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The 24th Annual

ESTATE & CHARITABLE GIFT PLANNING INSTITUTE

THE ANNUAL ESTATE PLANNING CHECKUP

Is your client's estate plan healthy enough to pass its annual exam?

Presented by

Ann B. Burns and Samuel A. Donaldson

SEPTEMBER 21, 2016

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ESTATE & CHARITABLE GIFT PLANNING INSTITUTE

September 21, 2016

CONDUCTING THE ANNUAL ESTATE PLANNING CHECKUP:

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Speakers:

Ann B. Burns and Samuel A. Donaldson

2016 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of December, 2015, through June, 2016. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

INDIVIDUAL FEDERAL INCOME TAXES FOR 2016

(Adapted from Rev. Proc. 2015-53)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th colspan="4">2015 Federal Income Tax Rates for Individuals</th></tr>
<tr><td>Unmarried</td><td>Joint</td><td>Ordinary Income</td><td>Adjusted Net Cap Gain* & Qualified Dividends</td><td>Medicare Surtax on Earned Income**</td><td>Medicare Surtax on Net Investment Income</td></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,275</td><td>$18,550</td><td>15%</td></tr>
<tr><td>$37,650</td><td>$75,300</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$91,150</td><td>$151,900</td><td>28%</td></tr>
<tr><td>$190,150</td><td>$231,450</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000***</td><td>AGI over $250,000***</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$413,350</td><td>$413,350</td><td>35%</td></tr>
<tr><td>$415,050</td><td>$466,950</td><td>39.6%</td><td>20%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

*** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

A. KEY PROVISIONS OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

Signed into law on December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") revived and made permanent dozens of provisions that had expired at the end of 2014. That these provisions are no longer subject to expiration and extension is welcome news for planners and clients. Still, the PATH Act did not make everything permanent, and some important provisions are now set to expire (again) at the end of 2016. Here is a sample of the newly-permanent benefits of interest to individual taxpayers.

1. Above-the-Line Deduction for Teachers' Classroom Expenses

PERMANENT. K through 12 teachers can deduct up to $250 of unreimbursed expenses in determining adjusted gross income. The expenses must relate to books, equipment, supplies (except for nonathletic supplies used in health or P.E. courses—read "condoms"), or computer equipment and related services or software.

2. Exclusion for Discharges of Debt on Principal Residence

THROUGH 2016. In 2007 Congress created a new exclusion for "qualified principal residence indebtedness" (QPRI), defined as up to $2 million of "acquisition debt" (any debt used to buy, build, or improve a principal residence). A taxpayer need not be insolvent to qualify for this exclusion, but the exclusion will not apply if the debt is discharged on account of services performed for the lender or for any other reason "not directly related to a decline in the value of the residence or to the financial condition of the taxpayer." The taxpayer's basis in the principal residence must be reduced (but not below zero) by the amount excluded from gross income under this rule.

3. Deduction of Mortgage Insurance Premiums

THROUGH 2016. Legislation in 2006 created an itemized deduction for premiums paid or accrued on qualified mortgage insurance. Generally, qualified mortgage insurance is mortgage insurance obtained in connection with acquisition debt on a qualified residence that is provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or certain private providers.

4. Sales Tax Deduction

PERMANENT. Individuals may still elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes may deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables to be prescribed by the Service. The chief beneficiaries of this election are taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

5. Bonus Depreciation

THROUGH 2019. Under §168(k), depreciable tangible personal property and computer software acquired and first placed in service in 2016 and 2017 is eligible for an additional up-front depreciation deduction equal to the 50% of the asset's adjusted basis after taking into account any §179 election made with respect to the property. The regular depreciation deductions would then be computed based on whatever basis remains after the §179 election and the 50% bonus. This bonus 50% allowance is also available for alternative minimum tax purposes. The 50% bonus does not apply to intangibles amortized under §197 (with the limited exception of computer software), or start-up expenses amortized under §195. The bonus also does not apply to assets with a class life in excess of 20 years. In 2018, the bonus drops to 40%, and it drops to 30% in 2019 before expiring altogether in 2020.

6. §179 Expensing Election

PERMANENT. The dollar limitation on the §179 expensing election continues at $500,000 2015 and forward. As before, the $500,000 maximum is not reduced until the total amount of §179 property purchased and placed in service during the taxable year exceeds $2 million.

7. Expanded Limitations for Contributions of Qualified Conservation Real Property

PERMANENT. Prior to 2006, a contribution of qualified conservation real property to a public charity was treated the same as any other contribution to public charity: to the extent the property was capital gain property in the hands of the donor, the most that could be deducted in any one year was 30% of the taxpayer's contribution base (generally, adjusted gross income) with a carryover of up to five years. Legislation in 2006 permitted the current deduction of such contributions up to 50% of the taxpayer's contribution base, and with a carryover of 15 years. Moreover, the 50% limitation was increased to 100% in the case of "qualified farmers and ranchers" (those whose gross income from farming or ranching business exceeds 50% of their total gross incomes), provided the property is restricted to remain generally available for agriculture or livestock production. This has now been made permanent.

8. Above-the-Line Deduction for College Tuition

THROUGH 2016. The above-the-line deduction for "qualified tuition and related expenses" continues through 2016. The deduction limit remains at $4,000, and the full deduction is available only to those taxpayers with adjusted gross incomes of $65,000 or less (or $130,000 for married taxpayers filing jointly). Individuals with adjusted gross incomes in excess of $65,000 but not more than $80,000 (and joint filers with adjusted gross incomes in excess of $130,000 but not more than $160,000) may claim a maximum deduction of $2,000. A taxpayer still cannot claim both the deduction and the § 25A credits.

9. Qualified Charitable Distributions from IRAs

PERMANENT. As in past years, individuals age 70½ or older can exclude from gross income up to $100,000 in "qualified charitable distributions" from either a traditional IRA or a Roth IRA. Such distributions are not deductible as charitable contributions, but the exclusion from gross income represents a better result over prior law. Under prior law, the retiree had to include a minimum distribution in gross income but could donate the amount to charity and claim a deduction under §170. The income tax deduction was subject to the overall limitation on itemized deductions, §68, as well as the other limitations applicable to all charitable contributions under §170. In many cases, therefore, the income tax deduction did not offset completely the amount included in gross income even though the entire distribution was paid to charity. The current rule should appeal to those required to take minimum distributions that have sufficient funds from other sources to meet their living needs. A qualified charitable distribution is any distribution from an IRA made by the trustee directly to a public charity (i.e., one described in §170(b)(1)(A)) to the extent such distribution would be includible in gross income if paid to the account holder. The distribution may be made on or after the date the account holder reaches age 70½.

10. 100% Exclusion on Gains from Sales of Section 1202 Stock

PERMANENT. We all know that § 1202(a)(1) generally excludes half of the gain from the sale or exchange of "qualified small business stock" (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is engaged in an active business and has aggregate gross assets of $50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28% under §1(h)(1)(F). In effect, then, the entirety of such gain is taxed at a rate of 14% (half of the gain is taxed at 28%, half of the gain is not taxed at all). But for qualified small business stock acquired in 2013 or later, a 100% exclusion applies. This gives §1202 some much-needed bite.

11. Stock Basis Adjustments for Charitable Contributions by S Corporations

PERMANENT. When an S corporation contributes property to charity, the corresponding charitable deduction, like all deduction items, passes through to the shareholders. Generally, a shareholder's basis in S corporation stock is reduced by the amount of deductions passing through, but an S corporation's charitable contribution will only cause a shareholder's stock basis to be reduced by the shareholder's pro rata share of the adjusted basis of the contributed property. Thus, for example, if an S corporation with two equal shareholders donated to charity real property worth $100 in which the corporation's basis was $40, each shareholder could be eligible to claim a $50 charitable contribution (half of the $100 value) while only reducing stock basis by $20 (half of the $40 basis). This offers a tremendous benefit to S corporation shareholders, especially where the contributed property would have triggered liability for tax under §1374 as built-in gain property. Charitable contributions of such property do not trigger

the §1374 tax, and now also have the chance to carry out a fair market value deduction to the shareholders at a cost equal only to the basis of the contributed property.

12. Five-Year Recognition Period for S Corporation Built-in Gains Tax

PERMANENT. When a C corporation makes an S election, the §1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). For 2009 and 2010, however, the recognition period was shortened to seven years. Then, the recognition period was shortened to five years in 2011. This shorter recognition period has now been made permanent. So if the corporation made its S election effective for 2011, any net recognized built-in gains in 2016 will not be subject to the tax.

B. BASIS REPORTING AND THE DUTY OF CONSISTENCY

1. Background

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (signed on July 31, 2015) created two new income tax provisions as revenue raisers. First, new §6035(a)(1) requires executors of estates required to file a federal estate tax return to provide "a statement identifying the value of each interest in" property included in the decedent's gross estate. The statement must be furnished to the Service and to "each person acquiring any interest" in such property within 30 days of the date on which the estate tax return filed for is due (including extensions), whichever is earlier. Section 6035(b) authorizes legislative regulations to enforce this new requirement, and it directs Treasury to consider, among other things, the application of this requirement to cases where no estate tax return is required to be filed. A conforming amendment to §6724(d)(1) makes the failure to furnish this statement subject to a $250 penalty.

Second, new §1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been "determined" for federal estate tax purposes. Where there has not yet been a "determination" of the property's value, the basis cannot exceed the amount provided in the §6035 statement. Basis is "determined" for federal estate tax purposes where the value is shown on the federal estate tax return and the Service does not contest it before expiration of the statute of limitations. If the Service does timely contest the value and the executor relents, the basis of the property will be "determined" as the value set by the Service. Of course, basis can also be "determined" by a court or through a settlement agreement between the Service and the estate.

The new rules, which effectively prohibit claiming property has a lower value for estate tax purposes and a higher value for income tax purposes, are applicable to property "with respect to which an estate tax return is filed" after July 31, 2015. That gave Treasury little time to implement the new regime. In *Notice 2015-57* (issued on August 21, 2015), Treasury indicated that for §6035 statements required to filed or furnished to a beneficiary before February 29, 2016, the due date

is postponed to February 29, 2016. This was supposed to give Treasury time to issue guidance implementing these new rules and, ideally, a form. Indeed, the notice told executors and others required to furnish §6035 statements not to do so "until the issuance of forms or further guidance by the Treasury."

2. Form 8971

On January 29, 2016, Treasury released the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, together with instructions. The Form asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The Form includes a Schedule A, the page to be furnished to each beneficiary of the estate. The schedule must provide a "description of property acquired from the decedent," along with an indication of where the item is reported on the estate's Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the "estate tax value (in U.S. dollars)." The Schedule A includes this notice to beneficiaries: "You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional."

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, "the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made." As Steve Akers observed in a February, 2016 report, "This [will] cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary."

In *Notice 2016-19* (issued February 11, 2016), Treasury extended the first deadline for §6035 statements (Forms 8971) from February 29, 2016, to March 31, 2016. Then, in *Notice 2016-27* (issued March 23, 2016), Treasury again extended the deadline for Form 8971 filings to June 30, 2016.

3. Proposed Regulations

On March 4, 2016, Treasury issued proposed regulations offering guidance on the application of §§1014(f) and 6035. The proposed regulations offer a number of clarifications. First, they clarify

that while §1014(f) caps the initial basis a beneficiary takes in property, subsequent adjustments to basis for improvements, depreciation, and the like will still be allowed.

Second, they clarify that §1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes; so property eligible for the marital and charitable deductions is not subject to §1014(f), nor is any tangible personal property for which an appraisal is not already required under the estate tax regulations. But all other property included in the gross estate is subject to §1014(f) if any federal estate tax liability is incurred.

Third, the proposed regulations address property discovered after the filing of the Form 706 and property omitted from the Form 706 (herein, "omitted property"). If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax, the regular rules for determining the final value of property shall apply. But if the omitted property is reported after expiration of the statute of limitations, it will have a final value of zero. Likewise, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to §1014(f) is deemed to be zero.

Fourth, the proposed regulations clarify that the §6035 reporting requirement does not apply where an estate tax return is filed solely for purposes of making a portability election or a generation-skipping transfer tax exemption allocation.

Fifth, the proposed regulations exempt the following assets from §6035 reporting: cash, income in respect of a decedent, items of tangible personal property for which an appraisal is not required under the estate tax regulations, and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction.

Sixth, the proposed regulations make clear that where the executor is also a beneficiary, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners. If the executor cannot locate a beneficiary in time, the Form 8971 is to explain the efforts taken to locate the beneficiary.

Finally, the proposed regulations provide that where the recipient of property reported on the Form 8971 transfers all or any portion of the property to a related party, the transferor must file a supplemental Form 8971 documenting the new ownership if the transferee's basis is to be determined with reference to the transferor's basis.

C. NONTAX REASONS FOR FAMILY LIMITED PARTNERSHIP REJECTED AS AFTER-THE-FACT JUSTIFICATIONS (*Estate of Holliday v. Commissioner,* T.C. Memo. 2016-51, March 17, 2016)

Late in 2006, Sarah Holliday (through a power of attorney held by her sons, Dr. Doug Holliday and Joe Holliday) formed a family limited partnership with $5.9 million in marketable securities. The sons owned all of the membership interests in the limited liability company that served as the general partner owning a 0.1% interest in the partnership. Sarah owned the remaining 99.9% interest as the sole limited partner. After formation, Sarah gifted a 10% limited partner interest to an irrevocable trust. At her death in January, 2009, Sarah still owned her 89.9% partnership interest. Alas, the marketable securities held by the partnership were worth only $4 million as of the alternate valuation date (July, 2009). The estate tax return reported the value of Sarah's 89.9% limited partnership interest at $2.4 million, reflecting an aggregate minority interest and marketability discount of about 33%.

The Service argued that the partnership should be ignored and that the full $4 million of partnership assets should be included in Sarah's gross estate under §2036(a). Section 2036(a) applies where the decedent made a transfer of property in which the decedent retained the right to income, possession, or enjoyment for life (or for a period not ascertainable without reference to the decedent's death or for a period that does not in fact end before the decedent's death). The Service argued that Sarah retained the right to income from the marketable securities contributed to the partnership because the partnership agreement required periodic pro-rata distributions of net cash flows. Moreover, Joe's testimony indicated that the partnership was prepared to make a distribution to Sarah if she needed it. On these facts, the Tax Court had little trouble upholding the Service's determination that Sarah had effectively retained the right to income from the partnership.

But §2036(a) does not apply in the case of a bona fide sale for a full and adequate consideration in money or money's worth. To determine whether the transfer of the securities to the partnership in exchange for the partnership interest was a bona fide sale, the Tax Court stuck to its precedent from the 2005 decision in *Estate of Bongard v. Commissioner*. Under *Bongard*, the formation of a partnership satisfies the "bona fide sale" exception to §2036(a) only where there is "a legitimate and significant nontax reason for creating the family limited partnership" and that "[a] significant purpose must be an actual motivation, not a theoretical justification." In this case, the estate proffered three nontax purposes for the partnership, but the court ultimately rejected them as theoretical justifications.

The estate first contended that the partnership was formed to protect Sarah's assets from "trial attorney extortion." Apparently there was a concern that Sarah could be sued and that a judgment creditor could attach assets that were not in the partnership. But the court observed that Sarah had never been sued and that no such suits were imminent. And if protecting assets from judgment creditors was a concern, said the court, Sarah would have transferred substantially more than just the $5.9 million in marketable securities that were actually contributed to the entity.

The estate then argued that the partnership was created to protect Sarah's assets from the undue influence of caregivers. There was evidence that Sarah's dead husband had been abused and taken advantage of by his caregivers late in life. But Sarah was never consulted about the formation of the partnership, and Dr. Holliday's weekly visits were an adequate safeguard to make sure assets were not stolen. More importantly, the court was not convinced that the formation of a partnership would protect an asset from theft. Besides, marketable securities are not exactly the type of assets in-home caregivers are apt to pilfer.

Finally, the estate argued that the partnership was formed to preserve assets for the benefit of the family. Again, however, the fact that Sarah was not consulted about the formation of the partnership belies this asserted purpose. Too, Sarah's husband had done the bulk of his planning through trusts, and there was never an issue as to whether trusts were an effective vehicle for the preservation of family assets.

That the partnership did not maintain all of the required records and never paid compensation to its general partner (both required under the partnership agreement) was not helpful to the estate in making its case. Ultimately, this is another case where the Service prevails under facts overwhelmingly in its favor. The planning lessons here are several. Among them: (1) partnership agreements probably should not contain provisions requiring periodic distributions to the partners; (2) those acting under a power of attorney should consult with their principals as to the reasons for the formation of the entity; (3) all parties should be prepared to respect the formalities of the entity and the provisions of the partnership agreement; and (4) the parties should be careful to identify and articulate the reasons for using the family partnership structure in advance of any actual transfers.

D. SETTLEMENT OF CASES INVOLVING INSTALLMENT SALE TO DEFECTIVE GRANTOR TRUST USING DEFINED VALUE CLAUSE (*Estate of Donald Woelbing v. Commissioner*, stipulated decision entered March 26, 2016; *Estate of Marion Woelbing v. Commissioner*, stipulated decision entered March 29, 2016)

In 2006, Donald sold all of his nonvoting stock in a closely-held business to an irrevocable life insurance trust in exchange for a promissory note with a face value of about $59 million with interest payable at the applicable federal rate. The purchase and sale agreement contained a defined value clause providing that what was sold was $59 million "worth" of stock and that the number of shares sold would be adjusted if the Service or a court determined that the per-share value of the stock was different from that set forth in an independent appraisal. Two of Donald and Marion's children gave personal guarantees to the trust; the combined value of the guarantees was worth 10% of the purchase price of the stock. This gave the trust "substantial financial capability" to pay the installment note to Donald. Donald and Marion filed gift tax returns for 2006 in which they elected to split gifts. He died in 2009 and she died in 2013 (two days after receiving a gift tax notice of deficiency in the amount of $32 million!).

The Service assessed both gift tax and estate tax deficiencies against Donald's estate and Marion's estate. The gift tax deficiencies resulted from the Service's position that the note has a value of zero and that the stock transferred was worth $116.8 million instead of $59 million. The zero value for the note stems from the Service's application of §2702—apparently the Service viewed the note as a retained equity interest in the stock that was sold, triggering the zero-value rule. The Service argued in the alternative that if the note was not worth zero, then Donald and Marion still made taxable gifts to the extent the value of the stock transferred exceeded the face value of the note.

On the estate tax side, the Service alleged that under both §§2036 and 2038, Donald's gross estate should include not the note but the date-of-death value of the stock sold to the trust ($162.2 million, per the Service). We don't know the exact rationale behind the application of §§2036 and 2038, but some have speculated that the trust lacked sufficient equity to be able to buy such a large amount of stock in exchange for a note bearing interest only at the applicable federal rate.

Planners worried what a Service victory in these cases could mean for installment sale transactions, gift-splitting, and the use of defined value clauses. But the Service and Donald's estate settled with no additional gift or estate tax due. A few days later, the Service and Marion's estate settled with no gift tax due, but the Service could still argue that her estate owes estate tax. That the Service walked away from a claim to over $150 million in taxes, interest, and penalties means this settlement is important, but its exact meaning going forward defies easy description. Alas, we will have stay tuned for further developments.

E. ECONOMIC BENEFIT REGIME APPLIED TO INTERGENERATIONAL SPLIT-DOLLAR ARRANGEMENT (*Estate of Morrissette v. Commissioner*, 146 T.C. No. 11, April 13, 2016)

In 2006, Clara's revocable living trust entered into two split-dollar life insurance arrangements with three separate dynasty trusts, one for each of her three sons and their families. Each dynasty trust bought two universal life insurance policies, one on the life of each of the other brothers. To fund these policies, the dynasty trusts and Clara's revocable trust entered into a split-dollar arrangement. Under the arrangement, Clara's trust would transfer about $10 million to each dynasty trust, and the trustees of those trusts would use the funds to pay the premiums on the policies. Upon the death of a son, Clara's revocable trust would receive a portion of the death benefits from the policies on the life of the deceased son. With respect to each policy, the amount payable to Clara's revocable trust would be the greater of the cash surrender value of the policy or the total premium payments made on the policy. The dynasty trusts owning the policies would then receive the balance of the death benefits, to be used to buy stock owned by (or held in trust for the benefit of) the deceased son. If the split-dollar arrangement terminated before the death of a son, Clara's revocable trust would still be entitled to receive the "greater of" amount described above.

This is a so-called "intergenerational split-dollar arrangement." Howard Zaritsky explains:

> Intergenerational split-dollar involves using the economic benefit regime with a collateral assignment non-equity split-dollar agreement, to avoid both gift and GST taxes and to reduce estate taxes. Under this arrangement, a senior-generation member (in this case, Clara's revocable trust) pays that part of the premiums on the policies insuring the lives of one or more middle-generation members (in this case, Clara's sons). The death benefits are payable to a trust for the benefit of lower-generation members (in this case, the three dynasty trusts). Typically, the senior-generation family member pays the portion of the premium equal to the value of the present insurance coverage, determined under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower.
>
> Proponents of this concept argue that the senior generation makes no taxable gifts by paying these premiums; rather, he or she is advancing funds with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. Moreover, when the senior generation family member dies, the value of the right of recovery in his or her estate is merely a "collateralized receivable" that must be paid at the insured child's death. The economic benefit regime impairs the value of these receivables, potentially reducing their value for estate tax purposes. The receivables are mere unsecured promises to pay uncertain amounts at an uncertain time, with no current return on their value and with ongoing tax liabilities.

Consistent with this strategy, Clara filed federal gift tax returns reporting gifts to each dynasty trust using the economic benefit regime under Regulation §1.61-22. Under that approach, the gift is equal to the cost of the current life insurance protection as determined under Table 2001 minus the amount of the premium paid by the dynasty trust. That reduced the total annual gifts from 2006 to 2009 to amounts ranging from just over $64,000 a little over $206,000. Following Clara's death in 2009, the estate valued the revocable trust's right to receive future repayments from the dynasty trusts at about $7.5 million.

But the Service determined that the entire $30 million transferred to the dynasty trusts in 2006 was a gift. That sent the estate to Tax Court, where it argued that the economic benefit regime should apply in determining the amount of the gift. In a reviewed opinion, the Tax Court granted the estate's motion for partial summary judgment on this issue. Clara's trust was entitled to recover all of the premiums paid on the policies (at a minimum), and that recovery was secured by the death benefits. The transaction was thus a valid split-dollar arrangement.

The key remaining issue, then, is whether the loan regime or economic benefit regime applies to this arrangement. Because the dynasty trusts were the owners of the policies, one would think the loan regime would apply. But the regulations provide that the donor is the deemed owner of the policies where the arrangement is donative in nature and the donee receives only the current life insurance protection from the policies. The court determined this exception applied here, especially after noting that the preamble to the regulation contains an example explaining this exception that uses facts nearly identical to those in the case at bar. Because Clara's trust

retained the greater of the total premiums paid or the cash surrender value of the policies, the dynasty trusts did not have any additional economic benefit. The dynasty trusts had no access to the cash values of the policies. Thus the economic benefit regime properly applies to this arrangement.

Note that this is only a decision on a summary judgment motion. There is still the issue of the value of the right to repayment that is included in Clara's gross estate. If the estate prevails there, notice that the arrangement will have worked to remove about $22.5 million from transfer tax ($30 million transferred to the trusts less $7.5 million included in Clara's gross estate).

F. MORE IN THE WAR ON CONSERVATION EASEMENTS AND FAÇADE EASEMENTS

The Service continues to monitor carefully transactions involving the donation of qualified conservation real property, usually in the form of a "conservation easement" (where the taxpayer attaches a perpetual restriction on real property that precludes any change to existing use without the consent of the charitable organization that receives the easement) of a "façade easement" (where the taxpayer attaches a perpetual restriction that the exterior of any structures on real property cannot be changed absent the consent of the charity that holds the easement). As the following litany of recent cases illustrates, taxpayers must be careful about the valuation of the easement, ensuring the easement attaches to property in perpetuity, complying with substantiation requirements, and both disclosing and valuing any consideration received in exchange for the donation.

Failure to Obtain Written Subordination from Banks Doomed Deduction (*RP Golf LLC v. Commissioner*, T.C. Memo. 2016-80, April 28, 2016). The taxpayer owns two private golf courses in Kansas City. In 2003, it conveyed a conservation easement over the courses to the Platte County Land Trust, a charitable organization. On its 2003 return, the taxpayer claimed a $16.4 million deduction, pursuant to an appraisal that found the pre-contribution value of the courses to be $17.4 million and the post-contribution value to be $1 million.

Interestingly, though, the court never got to the issue of this valuation. You see, two banks were mortgagees on loans made to the taxpayer. Regulation §1.170A-14(g)(2) precludes a conservation easement deduction for encumbered property "unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Here, while the easements were conveyed on December 29, 2003, consents were not executed until April 14, 2004, nor recorded until April 15, 2004. The Service claimed that because the consents were not given contemporaneously with the donation, the taxpayer was not entitled to a deduction. The Tax Court agreed, pointing to recent case law indicating that the subordination must be in place at the time of the transfer. The taxpayer argued that it had oral consents from both banks, but the court found that an oral consent would not be binding under applicable state (Missouri) law.

Fair Market Value of Easement is Not Always the Same as the Deduction Amount, a Distinction that Foiled a Deduction (*Carroll v. Commissioner*, 146 T.C. No. 13, April 27, 2016).

On December 15, 2005, the taxpayers contributed a conservation easement on nearly 26 acres of Maryland land jointly to the Maryland Environmental Trust and the Land Preservation Trust. The taxpayers claimed the easement was worth $1.2 million, and thus claimed charitable contribution deductions for each of 2005, 2006, 2007, and 2008.

Of the many requirements for a deduction, one is that the conservation purpose must be protected in perpetuity. Regulation §1.170A-14(g)(6)(ii) provides that "when a change in conditions give rise to the extinguishment of a perpetual conservation easement restriction…, the done organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction." The conservation easement in this case, however, provided that the charities' fractional share of any extinguishment proceeds would be equal to a fraction the numerator of which is the amount allowable as a federal income tax deduction to the taxpayers and the denominator of which is the fair market value of the whole property at the time of the donation. As the Tax Court observed, that's different than the fraction required by the regulations—the numerator needs to be the value of the easement, not the deduction allowed to the taxpayers.

Sure, in many cases those two figures will be the same (the deduction amount is, generally, the value of the easement). But not always: "For example, if the…Service denies petitioners' charitable contribution deduction for Federal income tax purposes for reasons other than valuation and the easement is extinguished in a subsequent judicial proceeding, the numerator [under] the conservation easement will be zero, and [the charities] will not receive a proportionate share of extinguishment proceeds." Alas, this is fatal to the taxpayers' claim for a deduction, for case law has established that the "perpetuity" element for a conservation easement deduction must be construed strictly.

Don't Forget the Written Acknowledgment (*French v. Commissioner*, T.C. Memo. 2016-53, March 23, 2016). The taxpayer was a beneficiary of a trust that, on December 29, 2005, donated a conservation easement on four contiguous parcels to the Montana Land Reliance. The trustees obtained an appraisal indicating the easement was worth $1.1 million, and the taxpayer's share of that deduction would be almost $351,000.

The first 2005 return filed by the taxpayer did not claim any deduction for the easement. But an amended return, filed before April 15, 2006, claimed a charitable contribution deduction of nearly $57,000. The taxpayer then carried over the remaining deduction to 2006 (nearly $45,000), 2007 (just over $57,000), and 2008 (almost $32,000). The Service initially determined that the total value of the easement was $432,000, but in this case before the Tax Court it went a step further and claimed the taxpayer gets no deduction at all for lack of receiving a contemporaneous written acknowledgement from the charitable donee.

The taxpayer argued that two documents could serve as the acknowledgement. The first was a letter from a representative of the organization dated June 6, 2006, stating no goods or services were furnished in exchange for the donation. The problem, though, is that this letter is not

"contemporaneous" with the donation because it was not received by April 15, 2006. The second was the donation agreement itself, in the form of a conservation deed recorded on the day of the donation. The Tax Court observed that a conservation deed can work as an acknowledgment where the deed states whether the donee provided goods or services in exchange for the contribution. Even where such express language is missing, the court will still "look to the deed as a whole" to determine whether the donee furnished consideration for the donation.

Here, though, the deed said nothing about consideration furnished by the donee, and the court did not find an absence of consideration from the deed as a whole: "Although the conservation deed includes provisions stating that the intent of the parties is to preserve the property, those provisions do not confirm that the preservation of the property was the only consideration because the deed did not include a provision stating that it is the entire agreement of the parties. Without such a provision, the IRS could not have determined by reviewing the conservation deed whether petitioners received consideration in exchange for the contribution of the conservation easement. We conclude, therefore, that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii)."

Taxpayers Do Sometimes Prevail in These Cases (*Palmer Ranch Holdings v. Commissioner*, 11th Cir., February 5, 2016). The taxpayer, a partnership, donated a conservation easement on an 82-acre parcel of real property (home to an eagle's nest, it should be noted) to Sarasota County, Florida. The taxpayer claimed a $23.9 million deduction for the contribution, but the Service concluded that maximum deduction amount should be $7 million. The taxpayer argued that the highest and best use of the property would be the development of a 360-unit residential complex. But the Service said the best use was limited to 41 units based on the property's current zoning designation. The Service noted an extensive history of failed rezoning requests, environmental concerns, limited road access, and strong neighborhood opposition to development as proof that the taxpayer would never be able to build more than the currently allowable number of residential units on the property.

But the Tax Court rejected the Service's position, observing that several of the failed rezoning requests were close votes and that while the property contains a "wildlife corridor," the corridor does not preclude development along the lines suggested by the taxpayer. The lower court also determined there was adequate road access for a multiple-unit development as large as that suggested by the taxpayer. Ultimately, then, the Tax Court held that the contributed easement was worth $19.9 million, a figure much closer to the taxpayer's original position.

On appeal, the Eleventh Circuit affirmed the Tax Court's determination of the property's "highest and best use" but reversed the determination of the amount deductible. The court agreed that a rezoning request would have a "reasonable probability" of approval. The Service argued that the proposed highest and best use was not likely to be needed shortly after the date of the donation, and while the appellate court agreed, it found that the Tax Court's error in not considering this fact to be harmless. "The evidence clearly shows that, in 2006, the market for…development was bullish." Where the lower court went wrong, said the Eleventh Circuit, was in reducing the "highest and best use" valuation offered by the taxpayer. The lower court based

its valuation on its own assumptions about market activity at the time and not on comparable sales. "The tax court must at a minimum explain why it departed from the comparable-sales method" in valuing the property at its highest and best use. Thus the court remanded the case for further determination, with these instructions: "On remand, then, the tax court must either stick with the comparable-sales analysis or explain its departure. Whatever the tax court chooses to do, the court must keep its sights set strictly on the evidentiary record for purposes of selecting an appreciation rate, and ensure that it crunches the numbers correctly." Stay tuned for further developments.

Don't Forget to Attach the Qualified Appraisal! (*Gemperle v. Commissioner*, T.C. Memo. 2016-1, January 4, 2016). In 2007, the taxpayers donated a façade easement on their Chicago home to the Landmarks Preservation Council of Illinois. A contemporaneous appraisal found the easement worth $108,000 (about 12% of the unencumbered value of the home). The taxpayers deducted this amount on their 2007 and 2008 returns. They did not attach the appraisal to the return, however, and §170(h)(4)(B)(iii)(I) conditions a deduction on the attachment of a qualified appraisal with the federal income tax return. Thus the Tax Court had little trouble sustaining the Service's adjustment disallowing the charitable contribution deduction in both years.

But it doesn't end there. Because the taxpayers did not make their expert available for cross-examination at trial, the court did not admit the appraisal into evidence because the statements were hearsay. That left the couple with no evidence to support the value of the easement, which in turn led to the imposition of a 40% gross valuation misstatement penalty.

G. FOLLOWING ORDERS, TAX COURT IGNORES ASSETS IN VALUING A GOING CONCERN (*Estate of Giustina v. Commissioner*, T.C. Memo. 2016-114, June 13, 2016)

The decedent died in 2005 with a 41.128% limited partner interest in Giustina Land & Timber Co. Limited Partnership, an entity that owns and operates nearly 48,000 of timberland as an active business. The timberland alone was worth $143 million at the decedent's death; the entity's total asset value at the time was just over $150.6 million. In a 2011 decision, the Tax Court valued the decedent's partnership interest by giving 25% weight to the entity's asset value and 75% weight to the entity's income stream. It based this allocation on its conclusion that there was a 25% chance the partnership would liquidate after the transfer of the decedent's interest to a hypothetical third-party willing buyer.

In 2014, however, the Ninth Circuit reversed, concluding the Tax Court's finding of a 25% chance of liquidation was clearly erroneous. The appellate court reasoned a third-party buyer who intended to dissolve the partnership would not be admitted by the general partners, so focusing on the asset value of the entity was the wrong approach. The court sent the case back to the Tax Court with instructions to disregard the assets in valuing the entity as a going concern.

The Tax Court did so, adjusting the value of the decedent's limited partnership interest from about $27.4 million to about $13.9 million, a value much closer to that offered by the estate's expert (roughly $13 million) than the Service's expert ($33.5 million). The court based its final

value on the present value of the entity's cashflows using a long-term growth rate of 4% and a capitalization rate of 14%.

H. POST-DEATH EVENTS, WHILE VALID, REDUCED CHARITABLE DEDUCTION AMOUNT (*Estate of Dieringer v. Commissioner*, 146 T.C. No. 8, March 30, 2016)

The decedent owned a controlling interest in a closely-held real property management corporation that managed a number of commercial and residential properties in Portland, Oregon (oh, and a Wendy's franchise in Texas). The decedent's revocable living trust provided that the closely-held stock was to pass to a private foundation the decedent had created during her lifetime. Her estate claimed a charitable contribution deduction for the value of the stock as of the date of death, with no minority or marketability discounts.

The Service reduced the amount of the deduction, however, as it concluded a series of post-death events undermined the decedent's intent to transfer control of the company to the foundation. The company elected to be taxed under subchapter S but didn't want the foundation to be subject to unrelated business income tax. So the company made arrangements to redeem all the decedent's voting stock and most of the nonvoting stock in exchange for a note. The thinking was this was good for the foundation since it converted the foundation from shareholder to creditor, giving it higher status in the liquidation food chain. To give the company cash to pay off the notes, the decedent's sons made capital contributions in exchange for more stock.

The Tax Court agreed that while these post-death events occurred for valid, non-tax business reasons, the effectively served to reduce substantially the actual amount passing to the foundation. The redemption agreements valued the foundation's stock using a 15% minority interest discount and a 35% marketability discount. Ultimately, the per-share price of the stock was much less than the value of the stock at the date of the decedent's death. One son testified the decline in value was due to the poor business climate at the time (2009). But the Tax Court held the decline was due to the son's instruction to the appraisers value the decedent's stock as a minority interest. Ultimately, said the court, the sons "thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest." So the estate tax deduction was reduced the amount used in the redemption appraisal. The instruction to value the decedent's stock as a minority interest was then used by the court as grounds for upholding the Service's assessment of a negligence penalty.

I. TERMINATION OF POLICY RESULTS IN CANCELATION OF DEBT INCOME (*Mallory v. Commissioner*, T.C. Memo. 2016-110, June 6, 2016)

In 1987, the taxpayer paid $87,500 to buy a single-premium variable life insurance policy on his life, naming his spouse as the beneficiary. Through the end of 2001, the taxpayer had taken 25 loans against the policy totaling $133,800. The taxpayer paid no interest on these loans, but luckily the cash value of the policy grew substantially over this time. By late 2011, however, the cumulative debt exceeded the cash value. The insurance company told the taxpayer to fork out

over $26,000 or the policy would be terminated. The taxpayer made no payment, so the policy terminated.

The insurance company sent the taxpayer a Form 1099-R showing a gross distribution of $237,897.25, $150,397.25 of which was taxable. That income never made its way onto the taxpayer's 2011 return, but the filed return did attach the Form 1099-R along with this handwritten note: "*Paid hundreds of $. No one knows how to compute this using the 1099R from Monarch--IRS could not help when called--Pls send me a corrected 1040 explanation + how much is owed. Thank you.*"

Unsurprisingly, the Service concluded the taxpayer had $150,397.25 of gain from the cancelation of his policy debt. The taxpayer ran to Tax Court, arguing that there could be no income absent an actual payment of cash and that the various amounts received from the insurance company over the years were payments of the cash value and not loans. The court rejected these claims. Every distribution from the insurance company was accompanied by a "loan activity confirmation," and the company annually sent notices requesting payment of interest. By using the cash value to extinguish the debt amount, there was a constructive distribution of $237,897.25 to the taxpayer.

The court also upheld a 20% substantial understatement penalty. It found no reasonable basis for failing to include the distribution amount in gross income. It didn't help that the insurance company specifically flagged the includible amount both in correspondence and in the Form 1099-R. As Howard Zaritsky observes, "This issue keeps coming before the courts … because so many policy owners simply do not read or understand the notices that insurers send them regarding policy loans. Typically, there will be at least several notices before a policy is terminated. An owner who does not receive cash on the policy termination will usually assume that there cannot be income. In fact, they have received the cash on which the tax is being imposed in the form of policy loans which now never will be repaid. The taxable income merely reflects the 'day of reckoning' that ultimately must occur, unless the loans are repaid."

J. SERVICE HAS BURDEN OF PROOF IN CASES OF EXECUTOR LIABILITY FOR UNPAID ESTATE TAXES (*Singer v. Commissioner,* T.C. Memo. 2016-48, March 14, 2016)

Under the federal claims statute, 31 USC §3713(b), and the case law interpreting it, an executor is personally liable for the payment of unpaid federal estate tax where an executor with notice of the unpaid tax liability distributes assets when the estate is insolvent (or is rendered insolvent as a result of the distribution). This case involves Scott Singer, the executor of the estate of Melvin Sacks. Sacks was an attorney who at his death left behind a spouse, two girlfriends, and a $4 million income tax deficiency. During the course of administration, Singer secured the release of some $750,000 from brokerage accounts that were subject to a restraining order imposed by the local court when it appeared the estate would lack sufficient assets to pay off all creditors. A portion of the amount was earmarked to be paid to the Service in satisfaction of the decedent's tax liabilities, but the rest (about $422,000) was paid to other creditors (the spouse and the State

of New York). But the Service invoked the federal claims statute to claim that Singer was now on the hook for the $422,000 paid to others.

The issue is whether the estate was insolvent at the time of the payment to the others. If it was, Singer would be personally liable for paying the $422,000 to the federal government. If not, there would be no personal liability. On this issue, the Tax Court held that the Service has the burden of proof. Further, in determining the estate's solvency, the court held that countable assets include the probate estate, nonprobate assets, and contribution rights the estate has against any beneficiaries. On these facts, the court held that the Service did not establish the estate's insolvency at the time of the distribution. Accordingly, Singer was not personally liable for the payment of estate taxes.

K. NO SPOUSAL ROLLOVER OF COMMUNITY PROPERTY INTEREST FROM INHERITED IRAs (Private Letter Ruling 201623001, June 3, 2016)

The decedent and the decedent's spouse resided in a community property state. The decedent named a child (not the spouse) as the beneficiary of the decedent's three individual retirement accounts. The spouse filed a claim against the decedent's estate for the spouse's share of the community property in the decedent's name, which included the IRAs. A state court approved a settlement agreement under which a fixed dollar amount was to be transferred to the spouse "as a spousal rollover IRA."

One of these parties (likely the spouse or the child) sought a ruling that the spouse be treated as the payee of the decedent's IRAs so that the spousal rollover would work. But the Service concluded that because the child was the beneficiary regardless of the operation of any state community property laws, there could be no spousal rollover. Consequently, any amounts placed into an IRA by the spouse will be subject to the IRA contribution limits and any assignment of the inherited IRAs to the spouse will be treated as a taxable distribution to the child. Oops.

L. LATE TRANSFER OF BUSINESS INTEREST BETWEEN EXES WAS STILL "INCIDENT TO THE DIVORCE" (*Belot v. Commissioner*, T.C. Memo. 2016-113, June 13, 2016)

The taxpayer and his ex-wife operated three businesses during their marriage: dance studios, retail sale of dancewear, and real estate holding. The couple divorced, and their January, 2007, settlement agreement provided they would continue to operate the businesses as equal partners. But in September, 2007, the ex filed suit seeking to force the taxpayer to sell his interests to her. That litigation resulted in an April, 2008, settlement agreement pursuant to which the ex agreed to buy out the taxpayer's interests in the businesses for $1.58 million, $900,000 payable at closing and $680,000 payable under a ten-year, 5% note. But since this transfer was more than one year after the divorce, the taxpayer's gain from the sale will qualify for nonrecognition under §1041 only if the transfer is "related to the cessation of the marriage."

The Service said it did not, since the sale transfer was not pursuant to the original divorce instrument but instead pursuant to separate litigation. But the Tax Court rejected this reasoning.

Yes, the regulations contain a presumption that §1041 does not apply to transfers "not pursuant to a divorce or separation instrument," but that same regulation states the presumption can be rebutted by "showing the transfer was made to effect the division of property owned by the former spouses at the time" of their divorce. On the record, the court determined that the sale of the interests was made to "effect the division of property owned by former spouses" and were thus "related to the cessation of the marriage."

M. POSNER HAS A FIELD DAY WITH THE HOBBY LOSS REGULATIONS (*Roberts v. Commissioner*, 7th Cir., April 15, 2016).

The taxpayer built a fortune through restaurants and bars in Indianapolis. In the late 1990s he developed an interest in horse racing. In 2005, he spent a good chunk of change on a horse training facility and then $1 million on a 180-acre tract of land for his horse operation. He then spent another half-million making improvements on the property. He worked eight hours a day on the activity, and up to 12 hours per day on race days. The Service alleged that the activity was a hobby in 2005 and 2006, and thus disallowed the expenses he deducted on his personal income tax return. Interestingly, the Service never challenged the activity as a business from 2007 on. The Tax Court applied the nine-factor test in Regulation §1.183-2 to conclude the horse racing activity was a hobby, so it upheld the deficiency.

But the Seventh Circuit, in an opinion by Judge Richard Posner, reversed. "We musn't be too hard on the Tax Court," he observed. "It felt itself imprisoned by a goofy regulation." Judge Posner noted the regulation lists nine non-exclusive factors to consider in determining whether an activity is merely a hobby instead of a trade or business. Ironically, perhaps, "the test is open-ended—which means the Tax Court was not actually required to apply all of those factors to Roberts' horse-racing enterprise." Nonetheless, the Seventh Circuit applied the factors itself and reached the opposite conclusion. The court concluded with some advice:

> Considering that most commercial enterprises are not hobbies, the Tax Court would be better off if rather than wading through the nine factors it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or other conventional sources of income, is a presumptively a hobby, though before deciding for sure the court must listed to the owner's protestations of business motive.

N. INNOCENT SPOUSE RELIEF CASES

Equitable Relief from Penalties and Interest Possible Even Where Underpayment is Attributable to Requesting Spouse's Income (*Boyle v. Commissioner*, T.C. Memo. 2016-87, May 2, 2016). Joe had a business selling new and refurbished printer cartridges. His wife, Pat, handled all the finances for the business and for the couple's personal matters. She even arranged for their 2003 joint return to be prepared. She had Joe sign the return but she never filed it. It was

only after Pat's death in 2006 that Joe first discovered no return had been filed, and he promptly filed one. The Service assessed deficiencies, penalties, and interest with respect to the late return. Joe wants equitable relief from the penalties and interest, saying the failure to file was Pat's fault.

The Service would not grant the relief because the underpayment at issue was related to Joe's income, not to Pat's (she had no income for 2003). But the Tax Court observed that Joe wasn't asking for forgiveness from the underpayment—he just wants relief from the penalties and interest. To deny Joe relief just because the underlying deficiency relates to his income "runs counter to our mandate…'to determine the appropriate relief available'." The court went on to find that Joe had been deceived by Pat in signing the dummy 2003 return that was never filed. On the whole, it was convinced that equitable relief from the penalties and interest was appropriate.

Not Questioning Returns and Enjoying the Good Life Preclude Innocent Spouse Relief (*Arobo v. Commissioner*, T.C. Memo. 2016-66, April 14, 2016). Larry and Sletta were married for the taxable years in question (2004 – 2007). Larry ran a mortgage origination company while Sletta worked in education. While Sletta paid the couple's bills, Larry kept their financial records and presented Sletta with joint returns for her to sign, which she did without question. It's just that Larry never filed them until after the Service started investigating the couple. The returns contained unsubstantiated business expenses and failed to include about $1.5 million in gross receipts from Larry's business.

Sletta wanted innocent spouse relief, but the Service did not grant her petition. The Tax Court agreed, finding she had reason to know of the understatements of income on each return. She "should have suspected that something might be amiss" when the 2004 return showed a $58,000 loss from Larry's business. "Even a cursory review of each year's tax return would have revealed that [Larry]'s mortgage origination business had reported (on line 12 of the first page of each return) substantial losses for 2004 and 2005 and that no business income or loss was reported for 2006 and 2007." Given Sletta paid the couple's bills, she knew first-hand that these "losses" were not impacting their standard of living.

The Tax Court also refused to extend equitable relief to Sletta. Sletta did not show how making her jointly and severally liable would cause her to suffer economic hardship. She had reason to know of the understatements and has not claimed to be a victim of abuse. She has not alleged Larry restricted her access to financial information. Perhaps most importantly, there was no change in the couple's standard of living, so she "received the benefit of paying no tax on hundreds of thousands of dollars."

O. SURVIVING SPOUSE CANNOT USE DECEASED SPOUSE'S AMT CREDIT CARRYFORWARD (*Vichich v. Commissioner*, 146 T.C. No. 12, April 21, 2016).

Nadine married Bill in 2002. It was his second marriage—his divorce from Marla was final just eight months before he tied the knot with Nadine. On their 1998 joint return, Bill and Marla paid

alternative minimum tax of over $708,000 in connection with the exercise of Bill's incentive stock options. That tax payment resulted in an AMT credit carryforward.

On their 2003 joint return, Bill and Nadine claimed over $304,000 of the carryforward. Bill died in 2004, and on the 2004 joint return filed by Nadine none of the carryforward was used. Things were quite for a while, until Nadine started claiming the remaining carryforward on her own individual returns starting in 2007. It worked for a while until the Service caught on, at which point it stopped issuing refunds and started sending deficiency notices with respect to the prior years.

The Tax Court agreed with the Service that Nadine could not use Bill's AMT carryforward as his surviving spouse. Although this was a case of first impression, the court looked to decisions holding that deductions do not pass to surviving spouses at death. "Marriage affords its entrants certain benefits, among them the option of filing joint returns. The Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but 'does not create a new tax personality.'" In effect, then, the carryover died with Bill.

P. THIS IS WHY YOU DON'T LOAN MONEY TO FRIENDS (*Riley v. Commissioner*, T.C. Memo. 2016-46, March 10, 2016)

A few years before her divorce, Kaylan worked at a Blockbuster video rental store (remember those?). There she met Frank, a fellow from the same neighborhood whose kids attended the same school as Kaylan's kids. "Their relationship blossomed." In 2002, Kaylan divorced her husband. As part of the divorce decree she received a pension plan and an IRA, each worth about $1 million, along with monthly alimony payments of $4,300. Soon thereafter, Frank told Kaylan he had invented a device that allowed cell phones to act as remote controls for television sets—just point your phone at the TV and you're surfing channels in no time. If only he could find an investor, he lamented. Over the next five years, then, Kaylan wrote checks totaling over $1.3 million, usually payable to Frank and once to his business, and sometimes in exchange for a note and sometimes not.

Kaylan noticed that Frank started dressing better and that he drove a nicer car. Her friend, Wendy, went to work at Frank's company in 2010 and soon reported to Kaylan that things weren't right with the company. Kaylan started to realize that maybe she had been duped. She hired an attorney to write a demand letter to Frank, but that did no good. She found another law firm willing to take her case on a contingency but she didn't hire them because they asked for a $10,000 retainer. On her 2010 federal income tax return, Kaylan claimed a $1.33 million theft loss deduction that created a large net operating loss carryback. She them amended her 2008 return to claim the carryback, but the Service denied her requested refund on the grounds that she did not sustain a theft.

The Tax Court considered whether the facts gave rise to a theft loss, a bad debt deduction, or a worthless securities deduction. In each scenario the court found no basis for a deduction. She did

not establish a theft because the only proof of misleading statements was her conversations with Frank and Wendy, neither of whom testified at trial. That rendered those statements inadmissible as hearsay (the court admitted them only to prove Kaylan's state of mind). So without any proof as to Frank's statements or his own state of mind, Kaylan can't prove a false representation was made with intent to defraud her.

As for the bad debt deduction, the court reasoned that even if Kaylan could make a case for a bad debt, it would be a nonbusiness bad debt since the advances to Frank were not part of any business activity of Kaylan. Nonbusiness bad debts are deductible as capital losses, and there is no carryback for capital losses. So that argument would not work for her 2008 return. The same goes for the worthless securities deduction, for it too would generate a capital loss that cannot be carried back. On top of that, said the court, Kaylan has not shown she lacks a reasonable chance of recovery. Heck, she found a law firm that would take her case on contingency. Frank is still around, and Kaylan still keeps in contact with him. She might have a bad debt or worthless security at some point, but not yet.

Q. STATUTE OF LIMITATIONS CAN'T BE USED TO AVOID REPORTING INCOME (*Squeri v. Commissioner,* T.C. Memo. 2016-116, June 15, 2016)

The taxpayers own an S corporation that operates a "full-service janitorial business." The company reported its gross receipts based on deposits made into its bank accounts during the calendar year, regardless of when the checks were received. The Service recalculated the company's gross receipts based on when checks were received instead of when they were deposited, and this resulted in deficiencies for each of 2009, 2010, and 2011. In computing the tax due for 2009, however, the Service did not exclude checks that had been received in 2008 and deposited in 2009. The taxpayers claimed the Service needed to do this, because those amounts were actually received in 2008 and the statute of limitation precluded the Service from making adjustments related to 2008.

But the Tax Court agreed with the Service that if the taxpayers were right, they would never pay tax on the income originally reported in 2009 but properly allocable to 2008, a now-time-barred year. The common law "duty of consistency" precludes taxpayers "from benefiting in a later year from an error or omission in an earlier year which cannot be corrected because the limitations period for the earlier year has expired." The court found that allowing the taxpayers to recharacterize the income as attributable to 2008 "would harm the Commissioner; it would allow petitioners to avoid tax on $1,634,720."

R. FORFEITURE OF INSIDER TRADING PROFITS IS A NONDEDUCTIBLE PENALTY (*Nacchio v. United States*, Fed. Cir., June 13, 2016)

The taxpayer was CEO of Qwest Communications International when, in 2001, he sold a large block of stock in the company for a $44.6 million gain. He paid almost $18 million in tax on the gain. In 2007 the taxpayer was convicted of insider trading. After several appeals, in 2010 the taxpayer was forced to forfeit his $44.6 million gain from the 2001 sale. So now the taxpayer

wants credit for the $18 million in tax paid on this sum. 2001 is a closed year, of course, but the taxpayer wants to use §1341 for relief. That section allows a taxpayer either a current deduction for the repayment of an amount previously included in income or a current credit equal to the extra tax paid from the prior inclusion.

To qualify for §1341, however, the taxpayer must be able to claim a deduction for the repaid amount. That's where the taxpayer's claim gets tricky. The Service disallowed the taxpayer's §1341 claim on the grounds that his forfeiture was a nondeductible fine or penalty. It also contended that the taxpayer was estopped from using §1341 because of his criminal conviction. The Court of Federal Claims rejected these contentions, finding the taxpayer could deduct his forfeiture payment as a loss under §165 (but not as a business expense under §162(a) because of §162(f)) and that he was not collaterally estopped from using §1341 just because he was convicted of a criminal offense. It thus granted the taxpayer's summary judgment motion on these points.

On appeal, though, the Federal Circuit reversed the lower court's grant of summary judgment. The appellate court held that §165 is subject to a public policy exception, citing a line of cases affirming that this exception applies both to §165 losses and to §162(a) business expenses. Moreover, the forfeiture was clearly in the nature of a fine or penalty. "We further understand [the taxpayer's] argument that not being allowed to deduct his forfeited income from his taxes would result in a sort of "double sting": both giving up his ill-gotten gains and paying taxes on them. But in this case, the relevant statutes, regulations, and body of relevant case law lead us to conclude that [his] criminal forfeiture must be paid with after-tax dollars, just as fines are paid with after-tax dollars." Since there is no income tax deduction for the forfeiture, §1341 cannot apply. The court thus did not reach the argument as to whether the taxpayer was estopped from using §1341 because of his conviction.

S. DEDUCTING LAW SCHOOL TUITION

German Lawyer Working as Apartment Manager Cannot Deduct Tuition to Attend United States Law School (*O'Connor and Tracy v. Commissioner*, 10th Cir., June 28, 2016). The taxpayer had been admitted to practice law in Germany in 2007. In 2009, after two years of working as an apartment building manager, the taxpayer started the J.D. program at San Diego. His 2010 and 2011 returns claimed deductions for his law school expenses. The Service disallowed the deductions because the course of study was not required to maintain or improve his job skills. The Tax Court agreed, finding the taxpayer was not established in the legal profession in the United States and thus the law school degree qualified him for a new trade or business. On appeal, the Tenth Circuit affirmed. The taxpayer argued that he was using his skills as a lawyer in his work, but that didn't cut the mustard. "For purposes of deductibility, courts have held that a person who is admitted to practice law in one jurisdiction, but then incurs expenses to become qualified to practice in another jurisdiction, is considered to be entering a new trade or business."

The Tax Court also upheld the imposition of 20% negligence penalty, which the Tenth Circuit also affirmed. "Appellants' failure to heed relevant precedent regarding [the regulations and case law], without any indication that such precedent has been superseded or overruled, supports the imposition of accuracy-related penalties."

Accountant Can't Deduct Law School Tuition (Nor Read Precedent, It Seems) (*Santos v. Commissioner*, T.C. Memo. 2016-100, May 17, 2016). The taxpayer worked as an accountant for 20 years before enrolling in law school. The taxpayer paid $20,275 in tuition for the 2010 taxable year and deducted that amount as a business expense on his Schedule C. There's just one problem: Regulation §1.162-5(b)(3)(ii), Example (1) expressly provides that law school costs for "a self-employed individual practicing a profession other than law" are not deductible "because this course of study qualifies him for a new trade or business."

Before the Tax Court, the taxpayer argued the regulation was invalid. But the Tax Court had already upheld the validity of the regulation in a 1971 case, and the underlying law on which the regulation was based has not changed in the interim. In fact, there is a long line of cases applying the regulation and denying a deduction in similar circumstances. This decision is yet another.

T. DISCRIMINATION AWARD TAXABLE SINCE NOT ATTRIBUTABLE TO PHYSICAL INJURY OR SICKNESS (*Barbato v. Commissioner*, T.C. Memo. 2016-23, February 16, 2016)

The taxpayer worked as a letter carrier when, in 1991, she sustained back and neck injuries in a work-related automobile accident. The injuries forced her to accept a new position at the Post Office answering telephones and helping customers. In 2004, her branch got a new manager. The new manager assigned the taxpayer to resume work as a letter carrier. The taxpayer tried to comply, but the pain was too much. She noticed the new manager and other supervisors retaliated against her when she requested medical accommodations, thus creating a hostile work environment. Eventually the taxpayer filed a complaint with the Equal Employment Opportunity Commission.

An EEOC administrative judge ruled that the taxpayer was "entitled to non-pecuniary damages in the amount of $70,000, for the emotional distress which she established was proximately caused by the discrimination" she suffered. The judge found the taxpayer suffered from depression, anxiety, sleep problems, and post-traumatic stress disorder, all conditions caused or exacerbated by the discriminatory actions. But the judge also found that the taxpayer's physical pain was not the result of discrimination. The United States Postal Service paid the $70,000 damage award to the taxpayer in 2011, but she did not include this amount on her 2011 tax return.

The Service concluded that the award was taxable, and the Tax Court agreed. The court concluded the damages paid to the taxpayer were for emotional distress attributable to discrimination and not to physical injury or physical sickness. Yes, the discrimination exacerbated her distress and pain, but it did not cause them.

U. CAPITAL GAINS STILL REQUIRE THE SALE OR EXCHANGE OF A CAPITAL ASSET (*Duffy v. United States*, Fed. Cir., January 8, 2016)

The taxpayer worked for United Commercial Bank as Tax Director and First Vice President. In that job, he was supposed to make sure the bank complied with the financial disclosure requirements of the Sarbanes-Oxley Act. In 2006, the taxpayer informed bank management of instances of noncompliance. His reward? The bank placed him on administrative leave and then terminated his employment. So the taxpayer filed a claim with the Department of Labor alleging that the bank fired him for whistleblowing and refusing to participate in the bank's illegal conduct. The taxpayer and the bank settled when the bank agreed to pay him $50,000 and pay $25,000 to his attorneys on his behalf. In exchange, the taxpayer agreed to accept his termination and withdraw his claim with the Department of Labor. The settlement agreement expressly provided it was "for the exclusive purpose of avoiding the expense and inconvenience of further litigation."

The taxpayer's original return included the $50,000 as "other taxable income," but he then amended the return and excluded it on the grounds it was either excludable under §104(a)(2) as compensation for physical injury or subject to tax at a reduced rate as a capital gain from the loss of goodwill to his separate financial consulting business.

The Service disallowed the refund, which sent the taxpayer to the Court of Federal Claims. That court found no capital gain income because there was no sale or exchange of a capital asset. Moreover, §104(a)(2) did not apply because there was no physical injury. So it upheld the Service's denial of the taxpayer's refund claim.

The taxpayer didn't stop there, appealing the capital gain ruling to the Federal Circuit. But the appellate court affirmed. Even if the taxpayer could show that the goodwill in his separate consulting business was a capital asset, there was no sale or exchange of that asset. No property was transferred to the bank and any goodwill in the business remained with the taxpayer. The settlement agreement made no mention of the goodwill either.

V. RALPH LAUREN SALESMAN CANNOT DEDUCT COST OF CLOTHING REQUIRED FOR HIS JOB (*Barnes v. Commissioner*, T.C. Memo. 2016-79, April 27, 2016).

In 2010 the taxpayer took a sales job with Ralph Lauren. The employer required sales staff to wear Ralph Lauren clothing while representing the company. The taxpayer tried to deduct the cost of the Ralph Lauren clothes he purchased as an unreimbursed employee expense, but the Service tore the deduction to shreds, citing the long line of precedent that clothing suitable for ordinary wear away from the job is not a deductible business expense. The Tax Court agreed, and even upheld the imposition of a 20% negligence penalty.

The more interesting issue in the case relates to the contribution of used clothing and household items to The Salvation Army in that same year. The taxpayer got receipts, all describing the various contributions (e.g., "4 box of clothes," "1 printer"). But the receipts did not reflect the value of the donated goods. When the Service disallowed the deductions, the taxpayer produced

"summary sheets" listing the values at the time of donation. Most of these amounts were calculated with reference to The Salvation Army's "Donation Value Guide." But the summary sheets list assets not reflected on any of the receipts. The Tax Court held these sheets, together with the receipts, did not constitute adequate substantiation for the $5,030 in claimed charitable donations. It thus upheld the assessed deficiency but waived the application of the 20% negligence penalty as to the charitable contribution deduction, for while the documentation submitted did not provide adequate substantiation, it offered proof of the taxpayer's good faith attempt to comply with the law.

W. RELATIONSHIP ISSUES

Payments for Sex are Gross Income (*United States v. Fairchild*, 8th Cir., March 17, 2016). The taxpayer was sentenced to 33 months in prison for making a false tax return. This is an appeal of her conviction, in which she claims there was insufficient evidence that she willfully underreported her gross income. For the years at issue, the taxpayer reported gross income ranging from $120,000 to just over $150,000 from her work as a professional adult entertainer. But bank records suggest the taxpayer received 37 checks from one man (not her husband or any other related party) totaling over $1 million, plus six checks from another guy totaling $50,000. None of these payments made their way onto any tax returns. The taxpayer said she gave private dances to the men making the payments but insisted they were all gifts. The free private dances were her way of thanking the men for their payments. Interestingly, there was one year in which some of the payments were reported as income. That, according to the taxpayer, was to relieve the man of having to pay gift tax on the transfers. The men told a different story, both of them testifying that the payments were in exchange for sex.

The Eighth Circuit found that there was sufficient evidence to support the jury's finding that the taxpayer willfully filed false tax returns by not including all of the payments in gross income. Although the taxpayer testified she truly believed she accurately reported the portions of the payments that were compensation, "the jury was free to disregard [her] statements as not credible." The court also rejected claims that the jury instructions were improper and that the sentence is unreasonably long.

Using the 1099-MISC as a Post-Breakup Weapon (*Blagaich v. Commissioner*, T.C. Memo. 2016-2, January 4, 2016). Lewis (age 72) and Diane (age 54) dated for about 18 months. During that time, Lewis provided Diane with cash and property (including a Corvette) worth over $743,000. Late in the relationship they entered into an agreement whereby Lewis agreed to provide financial accommodation to Diane and whereby both parties agreed to remain monogamous. When Diane moved out after the termination of their relationship, Lewis sent her a notice of termination of their agreement. Some time later, Lewis came to believe Diane was dating another man.

In 2011, Lewis sued Diane seeking repayment of the cash and property transferred to her. He also filed a 1099-MISC reporting that he had paid over $743,000 to Diane. The lawsuit ended in 2013 when the court found Diane liable for fraudulent inducement. It ordered her to pay

$400,000 to Lewis's estate; the rest of the payments made to Diane (including the car) were "clearly gifts" that she was entitled to keep. So Lewis's estate filed a revised 1099-MISC for 2010 reporting $400,000 as compensation paid to Diane.

The Service increased Diane's 2010 gross income by the $743,000 reported on the original 1099-MISC. That led to the deficiency and accuracy-related penalty that was the subject of this case before the Tax Court. At this point we are at the summary judgment phase, and Diane has argued that the modified 1099-MISC should be controlling such that only $400,000 is at issue, and she further claimed the state court's determination that the $400,000 was a gift should be binding here. But the Tax Court noted that the Service was not a party to the state court action, so it is not estopped by the state court's determination as to how much, if any, of the amount paid to Diane was a gift.

Diane then argued that although she received the $743,000 in 2010, she should not have income because of the repayment obligation. But the court noted that the obligation to repay any portion of the $743,000 did not arise until 2013, so the doctrine of rescission could not apply to supplant application of the claim of right doctrine

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The 24th Annual Estate and Charitable Gift Planning Institute

ETHICS SESSION – THE ANNUAL CHECK UP

I. Current Developments

A. Joint representation of a married couple.

1. An ethics advisory opinion by the New Hampshire Bar Association Ethics Committee again addressed the question of the ethical obligations of an attorney who is asked to represent spouses jointly in the preparation of estate planning documents. NHBA Advisory Opinion #2014-15/10.

2. A lawyer was asked to meet with a husband and wife to discuss the preparation of their estate planning documents to manage their health care and financial affairs. The couple had been married for 30 years and wanted to create a joint revocable trust to benefit the surviving spouse during life and then their mutual children after the death of the surviving spouse. The wife disclosed during the initial meeting that in addition to planning for their marital assets she wanted to direct a modest financial asset owned by her individually to charity at her death. Nothing during the initial meeting raised a concern for the attorney that the interests of either spouse might limit the lawyer's ability to prepare a joint estate plan for the couple.

3. Joint representation of multiple clients is addressed under New Hampshire Rule of Professional Conduct 1.7. Embarking on the joint representation of two clients in connection with the same subject matter requires a careful analysis of the lawyer's obligations to each client. The ethics committee affirmed that the majority of estate planning cases for spouses with common objectives are free of conflicts of interest and nothing in this factual scenario included direct adversity between the clients or a significant risk that the lawyer's representation of either client would be materially limited by the other client's objectives. The committee stated that there was no Rule 1.7(a) conflict of interest and no informed consent was required under Rule 1.7(b). However, informed consent was required under Rule 1.6(a) before proceeding with the joint representation.

4. Even where no direct conflict exists between spouses, the lawyer is obligated to communicate clearly to both clients what client information will be disclosed in the course of the representation. Previously, in New Hampshire, the Supreme Court had not opined on the issue of implied consent to share confidential information in a joint representation so the

committee turned to the law of other jurisdictions for the proposition that jointly represented clients do not "impliedly relinquish the protections afforded under Rule 1.6 merely by agreeing to engage one lawyer to provide joint representation in the same matter." The committee concluded that the lawyer must obtain informed consent of both clients to allow the sharing of their information in order for the joint representation to proceed. The committee noted that Rule 1.6 does not technically require the informed consent to be in writing but suggested that the best practice for estate planning attorneys is to require clients to acknowledge in writing that their information will be shared freely between the clients and the lawyer during the joint representation.

5. The lawyer's obligation to keep clients reasonably informed about the representation under Rule 1.4 is a duty the lawyer owes equally to both clients. Accordingly, the lawyer must have the consent of both parties for the free sharing of information.

6. The representation of two clients in connection with the joint estate plan is not a *per se* conflict under Rule 1.7 and is often the most efficient and economical way for spouses to accomplish their planning. In some instances, spouses have common but not identical goals and the lawyer must determine at the outset, and as the representation proceeds, whether any divergence between the spouses rises to the level of a conflict of interest under Rule 1.7(a) that may or may not be waived through written informed consent under Rule 1.7(b).

7. A lawyer must gauge the likelihood that the spouses' interests differ or may diverge during the course of the representation and if so must decide whether the differences between the spouses materially interfere with the lawyer's independent judgment and evaluation of the estate planning alternatives that otherwise would be pursued for either spouse. The committee indicated that in New Hampshire the determination of whether the attorney had properly assessed the potential conflict would be evaluated under New Hampshire's "harsh reality" test. The harsh reality test is an objective standard of whether a disinterested lawyer looking back to the inception of the representation would have seriously questioned the wisdom of the attorney's obtaining the client's consent to the representation and whether there had been full disclosure to the client prior to obtaining the consent.

8. The committee indicated that the existence of a conflict of interest must be evaluated throughout the entire course of any joint representation and that informed consent would be needed if:

- The interests of the clients diverge and they now want to benefit different people with different plans.

- Each client disagrees as to the other's choices of people to act in various fiduciary capacities.

- The clients no longer wish to use a joint revocable trust.

- One party asks for information to be held from the other party.

9. Under the current fact pattern, the committee determined that the wife's wish to make a separate, modest charitable bequest, which was disclosed to the husband, raised no issue of conflicts of interest and would not materially limit the lawyer's ability to represent the spouses.

10. The committee additionally commented on the potential need for a lawyer to withdraw from joint representation under circumstances in which the clients later develop significantly divergent goals or become estranged during the joint representation. If effective informed consent is not feasible under Rule 1.7(b), the lawyer may need to withdraw.

11. The opinion included an example of one spouse communicating information to the lawyer that is relevant to the overall estate plan but refusing to allow the lawyer to disclose the information to the other client. Withdrawal would be mandated if the inability to disclose the information would impair the lawyer's duties under Rule 1.4(a)(3). The difficulty, of course, is in accomplishing the withdrawal in a manner that protects both clients' interests. The lawyer must continue to protect the client information from disclosure even while terminating the representation. Query, what does one tell the other client about the reason for withdrawal? If the attorney, at the beginning of the representation, has obtained the informed consent of both parties to share client information with both clients, the lawyer would have a duty to disclose the information to the other client.

12. Alternatively, if the lawyer had failed to obtain the informed consent at the beginning of the joint representation, the lawyer would be prohibited from sharing the information that a client has requested be kept secret. In this scenario, if the lawyer is unable to obtain permission to make the disclosure, the lawyer would be required to withdraw as counsel for both spouses. This sometimes gives rise to the "noisy withdrawal" in which the lawyer discloses to the other spouse that the lawyer is unable to share information obtained from the other spouse and must withdraw.

13. When representing spouses jointly in connection with their estate plan, the engagement letter should contain language along the lines of the following:

> As we discussed at our meeting, there are two ethical considerations for us to represent both of you in connection with your estate plan. First, attorneys cannot represent two clients in the same matter if there is even a remote possibility of them having conflicting interests. Second, attorneys are required to preserve the confidentiality of discussions with each of our clients, and, in order to prepare appropriate estate plans for you, we need to be able to discuss your plans openly with both of you and to share information freely. By engaging us to represent you both, you are consenting to this arrangement. Although we may have a theoretical conflict in representing both of you, we believe that there is no realistic impediment to our representing you both effectively. Accordingly, you have agreed to have us represent you both, and you are waiving any potential conflict. If you have any questions about these issues, please contact me.

14. In instances in which the attorney also represents other family members, the following language may be added to an engagement letter:

> As you know, our law firm also represents your parents in connection with their estate plan and other matters. In representing your parents we are required to preserve the confidentiality of discussions with them regarding their estate plan and our discussions with you and your estate plan. We are able to continue to represent your parents and to represent you and will do so separately as long as everyone is aware about our requirement to preserve confidentiality. Additionally, if conflicts arise in the future we will be required to resolve those conflicts before proceeding in the representation of either you or your patents. By engaging us to represent you, you are consenting to this arrangement. If you have any further questions about these issues, please contact me.

15. In some circumstances parents provide their consent to the attorney to share some or all of their estate planning information with their adult child. In circumstances in which the client desires that the attorney share

their information with the child, the engagement letter, or subsequent communication, may contain the following language.

> As we discussed in our meeting, attorneys are required to preserve the confidentiality of discussions with our clients. Normally, I would only speak with you about your estate planning matters. However, it is my understanding that you would like your child to be involved in your estate planning process and to assist you and me in communicating effectively throughout this process. I will proceed with the understanding that you have authorized me to communicate with your child about your estate planning throughout the process. If at any time you do <u>not</u> want me to discuss your planning with your child you should let me know immediately in writing.

B. Disclosing potential malpractice to a client.

1. The North Carolina State Bar issued its 2015 Formal Ethics Opinion 4 (July 17, 2015) explaining when a lawyer must disclose an error to a client. North Carolina State Bar Association 2015 Formal Ethics Opinion 4 (July 17, 2015).

2. A lawyer's mistake may constitute professional malpractice but not rise to the level of professional misconduct under the rules of ethics. The North Carolina State Bar Ethics Panel quoted comment 9 to Rule 1.1 as follows:

> A lawyer who makes a good-faith effort to be prepared and to be thorough will not generally be subject to professional discipline, although he or she may be subject to a claim for malpractice. For example, a single error or omission made in good faith, absent aggravating circumstances, such as an error while performing a public records search, is not usually indicative of a violation of the duty to represent a client competently.

3. Although an error in representing a client may not in and of itself constitute professional misconduct, the lawyer's actions after the discovery of an error must be guided by the requirements of the Rules of Professional Conduct. The Lawyers' Board advised that in addition to the rules of ethics lawyers should be familiar with the terms of their malpractice insurance policies which may require notice to the insurance company of an error as soon as it is discovered. Additionally, lawyers were reminded that Rule 1.8(h)(2) prohibits settling a malpractice claim

with an unrepresented client or former client unless the person is advised in writing of the desirability of seeking counsel and given a reasonable opportunity to seek the advice of counsel.

4. The question of whether a lawyer must report the discovery of an error to a client falls within the duty of communication under Rule 1.4(a)(3) which requires the lawyer to keep the client reasonably informed about the status of a matter. Material errors that prejudice the client's rights or claims clearly must be disclosed immediately. These errors include any that effectively undermine the client's ability to achieve the client's primary objective for the representation. This would include failure to take adequate action prior to the expiration of a statute of limitations or filing date. Minor, harmless errors that do not prejudice the client's rights need not be disclosed and may include non-substantive typographical errors or missing a deadline that causes nothing more than a brief delay. The question of whether other errors must be disclosed depends on where along this continuum the error falls.

5. If the error will result in financial loss to the client, substantial delay in achieving the client's objectives, or materially disadvantage the client's legal position, the error must be disclosed to the client. Similarly, if disclosure of the error is necessary for the client to make an informed decision, change in strategy, timing, or direction of the representation, the lawyer must disclose the error. If in doubt the lawyer should err on the side of disclosure or seek the advice of outside counsel, the State Bar's ethics counsel or the lawyer's malpractice carrier.

6. Although a lawyer may be required to disclose that an error has been made the lawyer is not required to withdraw from the representation unless under Rule 1.7 the error materially limits the lawyer's ability to continue the representation or materially impairs the lawyer's professional judgment. In many instances, the lawyer may be able to mitigate or avoid any loss to the client by taking corrective action. When the interests of the lawyer and the client are aligned in proceeding with the mitigation the lawyer need not resign.

7. When disclosure of an error is required the lawyer must candidly disclose the material facts surrounding the error, including the nature of the error and its effect on the lawyer's continued representation of the client. If the lawyer believes that remedial action may be taken the lawyer must discuss the recommendation with the client while informing the client that the client has the right to terminate the representation and seek other counsel. Whether the lawyer must inform the client that the client

may have a malpractice action against the lawyer was addressed in Colorado Formal Ethics Opinion 113. That opinion states that:

> The lawyer need not advise the client about whether a claim for malpractice exists, and indeed the lawyer's conflicting interest in avoiding liability makes it improper for the lawyer to do so. The lawyer need not, and should not, make an admission of liability. What must be disclosed are the facts that surround the error, and the lawyer should inform the client that it may be advisable to consult with an independent lawyer with respect to the potential impact of the error on the client's rights or claims.

Co. Formal Ethics Op. 113 (November 19, 2005).

8. The North Carolina panel adopted the Colorado approach confirming that it appropriately limits the possibility that a lawyer will attempt to give legal advice to a client about a potential malpractice claim against the lawyer. To do so would place the lawyer squarely in a conflict of interest between the lawyer's own personal interests and the client's interest. However, the lawyer is required to tell the client the operative facts about the error and to recommend that the client seek independent legal advice about the consequences of the error. The Bar panel further stated that the lawyer is not required to inform the client of the statute of limitations applicable to legal malpractice actions, or to give the client information about the lawyer's malpractice insurance carrier or information about how to file a claim with the carrier. The lawyer should, however, put the lawyer's malpractice carrier on notice of the potential that a malpractice action could be filed.

9. The Bar panel advised that the lawyer should inform the client as soon as possible after the lawyer has determined that an error occurred and should not undertake remedial action without first informing the client. The opinion further allowed that if the lawyer could exercise impartial, independent professional judgment in recommending other counsel to the client, the lawyer could proceed to do so. Finally, because Rule 1.5(a) prohibits a lawyer from collecting a clearly excessive fee, the opinion suggested that a lawyer determine whether, in light of the lawyer's error and its consequences to the client, a refund of fees is necessary to avoid a clearly excessive fee.

10. Malpractice carriers strongly encourage lawyers to resist their gut reaction to try to fix their own mistakes without recognizing the potential conflict of interest and without informing the lawyer's law firm, malpractice carrier, or the client. One carrier in discussing prior work

conflicts, including those arising from mistakes, cautioned against sending e-mails or leaving voice mail messages when discussing their mistakes with counsel, their firm, or their malpractice carrier. Experts in ethics and malpractice, such as a firm's general counsel or malpractice carrier, are in the best position to objectively determine whether the lawyer has made a mistake, and if so, how the information should be communicated to the client and the mistake remedied.

C. Estate beneficiaries' suit against drafting attorney.

1. The Colorado Supreme Court in *Baker v. Wood, Ris & Hames*, No. 13SC554 (Jan. 19, 2016) again addressed the question of whether dissatisfied beneficiaries of a testator's estate have standing to bring a legal malpractice or contract claim against the attorney who drafted the estate planning documents. The court declined to abandon the strict privity rule and reaffirmed that an attorney's liability to a non-client generally is limited to circumstances in which the attorney has committed fraud or a malicious or tortious act, including negligent misrepresentation.

2. Floyd Baker had two children by a prior marriage, Baker and Kunda, and his wife, Betty Baker, had two children by a prior marriage, Roosa and Brown. Floyd's will provided that on his death each of the four children would receive a $10,000 distribution, Betty would receive Floyd's condominium and the residue of the estate would be divided between a testamentary marital trust and a testamentary family trust. Betty was named as trustee and beneficiary of both trusts. After Betty's death the remaining trust assets would be divided equally among the four children.

3. At Floyd's death, some of his assets were held in joint tenancy with Betty and passed to her as surviving joint tenant. Pursuant to Betty's will, upon her death, the condominium was devised to Roosa and the residue of her estate was divided among Roosa, Baker and Kunda. As a result of the assets that had been held in joint tenancy by Floyd and Betty, Roosa received approximately $3.4 million in assets after Betty's death, while Baker and Kunda each received approximately $962,000.

4. Baker and Kunda sued the attorneys alleging that they had failed to advise Floyd that the impact of holding his property in joint tenancy would be to frustrate his intent to leave his assets to the children equally. Additionally, Baker and Kunda alleged that the attorney was negligent in allowing Betty to override Floyd's estate plan after his death. Arguing that they were the intended beneficiaries of Floyd's will, Baker and Kunda asserted that they had suffered damages as a result of the attorney's actions and inactions.

5. The plaintiffs asked the court to abandon Colorado's strict privity rule and allow them to bring a legal malpractice claim against the attorney. The court concluded that an attorney's liability to non-clients is generally limited "to a narrow set of circumstances in which the attorney has committed fraud or a malicious or tortious act, including negligent misrepresentation." The public policy reasons justifying this limitation on attorney liability were described as follows:

   - protecting the attorney's duty of loyalty to and effective advocacy for the client;
   - avoiding the need to require the attorney to reveal confidences the testator might not want revealed;
   - confining the right to recover so as to avoid the attorney's liability to unforeseen and unlimited number of people; and
   - avoiding casting doubt on the testator's intentions long after the testator is deceased and unable to speak for himself or herself.

6. The court discussed the California Rule in which the California Supreme Court had established an approach for determining whether a beneficiary of an estate is entitled to bring an action against a testator's attorney for negligence in drafting the will, which involves:

   > the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of uncertainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury, and the policy of preventing future harm.

7. The Colorado court declined to adopt the California test because it was inconsistent with the public policies favoring a privity requirement and further held that even if the test had been the appropriate standard the plaintiffs did not meet it. The court reasoned that Baker and Kunda received precisely what Floyd's will said they should get and that no liability arose under a properly executed will that was free from legal defects and accurately expressed the testator's intent.

8. The court also addressed the Florida-Iowa Rule which would extend the third-party beneficiary theory of contract liability to allow Baker and Kunda to bring a claim against the attorney. The Colorado court declined to apply the Florida-Iowa Rule as contrary to the settled policies underlying the strict privity rule to which Colorado courts had long

adhered and finding that the rule would not have supported Baker's and Kunda's claims for the same reasons that the California test did not do so.

9. One of the underlying theories of the strict privity rule is that the personal representative acts in the shoes of the testator and has the ability to bring the malpractice action if one is appropriate. Baker and Kunda argued that only injured beneficiaries could effectively bring claims because the personal representative might have no motivation to do so. The personal representative might be a beneficiary who benefitted from the attorney's negligence, and aside from the fees paid to the attorney, the estate itself may have suffered no harm. The Colorado court noted that an appropriate vehicle by which disappointed beneficiaries might seek to effectuate what they believe to be the testator's true intent would be a reformation action.

10. Query whether the beneficiaries would be successful in obtaining court approval to reform the terms of the governing instrument if the instrument itself is unambiguous. Additionally, the court indicated that the personal representative could pursue a claim against the attorney if the personal representative believed that the testator's intent had been subverted. Query whether Baker and Kunda could have sought their own appointment as special administrator solely for the purpose of bringing the malpractice action?

II. 2016 ACTEC Commentaries on the Model Rules of Professional Conduct (5th Ed. 2016).

A. Update of ACTEC Commentaries.

1. The American College of Trust and Estate Counsel is a nonprofit association of attorneys and law professors in the estate planning, probate, and trust and administration area. One of the major projects of ACTEC has been to issue commentaries on the Model Rules of Professional Conduct discussing the application of the rules to the trusts and estates practice. These commentaries were initially issued in 1993 and most recently updated in 2005. The reporters' note to the Fifth Edition indicates that the newest commentaries have been updated to include information "on state judicial decisions and ethics opinions through December 31, 2014." Additionally, the commentaries added four more of the model rules to the discussion after concluding that these rules have a special impact on trust and estate practice. The new rules are MRPC 1.10, 5.3, 7.1, and 8.5.

2. Forty-nine states, the District of Columbia, and the Virgin Islands all have adopted the Model Rules of Professional Conduct (MRPC) or some form of them. Only California does not follow the format of the MRPC.

B. Commentary updates.

1. MRPC 1.2 involves the scope of representation and allocation of authority between the client and the lawyer.

Generally, the client and the lawyer, working together, are free to define the scope and objectives of the representation, including the extent to which information will be shared, limitations do exist.

One such limitation is the attorney's duty to avoid assisting in criminal or fraudulent activity. Lawyers who assist clients in asset protection planning, for example, must be particularly watchful of the possibility that a client's direction regarding movement of funds not be fraudulent. As international crime and terrorism have grown, the role that lawyers may play has become the focus of the Financial Action Task Force on Money Laundering (FATF). FATF is an intergovernmental body of major industrialized nations formed in 1989 to coordinate efforts to prevent money laundering. FATF has issued guidance for legal professionals to assist them in avoiding in assisting in illegal money laundering transaction. The ABA issued its own Voluntary Good Practice Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing. Formal Ethics Opinion 463 (2013).

In 2008, FATF issued its guidance for legal professionals in avoiding assisting in international or domestic money laundering or terrorist financing.

Circumstances in which the attorney is encouraged to perform substantial client due diligence include the following:

- Buying and selling real estate.
- Managing client money, securities, or other assets.
- Management of bank, savings, or securities accounts.
- Organization of contributions for the creation, operation, or management of companies.
- Creation, operation, or management of legal persons or arrangements, and buying and selling of business entities.

FATF RBA Guidance ¶ 12.

In 2013, the ABA issued formal opinion 463 which reinforces the FATF guidance.

http://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/formal_opinion_463.authcheckdam.pdf.

One of the reasons the ABA issued its formal opinion was that FATF had taken the position that lawyers act as gatekeepers to the financial system. The theory was that the lawyer has the capacity to monitor and control, or at least influence, the conduct of clients and prospective clients in order to deter wrongdoing. The ABA took issue with the gatekeeper theory because the Rules of Professional Conduct do not require the lawyer to perform a gatekeeper role and, more importantly, mandatory reporting of suspicious behavior of a client is in conflict with Rules 1.6 and 1.18. Reporting without first informing a client is also in conflict with Rule 1.4(a)(5).

Instead, the ABA took a position that a lawyer should undertake to perform client due diligence at differing levels depending on the risk involved in the client's actions. This approach requires the attorney to make appropriate assessment of the client, the client's objectives, and the client's means for obtaining those objectives before determining whether and how the attorney may proceed. Rule 1.2(d) prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud.

A lawyer is also subject to federal laws prohibiting conduct that aids, abets, or commits a violation of U.S. anti-money laundering laws or counter-terrorist financing laws. Lawyers must be mindful of legal restrictions on all persons with respect to sending and receiving money to and from individuals or entities identified on the U.S. Department of the Treasury Specially Designated Nationals List (SDN List). In certain circumstances, an attorney may be required to check a client's identity against the SDN List to avoid the risk of unlawful conduct by the lawyer.

The level of client due diligence required depends on the risk profile of the client and the legal services involved. For example, clients or legal matters associated with countries that are subject to sanctions or embargos by the United Nations or the United States may require a greater level of examination than locally-based clients. Clients who ask a lawyer to handle actual receipt or transmission of funds may require a higher level of scrutiny than those who have funds handled by U.S. banks which generally have their own client due diligence requirements.

Examples of circumstances in which a lawyer should have a heightened concern and possibly perform a higher level of client due diligence include these:

- Request to use attorney's client trust account for transfer of funds.

- Request that lawyer handle receipt and transmission of funds in order to mask the source or payee.

- Request to accelerate real estate transfers for no apparent reason.

- Purchases of significant assets with no apparent reasonable source of funds.

2. MRPC 1.7 deals with conflicts of interest involving current clients.

The ACTEC commentaries begin with a note that the general non-adversarial character of the trusts and estates practice makes applying these rules somewhat more difficult than in a corporate transaction or a litigation situation. It may be appropriate for a lawyer to represent more than one member of the same family, more than one beneficiary of an estate or trust, co-fiduciaries of an estate or trust, or more than one investor in a closely-held business. In fact, sometimes, the clients may actually be better served by the joint representation because it may be more economical and better coordinated than representation by separate attorneys.

The current version of the ACTEC Commentaries has added a couple of specific examples to illustrate the ability or inability of an attorney to represent clients jointly in the estate planning context. Two of these examples are as follows:

> Example 1.7-1. Lawyer (L) was asked to represent Husband (H) and Wife (W) in connection with estate planning matters. L had previously not represented either H or W. At the outset L should discuss with H and W their estate planning goals and the terms upon which L would represent them, including the extent to which confidentiality would be maintained with respect to communications made by each. Assuming that the lawyer reasonably concludes that there is no actual or potential conflict between the spouses, it is permissible to represent a husband and wife as joint clients. Before undertaking such a representation, the lawyer should elicit from the spouses an informed agreement in writing that the lawyer may share any information disclosed by one of them with

the other. See ACTEC Commentary on MRPC 1.6 (Confidentiality of Information).

Example 1.7-1a. Lawyer (L) was asked to represent Father (F) and Son (S) in connection with estate planning matters. L had previously not represented either F or S. At the outset L should discuss with F and S their estate planning goals and the terms upon which L would represent them, including the extent to which confidentiality would be maintained with respect to communications made by each. If the prospective clients have common estate planning objectives and coordination is important to them, and there do not appear to be any prohibitive conflicts, the best practice would for the lawyer to undertake the representation of the two clients jointly with an agreement that information can be shared. Depending on the circumstances, however, a lawyer may be able to represent the father and son as separate clients between whom information communicated by one client will not be shared with the other. Even then, the circumstances may be such that the lawyer knows or should know that their estate plans are interconnected. In that situation, separate representation may be appropriate, provided that there is no obvious conflict of interest between the clients. But even so the lawyer will need to make a conflict determination and may need to obtain the informed consent of each client if there is a "significant risk" that the representation of one might be materially limited by the representation of the other. In such a case, each client must give his or her informed consent confirmed in writing. The same requirements apply to the representation of others as joint or separate multiple clients, such as the representation of other family members, business associates, etc.

3. MPRC 5.5 relates to the unauthorized practice of law and multi-jurisdictional practice of law.

More than ever before, the trusts and estates practice spans multiple jurisdictions. Clients move from state to state, own property in multiple jurisdictions, have family members in multiple locations and often create trusts sitused in other states or countries. Generally, a lawyer admitted to practice in one jurisdiction cannot render legal services in another jurisdiction in which the lawyer is not admitted to practice. Doing so may

violate the laws of one or more jurisdictions and the lawyer may be subject to discipline in each of the multiple jurisdictions.

In some states what constitutes the practice of law is defined by statute and in others by court rule. In Washington, for example, the unauthorized practice of law includes selecting, drafting or completing legal documents or agreements which affect the legal rights of a person or entity, representation of a person or entity in court or other formal proceeding, but also includes giving advice or counsel to anyone as to their legal rights. Given the wide diversity of definitions of the practice of law, a lawyer engaged in a multi-jurisdictional practice needs to be familiar with the laws of each jurisdiction to determine whether the lawyer could be considered practicing law in those jurisdictions.

The ACTEC Commentaries advise the lawyer to assume that "any services the lawyer intends to provide will be the practice of law in each non-admitted jurisdiction and proceed accordingly."

One way to avoid the unauthorized practice of law in a foreign jurisdiction is to obtain permanent or temporary admission to practice law in that jurisdiction. In some cases, admission by motion is allowed, particularly with respect to a specific court proceeding.

A lawyer may also choose to associate with local counsel in the foreign jurisdiction. MRPC 5.5(c) allows an attorney to provide legal services on a temporary basis if the lawyer does so in association with a lawyer who is admitted to practice in that jurisdiction and who actively participates in the matter. Although active participation is not defined in the Rule or the comments in the estate planning context, generally, it would mean that the consulting lawyer thoroughly reviewed the estate planning documents and provided advice as to their compliance with local law. Some states, such as Florida, prohibit their lawyers from assisting outside lawyers in this fashion.

While the language of paragraph (c) appears to state all of the exceptions available to a lawyer seeking to practice law in a foreign jurisdiction on a temporary basis, comment 5 specifically provides that the fact that conduct is not specifically described in paragraph (c) "*does not* imply that the conduct is or is not authorized." Given the wide range of legal services encompassed in the estate planning and estate and trust administration area, there may be other situations in which a lawyer provides services in a foreign jurisdiction or concerning a matter related to a foreign jurisdiction that is not expressly authorized by this rule.

An interesting addition to the commentaries under MRPC 5.5 was a section regarding the rendering of legal services following a major disaster. After the 2001 terrorist attacks and Hurricane Katrina in 2005, the rules were revised to allow lawyers who desired to provide pro bono legal services on a temporary basis in a foreign jurisdiction that had been affected by a major disaster, and in which they were not otherwise authorized to practice law, to do so under the so-called "Katrina Rule." This rule also applies to displaced lawyers from the affected jurisdiction who seeks to practice law temporarily in another jurisdiction.

The Katrina Rule would allow the highest court of the state to determine that an emergency existed and temporarily authorize pro bono practice by out-of-state lawyers. Additionally, the Supreme Court of a neighboring state could authorize displaced lawyers to practice in that state on a temporary basis after a disaster.

4. MRPC Rule 8.5 provides that a lawyer licensed to practice in a jurisdiction is subject to the disciplinary authority of that jurisdiction regardless of where the lawyer's conduct occurred.

If a lawyer engages in the unauthorized practice of law in a jurisdiction where he or she is not admitted, the jurisdiction where the lawyer is admitted is the one to initiate disciplinary proceedings. Additionally, the jurisdiction in which an attorney performs services also has disciplinary authority even if the lawyer is not admitted to practice in that jurisdiction.

The ACTEC Commentaries question how a jurisdiction where a lawyer is not licensed would have the ability to discipline the lawyer. While a reprimand may be possible, it would be difficult for a court to disbar or suspend a lawyer who was not admitted to practice in that state in the first place. The answer is found in the concept of a reciprocal discipline. Most jurisdictions impose reciprocal discipline on attorneys admitted to practice if they have been disciplined in another jurisdiction.

The ACTEC Commentaries include several new specific examples of circumstances in the trusts and estates area in which lawyers can find themselves impacted by the laws of multiple states. These examples are as follows:

> Example 8.5-1. Lawyer (L), admitted and practicing only in H, is advising Client (C) about the effect of the C's divorce on C's estate plan, including C's life insurance designations. C advises L that C is about to move to another state (S) where L is not admitted. L advises C that

C's life insurance designations will be automatically revoked and the contingent beneficiary will take, since this is the rule in L's own state, H, where the advice is being given. Unbeknownst to L, S law provides that a divorce does not automatically revoke a life insurance designation made in favor of a divorced spouse, as does L's jurisdiction. Moreover, given that C has advised L that C is about to move to S, L cannot reasonably believe that the predominant effect of L's advice will be in H, L's home state. L's conduct shall be adjudged under the rules of professional conduct in place in S, not those in place in H. L's competence should be adjudicated based on what would be considered competent in S, not H.

Example 8.5-2. Lawyer (L) prepares a will for a foreign domiciliary (FD) while FD is temporarily resident in L's home state (HS). L assists FD in executing the will. L knows that FD will return to his/her home country (FC) in the near future. Unbeknownst to L, FC has special will execution formalities that L has not complied with. L's conduct should be adjudicated based on the rules of professional conduct of FC, not those of HS.

Example 8.5-3. Same facts as example 8.5-2 except that FD is closely related to L by blood and the will that has been drafted and executed leaves a substantial bequest to L. L is familiar with MRPC 1.8(c) which permits such a bequest, but not with the ethics rule o FC. Unbeknownst to L, the rules of professional conduct of FC totally prohibit such a bequest to be drafted by the beneficiary lawyer. L's conduct should be evaluated under the professional responsibility rules of FC, not those of HS.

Example 8.5-4. Lawyer (L) licensed to practice in one state (HS) advertises over the internet (or on TV) that L is an expert in establishing offshore trusts to protect clients from their creditors. The internet (or TV) advertisement reaches potential clients in states other than HS. L is not admitted or licensed in those other states (OS). Absent some disclaimer, L is offering to provide legal services in OS. As to such OS offers, L's ads should be evaluated under the rules of professional conduct of OS rather than those of HS.

Example 8.5-5. Lawyer (L) is admitted to practice in one state (S) and is handling a probate for a personal representative (PR) of an estate whose decedent died in S. L has also been admitted *pro hac vice* to handle an ancillary probate for PR in another state (OS) where L is not generally admitted, because decedent owned land in OS. L discovers that PR has been engaged in misconduct as a fiduciary. L withdraws from representing PR as is permitted (permits required) by the ethics rules of both S and OS. In withdrawing, LO also notifies the probate court in both S and OS of the PR's fiduciary breach. The rules of professional conduct of S permit this disclosure, but the rules of OS prohibit it. Whether or not L is before the disciplinary authority of S or OS, L's disclosure to the OS probate court should be evaluated under the ethics rules of OS, not those of S.

C. Additional rules added to ACTEC Commentaries.

Some of the most significant revisions to the ACTEC Commentaries to the model rules are the addition of several rules that previously had not been contained in the Commentaries.

1. MRPC 1.10 addresses when a lawyer's conflicts under MRPC 1.7 and 1.9 would be imputed to other lawyers practicing in the same firm with the conflicted lawyer or lawyers practicing in a firm where the conflicted lawyer previously practiced.

   This rule is as important as the primary conflicts rules because it is the vehicle for disqualifying a firm, and the lawyers in it, from taking on a new client when one lawyer in the firm has a conflict. Many trusts and estates lawyers practice within a larger firm and are just as affected by the imputed conflict rule as any other practice area.

   If a trusts and estates lawyer is working for a client and another lawyer in the firm wants to take on a client who is adverse to the estate planning client, even on in unrelated matter, this is precluded by the concurrent conflict rule 1.7 because that conflict is imputed to all the other lawyers in the firm under Rule 1.10.

   Likewise, if a trust and estate lawyer formerly worked for a client and another lawyer in the firm wants to take on a client who is adverse to the former estate planning client on a matter that is the same or substantially related to the estate planning, the matter would be precluded by the

successive conflict Rule 1.9 because that conflict is imputed to all the other lawyers in the law firm under Rule 1.10.

If a trust and estates lawyer, while at another firm, worked for a client who is adverse to a client of the new firm that the estate planner wants to join, the lawyer's Rule 1.9 conflict will be imputed to the new firm if the matter is the same or substantially related.

The ACTEC Commentaries point out that Rule 1.8 has its own imputation rule which prevents trust and estate lawyers from getting around these conflicts by arguing that these were "personal conflicts" which under Rule 1.10 might not have been imputed. In particular, the rules governing business transactions with clients (Rule 1.8(a)) and governing the drafting of instruments which make gifts to the drafter or his or her family (Rule 1.8(c)) cannot be avoided by sending the client to another lawyer in the same law firm.

2. MRPC 1.12 addresses former judges, arbitrators, mediators and other third-party neutrals.

In the past, ACTEC had not addressed this rule because the relevance of it to trust and estate lawyers seemed small. Now, more and more often, trust and estate lawyers involve themselves in mediating disputes between beneficiaries and fiduciaries or family members. The need to avoid imputed conflicts of interest arising from this type of work caused ACTEC to include a new commentary on this rule.

For any matter in which a lawyer participated personally and substantially in a role as a neutral third party, the lawyer is prohibited from later representing the party in connection with that matter unless all parties give their informed, written consent. Whenever a lawyer has served as a mediator or arbitrator in a case, the lawyer's involvement is likely to have been personal and substantial. A lawyer's involvement in a matter as a judge, however, may not have risen to the level of "substantial" if the parties settled or otherwise resolved the matter before the judge's involvement was needed.

Where a lawyer is personally disqualified under this rule, the disqualification is imputed to all lawyers practicing with that attorney. In some cases, a law firm may undertake to represent a client in a related matter if the former mediator is screened from the client matter, notice is given to all parties, and the lawyer is apportioned of the fee generated by the matter. The ACTEC Commentaries state that "In view of the availability of screening in this situation, trust and estate lawyers who wish to serve as third-party neutrals on occasion while also carrying on an

active practice representing clients should consider screening off that aspect of their practice from their other work at the outset of their third-party neutral work."

3. MRPC 1.15 addresses the issue of safekeeping property for a client. All lawyers are required to keep their clients' property separate from the lawyer's own property and to account for and safeguard the client's property.

   Rule 1.15 has special significance for trust and estate lawyers who undertake to store the originals of their clients' wills, trust agreements, and other related documents. These documents must be considered to be client property and must be held by the lawyer in a manner consistent with the requirements of this rule.

   Some states have very particular requirements for the safekeeping of estate planning documents. For example, California requires that the documents be held in a "safe, vault, safe deposit box, or other secure place where it will be reasonably protected against loss or destruction." Some states, such as Wisconsin, prohibit the lawyer from suggesting that the lawyer retain the documents, but allow the attorney to do so if the client initiates the request.

   The rule also requires that adequate records be kept of property for a period of years which varies from state to state. Most states have adopted a five-year period recommended in the model rule, but many states have longer periods ranging from six to ten years. Of course, wills and trust agreements may need to be retained far longer, in some circumstances for decades.

   Storage of client documents is also subject to the notice and accounting provisions of MRPC 1.15. The attorney must have a mechanism for notifying the client in writing what documents are being retained and under what circumstances.

   The ACTEC Commentaries also state that the "retention of the client's original estate planning documents does not itself make the client 'active' client or impose any obligation on the lawyer to take steps to remain informed regarding the client's management of property and family status." Best practice, however, is to confirm in the engagement letter what obligations the attorney has to the client.

   MRPC 1.15 also has been invoked in situations in which an attorney acted as personal representative or trustee and had custody of client property in a fiduciary capacity. Rule 1.15 notice and reporting requirements may

be more stringent than the trust or probate accounting requirements otherwise imposed on a fiduciary. Lawyers who serve in fiduciary roles such as these should be familiar with the requirements of Rule 1.15.

4. MRPC 5.3 governs the responsibilities of a lawyer regarding non-lawyer employees and other providers.

   Trust and estate attorneys, perhaps more than any others, have an occasion to engage and consult with a wide array of other professionals and service providers. From law firm employees such as associates, paralegals, administrative assistants, accountants and service center employees, to outside professionals such as CPAs, accountants, insurance professionals, appraisers, copy services and data storage providers. Some trust and estate lawyers use legal forms systems and others outsource legal work to non-lawyer firms in other states or countries. Even trash removal, photocopier maintenance, and technology services can pose risks of confidentiality and require careful consideration under the professional rules.

   Generally, non-lawyers are subject to the same rules as lawyers, and the lawyers who supervise them are required to make reasonable efforts to ensure that non-lawyers confirm to the rules of professional conduct.

   An important issue is what work may be delegated and under what circumstances. Virtually any kind of work may be delegated to non-lawyer assistance if:

   - The lawyer has reasonable and well-founded confidence in the non-lawyer.
   - The lawyer has given appropriate instruction to the non-lawyer.
   - The lawyer exercises appropriate supervision.
   - The lawyer takes responsibility for reviewing and correcting the final product.

   The exercise of legal judgment itself, however, cannot be delegated. Accordingly, in the estate planning context, a lawyer should not delegate responsibility for determining what estate planning documents or strategies are appropriate for the client. The lawyer should not delegate responsibility for making sure that the client understands the contents of the documents, and according to the ACTEC Commentaries, a lawyer should generally not delegate the supervision of the execution of the estate planning documents to non-lawyers. Likewise, the lawyer should

not delegate to a non-lawyer the responsibility for determining whether a client is competent to execute legal documents.

A lawyer must assure that all staff are educated in the Lawyer's Rules of Professional Conduct as they impact the work assigned. Non-lawyers should understand the sensitive nature of the confidentiality of a client's documents and other information and what their obligations are in preserving client confidences.

Failure to adequately supervise the work delegated to non-lawyers can be just as dangerous as hiring an incompetent person. A lawyer must adequately review the work product and take full responsibility for the exercise of legal judgments associated with the client work. The lawyer or the law firm should also have mechanisms in place to assure adequate supervision, training, and oversight occurs.

An estate planning attorney who uses estate planning form systems and document assembly systems has a duty to:

- Determine that the package or system is appropriate to the state laws in which they are used.
- Use the form systems competently.
- Assess and take responsibility for the adequacy of the forms to the client's given needs.
- Appropriately train any non-lawyer staff who use the system.

5. MRPC 7.1 relates to the manner in which a lawyer communicates information about the legal services provided.

   Most commonly, this rule applies to attorney advertising, but more recently encompasses the constantly changing technology involving internet networking sites and social media.

   The fundamental rule is that communication about the lawyer or the lawyer's services must not be false or misleading and that material omissions may be considered misleading. One of the most common areas of concern is when a lawyer makes a representation that he or she has special skills or expertise in a particular area. Rules vary significantly from state to state. Some states have active programs under which attorneys may obtain special designation or certification for specializations and other states prohibit nearly any mention of an

attorney as a specialist. Some states that allow specialization require specific disclaimers in order to assure that clients are not misled.

The requirement to avoid misleading communications can be challenging for an attorney, especially in the world of the internet. Sometimes information on the internet about the lawyer is not generated by the lawyer or the lawyer's law firm but is an amalgamation from other sources. Postings on websites that solicit comments and reviews about the services of an attorney may be entirely out of the hands of the attorney. If the lawyer has not participated in making the misleading communication, the statements should not violate MRPC 7.1. But the lawyer should take any reasonable steps to remove the untruthful statements if possible. Additionally, if the lawyer in any way actively participated in the statements, that behavior may be deemed to violate Rule 7.1. For example, linking to the website or in any other way indicating the lawyer's approval of the site may be a violation.

III. Technology Impact on Lawyers.[*]

A. Ethical rules.

1. Comment 8 to MRPC 1.1 provides that an attorney must "keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology." This comment was added in 2012 and, for the first time, lawyers are expected to be knowledgeable, not only on the current state of the law, but on the current state of technology.

2. MRPC 1.6(c) requires that a lawyer make reasonable efforts to prevent "the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client." The question, of course, is what is expected within the standard of "reasonable efforts"? Comment 18 to that rule requires a lawyer to "act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure."

Of course, it is incumbent upon the attorney to protect a client's information from hackers and thieves, but in reality, one of the biggest threats to inadvertent disclosure of client data is the lawyer, the lawyer's staff, and the client accidently sending an e-mail to the wrong address or leaving a smart phone or lap top in a coffee shop are errors easily made

[*] The author gratefully acknowledges the assistance of the original author of this section, James D. Lamm, Esq. at Gray, Plant, Mooty, Mooty & Bennett, P.A.

by everyone. Training staff, attorneys and clients about protecting client data is an important first step.

Comment 18 to MPRC 1.6(c) provides that the unauthorized access to or inadvertent disclosure of information relating to a client representation does not constitute a violation of the rule if the lawyer has made "reasonable efforts" to prevent the access or disclosure. The factors involved in determining what are reasonable efforts include:

- Sensitivity of the information.
- Likelihood of disclosure if additional safeguards are not employed.
- Cost of employing additional safeguards.
- Difficulty of implementing the safeguards.
- Extent to which the safeguards adversely affect the lawyer's ability to represent clients.

Comment 18 also states that a client may require a lawyer to implement special security measures that are not otherwise required by the rule or may give informed consent to allow the attorney to forego security measures that would otherwise be required by the rule. In other words, we must discuss this matter with our clients and determine what level of security they wish to authorize. For example, a client may require that the lawyer encrypt e-mails or refrain from sending e-mails at all. Alternatively, the client may authorize the lawyer to communicate confidential information by e-mail without encryption.

ABA Formal Opinion 99-413 determined that a lawyer may transmit information relating to the representation of a client by unencrypted e-mail sent over the internet without violating the model rules of professional conduct. That was the standard in 1999.

ABA Formal Opinion 11-459 provided that:

> A lawyer sending or receiving communications with a client via e-mail . . . ordinarily must warn the client about the risk of sending or receiving electronic communications . . . where there is a significant risk that a third party may gain access.

The opinion also obligates the lawyer to warn a client who uses an employer-provided device or e-mail account that the employer may have

access to the e-mails. The lawyer may also wish to consider circumstances in which a third party may have access to a client's e-mails such as shared e-mail accounts or shared devices.

Most employee manuals clearly inform employees that their work e-mail is not confidential and belongs to the employer. If a client e-mails an attorney from the client's work e-mail address the attorney should warn the client that it would be more appropriate to use a personal e-mail address.

Cautious lawyers should include a warning in the engagement letter about the use of work-related e-mail. The engagement letter might also provide that the client consents to unencrypted electronic communications unless directed otherwise in writing.

Some states permit unencrypted e-mails with clients while others require the attorney to advise the client that e-mail is not a secure means of communication. Some states require client consent to use unencrypted e-mail. And some states require appropriate precautions to be used when using public Wi-Fi.

B. What is encryption?

1. Encryption scrambles data using a key so that the original data cannot be recovered without knowing the key to decrypt it.

In its simplest form, encryption is a simple password protection of data. Both the sender and the recipient have the password and can access the document. This is the process to encrypt a pdf document, a word document and a zip file.

Public key encryption or asymmetrical encryption uses two keys. One key to encrypt the data, and a second key to decrypt the data. Again, the sender and recipient might each have a password to open the encryption. This process is quite complicated and generally is impractical for lawyers to use with all of their clients, but may be useful on a particular matter with a particular client.

If encryption is not strong enough, data can be decrypted relatively easily even without knowing the password. A good computer can "guess" all of the permutations of a password in a short amount of time. Strong encryption means the password is practically impossible to decrypt.

Weak encryption is not necessarily inadequate for purposes of client communication. Weak encryption can be broken with the right computer

program and a decent computer, but will generally at least keep the data from being inadvertently disclosed to the wrong parties. In other words, a password protected document will not be inadvertently opened by the wrong recipient even if the encryption is fairly weak.

Weak passwords include:

- Any normal dictionary word.
- A short password like the last four digits of the client's social security number.
- Commonly used passwords such as "password," "12345," the client's name.

Some experts say a password should be at least 12 characters long, Microsoft recommends 14 and others say 16 just to be safe. Generally, the strongest passwords use a mix of upper case letters, lower case letters, numbers, and symbols.

A simple four-digit password on an iPhone or iPad can be made more secure if you limit the passcode attempt allowed.

C. How to use encryption.

1. Consider encryption for confidential client data that is:

- Stored on a laptop, tablet, smart phone, or other storage device that is not secured in your office.
- Stored in the cloud (e.g., Drop Box or other website).
- Transmitted in a manner where there is a significant risk that a third party may gain access.

A single file may be encrypted by printing or scanning to a pdf document. In the document change the security settings to "password security" and select "require a password to open the document." Then use a strong password and separately convey the password to the client in a secure manner (not in the same e-mail). Nearly all clients have software needed to view pdf documents on their computer, tablet, or smart phone, and if not, it can be installed easily at no cost.

Word, Excel, and PowerPoint documents may be encrypted as well if you need to send a document to a client or opposing counsel that they will need to be able to edit. Be sure to double check that your file formats

end in "x" such as .docx, .xlsx, or .pptx to assure that you are using the new file format with its stronger encryption method.

Encrypting a storage device such as a laptop, iPad or USB flash drive or CD requires special software such as Windows BitLocker or Mac OS X FileVault or other third-party software.

Lawyers are advised not to store any confidential client data on laptops or other devices. Most attorneys now have remote access to their firm's document systems and the client data and documents are stored either on hard drives at the law firm or in the cloud. The law firm then has arranged for the security of the client data. If a lawyer does store confidential client data on a laptop, jump drive, or other device, the lawyer must assure that the level of security to protect that data is adequate.

Often when communicating with clients by e-mail, the e-mail itself need not be encrypted as long as the confidential information or data is contained in an attachment that is otherwise password protected or encrypted. If the e-mail itself contains client confidential information the e-mail should be encrypted with a password. Using public Wi-Fi is another area in which an attorney risks the inadvertent disclosure of confidential client information. A few general rules of thumb for use of public Wi-Fi include the following:

- Use "https" if available for websites to encrypt data in transit.
- Turn off file and printer sharing.
- Turn on your firewall.
- Use a virtual private network if available (though some public Wi-Fi hotspots block VPN services).
- Turn off Wi-Fi-enabled capability while not using the device.
- "Forget" the network at the end of the session to avoid having the device automatically log in.

The 24th Annual Estate and Charitable Gift Planning Institute

SESSION II

CONDUCTING THE ANNUAL ESTATE PLANNING CHECKUP:
Is your client's estate plan healthy enough to pass its annual exam?

Ann B. Burns and Samuel A. Donaldson

1. Client Family & Financial Information

- Estate Planning Guide
    - Gather current family and financial information
    - Obtain information about beneficiary designations
    - Ask questions to highlight changes that may have occurred
    - Suggest questions for consideration prior to the client meeting
- Estate Planning Summary Worksheet
    - Summarize the client's current estate plan
    - Carefully review documents for errors and inconsistencies
    - Determine appropriate calendaring of items
    - Determine who is responsible for various filings
    - Code the estate plan for ease of future search
- Update Illustration of Estate Plan
    - Brings together review of the documents with current financial information and current estate tax exclusion amounts and rates
    - Best way to catch mistakes and oversights

2. Annual Law Updates

- Greenbook
- Proposed Regulations
- Tax Legislation
- Current Case Law
- State Law Changes

3. <u>Active Management of Estate Planning Strategies</u>

A. Generally

- Diary gift tax return due dates
- Diary annual review
- Stay in touch with clients
- Contact other advisors

B. Revocable Trusts

- Funding
- Beneficiary designations

C. Irrevocable Life Insurance Trusts

- Premium payment due dates
- Notice letters
- Annual review of life insurance policies

D. Qualified Personal Residence Trust

- Home improvements
- Sale of house
- After expiration – lease agreement

E. Grantor Retained Annuity Trusts

- Periodically check valuation of assets
- Swap out if values have declined and create new GRAT
- Swap out if values have increased to freeze
- No generation skipping distributions
- Termination date
- Income Tax returns
- Continuation of grantor trust after termination

F. Trusts Generally

- Any changes in trustees
- Change of state of residence of trustees or beneficiaries
- Change in capacity of trustees
- Powers and duties of trustees
- Trustees serving alone or jointly

G. Grantor Trusts

- Annual income tax payments
- Swap assets
- Terms of installment sale – e.g. note payments
- Subchapter S elections

4. Ethical Considerations

A. Conflicts

- Have I undertaken any additional representation?
- Have new clients/matters/interests arisen?
- Have any conflicts arisen?

B. Communications

- Have I communicated all recommendations and decisions to the client?
- Have I included all the clients in the communications?
- Have I included the other advisors in the appropriate communications?
- Have I protected attorney-client privilege?
- Have I protected my work product?