Keep 5 Local.

What Will Your Legacy Be?

A successful Keep 5 Local effort could mean more community resources:

- Economic Development
- Community Revitalization and Growth
- Education/Higher Education
- Youth and Family Services
- Senior Services
- Health and Human Services
- Quality of Life Amenities
- Arts and Culture
- And More!
- Partner with all Nonprofits

The Opportunity for Professional Advisors

Broaden the outreach to the State and our Citizens

<u>VARIETY of IN-ROADS with Professional Advisors</u>

1. Community Banks
2. Bank Trust & Wealth Depts
3. Attorneys
4. CPAs/accountants
5. Financial Advisors
6. Wealth Managers
7. Insurance Agents
8. Funeral Home Directors
9. Other Professional Advisors

Making Citizens Aware of what their Involvement can Accomplish!

How to Keep 5 Local

By working with the community foundation in your county or region, their expert advisers can help you identify the resources that will help you create a legacy for future generations. Ways to keep 5% of your wealth local:

CREATE:

- Cash
- Personal Property
- Stocks and Bonds
- Real Estate
- Life Insurance
- Retirement Accounts
- Mineral Interest

DONATE:

- Bequests
- Discretionary or Unrestricted Funds
- Designated Funds
- Scholarship Funds
- Agency Endowments
- Field of Interest Funds

Visit www.keep5local.org to find your local community foundation.

For Professional Advisors…

Top 10 reasons to help your clients Keep 5 Local:

1. It's a Good Investment of Expertise & Service for your clients, community and society.
2. Many of your clients are searching for an effective way to give FORWARD to their community, to memorialize a loved one and/or simply to "do good". You can help them achieve these results and derive personal satisfaction from doing so.
3. Discussing philanthropy with your clients should be done unobtrusively, in a way that respects their privacy, values and autonomy. You are among the best positioned to initiate and engage your client in these conversations.
4. By expanding the menu of services offered to your clients, you build their confidence in you and increase their satisfaction with your professional services.
5. Your areas of expertise as a professional advisor are broadened personally.
6. The potential for new referrals is enhanced, opening the door to many new clients through peer to peer.
7. You effectively connect your chosen profession with a personal desire to do something good for your community.
8. Through your efforts, important social needs in your community can be addressed, producing a healthier, more vibrant place to live – an enduring legacy of real benefit to future generations.
9. You become part of a supportive network of like-minded colleagues who are willing to share their time and expertise voluntarily.
10. With practice, confidence and experience, you will find it easy to do.

Behind the Scenes

Keep 5 Local is a statewide program of Philanthropy West Virginia's Give2WV: Community Foundations Network.

Research for Transfer of Wealth completed by the Center for Rural Entrepreneurship and Philanthropy West Virginia with multiple investments from local community foundations, ARC Flex-E-Grants, and economic development authorities. Keep5Local was launched thanks to a generous investment from the Claude Worthington Benedum Foundation.

Any Questions?

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ESTATE AND FINANCIAL PLANNING SEMINAR

Edgewood Country Club

May 19, 2016

Outline
of
The New West Virginia Self-Settled Spendthrift Trust Act

I. Legislative History
   A. Legal background.
      1. In general, a spendthrift trust shields assets from the creditors of the trust beneficiary.
      2. However, under the common law and historic statute law, a spendthrift trust could only be created for a third party and could not be created for the settlor's own benefit (a self-settled trust).
      3. In recent years, states have been passing legislation to allow a settlor to create his or her own spendthrift trust and protect the settlor's own assets from the settlor's own creditors.
      4. These trusts are known as "domestic asset protection trusts" (DAPTs).
   B. In October 2014, the Joint Standing Committee on the Judiciary of the West Virginia Legislature held hearings to consider DAPTs in West Virginia.
      1. Members of West Virginia State Bar Probate Committee and Edward Brown, a Colorado attorney and national expert on DAPTs, made presentations to the Committee and advocated that West Virginia enact legislation.
      2. Sixteen (16) states now fully allow DAPTs by statute.
      3. DAPTs are seen as an economic development issue and allow West Virginia to compete in the legal marketplace for trust business.
   C. Probate Committee in 2015 worked on a draft bill.
      1. The bill was modeled primarily after provisions from:
         a. Virginia Code (Virginia Code Ann. §§ 64.2-745.1, 64.745.2); and
         b. Ohio Legacy Trust Act (Ohio Revised Code § 5816.01, et seq.).
      2. In October 2015, the Probate Committee's bill was approved by the West Virginia State Bar Board of Governor for presentation to the leadership of the West Virginia Legislature.
   D. Senate Bill 493 was introduced by Senator Trump on February 3, 2016.
      1. Limited changes were made in Senate Judiciary Committee (Committee Substitute bill).

        2. Committee Substitute bill added the requirement to the qualified affidavit of a statement of whether child support or alimony is owed by the grantor under an agreement or court order.
    E. Committee Substitute bill:
        1. Passed Senate on February 16, 2016; and
        2. Passed House on March 10, 2016.
    F. S.B. 493 was signed by Governor on March 23, 2016.
    G. Act is in effect 90 days from passage, meaning June 11, 2016.
    H. Main provisions of the new law now appear in W. Va. Code §§ 44D-5-503b, 503b, and 503c.

II. Statutory Requirements for West Virginia Self-Settled Spendthrift Trust:
    A. The trust is irrevocable.
    B. The trust is created during the grantor's lifetime.
    C. The trust instrument expressly incorporates the laws of West Virginia.
    D. The trust instrument includes a spendthrift provision.
    E. The grantor does not have the right to disapprove distributions from the trust.
    F. The grantor executes a “qualified affidavit”, essentially certifying that:
        1. The transfer of property to the trust will not make the grantor insolvent; and
        2. The transfer is not defrauding any creditor.
    G. There is, at all times when distributions could be made to the grantor pursuant to the grantor's “qualified interest”, at least one beneficiary other than the grantor who can receive income, principal, or both income and principal.
        1. “Qualified interest” means that the grantor is entitled to receive distributions of income, principal, or both, in the sole discretion of an independent qualified trustee.
        2. The other beneficiary will typically be a family member.
    H. The trust has at all times at least one “qualified trustee”, who may be, but need not be, an “independent qualified trustee”.
        1. “Independent” means that the trustee IS NOT:
            a. the grantor; or
            b. the grantor’s spouse, parent, descendant, or sibling.
                (1) These are individuals who could be under the control of the grantor.
        2. “Qualified trustee” means:
            a. a natural person who is a resident of West Virginia or an entity that can engage in trust business in West Virginia; and
            b. maintains custody within West Virginia of property in the trust, maintains records in state, prepares fiduciary income tax returns in the state, or materially participates in administration in the state.
                (1) These requirements assure a West Virginia nexus or

connection.

III. Effect of Creation of West Virginia Self-Settled Spendthrift Trust.
   A. Assets in the trust are exempt from most, but not all, of the creditors of the grantor-beneficiary.
   B. Normal spendthrift "exception creditors" from W. Va. Code § 44D-5-503(b) can levy against the trust and its assets:
      1. Beneficiary's child under a child support judgment;
      2. Judgment creditor who has provided services for protection of beneficiary's interest in the trust;
      3. Claim of West Virginia as provided by statute; and
      4. Claim of United States as provided by statute.
   C. Once distributions from the trust are made to the grantor-beneficiary, his or her creditors can then levy against the assets directly held in the grantor's hands.
   D. Direct creditors of the trust itself can levy, such as:
      1. Written lien or pledge of trust assets executed by trustee;
      2. Contract claim on contract signed by trustee on behalf of the trust; or
      3. State or federal tax liability for taxes owed by the trust.
   E. A claim under West Virginia Uniform Fraudulent Transfers Act, Code § 40-1A-1, can still be made against transfers to the trust.
      1. There is a statute of repose barring existing creditor claims four (4) years after the date of the transfer of property to the trust.
         a. Four-year period starts anew for each separate transfer to the trust.
         b. If a transfer is set aside, costs and expenses including attorney's fees of the trustee in defense of the proceeding are chargeable first out of the transferred property.
            (1) This dilutes the potential recovery of the creditor.
      2. Creditor would need to prove that the trust was created and funded with actual intent to hinder, delay or defraud a creditor.
   F. Transfer to trust can still be avoided within ten (10) years from filing of bankruptcy petition under Bankruptcy Code § 548(e).
      1. Standard is that the debtor made the transfer with actual intent to hinder, delay or defraud a creditor.
   G. Creditors can also attack the trust as defective, meaning it fails to meet all of the technical requirements for the statute.

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WEST VIRGINIA LEGISLATURE

2016 REGULAR SESSION

Enrolled

Committee Substitute

for

Senate Bill 493

BY SENATOR TRUMP, *original sponsor*

[Passed March 10, 2016; in effect 90 days from passage]

AN ACT to amend the Code of West Virginia, 1931, as amended, by adding thereto three new sections, designated §44D-5-503a, §44D-5-503b and §44D-5-503c; and to amend and reenact §44D-5-505 of said code, all relating to allowing the creation of self-settled spendthrift trusts; permitting a grantor to transfer assets into a qualified self-settled spendthrift trust and retain an interest in that trust; excluding applicability of certain provisions of code to that qualified interest; clarifying applicability of self-settled spendthrift trust provisions when certain interests are not qualified interests; prohibiting inference of intent to delay, hinder or defraud creditors solely based on grantor's establishment of or transfer to a self-settled spendthrift trust; permitting transfer to trust to be set aside under certain circumstances; providing for the payment of expenses associated with defending the trust to be paid from transfer; permitting creditors to bring actions against transfer of trust assets within four years after date of grantor's transfer; limiting creditor rights to grantor's transfer; prohibiting credit claims or causes of action against certain other persons or entities; providing applicability of provisions governing creditor's actions to avoid transfers to situations involving multiple transfers; setting statute of limitations for self-settled spendthrift trust moved to this state for four years from date assets moved to the state; defining terms; providing for filling of vacancies in office of qualified trustee or independent qualified trustee; permitting certain terms to be included in self-settled spendthrift trust without deeming trust irrevocable; requiring treatment of beneficiary with right to withdraw entire beneficial interest be treated as grantor once right to withdraw has lapsed, been released or otherwise expired; and exempting self-settled spendthrift trusts from being subject to claims of the grantor's creditors.

Be it enacted by the Legislature of West Virginia:

That the Code of West Virginia, 1931, as amended, be amended by adding thereto three new sections, designated §44D-5-503a, §44D-5-503b and §44D-5-503c; and that §44D-5-505 of said code be amended and reenacted, all to read as follows:

ARTICLE 5. CREDITOR'S CLAIMS; SPENDTHRIFT AND DISCRETIONARY TRUSTS.

§44D-5-503a. Self-settled spendthrift trusts.

(a) A grantor may transfer assets to a qualified self-settled spendthrift trust and retain in that trust a qualified interest, and, except as otherwise provided in this article, the provisions of section five hundred five of this article do not apply to such qualified interest.

(b)The provisions of section five hundred five of this article shall continue to apply with respect to any interest held by a grantor in a qualified self-settled spendthrift trust, other than a qualified interest.

(c) A grantor's transfer to a qualified self-settled spendthrift trust shall not, to the extent of the grantor's qualified interest, be deemed to have been made with intent to delay, hinder or defraud creditors, for purposes of article one-a, chapter forty of this code, merely because it is made to a trust with respect to which the grantor retains a qualified interest and merely because it is made without consideration. A grantor's transfer to a qualified self-settled spendthrift trust may, however, be set aside under article one-a, chapter forty of this code or if the qualified affidavit contains a material misstatement of fact: *Provided,* That any transfer made to a qualified self-settled spendthrift trust which may be set aside under article one-a, chapter forty of this code shall be chargeable first with the entire costs and expenses, including attorney's fees, properly incurred by the trustee in the defense of the action or proceeding to set aside the transfer.

(d) A grantor's creditor may bring an action under article one-a, chapter forty of this code to avoid a transfer to a qualified self-settled spendthrift trust or otherwise to enforce a claim that existed on the date of the grantor's transfer to such trust within four years after the date of the grantor's transfer to such trust to which such claim relates.

(e) A creditor shall have only such rights with respect to a grantor's transfer to a qualified self-settled spendthrift trust as are provided in this section. No creditor and no other person has any claim or cause of action against any trustee, trust adviser, trust director or any person involved in the counseling, drafting, preparation or execution of, or transfers to, a qualified self-settled spendthrift trust.

(f) If a grantor makes more than one transfer to the same qualified self-settled spendthrift trust, the following rules apply:

(1) The grantor's making of a subsequent transfer shall be disregarded in determining a creditor's claim with respect to whether a prior transfer is valid under this section;

(2) With respect to each subsequent transfer by the grantor, the four-year limitations period provided in subsection (d) of this section, with respect to actions brought under article one-a of chapter forty of this code with respect to the subsequent transfer, commences on the date of such subsequent transfer; and

(3) Any distribution to a beneficiary is deemed to have been made from the latest such transfer.

(g) The movement to this state of the administration of an existing trust, which, after such movement to the state, meets for the first time all of the requirements of a qualified self-settled spendthrift trust, shall be treated, for purposes of this section, as a transfer to this trust by the grantor on the date of such movement of all of the assets previously transferred to the trust by the grantor.

§44D-5-503b. Definitions.

As used in this article, unless the context requires a different meaning:

(a) "Qualified trustee" means any person who is a natural person residing within the state or a legal entity authorized to engage in trust business within the state and who maintains or arranges for custody within the state of some or all of the property that has been transferred to the trust by the grantor, maintains records within the state for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation within the state of fiduciary income tax returns for the trust or otherwise materially participates within the state in the administration of the trust. A trustee is not a qualified trustee if such trustee's authority to make distributions of income or principal or both are subject to the direction of someone who, were that person a trustee of the trust, would not meet the requirements to be a qualified trustee.

(b) "Independent qualified trustee" means a qualified trustee who is not, and whose actions are not, subject to direction by:

(1) The grantor;

(2) Any natural person who is not a resident of the state;

(3) Any entity that is not authorized to engage in trust business within the state;

(4) The grantor's spouse;

(5) A parent of the grantor;

(6) Any descendant of the grantor; or

(7) A sibling of the grantor.

(c) "Qualified interest" means a grantor's interest in a qualified self-settled spendthrift trust, to the extent that such interest entitles the grantor to receive distributions of income, principal or both in the sole discretion of a qualified trustee. A grantor may have a qualified interest in a qualified self-settled spendthrift trust and also have an interest in the same trust that is not a qualified interest, and the rules of section five hundred five of this article shall apply to each interest of the grantor in the same trust other than the grantor's qualified interest.

(d) "Qualified self-settled spendthrift trust" means a trust if:

(1) The trust is irrevocable;

(2) The trust is created during the grantor's lifetime;

(3) There is, at all times when distributions could be made to the grantor pursuant to the grantor's qualified interest, at least one beneficiary other than the grantor: (i) To whom income may be distributed if the grantor's qualified interest relates to trust income; (ii) to whom principal may be distributed if the grantor's qualified interest relates to trust principal; or (iii) to whom both income and principal may be distributed if the grantor's qualified interest relates to both trust income and principal;

(4) The trust has at all times at least one qualified trustee who may be, but need not be,

an independent qualified trustee;

(5) The trust instrument expressly incorporates the laws of this state to govern the validity, construction and administration of the trust;

(6) The trust instrument includes a spendthrift provision, as defined in section five hundred two of this article, that restrains both voluntary and involuntary transfer of the grantor's qualified interest;

(7) The grantor does not have the right to disapprove distributions from the trust; and

(8) The grantor duly executes a qualified affidavit before or substantially contemporaneously with the making of the transfer of the asset or assets into the trust.

(e) "Qualified affidavit" means a duly executed affidavit of the grantor which contains under oath all of the following statements, or statements substantially to the effect:

(1) The property being transferred to the trust was not derived from unlawful activities;

(2) The grantor has full right, title and authority to transfer the property to the trust;

(3) The grantor will not be rendered insolvent immediately after the transfer of the property to the trust;

(4) The grantor does not intend to defraud any creditor by transferring the property to the trust;

(5) There are no pending or threatened court actions against the grantor except for any court action expressly identified in the affidavit or an attachment to the affidavit;

(6) The grantor is not involved in any administrative proceeding except for any proceeding expressly identified in the affidavit or an attachment to the affidavit;

(7) The grantor is not 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 incident to a judicial proceeding with respect to a divorce or annulment in favor of such transferor's spouse or former spouse, except for any such indebtedness expressly identified in the affidavit or an attachment to the affidavit; and

(8) The grantor does not contemplate at the time of the transfer the filing for relief under the Bankruptcy Code of the United States.

An affidavit is defective and is not a qualified affidavit if it materially fails to meet the requirements set forth in this subsection. An affidavit is not considered defective and is a qualified affidavit if it contains any nonsubstantive variances from the language set forth in this subsection, it contains statements or representations in addition to those required in this subsection which do not materially contradict the required statements or representations or there are any technical errors in the form, substance or method of preparation or execution of the affidavit if those errors were not the fault of the affiant and the affiant reasonably relied upon another person to prepare or notarize the affidavit.

§44D-5-503c. Vacancies; revocability of trust; right to withdraw.

(a) A vacancy in the position of qualified trustee that occurs for any reason, whether or not there is then serving another trustee, shall be filled in the following order of priority:

(1) By a person eligible to be a qualified trustee and who is designated pursuant to the terms of the trust instrument to act as successor trustee;

(2) By a person eligible to be a qualified trustee and who is designated by unanimous agreement of the qualified beneficiaries; or

(3) By a person eligible to be a qualified trustee and who is appointed by the court pursuant to any of the provisions of article seven of this chapter.

(b) A vacancy in the position of independent qualified trustee that occurs for any reason, whether or not there is then serving another trustee, shall be filled in the following order of priority:

(1) By a person eligible to be an independent qualified trustee and who is designated pursuant to the terms of the trust instrument to act as successor trustee; or

(2) By a person eligible to be an independent qualified trustee and who is designated by unanimous agreement of the qualified beneficiaries; or

(3) By a person eligible to be an independent qualified trustee and who is appointed by

the court pursuant to any of the provisions of article seven of this chapter.

(c) A trust instrument shall not be deemed revocable on account of the inclusion of any one or more of the following rights, powers, and interests:

(1) A power of appointment, exercisable by the grantor by will or other written instrument effective only upon the grantor's death, other than a power to appoint to the grantor's estate or the creditors of the grantor's estate;

(2) The grantor's qualified interest in the trust;

(3) The grantor's right to receive income or principal pursuant to an ascertainable standard;

(4) The grantor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust (each within the meaning of Section 664(d) of the Internal Revenue Code) and the grantor's right, at any time, and from time to time, to release, in writing delivered to the qualified trustee, all or any part of the grantor's retained interest in such trust;

(5) The grantor's receipt each year of a percentage, not to exceed five percent, 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;

(6) The grantor's right to remove a qualified trustee or independent qualified trustee and to appoint a new trustee who meets the same criteria;

(7) The grantor's potential or actual use of real property held under a personal residence trust (within the meaning of Section 2702(c) of the Internal Revenue Code);

(8) The grantor's potential or actual receipt or use of a qualified annuity interest (within the meaning of Section 2702 of the Internal Revenue Code);

(9) The ability of a qualified trustee, whether pursuant to discretion or direction, to pay, after the grantor's death, all or any part of the grantor's debts outstanding at the time of the grantor's death, the expenses of administering the grantor's estate, or any federal or state estate,

inheritance, or death tax imposed on or with respect to the grantor's estate; and

(10) A grantor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on trust income, or the direct payment of such taxes to the applicable tax authorities, pursuant to a provision in the trust instrument that expressly provides for the direct payment of such taxes or the reimbursement of the grantor for such tax payments.

(d) A beneficiary who has the right to withdraw his or her entire beneficial interest in a trust shall be treated as its grantor to the extent of such withdrawal right, when such right to withdraw has lapsed, been released, or otherwise expired, without regard to the limitations otherwise imposed by subsection (b), section five hundred five of this article.

§44D-5-505. Creditor's claim against grantor.

(a) Whether or not the terms of a trust instrument contain a spendthrift provision, the following rules apply:

(1) During the lifetime of the grantor, the property of a revocable trust is subject to claims of the grantor's creditors, except to the extent otherwise provided in sections five hundred three-a, five hundred three-b and five hundred three-c of this article.

(2) During the lifetime of the grantor, with respect to an irrevocable trust, a creditor or assignee of the grantor may reach the maximum amount that can be distributed to or for the grantor's benefit. If a trust has more than one grantor, the amount the creditor or assignee of a particular grantor may reach may not exceed the grantor's interest in the portion of the trust attributable to that grantor's contribution.

(3) After the death of a grantor, and subject to the grantor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the grantor's death is subject to claims of the creditors of the deceased grantor, to the extent the grantor's probate estate is inadequate to satisfy them, and with such claims payable in order of priority of the following classes:

(A) The costs and expenses of administration of the grantor's estate;

(B) Reasonable funeral expenses;

(C) Debts and taxes with preference under federal law;

(D) Unpaid child support which is due and owing at the time of the decedent's death;

(E) Debts and taxes with preference under other laws of the State of West Virginia;

(F) Reasonable and necessary medical and hospital expenses of the last illness of the decedent, including compensation for persons attending the decedent during his or her last illness; and

(G) All other claims.

(b) For purposes of this section:

(1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the grantor 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 grantor 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 specified in Section 2041(b)(2), Section 2503(b) or Section 2514(e) of the Internal Revenue Code.

COMPARISON OF DOMESTIC ASSET PROTECTION STATUTES

SUBJECT	VIRGINIA	WEST VIRGINIA
1. What requirements must trust meet to come within protection of statute?	(1) The trust is irrevocable; (2) There must be, at all times when distributions could be made to the settlor pursuant to the settlor's qualified interest, at least one beneficiary other than the settlor; (3) The trust must have at all times at least one qualified trustee, who may be, but need not be, an independent qualified trustee; (4) The trust instrument must expressly incorporate the laws of the Commonwealth to govern the validity, construction, and administration of the trust; (5) The trust instrument must include a spendthrift provision. Va. Code § 64.2-745.2.	(1) The trust is irrevocable; (2) The trust is created during the grantor's lifetime; (3) The trust instrument expressly incorporates the laws of WV; (4) The trust instrument includes a spendthrift provision; (5) The grantor does not have the right to disapprove distributions from the trust; (6) The grantor executes a "qualified affidavit", essentially certifying that the transfer of property to the trust will not make the grantor insolvent and the transfer is not defrauding any creditor; and (7) There is, at all times when distributions could be made to the grantor at least one beneficiary other than the grantor who can receive income, principal, or both income and principal.
2. May a revocable trust be used for asset protection?	No. Va. Code §§ 64.2-745.2(A) and 64.2-747(A)(l).	No.
3. Has the state legislature consistently supported DAPTs and related estate planning by continued amendments?	This statute is the first enactment for broad approval of self-settled spendthrift trusts.	2016 statute is the first enactment for broad approval of self-settled spendthrift trusts.

SUBJECT	VIRGINIA	WEST VIRGINIA
4. What contacts with state are suggested or required to establish situs?	Required: The VA qualified trustee must (1) maintain or arrange for custody within the Commonwealth of some or all of the properly that has been transferred to the trust by the settlor, (2) maintain records within the Commonwealth for the trust on an exclusive or non-exclusive basis, (3) prepare or arrange for the preparation within the Commonwealth of fiduciary income tax returns for the trust, or (4) otherwise materially participate within the Commonwealth in the administration of the trust. Va. Code § 64.2-745.2(A).	WV qualified trustee must be (1) a natural person who is a resident of WV or an entity that can engage in trust business in WV and (2) must maintain custody within WV of property in the trust, maintain records in WV, prepare fiduciary income tax returns in WV, or materially participate in administration in WV.
5. What interests in principal and income may settlor retain?	Settlor may retain any interests in: (1) CRT; (2) up to 5% interest in total-return trust; (3) QPRT; (4) GRAT; (5) ability to have debts, expenses and taxes of the settlor's estate paid from the trust; and (6) ability to be reimbursed for income taxes attributable to trust. Va. Code §§ 64.2-745.2(A) and 64.2-745.2(0).	In addition to the grantor's qualified interest in the trust, grantor may retain: (1) the right to receive income or principal pursuant to an ascertainable standard; (2) interest in CRUT or CRAT; (3) up to 5% interest in total-return trust; (4) interest in QPRT; (5) a qualified annuity interest under IRC § 2702; (6) ability to have debts, expenses, and taxes of the grantor's estate paid from the trust; and (7) ability to be reimbursed for income taxes attributable to trust.

SUBJECT	VIRGINIA	WEST VIRGINIA
6. What is the trustee's distribution authority?	Absolute discretion. Va. Code § 64.2-745.2(A).	Sole discretion.
7. What powers may settlor retain?	Settlor may retain: (1) A testamentary special power of appointment; (2) A right to remove a trustee and to appoint a new trustee. Note: The settlor may NOT have the right to disapprove distributions from the trust. Va. Code § 64.2-745.2(A), (D).	Settlor may retain: (1) A testamentary special power of appointment, exercisable by will or lifetime instrument; and (2) A right to remove a trustee and to appoint a new trustee. Note: The settlor may NOT have the right to disapprove distributions from the trust.
8. Who must serve as trustee to come within protection of statute?	There must always be at least one "qualified trustee," who must be a natural person residing within the Commonwealth or a legal entity authorized to engage in trust business within the Commonwealth. Va. Code § 64.2-745.2(A).	There must always be at least one "qualified trustee," who must be a natural person residing in WV or a legal entity authorized to engage in trust business in WV.
9. May non-qualified trustees serve?	Yes. See Va. Code § 64.2-745.2(A) (using nonexclusive terminology for the requirement of a qualified trustee).	Yes, but the trust must also have at all times at least one other "qualified trustee".

SUBJECT	VIRGINIA	WEST VIRGINIA
10. May trust have distribution advisor, investment advisor, or trust protector?	Not addressed expressly, but it does state that the discretion of a qualified trustee cannot be subject to the direction of someone who, were that person a trustee, could not be a qualified trustee, and protects trust advisers and trust directors from liability. Va. Code § 64.2-745.2(A).	Not addressed expressly, but the discretion of a qualified trustee cannot be subject to the direction of someone who, were that person a trustee, could not be a qualified trustee. The statute protects trust adviser, trust director, or any person involved in the counseling, drafting, preparation or execution of, or transfers to, the trust.
11. Are fraudulent transfers excepted from coverage?	Yes. Va. Code § 64.2-745.1(0).	Yes.
12. Fraudulent transfer action: burden of proof and statute of limitations	Clear and convincing evidence. *Bruce v. Dean*, 140 S.E. 277, 149 Va. 39 (1927); *Mills V. Miller Harness Co., Inc.*, 326 S.E.2d 665, 229 Va. 155 (1985); *In re Coleman*, 285 B.R. 892 (2002). Suit must be brought within five years from recordation of transfer or, if not recorded, within five years from the time the same was or should have been discovered. Va. Code § 64.2-745.1(D).	Clear and convincing evidence. *Board of Trustees v. Blair*, 45 W. Va. 812 (1899)("strictly and clearly proved"); *Kesling v. Mick*, 103 W. Va. 485, 138 S.E. 386 (1927). Suit must be brought within four (4) years after the date of the transfer to the trust.

SUBJECT	VIRGINIA	WEST VIRGINIA
13. Does statute provide an exception (no asset protection) for a child support claim?	Yes. Va. Code § 64.2-744(A) protecting rights of a beneficiary’s child who has a judgment or court order against the beneficiary for support or maintenance).	Yes. The spendthrift provision is unenforceable against a beneficiary’s child who has a judgment or court order against the beneficiary for child support. Also, grantor’s “qualified affidavit” must identify any agreement or order of court for support in favor of the transferor’s children.
14. Does statute provide an exception (no asset protection) for alimony?	No.	No, but grantor’s “qualified affidavit” must identify any agreement or order of court for support or alimony in favor of the transferor’s spouse or former spouse.
15. Does statute provide an exception (no asset protection) for property division upon divorce?	No.	No, but grantor’s “qualified affidavit” must identify any agreement or order of court for a division or distribution of property incident to a judicial proceeding with respect to a divorce or annulment in favor of the transferor’s spouse or former spouse.
16. Does statute provide an exception (no asset protection) for tort claims?	No.	No.

SUBJECT	VIRGINIA	WEST VIRGINIA
17. Does statute provide other exceptions (no asset protection)?	Yes. No spendthrift protection against: (A) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust. Va. Code § 64.2-744(B). (B) the United States, the Commonwealth, any city, county, or town. Va. Code § 64.2-744(C). (C) claims under a statute or regulation of the United States or the Commonwealth that requires a beneficiary to reimburse the Commonwealth or any agency or instrumentality thereof, for public assistance. Va. Code § 64.2-745(A).	Yes. The spendthrift provision is unenforceable against (1) judgment creditor who has provided services for the protection of a beneficiary's interest in the trust; (2) claim of State of WV to the extent a statute so provides; and (3) claim of the United States to the extent federal law so provides.
18. Does statute prohibit any claim for forced heirship, legitime or elective share?	No.	No. Forced heirship or legitime does not exist under WV law. Spousal elective share may apply against the self-settled spendthrift trust, depending on how established.

SUBJECT	VIRGINIA	WEST VIRGINIA
19. Are there provisions for moving trust to state and making it subject to statute?	Yes. Va. Code § 64.2-745.1(G) states that "The movement to the Commonwealth of the administration of an existing trust, which, after such movement to the Commonwealth, meets for the first time all of the requirements of a qualified self-settled spendthrift trust, shall be treated, for purposes of this section, as a transfer to this trust by the settlor on the date of such movement of all of the assets previously transferred to the trust by the grantor."	Yes. The movement to WV of the administration of an existing trust, which, after such movement to the state, meets for the first time all of the requirements of a qualified self-settled spendthrift trust, shall be treated as a transfer to this trust by the grantor on the date of such movement of all of the assets previously transferred to the trust by the grantor.
20. Does statute provide that spendthrift clause is transfer restriction described in Section 541(c)(2) of Bankruptcy Code?	No.	No.
21. Does statute provide that trustee automatically ceases to act if court has jurisdiction and determines that law of trust does not apply?	No.	No.
22. Does statute provide that express/implied understandings regarding distributions to settlor are invalid?	No.	No.

SUBJECT	VIRGINIA	WEST VIRGINIA
23. Does statute provide protection for attorneys, trustees, and others involved in creation and administration of trust?	Yes. Va. Code § 64.2-745.1(E).	Yes. The statute protects trust adviser, trust director, or any person involved in the counseling, drafting, preparation or execution of, or transfers to, the trust.
24. Does statute authorize a beneficiary to use or occupy real property or tangible personal property owned by trust, if in accordance with trustee's discretion?	No.	Not specifically addressed, but the trust instrument shall not be deemed to be revocable on account of the inclusion of a provision allowing the grantor's potential or actual use of real property held under a personal residence trust (within the meaning of Section 2702(c) of the Internal Revenue Code).
25. May a trustee pay income or principal directly to a third party, for the benefit of a beneficiary, even if the beneficiary has an outstanding creditor?	No.	Yes because not expressly prohibited in statute.
26. Is a non-settlor beneficiary's interest protected from property division at divorce?	Yes. Va. Code §§ 64.2-743 - 64.2-744.	Yes; if settlor's assets are transferred into trust, the non-settlor beneficiary's interest in the trust should be treated as separate property of the non-settlor beneficiary.

SUBJECT	VIRGINIA	WEST VIRGINIA
27. Are due diligence procedures required by statute?	No.	Yes. The grantor must execute a “qualified affidavit”, essentially certifying that the transfer of property to the trust will not make the grantor insolvent and the transfer is not defrauding any creditor.
28. Is the trustee given a lien against trust assets for costs and fees incurred to defend the trust?	No.	Partially. Any transfer made to the qualified self-settled spendthrift trust which may be set aside as a fraudulent conveyance shall be chargeable first with the entire costs and expenses, including attorney’s fees, properly incurred by the trustee in the defense of the action or proceeding to set aside the transfer.
29. Is there statutory authority supporting a trust’s non-contestability clause even if probable cause exists for contest?	No.	No.
30. Is the trustee given “decanting” authority to modify the trust?	Yes. See Va. Code § 64.2-778.1 (effective July 1, 2012).	There is no statutory authority to decant. It is unclear whether trustee may have common-law authority to decant if the trust instrument contains appropriate language.

SUBJECT	VIRGINIA	WEST VIRGINIA
31. What is the allowable duration of trusts?	USRAP adopted. Va. Code §§55-12.1 to 55-12.6. Rule does not apply to personal property held in trust if the trust instrument, by its terms, provides that the rule shall not apply to such trust. Va. Code § 55-13.3(0).	USRAP adopted.
32. Does state assert income tax against DAPTs formed by non-resident settlors?	Yes. See VA Code § 58.1-302.	Yes.
33. Have state limited partnership and LLC statutes been amended to provide maximum creditor protection?	Yes. On LLC, see Va. Code § 13.1-1041.1(D). On Limited Partnership, see Va. Code § 50-73.46.1(D).	Yes. For LP, court may charge the debtor’s partnership interest with the judgment but judgment creditor only has the rights of an assignee which include the entitlement only to the debtor partner’s distribution. W. Va. Code § 47-9-41. For an LLC, charging order only constitutes a lien on the debtor’s distributional interest. W. Va. Code § 31B-5-504.

SUBJECT	VIRGINIA	WEST VIRGINIA
34. What is the procedure and time period for a trustee to provide an accounting and be discharged from liability?	Rules similar to Sections 411 to 414 of the Uniform Trust Code for termination of trust. See Va. Code §§ 64.2-729 to 64.2-733. No specific procedure for being discharged from liability on a trust.	Statute of limitations is one (1) year if the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and was informed of the time allowed for commencing a proceeding. W. Va. Code § 44D-10-1005(a). Otherwise, statute of limitations is five (5) years after the first to occur of (1) The removal, resignation or death of the trustee; (2) The termination of the beneficiary’s interest in the trust; (3) The termination of the trust; or (4) The time when the beneficiary knew or should have known of the breach of trust. W. Va. Code § 44D-10-1005(b).

Prepared: April 19, 2016

2016 FINANCIAL AND ESTATE PLANNING SEMINAR
May 19, 2016
Edgewood Country Club

"The Use of Qualified Affidavits as Required by the New West Virginia Self-Settled Asset Protection Trust Legislation"

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"The Use of Qualified Affidavits as Required by New West Virginia Self-Settled Asset Protection Trust Legislation"

Introduction

Taking a cue from our neighboring state of Ohio[1], as part of the legislation adopting West Virginia's new self-settled asset protection trust legislation[2] the requirement for a "qualified affidavit" from the grantor of a WV DAPT was included in the legislation.

The rest of this paper will examine the impact of this statutory requirement for an enforceable WV DAPT and suggestions for practitioners drafting WV DAPTs as how to comply with this part of the new legislation.

The qualified affidavit provisions under our new law are intended partly as due diligence requirements for practitioners advising clients on the WV DAPT which mandates the use of such an affidavit as a statutory requirement before or substantially contemporaneous with the funding of a DAPT trust[3]. A "material misstatement" in a qualified affidavit is cause for a creditor to set aside a transfer or transfers to a WV DAPT.[4]

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[1] Ohio is not the only DAPT state that requires the use of affidavits; Alaska, Mississippi, Ohio, Tennessee, Utah and Wyoming as well as West Virginia require some form of affidavit, though not necessarily identical to the West Virginia "qualified affidavit" provisions discussed in this paper. Shaftel, "ACTEC Comparison of the Domestic Asset Protection Trust Statutes", (updated through September 2015)(http://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf) (hereafter "ACTEC Survey").

[2] West Virginia Code §§44D-5-503a-503c and 44D-5-505 (hereafter "WV DAPT").

[3] W.Va. Code Ann. §44D-5-503b(d)(8).

[4] W.Va. Code Ann. §44D-5-503a(c). Anecdotally, this sentence was added to the legislation by the West Virginia Senate Judiciary Committee during the review and discussions of this bill during a Committee hearing on the bill.

Qualified Affidavit

The West Virginia Uniform Fraudulent Transfers Act is set forth at §40-1A-1 *et. seq.,* of the West Virginia Code.[5] Among its provisions is W.Va. Code Ann. §40-1A-4(a)(1), which states that "A transfer made or obligation incurred by a debtor is fraudulent as to a creditor…if the debtor made the transfer or incurred the obligation with actual intent to hinder, delay or defraud any creditor of the debtor…."

W.Va. Code Ann. §44D-5-503a(c) states that "A grantor's transfer to a qualified self-settled spendthrift trust shall not…be deemed to have been made with intent to delay, hinder or defraud creditors, for purposes of [WV UFTA]…merely because it is made to a trust with respect to which the grantor retained a qualified interest and merely because it is made without consideration."

A "qualified self-settled spendthrift trust" is defined at W.Va. Code Ann. §44D-5-503b(d)("QSSST"). The eight requirements, all of which must be met, to have a QSSST in West Virginia are—

- The trust must be irrevocable;
- The trust must be created during the grantor's lifetime:
- There must be, at all times when distributions could be made to the grantor pursuant to the grantor's qualified interest, at least one beneficiary other than the grantor (i) to whom income may be distributed if the grantor's qualified interest relates to trust income; (ii) to whom principal may be distributed if the grantor's qualified interest relates to trust principal; or (iii) to whom both may be distributed if the grantor's qualified interest relates to both trust income and principal;

[5] Hereafter the WV UFTA.

- The trust has at all times at least one qualified trustee who may be, but need not be, an independent qualified trustee;
- The trust instrument expressly incorporates the laws of West Virginia to govern the validity, construction and administration of the trust;
- The trust instrument contains a spendthrift provision as defined in W.Va. Code Ann. §44D-5-502, that restrains both voluntary and involuntary transfer of the grantor's qualified interest;
- The grantor does not have the right to disapprove distributions from the trust; and
- The grantor duly executes a qualified affidavit before or substantially contemporaneously with the making of the transfer of the asset or assets into the trust.[6]

The term "qualified affidavit" is then defined in W.Va. Code Ann. §44D-5-503b(e). The eight required statements (or substantially similar statements) required under the statute are—

- The property being transferred to the trust was not derived from unlawful activities;
- The grantor has full right, title and authority to transfer the property to the trust;
- The grantor will not be rendered insolvent immediately after the transfer of the property to the trust;
- The grantor does not intend to defraud any creditor by transferring the property to the trust;
- There are no pending or threatened court actions against the grantor except for any court action expressly identified in the affidavit or an attachment to the affidavit;
- The grantor is not involved in any administrative proceeding except for any proceeding expressly identified in the affidavit or attachment to the affidavit;

[6] W.Va. Code Ann. §44D-5-503b(d).

- The grantor is not 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 incident to a judicial proceeding with respect to a divorce or annulment in favor of such transferor's spouse or former spouse, except for any such indebtedness expressly identified in the affidavit or attachment to the affidavit; and
- The grantor does not contemplate at the time of the transfer the filing for relief under the Bankruptcy Code of the United States.[7]

The statute continues that an affidavit will be considered defective if it "materially fails to meet the requirements set forth in this subsection." An affidavit is not defective and is a qualified affidavit if it "contains any nonsubstantive variance(s) from the language set forth in the subsection, it contains statements or representations in addition to those required in this subsection which do not materially contradict the required statements or representations or there are any technical errors in the form, substance or method of preparation or execution of the affidavit if those errors were not the fault of the affiant and the affiant reasonably relied upon another person to prepare or notarize the affidavit."[8]

In-Depth Examination of Each Qualified Affidavit Requirement

Background

It is recommended that the practitioner counseling clients who may ultimately enter into a WV DAPT undertake due diligence, most (or all) of which will be mandated by the requirements of a qualified affidavit. Several cases in other jurisdictions illustrate the perils that exist to estate planning attorneys counseling clients about asset protection planning[9]. The particular facts and

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[7] W.Va. Code Ann. §44D-5-503b(e).

[8] *Id*, last paragraph.

[9] *See e.g.,* Goldberg v. Rosen, 439 Red. Appx. 11(11th Circ. Fla. 2012); Joel v. Weber, 602 N.Y.S.2d 383, 396-397 (App.Div. 1993); 8699 Biscayne, LLC v. Indigo Real Estate LLC, 2010 Bankr. Lexis 105 (2010).

circumstances are critical on these cases, and clients who engage or wish to engage in this planning should not do so without engaging in due diligence and background checks about their client. The qualified affidavit requirement in the WV DAPT was intended by the Probate Committee of the West Virginia State Bar as a mandatory exercise in due diligence by a practitioner in that meeting the requirements to constitute a qualified affidavit will require the collection of background financial information about the client and gathering information about any potential or threatened (or existing) claims from his or her creditors.

The Probate Committee looked at the requirements of Ohio law as part of the Ohio Legacy Trust Act[10] on the necessity of a "Qualified Affidavit" from a grantor to qualify as a DAPT in Ohio[11]. The Committee decided to include a qualified affidavit as a requirement for a WV DAPT. While borrowing heavily from that section, the Probate Committee added some of its own language and requirements.[12]

Statutory Requirements

1. *"The property being transferred to the trust was not derived from unlawful activities."*

> **Practitioners**—As part of the qualified affidavit this precise statement should be included. But what other steps should a practitioner do to insure the accuracy of the statement? While the author is not suggesting that the estate planning lawyer is the insurer of the accuracy of the qualified affidavit of a client certain due diligence, accompanied by backup in the estate planners, files, is recommended. It should go without saying that the estate planning lawher should not engage in

[10] Ohio Revised Code ("ORC") Chapter 5816.

[11] ORC §5816.06.

[12] The requirement of a "qualified affidavit", the author would like to note, was an important consideration for passage of this legislation in West Virginia based on the comments made during hearings in both the Senate and House Judiciary Committees.

this exercise if they know all or part of a client's qualified affidavit is false. But what level of due diligence should be undertaken? The author recommends that some due diligence is prudent. How much is a function of the relationship of that client to the lawyer and the knowledge that lawyer possesses of the client's financial and family circumstances. For a brand new client who presents herself to the estate planning lawyer for this trust—probably more due diligence and file building should be undertaken. Must the lawyer do a background check? Unlikely, but once again perhaps a simple Google search or the like should be considered.

On this specific representation as part of the qualified affidavit, familiarity of the lawyer with the client is important. The more familiar likely the less background checking you would need to undertake; and the converse is true.

Ask yourself this—down the road if you were representing the creditor of a grantor of a QSSST, how would you attack the trust to get to the assets? Probably the first thing you would do is take apart the qualified affidavit. Any criminal conviction, even if relatively minor, would provide an opening for you to go after the veracity of the qualified affidavit. So as the draftsperson of a QSSST and of a qualified affidavit, some due diligence seems warranted and is recommended. This requirement should not result in the necessity of much of such checking, but some in certain circumstances is prudent.

2. "*The grantor has full right, title and authority to transfer the property to the trust.*"

Practitioners—Consider preparing a statement of all these requirements for your client to complete and sign for you to keep in your file prior to presenting to the client the qualified affidavit to sign. Attached to that client statement would be the backup for all these 8 provisions and requirements. Again—the statute requires that the client make a statement under oath as to all these requirements—

it seems best practices may require that the practitioner, before undertaking this planning for the client, obtain background information that evidences the client's compliance with the statements sworn to under oath, for the benefit of the client—and the practitioner. And this "due diligence" should comprise the practitioner's file for the benefit of everyone.

3. "*The grantor will be rendered insolvent immediately after the transfer of the property to the trust.*"

<u>Practitioners</u>—Here is where the rubber hits the road. The concept of "insolvency" is critical to this process. Is your client insolvent? How do you know? What evidence of solvency is necessary? What definition of solvency satisfies the statutory requirements?

While there is no definition of insolvency in the Uniform Trust Code provision's (which contain the WV DAPT provisions), in W.Va. Code Ann. §40-1A-2, part of the WV UFTA, Notably, that section states—

> "(a) A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation.
> (b) A debtor who is generally not paying his (or her) debts as they become due is presumed to be insolvent….
> (d) Assets under this section do not include property that has been transferred, concealed or removed with intent to hinder, delay or defraud creditors or that has been transferred in a manner making the transfer voidable under this article.
> (e) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset."

A solvency analysis should be undertaken by the practitioner engaging in this planning with a client. For now utilizing the definition in the WV UFTA of insolvency would be a guide in this process.

Consider involving the client's accountant or financial planner to assist in this analysis. This analysis will protect the client; the practitioner and will also provide insight into how much your client can place into the WV DAPT. While there are no mathematical guidelines, treating this planning as "nest egg planning" may mean that the WV DAPT should contain and be funded with up to no more than one-quarter of the client's net worth.[13] That is a rough guideline; not a rule.

The financial statement should be prepared at a "fair valuation"—does that mean fair market valuation? Probably. Should contingent debts or guarantees be considered? To be prudent yes, and disclosed. Consider a separate Affidavit of Insolvency to have completed, signed and included in your files.[14] Consider having the mathematical solvency analysis completed and in your file—perhaps the accountant or financial planner can assist with this exercise.

Some type of Questionnaire for the client to complete, perhaps coupled with an Affidavit of Insolvency, is recommended. The Questionnaire should collect information such as any lawsuits in which client is named as a party (a requirement discussed below), representations on tax filings and payments, disclosure of any administrative proceedings (tax, environmental, securities, etc.), threatened legal actions, contingent debts (loan guarantees or the like), business

[13] There is no rule, statutory or otherwise, as to what this percentage should be. We know that the transfer into the WV DAPT should not render the grantor insolvent. Each case will have to be evaluated on its own merits. The more unencumbered assets of the grantor (the larger the net worth) and the lower the debts (remember the grantor much be able to pay her debts as they become due) may allow for the client to safely put away more than 25% of their assets, though it is highly unlikely any client will do that. This author's experience with counseling clients on this type of planning is that once the client learns they lose most, if not total control, of the assets placed in a DAPT they quickly lose interest most of the time.

[14] A good resource for this type of planning and due diligence is Rothschild and Rubin, *"Asset Protection Planning,* BNA Tax Portfolio 810-3rd. Worksheet 21 in that publication contains a form Affidavit of Insolvency to consider.

activities, any criminal convictions, etc. This form should be backed up with recently filed tax returns and current financial statements signed by the client.

As to medical or legal professionals as clients, compliance with malpractice insurance requirements (or not) is important to pin down. What if a medical client has determined not to carry malpractice insurance (assume there is compliance with their ethical and licensing rules in that instance)? What level of due diligence and information and back up in your file is necessitated in that circumstance?

How much independent background checking should you undertake, and when is that necessary? These issues must be wrestled with and considered.

4. *"The grantor does not intend to defraud any creditor by transferring property to the trust."*

5. *"There are no pending or threatened court actions against the grantor except for any court action expressly identified in the affidavit or an attachment to the affidavit."*

6. "*The grantor is not involved in any administrative proceeding except for any proceeding expressly identified in the affidavit or an attachment to the affidavit."*

Practitioners—If you use a Questionnaire, you can obtain the representation from the client on these matters. As to court proceedings, should you verify the answer of your client? If a new client, you probably should to some extent. Even if not a new client consider doing some checking and verification is prudent. The statute does not say you can't engage in this planning if you are being sued, it just says you must disclose. As to what that means, then the solvency analysis is key to determine the level of potential liability that must be considered. Same with administrative proceedings—follow up on those and disclose them. Determine conservatively any exposure and take that into consideration in the solvency analysis also.

On the fourth requirement, that is purely subjective—unless you know something otherwise. You must then resolve that issue with the client. It is never wise to sit back quietly while a client executes a qualified affidavit if you know their affidavit may not be true….

7. *"The grantor is not 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 incident to a judicial proceeding with respect to a divorce or annulment in favor of such transferor's spouse or former spouse, except for any such indebtedness expressly identified in the affidavit or an attachment to the affidavit."*

Practitioners—This section does NOT appear in the Ohio qualified affidavit provisions. It was added during the hearing in the West Virginia Senate Judiciary Committee to insure these trusts are not used to skirt divorce or property settlement provisions, and especially child support obligations. These types of obligations, if they exist at the inception of a QSSST, must be disclosed because of this section.

Would a QSSST protect a grantor from any later-imposed liability for child support or alimony that was in fact not present at the inception of the funding of a QSSST? I would not bet that such a trust would not be breached by a West Virginia judge under those circumstances…..for example, a family court judge might determine that the transfer into the QSSST rendered the grantor insolvent. So this goes to consideration of how much of a grantor's net worth he or she can safely place in a QSSST and be comfortable it is out of the reach of creditors.

8. *"The grantor does not contemplate at the time of the transfer the filing for relief under the Bankruptcy Code of the United States."*

Possible Example

An example of what might constitute a qualified affidavit under WV DAPT statute is attached as **Exhibit A.**

EXHIBIT A

FOR YOUR CONSIDERATION AS FORM OF QUALIFIED AFFIDAVIT

[W.Va. Code §44D-5-503b(e)]

STATE of WEST VIRGINIA)

COUNTY of _____________)

Edward A. Doe, Jr., being first duly sworn, states as follows:

1. I am the transferor of the following property to the Edward A. Doe, Jr. 8/27/2016 Irrevocable Trust, Edward A. Doe, Sr., Trustee (the "trust"):
2.

[DESCRIBE PROPERTY]

[Editorial comment—Include valuation of assets also—all this backed up with info in your files]

3. The above-described property (the "property") was not derived in whole or in part from unlawful activities.
4. I have full right, title and authority to transfer the property to the trust.
5. I will not be rendered insolvent immediately after the transfer of the property to the trust.
6. I do not intend to defraud any creditor by transferring the property to the trust.
7. There are no pending or threatened court actions against me [except as set forth in Attachment___ hereto].
8. I am not involved in any administrative proceeding [except as set forth in Attachment__ hereto].
9. I am not indebted as a result of any agreement or court order for the payment of child support or alimony in favor of any spouse or former spouse or any children, or for any division of property incident to any judicial proceeding incident to any divorce or annulment from my present or any former spouse [except as set forth in Attachment ___ hereto].
10. I do not contemplate at the time of the transfer of the property to the trust the filing of relief

under the Bankruptcy Code.

IN WITNESS WHEREOF, I have set my hand this _____ day of _____________, 2016.

____

Edward A. Doe, Jr.

Sworn to and subscribed before me this ___ day of ____________, 2016 by Edward A. Doe, Jr..

____

Notary Public

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Financial and Estate Planning Seminar

May 19, 2016

Fiduciary Income Tax Issues

J. Marlin Witt, CPA, CFP®

Fiduciary Income tax issues

- An Estate Planner is someone who solves a problem you didn't know you had in a way you don't understand.

Tax Efficient Planning

- Estate planning focuses desires of individuals and plans for legacy
- Income tax is often secondary, especially when estate rates were significantly higher than income tax rates.
- Lower estate tax rates and higher exemptions have changed the planning landscape

Estate tax numbers

- 2016 Exemption - $5.45 million
- Estate tax rate 40%
- Step up in basis – reduces future income tax
- Income in Respect of a Decedent (IRD) – no step up
- Portability available for spouses - $10.9mm

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Income tax numbers

- Maximum Rate – 39.6%
  NII rate – 3.8%
  WV rate – 6.5% = 49.9%
- Capital gain rates 15-20%
- Deferral opportunities – qualified plans
- Exclusion opportunities – life insurance

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Trust and Estates rates

- Maximum income tax rate of 39.6% at $12,300
- Net Investment Income tax at $12,300
- Some tools available to manage taxable income at trust and estate level

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New planning environment

- Estate tax planning less prominent for smaller estates
- Loss of step up in basis may cost heirs money if no taxable estate
- Revisit estate plan in light of current estate exemption amounts and future income tax savings from step-up in basis

Fiduciary Income Tax Overview

- Estates and trusts are hybrid entities
- Can be a taxable entity
- Also pass-through entity
- Also can be a disregarded entity

Types of Trusts

- Charitable trusts
- Split Interest Trusts (CRTs)
- Grantor Trusts
- Simple Trusts
- Complex Trusts

Fiduciary tax core concepts

- Trust Accounting Income
- Distributable Net Income (DNI)
- Distribution Deduction
- Principal and Income

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Principal and Income overview

- Principal (Tree) – Corpus of the trust
  - Investments and capital gains/growth
- Income (Fruit) – produced by the Corpus
  - Interest, Dividends, Rents
- Determined under state law
- Trust instrument/Will

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TAI vs DNI

- Trust Accounting Income – Trust Net Income
  - Income minus expenses allocated to Income
  - Used by trustee to determine amount of income to pay to beneficiaries
- Distributable Net Income (DNI)
  - Federal tax concept
  - Generally taxable income other than gains
  - Less deductible expenses.

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"Recent" developments

- Trustees Fees – required to be bifurcated
  - Fiduciary fees vs investment management fees
  - Investment management fees subject to 2% limitation
- §1411 Net Investment Income tax
- §469 material participation by trustees
- DSUE reporting for portability
- New Basis reporting requirements for estate required to file Form 706

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Fiduciary Special rules

- §179 deduction – not available to trusts
  - Can depreciate the underlying assets – MACRS
- Charitable deduction – additional requirements discussed later
- Unique expenses related to trust are fully deductible – not subject to 2% limitation
  - Trustee fees
  - Legal and Accounting
  - State income and property taxes

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Fiduciary Special rules (Cont)

- Election to allocate estimated taxes to Benes in final year
  - Within 65 days of year end on 1041-T
- §663(b) Election – 65 Day rule
  - Payout up to lessor of remaining TAI or DNI within 65 days of year end.
- Specific bequests do not carry out DNI – no distribution deduction

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Fiduciary Special rules (Cont)

- Charitable deduction
  - Additional requirements
  - Paid from Gross Income
  - Paid pursuant to the governing instrument
  - Estates and pre-1969 trusts get deduction if "permanently set aside"

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Fiduciary Special rules (Cont)

- Separate Share Rule
  - Multiple Shares established for beneficiaries
  - One trust – one return
  - DNI is calculated for each share as if the share was a separate trust
- Estates don't have to make estimated tax payments for the first two years

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Planning ideas

- Fiscal Year for the estate
  - Estates can have any month end fiscal year
  - Can't be more than 12 months
  - Allow to match income with expenses
  - Potential income tax deferral/savings
- Accrual Basis
  - Potential to use when income and expenses hit different taxable years.

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Planning ideas (Cont)

- §645 Election
  - Trusts generally use calendar year
  - Allows qualified revocable trust to report income on estate return
  - Effectively gives benefit of fiscal year planning above
- Short administrative period
  - Filing one return can result in tax savings as well as cost savings.

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Planning ideas (Cont)

- Remember to step-up basis on assets
  - Includes investments and depreciable property
  - Not available for IRD property
  - Normally eliminates most gains in estate income tax

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Planning ideas (Cont)

- Claim IRD deduction
  - If tax was paid on IRD assets
  - Deduction available for the taxes when IRD is recognized

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Estate planning traps

- 10 areas to watch for in estate planning and administration

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1. Step up in basis

- Adjustment of basis of assets to date of death value – up or down
- Alternate valuation date if lower than DOD value AND reduces estate taxes
- Depreciated assets affected as well
- IRD assets don't receive basis adjustment
- Other Considerations
  - New form to report basis coming soon
  - DSUE election for portability

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2. §179

- §179 provides an opportunity to expense otherwise depreciable tangible assets
- Non-grantor trusts are not eligible to deduct section §179 expenses.
- Pass-through entities often generate §179 and report to trust on Schedule K-1
- Trust may depreciate assets expensed under §179 by partnerships and S-Corps

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3. Income in Respect of a Decedent

- Income that would have been income to the decedent if received prior to death.
- Generated as a result of assets not stepped up
- i.e. IRAs, Retirement plans, Installment Sales, Accrued Rent
- Deduction is based on incremental estate tax paid due to IRD inclusion

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4. Partnership Basis Adjustments

- Partnerships have inside and outside basis
  - Inside – basis of assets inside the partnership
  - Outside – basis of partners ownership interest
  - Outside increased with income, contributions
  - Outside decreased with distributions, deductions, credits
  - Step up at death can create difference between inside and outside basis

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4. Partnership Basis Adjs (Cont)

- If §754 election in place, can adjust inside basis for changes in outside basis
- On death §743 adjustment is made to adjust
  - Adjustment to inside basis allocated to represent basis in the assets of the partnership
  - May generate additional depreciation or basis to offset gains
- §743 adjustment required when adjustment would be reduction and > $250,000

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4. Partnership Basis Adjs (Cont)

Example:

50% Partner outside basis $10,000

DOD Value of Partnership basis $20,000

Inside basis at death $10,000

Partnership owns $20,000 building with accumulated depreciation of $10,000

§743 adjustment of $10,000- can be depreciated

- If §754 in place by partnership

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4. Partnership Basis Adjs (Cont)

Example:

25% Partner outside basis $1,000,000

DOD Value of Partnership basis $700,000 (30% combined discounts)

Inside basis at death adjusted to $700,000

§743 adjustment of ($300,000) is required irrespective of §754 election because adjustment is > $250,000

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5. S Corp Qualifying Trusts

- Only certain trusts eligible to be S Corp S/H
  - Grantor Trusts
  - Qualified Subchapter S Trusts (QSST)
  - Electing Small Business Trusts
  - Voting Trusts
  - 401(a) and 501(c)(3) tax exempt
  - Administrative grace period of 2 years for estates and some trusts may be available
  - Transfer to disqualified shareholder = bad things

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6. QSST Sale of S Corp Stock

- Beneficiary of a QSST treated as owner of the S Corp Stock – reports the K-1 income
- Surprising piece is if stock is sold then trust is considered one selling the stock.
- Can create disconnect between loss trapped in trust and gain reported by the beneficiary.

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6. QSST Sale of S Corp Stock (Ex.)

S Corp owned by QSST

S Corp sells assets for $5 mil, basis $2 mil

Beneficiary, as deemed owner - <u>$3 mil gain</u>

Trust has basis of $4mil in S Corp which is increased by $3 mil gain to $7 mil

$5 mil cash is distributed in liquidation to trust against $7 mil basis – <u>$2 mil loss</u> trapped at trust level.

If Stock sold - $5mil – 4 mil = <u>$1 mil gain</u> to trust

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7. S Corp AAA and Life Insurance

- AAA tracks income taxed to shareholders but not distributed
- Applies to S Corps with prior C Corp E&P
- Amount that can be distributed without causing dividends
- Life insurance increases basis, but not AAA
- Cash from life insurance can trigger dividends if distributed in excess of AAA

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8. Accounting Income VS DNI

- Trust Accounting Income based on State Law and Instrument provisions
- DNI is federal tax concept.
- Difference can result in taxable income to the trust but cash to the beneficiaries.
- Common issues with partnerships, S Corps, Oil/Gas/Coal/Timber

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8. Accounting Income VS DNI (Ex.)

- Partnership distributes $40 cash, $100 K-1
- Trust Accounting Income = $40
- Simple trust – distributes $40 of TAI to bene
- Trust taxed on $60 of income

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8. Accounting Income VS DNI (Cont.)

- Coal and Timber Sales normally Capital Gains and not included in DNI – and allocated to principal
- Oil and Gas Royalties and Working Interest included 10% in TAI and 90% principal. Included 100% in DNI (but subject to depletion)

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9. Pecuniary Funding Formulas

- Pecuniary requires distribution of a fixed amount, ie $5 mil
- Pecuniary Funding formulas sets amount as formula – "Maximum amount that will result in an estate tax of zero".
- If funded in kind can trigger gain/loss on funding
- Pecuniary marital formulas can jeopardize estate tax marital deduction

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10. IRA's with Trust as Beneficiary

- Required Minimum Distribution – timely to allow stretch out
- Appropriate language to allow look through

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QUESTIONS?

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"What Makes Us Different, Makes You Better" 39

The Basics of Generation Skipping Tax

May 19, 2016

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WHY?

- Perceived abuse of using trusts to avoid estate tax and gift tax;
- Trust lasting for as long as permitted under the rule against perpetuities escaped several generations of transfer tax

HISTORY:

- Tax Reform Act of 1976 enacted the first generation-skipping transfer tax as an entirely separate and new tax Chapter 13 of the Internal Revenue Tax
- Widely criticized due to complexity
- 1986 retroactivity repealed the 1976 Chapter 13

- 1986 Tax Reform Act applies to all transfers after October 22, 1986 with certain exceptions and to irrevocable trusts created after September 25, 1985

- Purpose is to tax transfers in trust or other ways that result in avoidance of estate or gift tax

- Tax on transfers of interests in property that pass to a person who is two or more generations below the "transferor"

Language Important:

<u>Transferor</u> –

- the decedent as to any property subject to the tax imposed by Chapter 11 (estate tax) and the donor as to any property subject to the tax imposed by Chapter 12 (gift tax)

- Generation assignments are determined based on who is the Transferor except in a reverse QTIP election under §2652(a)(3)

- GST exception can only be allocated by the transferor
- However a new transferor is established at the time the property is subject to transfer tax.

Interest –

- Person has interest in trust property if the person has a present right to receive income **or** principal from the trust

Skip Person –

- Can be a person or a trust -
- Person - all natural persons assigned to the second or more remote generation below the transferor or skip person

A trust can be a skip person if:

(1) if all interests in the trust are held by skip persons;

T Establishes a trust for T's grandchildren for life remainder to grandchildren's issue; or

(2) No person holds an interest in the trust and at no time after the transfer may a distribution be made to non-skip persons;

T establishes a trust to accumulate income with distribution of the trust to T's grandchildren at age 21 or grandchildren's estate if dies before age 21 (grandchildren are under age 21 when trust created)

Non-Skip Person –

- Person or trust who is not a skip person

Tax – Generation Skipping Tax –

- Flat Rate equal to the maximum estate tax rate

GST Exemption –

- $5,430,000 - 2015
- $5,450,000 - 2016

No Portability of GST Exemption

What are Generation Skipping Transfers?

✓ Taxable Termination

✓ Taxable Distributions

✓ Direct Skips

IRC §2612(a) Taxable Termination –

- When a trust terminates and an interest in property passes to a person who is a skip person

IRC §2612(b) Taxable Distribution –

- Any distribution from a trust to a skip person other than a taxable termination or a direct skip

IRC §2612(c) Direct skip –

- transfer subject to estate tax or gift tax to a skip person –
- outright bequest or gift to a grandchild or more remote beneficiary

Predeceased Parent Exception –

To determine if a generation skipping transfer has occurred one does not count the generation of a predeceased parent -

- ➢ If Grandparents make gifts to a Grandchild whose parents (Grandparent's child or stepchild) has died - not a transfer to a skip person
- ➢ Grandchild moves up a generation.

GST Tax - taxes a direct skip that skips multiple generations as if only one generation is skipped

Property held in trust after a generation skipping transfer occurs continues to be subject to the GST tax as the property moved down from one generation to the next

Transferor moved down to first generation above the trust beneficiary in the highest generation after the transfer

Inclusion Ratio –

Fraction which reflects the amount of GST exemption allocated to a trust -

- If no GST Exemption is allocated to a trust inclusion ratio is **1**
- If GST Exemption is allocated and covers entire trust property value at time allocation the inclusion ratio is **0**

Reverse QTIP Election allows the creator of a QTIP trust to treat the property as if no QTIP Election had been made for GST purposes (IRC §2652(a)(3) -

- must be made as to all or none of the QTIP property
- create a separate trust

Create separate trusts so no partial election -

- want inclusion Ratio of 1 or 0 so as to minimize GST tax and maximize use of exemption

Generation generally based on family relationship:

- Present or former spouse of transferor is of transferor's generation
- Spouse of a descendent is same generation as descendent
- Person legally adopted is treated as blood relative of adopting parent – Regulations deal with unusual situations

Generation assignment of nonrelatives:

- Any person not more than 12 ½ years younger than the transferor is assigned to transferor's generation
- Any person more than 12 ½ years but not more than 37 ½ years younger is assigned to first generation below transferor

Payment from a trust is not a generation skipping transfer if the payment would qualify as a nontaxable gift for the direct payment of medical and education expenses

Certain Direct Skips that qualify for annual gift tax exclusion under IRC §2503 (b) or (3) are exempt from GST tax.

----Much more limited ----

- for GST purposes it must be an outright transfer to a skip person
- not to a transfer to a trust with withdrawal power

Allocation of GST exemption during life or after death –

- Any allocation of GST exemption is irrevocable

- Failure to allocate on a timely filed return may produce an irrevocable result

GST exemption was automatically allocated to direct skips -

- After 2001, automatic allocation occurs to lifetime indirect skips as well as to a GST trust
  - certain exceptions
  - can elect out of a automatic allocation